Kirr, Marbach & Company, LLC
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"I study nuclear science. I love my classes. I got a crazy teacher, he wears dark glasses. Things are going great and they're only getting better. I'm doing alright, getting good grades. The future's so bright, I gotta wear shades."—Timbuk 3 (1986)

October 8, 2018

Dear Clients:

There is no doubt U.S. stocks and the economy are on a tear. Stocks are at record highs, fueled by higher corporate earnings, which are surging based on strong economic growth and lower tax rates. The unemployment rate continues to fall and with the economy essentially at full employment, wages are starting to go up. Higher stocks and wages have propelled consumer confidence to an 18-year high, bolstering spending and corporate profits.

With this virtuous circle/positive feedback loop in full swing, it sure ***seems*** like the future will continue to be bright for U.S. stocks and the economy. While we don't see anything on the near-term horizon to derail stocks, like a recession, the fact is both the stock market's advance from the March 2009 lows and the economic expansion are long in the tooth.

Indeed, we are carefully monitoring a number of signs that may be indicating Goldilocks (in the form of the combination of low interest rates, low inflation, low unemployment and low oil prices) has left the building. Valuations are reasonable and our outlook for the future remains positive, but this is no time to be complacent or overconfident (like the song above). As always, we urge you to tune out the noise (there will be plenty) and focus on the fundamentals.

Periods ending September 30, 2018
(Total Returns-Annualized*)

	Russell 3000 Index	Russell 3000 Growth Index	Russell 3000 Value Index	S & P 500 Index
Three-Months	7.12%	8.88%	5.39%	7.71%
Nine-Months	10.57%	16.99%	4.17%	10.56%
One-year*	17.58%	25.89%	9.46%	17.91%
Two-years*	18.14%	23.86%	12.45%	18.26%
Three-years*	17.07%	20.36%	13.75%	17.31%
Five-years*	13.46%	16.23%	10.56%	13.95%
Ten-years*	12.01%	14.18%	9.76%	11.97%

The Stock Market

As you can see from the table, we're frustrated "Growth" continued to dominate "Value" in the third quarter of 2018. According to Bespoke Investment Group, "stocks with low P/E ratios and high dividend yields are dramatically underperforming this year, while stocks with the highest valuations and no dividend yields are up the most." Further, "the stocks that did the best in 2017 are also doing the best in 2018." In other words, unfortunately the song remains the same.

Our mantra is stock prices follow earnings, which were strong enough to swamp the historically reliable tendency of stocks to struggle during midterm election years (like 2018). According to Strategas Research Partners, during midterm election years since 1962, stocks have been flat-to-down through the first three quarters of the year and experienced an average correction of 19% during the year. That obviously didn't happen this year, but we're hopeful the perfect record of the S&P 500 rising in the 12-months following the midterm election remains intact.

Low interest rates have been an important driver for higher stock prices. All other things being equal, lower rates justify a higher P/E ratio (and vice-versa). Additionally, lower rates tend to make bonds less competitive with investors compared with stocks. The yield on the 10-year U.S. Treasury Bond has surged by more than 35% over the past year due to the strengthening economy, from 2.33% to a recent 3.16% (the highest level since July 2011—Exhibit A). Higher bond yields equate to lower bond prices; a harsh reality bond fund investors will become familiar with when they open their September 30 statements.

Since bottoming at $26.21/barrel (West Texas Intermediate) in February 2016, crude oil prices have almost tripled to a recent $76.41/barrel, the highest level since 2014 (Exhibit B). Strength in the global economy is leading to higher demand while supply from Iran (U.S. sanctions go into effect November 4) and Venezuela (economic collapse) falls. Oil is an important production input into many products, so higher oil will lead to higher prices and inflationary pressures. Consumers had grown accustomed to guzzling cheap gasoline, so higher prices at the pump are like an additional tax.

Higher stock prices and the robust employment picture have combined to send consumer confidence to an 18-year high. The Conference Board's Consumer Confidence Index recently hit 138.4, up from 25.3 in February 2009 (at the bottom of the Great Recession) and the highest level since the 142.5 reached in September of 2000. With consumer spending accounting for almost 70% of economic activity, surging confidence has clearly been great for the economy.

The downside is there is an ***inverse*** relationship between consumer confidence and future stock performance. Historically, when stocks are low, confidence is low and future returns tended to be higher and vice-versa. According to Ned Davis Research going back to 1969, when consumer confidence was below 66, stocks returned 14.8% on average over the following year. When the index was between 66 and 113, the average return dropped to 6.3%. When the index was above 113, the average return dropped even further to 2.0% (Exhibit C).

Interest Rates and the Bond Market

The yield on the 10-year U.S. Treasury Bond rose from 2.86% at the start of the third quarter to 3.06% at the end of the quarter. During the third quarter, the Federal Reserve raised its Fed Funds target rate by 0.25% to 2.25%. The current consensus is the Fed will not raise the target rate at its November 8 meeting, but will bump an additional 0.25% at its December 19 meeting.

The Fed has indicated its future actions will be "data dependent," so forecasting too far out is problematic. Fed Chairman Powell recently described the current state of the economy as "historically rare," "[a} pairing of steady, low inflation and very low unemployment," but noted the Fed would be watching carefully for inflationary pressures.

Thus far, neither the economy nor the stock market has been harmed by these gradual rate hikes. Yield spreads on corporate bonds versus comparable maturity U.S. Treasury securities have narrowed slightly. While this has made corporate bonds less compelling, we still believe they are the best choice for client bond allocations.

Summary

We think Howard Marks from Oaktree Capital Management is a bright guy and makes a lot of sense. He says, "The best response when seas are choppy is to focus on completing the long-term voyage and not think about whether the next wave is going to push the nose of the boat up or down. Our investment destination is best reached by accurately valuing assets, assessing the relationship between price and that value, and acting resolutely and unemotionally when mispricings are detected. That's still the best-I think the only-reliable path to investment success. Nothing about the current environment alters that one bit." We couldn't agree more. Unlike Timbuk 3, Marks isn't a "one hit wonder" and neither are we.

KM Privacy Policy Notice

Under Securities and Exchange Commission Regulation S-P, KM is required to deliver its Privacy Policy Notice to each client prior to the establishment of an account and updates annually. We are delivering our 2018 annual update to each client account with this letter. In addition, given the increasing importance of protecting clients' personal information, we have implemented a policy whereby KM personnel will not release any information about a client's account without specific authorization from the client. If you would like KM to release information about your account to your CPA or other service provider, please contact Kip Wright, CFA (kip@kirrmar.com) or Matt Kirr (matt@kirrmar.com) by e-mail or at 812-376-9444 or 800-808-9444.

Regards,
Kirr, Marbach & Company, LLC

Past performance is not a guarantee of future results.

The Russell 3000 Index is an unmanaged, capitalization-weighted index generally representative of the U.S. stock market. This index cannot be invested in directly.
The Russell 3000 Value Index is an unmanaged, capitalization-weighted index that measures the performance of the value segment of the U.S. equity universe. It includes those Russell 3000 Index companies with lower price-to-book ratios and lower expected growth values. This index cannot be invested in directly.

The Russell 3000 Growth Index is an unmanaged, capitalization-weighted index that measures the performance of the growth segment of the U.S. equity universe. It includes those Russell 3000 Index companies with higher price-to-book ratios and higher forecasted growth values. This index cannot be invested in directly.

The S&P 500 Index is an unmanaged, capitalization-weighted index generally representative of the U.S. market for large capitalization stocks. This index cannot be invested in directly.

Exhibit A - Yield on 10-Year U.S. Treasury Bond has Surged

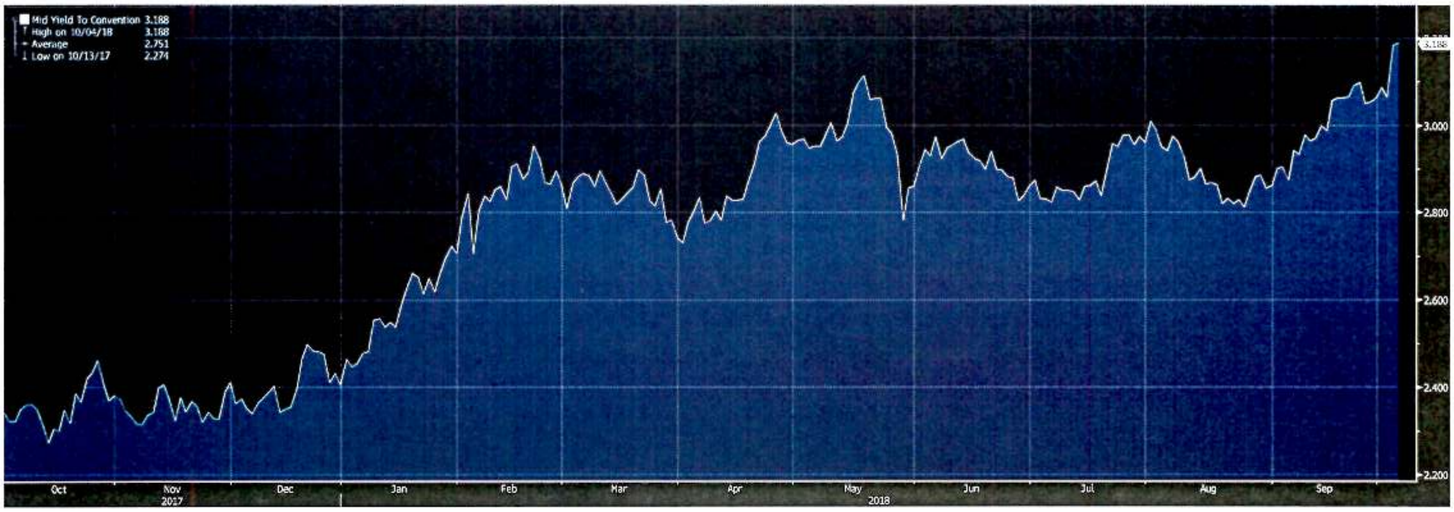


Exhibit B - Low Oil Prices Gone for Good?

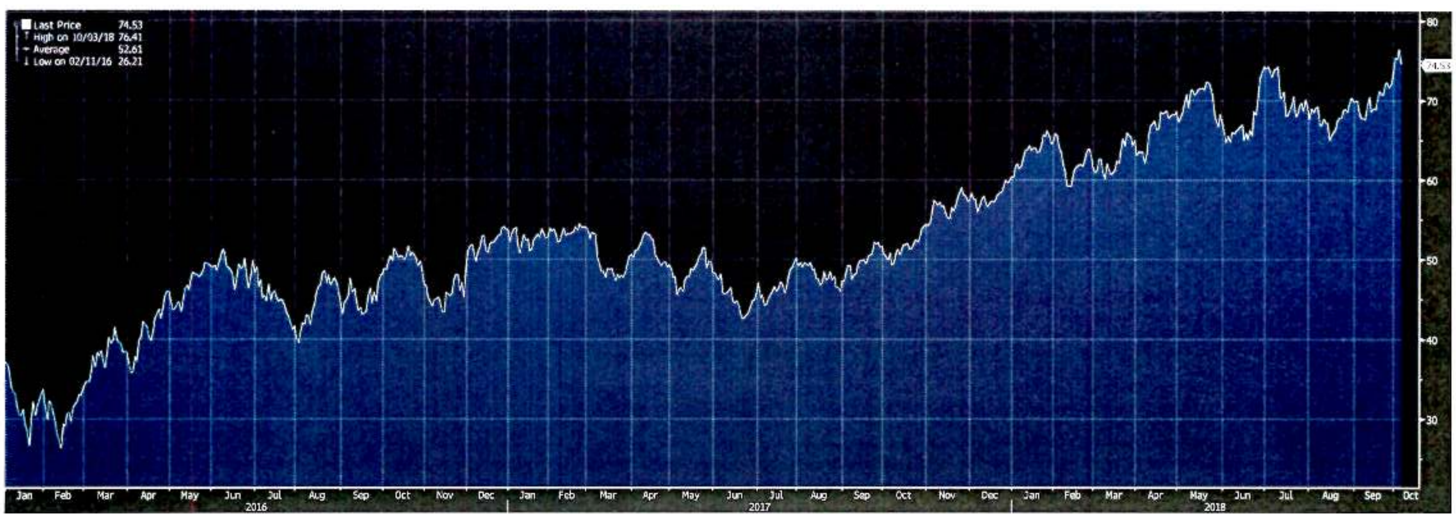
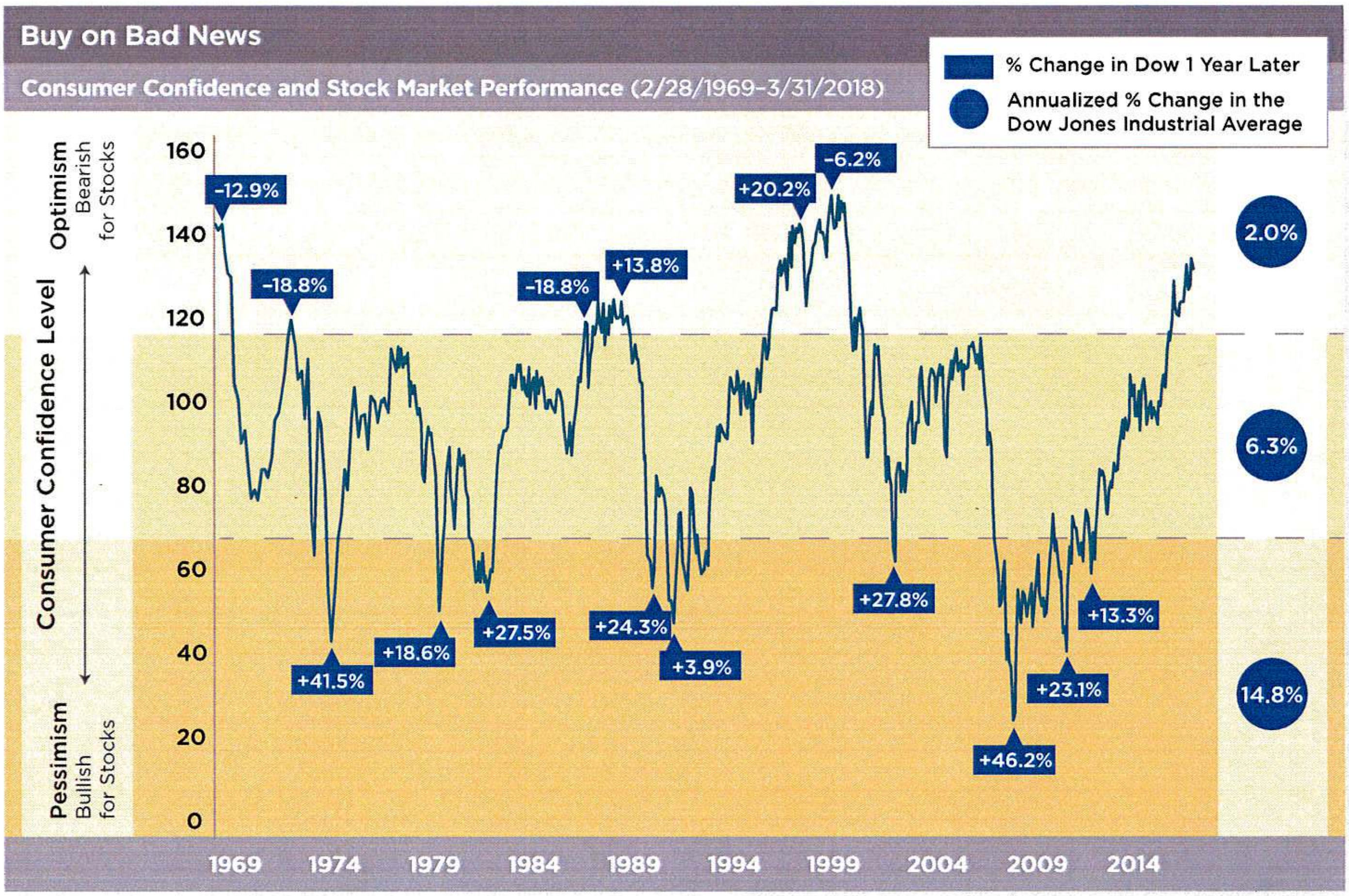


Exhibit C - Consumer Confidence Has Been a Contrary Indicator



Sources: Ned Davis Research, Inc., The Conference Board, Bloomberg and Edward Jones calculations. Past performance is not a guarantee of future results.