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Stocks

We believe the stock market of 2017 will be remembered for quite some time. Few, if any, predicted the equity markets would be up over 20%, especially given the post-election rally at the end of 2016. In fact, if one would have slept the entire year and, upon awakening, was notified of all of the headlines in 2017 and asked to predict the market returns, we believe a negative answer would follow in most instances.

The market rise of 2017 took place during a year where there were no pullbacks greater than 5%. In fact, the last pullback greater than 5% in the S&P 500 occurred in June of 2016. Volatility was extremely low in 2017, except to the upside. In 2017, there were only 4 days in the entire year where the S&P 500 finished down more than 1%, the fewest in over 20 years! In 2016, there were more than 20 such days and in 2008, our favorite year, there were over 70! On January 7, we had to call an impromptu investment meeting because we couldn't remember what the negative was in front of the DJIA index. The numbers were also tinted red. Our concerns were alleviated that day as the market finished higher, of course. Back to normal.

Every day, it seems, there is a warning from Wall Street. On September 25, 2017, Goldman Sachs announced its Bear Market Risk Indicator showed the odds of a crash rising to 67%. That was 10.7% ago. We understand the prediction as, at that point in time, the S&P had gone the fifth longest time without a 5% correction. Corrections do and will happen again. But what is the point of alarming investors? Is "crash" the proper word? Should investors change strategy because of a potential 5% drop in the market? Well, had one done that on September 25th, one would have missed out on an 11% rise in the market.

After the presidential election, Paul Krugman of the New York Times warned to get out of the market. Just hours after the election, with equity futures plunging, Krugman wrote "So we are very probably looking at a global recession, with no end in sight." Since election day, the market is up 31.5%. Timing the market is too hard. The best strategy, we believe, is to design an allocation in line with one's risk tolerance and make marginal moves in the portfolio, not full scale selling of equity positions.

Just this past September, David Stockman, former director of the Office of Management and Budget for the Reagan administration, warned that stocks are heading for a 40-70% plunge. That was 9.6% ago. We suppose it can happen, but why would it? If corporate profits are at all-time highs, shouldn't the stock market be?

We are proud of the long-term relationships we have built at Northern Oak. Many of our clients have been with us for over 20 years. The common thread of these clients is a long-term approach and checking their emotions at the door. It sounds cliché, we admit, but what is the alternative? Reacting to news flows and market volatility is a loser's game. For every investor we hear that successfully times the market and got out before a decline, we hear that they never get back in. You have to make both calls correctly (when to get out and when to get back in) and we rarely witness this. This doesn't mean you sit back and do nothing. We do employ technical analysis (analysis of stock chart patterns) in our research. We find the market knows something about a company much earlier than when the general public finds out. It's not a fail-safe tool, but if a stock breaks a 10 year uptrend, perhaps something is amiss. Selling is much harder than buying.

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The market will correct. It always does and it won't be comfortable. But as long as the underlying fundamentals of the economy and earnings growth for corporations is still expected to be solid, the markets will come back. So far, they always have. If we can recover from 2008-2009, we can recover from a correction or even a recession. Yes, it's not fun to endure those times, but that is why one needs to look
forward and take advantage of any downturn in the markets. We think the biggest mistake investors may make during a future correction is thinking back to 2008 and fearing that decline could happen again. Anything is possible, but the global economy and more importantly, the banking systems are in a much stronger position compared to that time.

With respect to earnings growth for the S&P 500, final 2017 and estimated 2018 growth rates are projected to come in at 10.3% and 12.7%, respectively. The 2018 estimate has not changed since the tax bill was passed reducing the corporate tax rate from 35% to 21%. Once fully implemented into earnings estimates, we expect 2018 earnings growth to be at least 15%. This doesn't even consider the fact that companies will repatriate dollars from oversees and buy back more of its stock. However, we don't expect the market in 2018 to be as strong as 2017's performance. Why? The market discounts future events and we believe some of the benefit in earnings from tax hikes was partially anticipated and priced in. In other words, 2017 stole from 2018. Despite this thievery, the absolute growth in 2018 earnings still warrants strong returns for the stock market in 2018, *assuming earnings expectations are realized*.

Valuation is another subject for the experts on TV and in print. "The market has never been this expensive." Really? Why is it expensive? Is it because on an absolute basis the Dow Jones is in excess of 25,000? The price level of the Dow has nothing to do with whether or not it's expensive. Looking at the price, relative to earnings, does. On a forward price-to-earnings basis, meaning looking at earnings expected over the next 12 months, the S&P 500 is trading at 18.2x. In the absolute, it is hard to evaluate this number. However, compared to its 25-year history average of 16.0x, the market appears to be moderately above its average valuation. We believe a few items mitigate this premium valuation. First, as we mentioned previously, corporate tax savings are not fully implemented into the earnings estimate for 2018. When they are, the denominator will increase and the P/E will come down. In addition, interest rates are low. Asset prices deserve a higher valuation when interest rates decline which they have over the last 25 years. It is hard to estimate what price-to-earnings ratio is warranted given current interest rates. However, over the past 60 years, the average 10-year nominal US Treasury rate is 6.10% and currently the yield is 2.50%, or just 40% of the average. Finally, 2017 marked expansion in economies not only in the US, but also in the rest of the world. For the first time in 9 years, international markets outperformed the US market. With synchronized global growth prevailing at the current time, isn't an above average valuation warranted? We think so.

This market is innocent until proven guilty. Certainly, the market could pull back for non-earnings growth-related reasons, such as geopolitical ones, but any such drop would be viewed as a buying opportunity, in our opinion.

Interest rates

Long-term interest rates are starting to climb. In early January, the 10-year US Treasury yield crossed above 2.6% for the first time in almost a year. We have heard both sides to the argument; higher rates will send the

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market lower and higher rates will send the market higher. The argument that the market will go lower is based on the fact that asset prices are worth less in a higher interest rate environment. That is basic finance. However, **IF** rates go higher because the economy is improving, we believe that's a different story. Higher GDP growth rates should translate into higher corporate earnings and therefore, higher stock prices. Interest rates should climb higher if the economy accelerates as the demand for money increases. On the short end, the Fed would be expected to increase rates to keep inflation under control and also to give the Fed greater latitude to be flexible later in the cycle should it be needed. We believe that a gradual increase in rates is expected and desired. It would actually cause concern, in our opinion, if rates *didn't* go higher.

Putting it All Together

We hate to extrapolate trends, as that is the easy thing to do, but we feel the underlying strength of the market is just too good at the moment and stocks will continue to go higher. As yields rise, we will be tactical with our bond positions and extend the maturities to capture the increase in yield. The next challenge for the market, we believe, will be in the second half of the year as the mid-term elections and the outlook for 2019 come into focus.