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Market Commentary

Spring 2018

Filtering the Noise

It has been hard to sleep at night, but it is not because of the markets. Here in southeastern Wisconsin, winter is having a hard time letting go. Throughout this past weekend, one could hear the constant pounding of the sleet pelting against the window, the noise being amplified by the force of 50 MPH wind gusts off Lake Michigan. If you want to sleep well, one must find a way to ignore it. A cozy Sunday morning like this would be welcomed in December or January, but not in April. However, this is not the noise the title of this paper refers to. It is referring to the many events that we see affecting the volatility of the market, but not the underlying fundamentals. And on a quite timely basis, this includes the US-led bombings in Syria over the weekend.

After an extremely calm market in 2017, stocks have since been off to a rocky start in 2018. Perhaps you've noticed. Fortunately, the large swings in the market are not that big when looked at in percentage terms. And it does seem that a down day one day is offset by an up day the next day and vice versa. Remarkably, despite all the volatility in Q1, the S&P 500 was down less than 1% which we believe helps to support the thesis of this letter. That is, the economy is not as bad as you hear. If this were the case, why is the market essentially where it was to start the year?

One thing the markets do not like is uncertainty and when events happen that cause uncertainty, it causes volatility. The volatility can be especially difficult when it comes after a long period of calmness. But it is important to note what issues causing volatility are legitimate and which ones are not. We further believe that the moves in the market are amplified by fears investors have because of the financial crisis experience in 2008-2009, a once in a generation event.

The financial crisis, seems to have increased investors' sensitivity to market declines. For the most part, we have seen the increased volatility as buying opportunities, although, we admit, a further escalation in one of the possible events would have an adverse effect on the economy, earnings and the market.

The US bombing of Syria in retaliation for the government use of chemical weapons against its own people on April 7th, as horrific as the whole story is, really should have no impact on the stock market. This includes a potential response from Russia toward the US. First, a military strike from Russia seems very unlikely. In addition, any tariffs on the importation of US goods into Russia wouldn't have an impact either as the US exported just $7 billion to Russia and imported just $17 billion from Russia in 2017 (source: statista.com). In addition, Russia's economy is less than the state of Texas ($1.3 trillion v $1.6 trillion). We think any retaliation from Russia comes in the form of cyberattacks.

The list of legal struggles the White House is enduring has also caused stress on the market. This has been felt frequently as the news flow on the various issues is dominating the news on a daily basis. Perhaps the underlying fear in the markets is an impeachment of President Trump if Democrats get control of the House this fall. Only two presidents (Andrew Johnson and Bill Clinton) have ever been impeached by the House and both were acquitted by the Senate according to Wikipedia. We think the odds of the Democrats gaining both the House and the Senate (where a two-thirds vote is required to impeach) this fall are unlikely. Even if Congress were to impeach President Trump

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(and it would have to successfully charge him with a crime), Vice President Pence would step in and we believe, would have little overall effect on the economy.

Finally, perhaps the issue having the largest influence on the ups and downs of the market, and justifiably so, are the threatened trade tariffs with US trading partners, especially those aimed at China. First, we don't believe the White House has any intention of starting a trade war. As we have seen in the Trump administration, extreme positions are taken initially to use as leverage to eventually negotiate toward a common ground. Shortly after announcing tariffs on steel and aluminum, the Trump Administration exempted Canada and Mexico. China, of course, is our largest trading partner. According to Barron's, we import $500 billion from China and export just $130 billion, so it does seem China has more to lose than the U.S. Recently, President Xi announced China would cut taxes on US auto imports, although he stated the decision was unrelated to Trump's tariffs. Hmm. Because of what China has at stake, we expect further negotiations to result in lower tariffs from China as well as an agreement that would give US companies better patent protection on intellectual property. The resolution to this would release the most pressure on the markets as this is the one area that is not completely "noise." We believe the market will eventually move past this issue just like it did with North Korea.

So, if most of what we hear out there is noise and shouldn't impact the market, what would cause the market to fall? The two most important inputs into the valuation of the market are cash flows (earnings) and interest rates. According to FactSet, earnings for the S&P 500 are expected to grow nearly 19% in 2018 compared to 11.5% in 2017. Also, while a little early yet, the preliminary 2019 estimates are 10.5% higher than 2018. While one could argue some of the growth in 2018 is due to the corporate tax cut, the growth in 2019 over 2018 represent two periods with similar tax rates. Therefore, the growth in earnings most likely is due to the underlying economic growth which is slated to be 2.7% in 2019. We also believe it is too soon for the economy to feel the full impact from the tax cuts which will provide further support in the next year.

Interest rates, in our opinion, are clearly the biggest risk to the stock market. A gradual increase in rates is one thing, but a more rapid rise along with higher inflation would cause a repricing of the market. At the start of 2018, the 10-Year US Treasury rate was 2.43% and, after peaking at 2.94%, settled back to 2.82% currently. Yes, 0.51% does not seem like a large increase, but on a percentage basis that is 21% higher (that is why we like financial stocks!). The increase in rates, we believe, was a factor that contributed to the market correction at the end of January.

A driver of short-term interest rates could be actions taken by the Federal Reserve. It has increased rates by 0.25% once this year and is expected to have two more increases by year end. If the longer end of the yield curve follows suit, one could see the 10-Year hovering around 3.50%, a 45% increase from the start of the year. We feel the market would be good with that as it reflects an improving economy and a return to a normalized interest rate level due to the ending of the Fed's quantitative easing program. However, when rates start to head toward 4.0%, we think the markets will take notice. Some have predicted that higher rates in 2019 will slow down the economy and possibly lead to corporate credit defaults and then to a recession. We do not see this happening, but one cannot rule it out either. Another factor that could pressure interest rates is inflation. Wage growth is the largest component of inflation and in January, wages grew at the fastest

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pace in 9 years, up nearly 3%. That happens when unemployment hits 4.1%, its lowest rate since 2000, reflecting a tightening labor market. In summary, interest rates heading higher due to a pickup in the economy is one thing, but higher rates due to inflation is more worrisome.

There are other concerns of the market that we are aware of such as the current length of the bull market (according to First Trust it's near the average), the valuation of the market (due to pullback and EPS growth revisions, it is just 16.4x compared to the 25-year average of 16.0) and possibly snow in May. However, we believe the underlying economic growth supersedes the issues and noise addressed in this letter. In summary, valuations are in line, earnings growth is accelerating, interest rates are low and we believe the full impact of the tax cuts have not been fully realized by the economy. While we expect more volatile markets than 2017, equity investors will be rewarded in 2018 for the added risk they take, although not as much as last year. The start of earnings season provides a good chance for this market to hit new record highs. We can hear it coming…