JANUARY 9, 2018 NEWSLETTER

For the past 12-18 months we have witnessed some amazing economic and political events which continue to dominate the headlines.

- Brexit and the UK's decision to leave the European Union
- a slowing economy in China
- North Korean instability (yes, an understatement)
- constant curveballs in Washington (another understatement)

Despite these circumstances, the stock market continued to defy all odds in 2017. At the conclusion of 2017, I can only shake my head as the market surpassed the gains of last year, finishing up 20% (S&P[1] 500 Mstar[2]).

In addition, the sweeping changes made to the United States tax code at the end of 2017 have dumped fuel on this already burning market. The reforms are expected to boost personal savings and lower corporate taxes in the near term. But as the market takes in the magnitude of the new tax changes, many investors ask if it will really help "them" and how to position their portfolios accordingly. Many questions have become common such as:

- Should I wait for a stock market correction?
- Is it better to sell now while markets are high?
- Should we just jump into bonds?
- Why not get more aggressive?

There are no standard answers that apply to these questions because each of you have unique circumstances. In order to be successful, our business cannot be a one-size-fits-all enterprise. But make no mistake, most investors have reaped the benefits of bull markets in recent years and now are faced with challenging questions, mainly "what now?" We remain very cautious, as we have been for 12+months, while some have become overly optimistic/bullish/irrational. The topics below will attempt to explain this cautious rationale, while pointing out some positives and negatives along the way.

Equity markets are at all-time highs

The major indexes are sitting at or near all-time highs. We are in the midst of a bull market which is the second longest in the post WWII era. I mentioned a few months ago that the Shiller P/E Ratio is in the mid-30's. The only other time it was this high, was in the late 1999 early 2000 prior to epic declines in the overall market north of 50%, and the inevitable tech-bubble bursting. Part of this valuation is dependent on interest rates remaining low. If rates tick up, then stocks must get cheaper.

Bonds

From 1953 to 1981 we saw a generally-increasing interest rate environment, during which time the average annual return for all bonds was 2.5%. Conversely, from 1981 to 2015 we saw a generally decreasing interest rate environment, a boon for the price of bonds (John Hussman Sept 2017[3]). ***While difficult to digest, we've been in a bull market for bonds and bond funds for years, but a seemingly quiet one compared to the equity markets.*** The important takeaway is that in order for this to continue, interest rates would likely have to decrease again. Conversely, that would indicate "potential problems" in the economy. Thus, it appears that we are entering a potential inflationary environment which the stock market "may not" like either. Although we cannot predict the speed at which it will occur, when rates do go up, your longer-term bond values will decrease. Thus, the need to stay higher in quality and shorter in maturity. As mentioned last year, bonds remain an important part of a diversified portfolio. Perhaps moving forward, bonds may represent a smaller portion utilizing cash and other fixed income products as a replacement.

Tax Cut and Politics

The new tax law could be a plus for first quarter earnings announcements and many companies in varied industries could be affected positively. If companies repatriate from overseas and spend that cash, some project a 5-6% bump in annual stock returns. (Barrons[4]). Let's revisit the question in our last newsletter, "what about the unprecedented $20 trillion in debt?" This tax cut produces $1.2 Trillion of additional debt over the next few years. Regardless of political affiliation, why is this tax cut happening ***now*** when the U.S. does not need fiscal stimulus? Is that really being fiscally responsible? However, according to the 2016 Tax Policy Center, 44% of the people in this great nation did not pay any federal taxes last year. Let both of those statements sink in for a second.

Most economists cannot find a recession anywhere in the first half of 2018 (WSJ[5]). There is a feeling of a reemergence of a Goldilocks economy and a market that is somewhat reminiscent of 1998-99 as mentioned months ago (First Eagle[6]). To come full circle, this current market is priced for a lot of great things to occur in a world with no political unrest and perfect harmony.

Bitcoin is a great example of a futuristic technological backdrop that is beyond the scope of our analysis, but inherently flawed with zero regulation. Lastly, as a reminder, the primary reason this economy lies in the current context was the infusion of money into the system during the financial crisis and quantitative easing that occurred. Without which, a depression-like scenario could have evolved. Future growth was "brought and brought forward" in the form of debt. We continue to exert concern about this mountain of debt, along with similar problems in Europe and Japan.

Loans and Liabilities

Detroit recently hosted the North American International Auto Show, although fewer cars were sold in 2017 than the previous year. Yes. Automobile sales were down for the first time in 5 years (NBC[7]). Yet, outstanding car loans are trending up. Student loans are becoming a major social problem as well. I could write a few pages on this alone, but my low blood pressure will indeed rise. Suffice it to say it is unfair to charge a medical school student 6% for graduate level loans in this interest rate environment. It will not end well or fairly. In addition, state and local government pension liabilities remain underfunded while using unrealistically high expectations that are unsustainable (WSJ[8]). Lastly, the primary driver of the current earnings has been consumer spending. Savings have gone from 6% to less than 3%, which again rhymes with pre-financial crisis levels. You should also be ***saving*** money when times are good.

Technology

The large economic driver today is the growing impact of technology. The efficiency is truly amazing and this could be a continued economic positive. Some of these dominant forces (Google, Amazon and even Uber) have basically eliminated the middle man, going straight to the consumer. I read recently that "Uber and Lyft collectively have about 1.3 million drivers in the U.S., and are on their way to becoming the largest employer in the nation" over the next few years (Barrons[9]). Instead of selling widgets, companies are selling lifestyle through tech/speed/innovation. It is remarkable how humans continue to adapt and change, yet the majority of the globe remains untapped by tech as of yet. In the future we will have groceries brought to the door on a regular basis, rent cars vs buying them, or even utilize mini helicopter-like pods to take us from point A to point B. Basically it is becoming a real-life version of George and Jane Jetson (totally dating myself now – to be fair I was only Elroy's age. Not commenting on Judy).

Conclusion - *Preparation*

Clients generally appreciate relatable stories as opposed to financial jargon. So, I did watch the second half of the CFB national championship game. In a nutshell, an 18-year-old freshman QB was plugged in to start the second half as his team was trailing by 13 points. Nick Saban, the Alabama coach, had the guts to insert a freshman, who had barely played in college, into the biggest game of his life. The rest is history as he led the team back, throwing a 40-yard TD as time expired. I don't care how much talent that the kid has, to deliver in the clutch on that level, and that stage, was one of the more impressive feats I've witnessed recently in any sport. His interview afterward was equally telling, as the kid was as cool as a cucumber. My point is that the coaching staff had that entire team…***prepared***. Unbelievably and undeniably ***prepared*** for the unexpected. In conclusion, the theme for this year is similar to last year with a slight twist. Most of the diligent work and preparation needs to occur prior to the "unexpected" rearing its (sometimes) very ugly head. When this "music" stops, it could leave many wondering why they weren't a little more focused, realistic, rational forward thinking and less emotional. Call it proactive vs reactive as mentioned last fall. Some say there are still major benefits to be had in this market. With animal spirits alive and well, they may be proven to be correct…temporarily. But, Warren Buffett and other value investors are hoarding larger amounts of cash, which is perhaps something to take into consideration. I will leave you with a quote that sums it up nicely …

"Would you rather arrive at the airport an hour before your flight, or just one minute too late?"

Thank you for your business. We value our relationship and take this job very seriously, especially under the current conditions.

Prepare…

Corey A. Staub, CFP ®

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S&P[1] 500 Mstar[2], Barron's, John Hussman Sept 2017[3], Barron's 1/8/18[4,] WSJ 1/3/18[5], NBC Jan 18[6], First Eagle September 2018[7], WSJ[8,] Barron's[9]

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