

NOTES FROM THE NORTH: MARKET OUTLOOK

February, 2018

Investor sentiment soared in January, as 80% of S&P 500 companies reported fourth quarter earnings that exceeded expectations and the market powered ahead by more than 7%. As shown in Chart 1 (below), analysts responded to the good earnings news (plus the tax reform calculus) by raising earnings growth expectations for 2018 significantly. Then, suddenly, major stock indices fell 10% and the typical stock in the S&P 500 was 14% off its 2018 high. January 26th, the date of the most recent stock market peak, now seems like ancient history.

The reasons for the sharp sell-off are still being debated. One reason could have been a surge of inflation fears, stoked by the report of a 2.9% advance in wages in December and a sharp rise in the yield of the 10-year Treasury bond. Given that the 2/14 inflation report was stronger than expected and the markets did not respond, perhaps we simply reached a Malcom Gladwell “tipping point.”

Estimated Earnings Growth For 2018

SECTOR	FEB 1, 2018	JAN 1, 2018	OCT 1, 2017
CONSUMER DISCRETIONARY	15.4%	9.2%	10.2%
CONSUMER STAPLES	10.5%	8.3%	8.3%
ENERGY	63.7%	40.8%	35.5%
FINANCIALS	28.4%	17.5%	12.2%
HEALTH CARE	11.5%	6.9%	8.5%
INDUSTRIALS	16.4%	9.7%	10.7%
MATERIALS	19.9%	17.7%	18.0%
REAL ESTATE	5.9%	6.0%	7.3%
TECHNOLOGY	13.6%	13.1%	12.0%
TELECOM	11.9%	1.2%	1.6%
UTILITIES	4.9%	4.6%	5.0%
S&P 500	17.5%	12.0%	11.1%

SOURCE: THOMSON REUTERS I/B/E/S.

It's not clear whether they were the cause or the effect, but volatility and volatility-related products surely played a role in the decline. On February 5, the Volatility Index (the “VIX”) suddenly *tripled*, catching the “low-vol” positions and products off-guard. The risk in these positions was heralded as long ago as last summer, when Barron's magazine wrote on July 29th: “A one-day Standard & Poor's 500 correction of 3% to 4% could force some funds that short futures on the [VIX] index, such as the ProShares Short VIX Short-Term Futures exchange-traded fund (ticker: SVXY) and the VelocityShares Daily Inverse VIX ST ETN (XIV), to cover their positions. That could make VIX skyrocket.... If the weighted-average of the 30-day VIX futures sharply jumped—say by 80% in one day—it would, in turn, trigger an “acceleration event” that would force more funds to buy back short VIX futures contracts. Some VIX funds would face margin calls. And a chain reaction

would likely explode across the volatility spectrum and ultimately the stock market, pushing down share prices and boosting volatility further.” (The above-mentioned SVXY and the XIV products fell by about 95% overnight.)

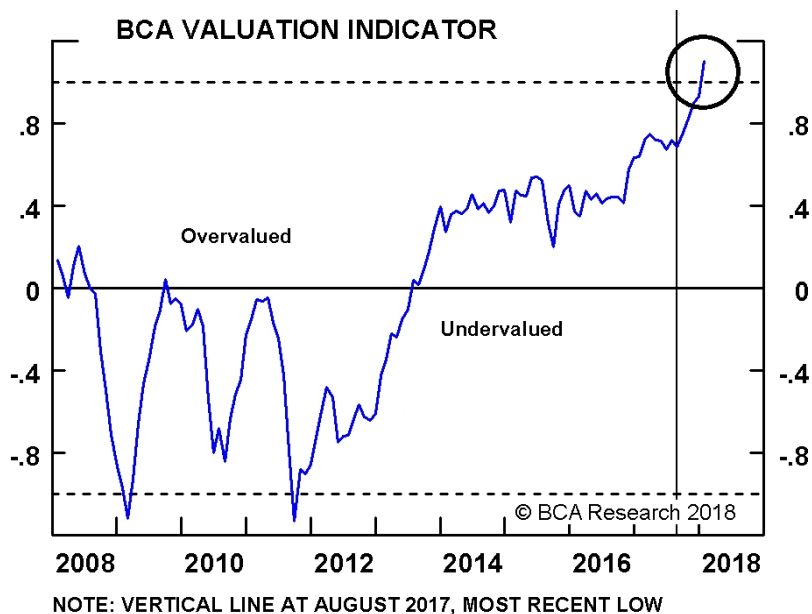
The “VIX trade” losses do not, however, explain why stocks in Europe, Japan and much of Asia fell just as much as in the United States. It seems to us that many investors have long felt that stocks were overpriced, but it made no sense to sell as long as the steady uptrend continued. Everyone's plan was to sell when the uptrend was broken. Unfortunately, when so many have the same plan, the execution gets messy. Now what?

The consensus appears to be that this was a “correction” and not the end of the bull market. We do not disagree, although the bull market is likely entering its late stages. Both the economy and corporate earnings growth will be strong in 2018, but profit margins and the rate of growth could be peaking by mid-year. BCA warns us to watch the Federal Reserve closely. As we have discussed at length, the Fed has used an arsenal of monetary policy tools to stimulate the economy for nearly a decade. Now it falls to newly-appointed Chair, Jerome Powell, to unwind this monetary experiment. How he proceeds may determine how much investors need to recalibrate their enthusiasm for risk. If rates rise too rapidly or the Fed is seen as being behind the curve, markets may react negatively.

After the market correction, U.S. stocks were back to prices last seen in late November of 2017. Valuations are better, but still historically high. This is true whether one examines forward price/earnings ratios, Shiller P/E's (which use 10-year numbers), or Warren Buffett's ratio of total market value to GDP. BCA's measure of valuation is shown in Chart 2, (over).

NOTES FROM THE NORTH: MARKET OUTLOOK, CONT'D

Chart 2



Fortunately, high valuations rarely presage a market “crash.” Unfortunately, high valuations do imply that returns in the future will be lower than normal.

Lower future returns could impact those relying on their portfolios for living expenses. Anne Tergesen's Wall Street Journal article from February 10 entitled "It's Time to Rethink Some Common Beliefs" called into question the level of withdrawal that should be considered prudent, as well as the typical strategy of reducing equity exposure over time as an individual ages. For decades, the “4% Rule” has dominated income planning. Given the return history of the capital markets, 4% was the rate that provided securely for a long retirement with some protection from inflation.

Given today's high valuations and lower than normal expected future returns, we may be entering an extended period where a 4% draw could result in excessive diminution over time: A 3% draw figure may be more prudent. As to reducing equity exposure over time, Tergesen cites a study which showed that reducing equity exposure in the years just around retirement, then ratcheting it back up over time was more successful than the standard approach of reducing equity exposure incrementally as time marches on. We've always found asset allocation to be more of an art than a science, and typically there's a point at which an investor realizes they have more than they'll ever need. Their investing time horizon gradually extends to the next generation, which suggests a higher allocation to equities. Obviously client time frames and the value of other assets play into asset allocation and withdrawal decisions, but spending needs are an issue we will want to discuss with any client consistently taking out more than 4% of their capital each year.

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