Financial Markets Perspective

January 2018

A Look Back and A Look Ahead

One Year Later

One year ago, we made the following prognostications in our yearend Perspective about the outlook for the U.S. and global economy and the stock market:

"There has never been a period when these positive changes have come together to affect the corporate sector. Few economists have even considered what happens to corporate profits in an environment of economic growth that could exceed the 3-4% potential growth rate for the U.S. economy."

Here is what we expected (with follow-up commentary):

✓ *An increase in domestic economic growth to 3%+*

- Economic growth in the 2nd and 3rd quarter exceeded 3%.

✓ *faster and broader economic growth around the world*

- The World Bank has announced that the global economy is operating at full potential, a level not reached in the past 10 years.

✓ *slower increases in the fed funds rate during the year*

- Three increases of 0.25% during the year. The Fed was surprised by low inflation.

✓ *modest increases in interest rates early in the year with further increases affected by the rate of overall economic growth*

- Short-term interest rates rose but long-term rates remained steady.

✓ *a resumption in corporate profit growth that will exceed expectations*

- Corporate profit expectations for both 2017 and 2018 were continually revised upwards during the year.

✓ *improved business spending and consumer confidence*

- Both business and consumer confidence reached record levels

✓ *another year of double-digit gains in stocks but weaker bond prices (higher yields)*

- the S&P 500 rose 20.49% for 2017 while 10-year Treasury bonds had a total return of approximately 2.50%.

✓ *continued turmoil in Europe with elections in France, Germany and the Netherlands*

- The French elected a moderate businessman (Macron) while German elections resulted in a reduction of Angela Merkel's power. Elections in the Netherlands resulted in a continuation of the People's Party for Freedom and Democracy.

- ✓ *the invocation of Article 50 of the Treaty of Lisbon that will formally start Britain down the path of Brexit*
    - Article 50 was invoked, and Brexit continued to be the most controversial issue in Great Britain.

Virtually all our expectations were fulfilled although we were not as euphoric about the stock market given the uncertainty surrounding the potential for the major tax cut proposal that became law. As markets adjusted to the reality of those tax cuts, stocks zoomed ahead as the logic of accelerating earnings pushed the broad stock market higher.

On the other hand, the bond market has remained in limbo as long-term treasuries have yielded the same year over year and short-term rates have ratcheted up slightly as the federal reserve pushed the fed funds up to 1.25%. Even though we are into a nine-year bull market in stocks, bond yields remain low by historic standards. With the stock market surging 20% plus last year, a bond yield of 4% or less isn't going to cut it for accumulating wealth in a long-term savings plan—yet substantial funds flowed into the bond market for virtually all of 2017. How long will investors who require a viable nest in retirement continue to seek out the safety of a 4% yielding investment when the broad stock market has the potential for growing at double-digit rates for at least the next two years?

For the Foreseeable Future

A year ago, we were asked to characterize our optimism about the stock market. We said that "we feel like kids in a candy store." Recently that same question came our way and our response was, "the candy store is undergoing a major expansion." So, why do we say that? Here are just a few reasons:

The Energy Renaissance remains in full force as the miracle of fracking continues to provide new sources of oil and gas that is increasing U.S. energy production. The surge in oil prices above $60 per barrel keeps high cost U.S. energy producers in business and contributes to more money kept in the U.S. rather than shipped out to OPEC. This long-term theme will continue to infiltrate many different industries and sectors and should result in positive flows to the bottom line.

The other "Renaissance" is the Industrial Renaissance whereby many industrial companies are building plants and related equipment in the U.S. We first wrote about this "Industrial Renaissance" in 2012, and it remains one of our favorite investment themes and will likely continue over the next decade. Even though the United States will not likely be the manufacturing powerhouse that it was during the 1950s and 1960s, many factors are suggesting that the U.S. industrial sector will continue to gain market share. Evidence of this phenomenon is mounting as seen from the fact that stocks of industrial companies continue to populate the new high list on the NYSE.

Tax rate reductions will increase output and wealth as the rewards for working rise. Companies will hire additional employees and those employees will spend most of their wages contributing to both economic growth and tax collections. The announcement that Walmart is raising hourly wages is just the tip of the iceberg of decisions by corporations to remain competitive by distributing some of the benefits of the tax cuts to employees. Recent measures of consumer and small business confidence have reached record highs.

Our tracking of individual stocks indicates that recent earnings revisions for 2018 are up to the tune of 90% -- up from the low 70s in early December. Further revisions for 2018 and 2019 are likely given the gradual impact of the tax rate cuts.

Global growth will undoubtedly find its way into the U.S. economy adding another positive factor to extending the current economic expansion.

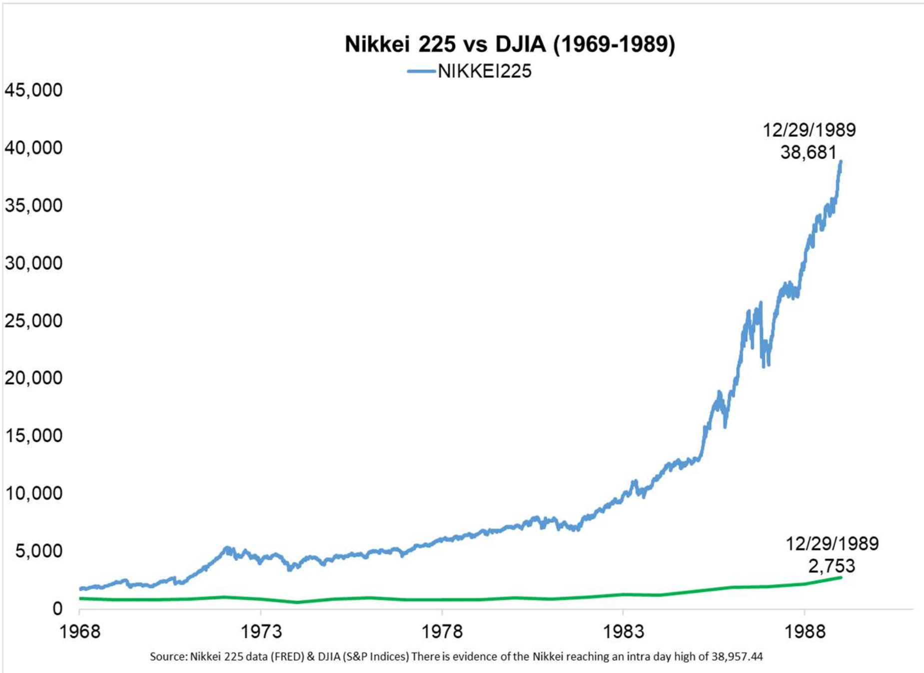
Many stock market forecasters are convinced that stocks are overpriced or expensive. While this analysis may fit into the historic valuations of stocks in general, it fails to consider the accelerating trend in corporate profits that will undoubtedly lower the P/E ratio of the market. There are two good historic parallels that might be used to defend an optimistic outlook for the stock market.

The first period extends from 1994 to 1999. In the 1994 mid-term elections, the Republicans gained control over the Senate and House of Representatives. As part of their "Contract with America," they initiated major economic changes in laws that benefitted the economy. Even President Clinton turned from being a tax and spender in his first term to a tax cutter in his second term, lowering the capital gains tax rate and the income taxes on profitable home sales. The following exhibit presents the reaction to these events in the stock market as measured by the S&P 500 index.

The gain for the S&P 500 in 2017 was 21.8%. We compare that return to the return of the index in 1995 of 37.6%, a year after a national election as was 2017. For portfolio managers reflecting on the market's performance in 1995, few of us expected any type of repeat of that experience. Yet the double-digit market gains that were achieved from 1996 through 1999 provided investors with a unique opportunity to gain in the late Nineties.

The second period extends over a longer period and compares the performance of the Dow Jones Industrial Average with the Nikkei Dow Jones, the Japanese equivalent of that market.

Note that while the DJIA doubled in price from 1969 to 1989, the Nikkei rose close to 40 times! Our point is that using history to handicap the potential for the stock market leaves out current events that haven't happened before.



Conclusions:

Our beginning of the year optimism about stocks was rewarded with record rallies in many domestic and foreign stock indices so far in January. Passing the president's tax proposals is ushering in record reductions in tax rates that will contribute to a better economy for several years. On the earnings front, narrowing wage differentials, lower energy and logistical costs, and political stability are just some of the factors that should contribute to healthy profits. We believe that investors are over-estimating the risks within the United States and that domestic stocks will finish out the year in positive territory. There will always be some intermediate declines along the way, but we believe stock investors will continue to be rewarded by staying the course. Ask yourself: can you afford not to invest in one of the best bull markets of our time?

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