Market Outlook – November 2017

Market eclipses records as new money floods into the market. Despite its reputation as the worst seasonal period for stocks, global stock markets rallied again in the third quarter. The U.S. market delivered strong returns extending its winning streak to eight consecutive quarters and a remarkable 18 out of the last 19 quarters. The rally since last November has been supported by four pillars. First, global economic growth prospects continue to improve. Second, still incredibly accommodative global monetary policy has resulted in the tranquility that permits financial assets to soar. Third, investors' unwavering optimism for the Republican fiscal policy agenda has further boosted asset prices as the Trump administration releases an ambitious proposal to slash individual and corporate taxes. If passed, the most sweeping changes to the federal tax code in decades would likely further fuel the bull market. And last, but certainly not least, corporate earnings have steadily improved since suffering a recession through the third quarter of last year.

Is this cause for celebration? Certainly, market returns to date would indicate such. When thinking of the seemingly never-ending run up in the market, however, Shakespeare's *Macbeth* comes to mind: "double, double, toil and trouble; fire burn and cauldron bubble!" Equity markets are at an all-time high and interest rates still relatively low. This combination leaves financial markets gleefully soaring ahead while only cautiously looking over their shoulder. Let us consider what would happen if cracks were to appear in any of the four pillars. Michael Arone, Chief Investment Strategist at State Street Global Advisors, warned about market correlation to corporate earnings: "without earnings growth as a support beam, the bull market could collapse like a house of cards." Earnings growth is essential to the structural integrity of the bull market. Third quarter earnings season is in full swing and the results are very positive versus expectations. That last part, "versus expectations" is where the concern lies. Market analyst FactSet anticipates that S&P 500 Index earnings will come in, on average, reporting growth of about 6% for the quarter. This is relative to *expectations* for 2.8% growth. While positive, this is a dramatic slowdown compared with the first half of the year – 13.9% earnings growth in the first quarter and 10.3% in the second quarter. In addition, the typical pattern for earnings season is for analysts to reduce earnings estimates during the quarter and then for two-thirds of those companies to easily beat the lowered expectations. Although beating lowered quarterly earnings forecasts is a foregone conclusion, profit margins are another matter. Only energy and technology sectors are expected to demonstrate profit margin improvement in the third quarter. The very tight labor market is just starting to put pressure on wage growth. While increased wages will be good for consumers, broad corporate profits are more difficult to achieve with higher wages.

Next, we must consider what earnings really indicate. While all publicly traded U.S. companies report earnings per share on a GAAP (Generally Accepted Accounting Principles) basis, many companies also choose to report earnings on a non-GAAP basis. Supporters argue that non-GAAP reporting is more accurate in showing the day-to-day earnings of the business, as items that companies deem to be one-time or non-operating in nature are typically excluded from the figures. Critics argue that the ambiguity of this practice allows companies to boost non-GAAP earnings by not reporting one-time expenses such as stock based compensation. Stock based compensation hardly seems like an insignificant item. Perhaps these different interpretations of earnings indicate that earnings are not really as strong as we think.

The near-term macroeconomic (fundamental) backdrop for U.S. stocks looks quite solid. That said, U.S. stocks have high valuation risk. Across almost every absolute valuation metric, U.S. stocks look expensive to very expensive. International and emerging market stocks, on the other hand, have generated strong relative and absolute performance over the past year. Part of this performance can be explained by the euro's sharp 12% appreciation against the U.S. dollar in 2017.

The roughly 9 percent decline in the U.S. dollar year-to-date has been a powerful tailwind for large multinational companies that generate a significant portion of their revenue from outside the United States. Remember, the earnings growth rate for the S&P 500 companies is expected to be 2.8% for the third quarter. Companies that generate more than 50% of their sales inside the U.S., are expected to see earnings decline about one-tenth of 1 percent. Companies that generate less than 50% of their sales inside the U.S., are expected to see earnings increase 7.9 percent. As such, we maintain our position that international market exposure is increasingly attractive.

How will Fed action and tax reform affect our outlook?

Investors have spent much of the past eight years with only half an ear toward the Fed's announcements, not expecting any monetary tightening. The Fed's September announcement that they will start downsizing their balance sheet took many investors by surprise and yesterday's near promise of a December rate hike further confirms this position. Yesterday's nomination of Jerome Powell as the new Fed chair will possibly change the outlook of the Fed but is not expected to alter it dramatically. There may be implications for short-term market volatility as other Fed leadership positions change but it is unlikely to result in a major direction change to monetary policy.

The current tax reform framework centers on cutting corporate tax rates from 35% to 20%, compressing the number of individual income tax brackets, and repealing the taxes paid by large estates. Much of these cuts are funded with the elimination of the state and local tax (SALT) deduction. The deduction currently allows taxpayers to shave off what they pay in state and local taxes from their federal tax bill. The elimination of this deduction would save $1.3 trillion over 10 years, according to the Tax Policy Center. Taxpayers in low tax states might find themselves with tax savings if the standard deduction is, in fact, nearly doubled; but taxpayers in high-tax states will owe far more in taxes. Current negotiations are in progress regarding 401(k) plan contributions, specifically reducing the amount that individuals and households can contribute to these plans without being taxed. We hope it will stand at $18,000 per year as proposed. With the Fed's announcement yesterday that rates are likely to increase in December, and increasing expectations for a tax reform package to come out of Washington, the U.S. dollar may rebound which would depress future earnings results for multinational corporations.

Back to the U.S., despite the U.S. economy's rather healthy economic indicators, it's worth noting that a typical 5% to 10%-plus stock market pullback can happen at any time, triggered by any number of unpredictable or unexpected events. Higher valuations on risk assets, continued delays and disappointment in economic policy, rising bond yields, and subpar growth are all catalysts that could lead to investor uncertainty and potentially a market pullback. We view a pullback as a healthy and natural adjustment for the market. Historically, the U.S. market has dropped at least 5% roughly *three times a year* and declined 10% or more about once a year. We are at almost a year since the last 5% drop; this is the longest such streak in *26 years*. Given that historical reference, the U.S. market seems long overdue for an adjustment. As John Templeton famously penned, "Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria." This bull market has fed off skepticism for much of its duration – only recently displaying optimism, but not yet starting to be euphoric.

We do believe the current bull market will ultimately be followed by a traditional bear market (a sustained 20%-plus decline) but such a market is usually associated with an economic recession. Absent a recession, a bear market is not likely. Recessions, in turn, are typically caused by excessive Fed tightening, usually in response to inflationary pressures, an overheating economy, or financial market excesses, none of which seem imminent in the U.S. or global economy. So, although this is now the third-longest economic expansion and second-longest bull market in U.S. history, neither appears ready to die of old age just yet.

As the cycle turns, however, the likelihood of a recession increases. In the next five years, both a recession and bear market are possible. Investors must be prepared—psychologically and financially—for market dips and drops along the way. They are inevitable and may be unsettling, but they are also *temporary, a natural retracement, consolidation, and consequence of participating in investments that grow your principal wealth.* In the meantime, we have built balanced portfolios that are resilient across a range of scenarios; diversified across investment strategies, asset classes, and risk exposures; and tilted to the areas our analysis indicates currently have the most attractive risk and return profiles, such as European stocks, emerging-market stocks, high quality bonds, floating-rate loan funds, and alternative asset classes.

As famed investor Peter Lynch has said, “Far more money has been lost by investors trying to anticipate corrections, than lost in the corrections themselves.” So where does this leave us? Let us remember the words of Benjamin Graham, the father of value investing: “The best way to measure your investing success is not by whether you are beating the market but by whether you’ve put in place a financial plan and a behavioral discipline that are likely to get you where you want to go.” This perspective is what drives us in our work to develop a long-term financial plan for every client, monitor your time horizons and risk tolerances to adjust that plan, and use your investments as the means to execute that plan. Thank you for your continued confidence and trust as we look into the future to anticipate opportunities for and risks to your objectives.

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