Market Update

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Markets-Buy on the rumor, sell on the news?

Fourth quarter S&P 500 profits are predicted to grow at about 4.2%, marking the first time the index has seen year-over year growth in earnings for two consecutive quarters since Q4 2014 and Q1 2015. Interest rates remain favorable and the economy continues to expand at a modest pace, providing an underpinning for what today are historically high market valuations. But according to a recent Bank of America Merrill Lynch survey, this is already baked into the cake, noting that investors are already expecting and pricing in **above trend economic growth, higher inflation, and stronger corporate profits for 2017.**

We try not to get caught up in predictions for the New Year, as the majority of market pundits are usually wrong and end up chasing the surprises that no one saw. So predictions and surprises aside, our focus remains on earnings and the premium the market is willing to pay for those earnings.

Hope and optimism often drive markets until reality sets in. The market is after all, a forward looking mechanism that should discount future profits. Since the November election, a number of industries have experienced breathtaking runs, namely energy, infrastructure, and banking, all on the hope of broad and sweeping deregulation, corporate tax reform, and meaningful infrastructure spending. We believe the markets are now entering a "show me" phase where promises will soon need to play out on corporate income statements.

Take for example the banking industry. Embedded in our economy and somewhat of a canary in a coal mine, financial stocks like banks are great indicators of economic reality and direction, and we always listen closely to what the industry leaders have to say. These stocks have experienced huge price increases as they look ahead to the dismantling of Dodd Frank and higher interest margins due to rising interest rates. Below are some comments from recent earnings calls that we participated in.

Donofrio, BAC CFO: *" Way to early to determine the impact of new Trump administration on banking regulations."*

Davis, USB CFO: *" there is more optimism and positive commentary for a lot of our business customers. But we haven't seen a significant change in utilization or actually takedown of credit yet".*

Donofrio: *"Credit statistics here are phenomenal"*

Moynihan, BAC CEO: *" So as I go out and visit these clients, they're very optimistic. They think policies will be supportive of growth in their businesses."*

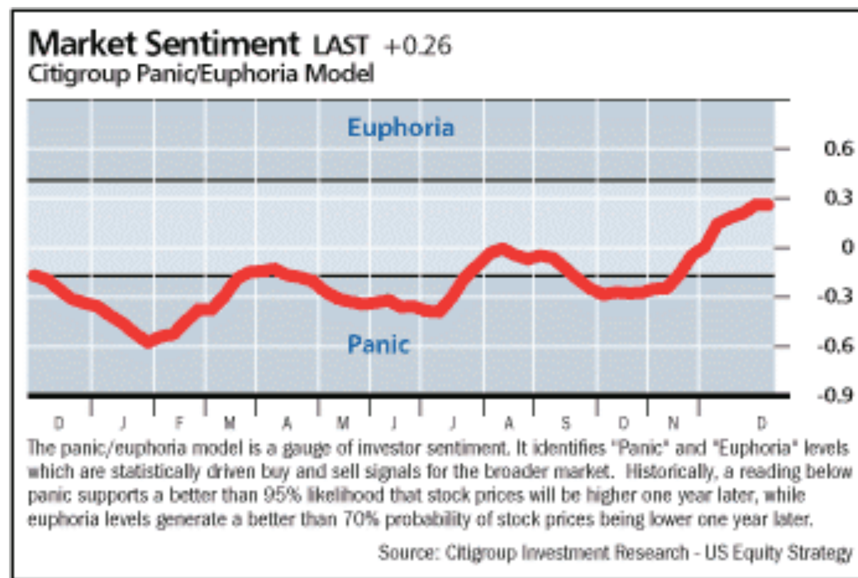
So while we are clearly seeing signs of increased optimism in consumers and businesses amidst a very solid credit cycle, bankers are still waiting for all of this to show up in new business.

As we mention above, fundamentals and earnings are fairly solid, bank balance sheets are strong, and businesses are optimistic about their prospects for expansion under the new administration. The forward 12-month P/E ratio is 17.2—above the 5-year average of 15.1, and above the 10-year average of 14.4. It is difficult to find any one sector or asset class that is trading at historically low levels. We often watch the credit markets and bond spreads for confirmation on valuation levels and the direction of what investors are willing to pay for risk assets.

Right now, corporate credit spreads are fairly tight to U.S. Treasury Notes, as are lower quality high yield bonds, supporting current valuation levels in the equity markets. To put it in perspective as to how quickly theses "spreads" can change, going back only one year ago to February 2016, high yield spreads over U.S. Treasury Notes rose to over 8%. Today, they have receded back to a calm 4% level, approaching historically low levels. We do expect a fair amount of volatility in the markets with the new administration, and this may create opportunities in certain asset classes over the next year.

Looking Ahead: Market Sentiment and Valuation

In our last newsletter, we wrote that investors had not yet entered the optimistic stage of the investor emotion spectrum, and that we were somewhere between optimism and pessimism. Our wall of worry was held in place by a fair amount of pessimism. That has since changed, and the promise of higher corporate earnings due to a number of policy changes has moved investors further out the spectrum and into the optimistic stage.



The panic/euphoria model is a gauge of investor sentiment. It identifies "Panic" and "Euphoria" levels which are statistically driven buy and sell signals for the broader market. Historically, a reading below panic supports a better than 95% likelihood that stock prices will be higher one year later, while euphoria levels generate a better than 70% probability of stock prices being lower one year later.

Source: Citigroup Investment Research - US Equity Strategy

While not yet near the euphoric stage that precedes the end of most bull markets, we may have entered a "show me" stage. And not unlike the old adage "buy on the rumor, sell on the news", the post-election rally will eventually need to be ratified by actual earnings showing up on corporate income statements. Delays in congress, combined with any negative effects of a strong dollar, may hold the market in check for the near term. As we have noted many times before, valuation gives us information on the potential severity of a correction or the strength of an upside move in the market. Yet it tells us nothing about timing.

For example, since the 1920's, when stocks have been in the upper quintile of valuations-which is where they are currently—the average market move from peak to bottom(referred to as drawdown), has been 33%. Conversely, when stocks are in the cheapest quintile—think immediately post 2008 crisis—the average drawdown has been only 6%. So as we always say, the starting point matters.

The eventuality of a bear market is a certainty. And the fact that stocks only reach highs on 5% of all trading days leaves investors with the anxiety of the markets being below prior highs 95% of the time. Yet even so, equity markets have shown positive returns on average 70% of the time following all time highs.—see below chart.

	Dow Jones Industrial Average Following an All-Time High: 1915-2017		
	Average Performance	Positive Returns	Negative Returns
One Year	8.9%	70.6%	29.4%
Three Years	21.0%	76.1%	23.9%
Five Years	31.7%	67.8%	32.2%

Source: Bloomberg

We always say patience is key in investing, yet it is cold comfort when taking your first drawdown from your IRA in the middle of a bear market. For this reason we think it is important to stress test your portfolio to have a reasonable expectation of what the next bear market impact may have on your assets and long term planning. We always welcome an opportunity to meet with you to review your investments, affirm your goals, and also to affirm the probability of meeting those goals.

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