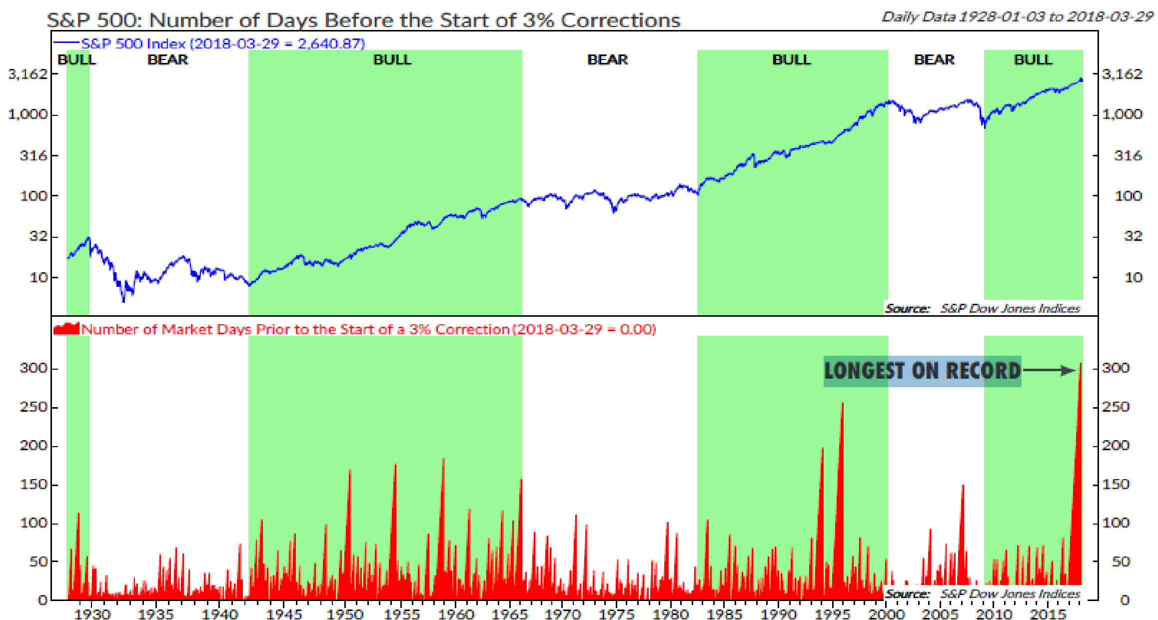
Where Do We Go From Here?

"The key to making money in stocks is not to get scared out of them" – ***Peter Lynch***

Successful investing is often determined by one's ability to stay the course. Since 2009, investors have had every excuse to bail out of stocks, but the market has continued to climb a wall of worry, becoming one of the largest bull markets in history. In fact, since March of '09, the S&P 500 is up 290%. By historic measures, this market has lasted 108 months vs 54 months for the average bull market. The question becomes: Where are we now? In our humble opinion, we are probably pretty deep into the 4th quarter and might go into overtime.

A Look Back

As we predicted in our previous newsletter, volatility returned to the market. From the peak in late January, stocks dropped over 10%, but ultimately ended the quarter down less than 1%. To us, this seems like a pretty good trade off after last year's 20%+ gains. The chart below puts 2017 into perspective, as it was the longest period in history without a drop of over 3%. It was certainly nice while it lasted, as the 1st quarter saw moves that large in a single day.



History doesn't repeat itself, but it does tend to rhyme. In the late 1990s, the market experienced 3 corrections greater than 10%. Investors that gave up on stocks after the first dip would have missed 50% gains before the bull market ultimately ended. In the 2006-2007 time period, stocks also corrected 3 times, by 8-10% each, and went up another 20% from the first correction. We believe we may have just had that

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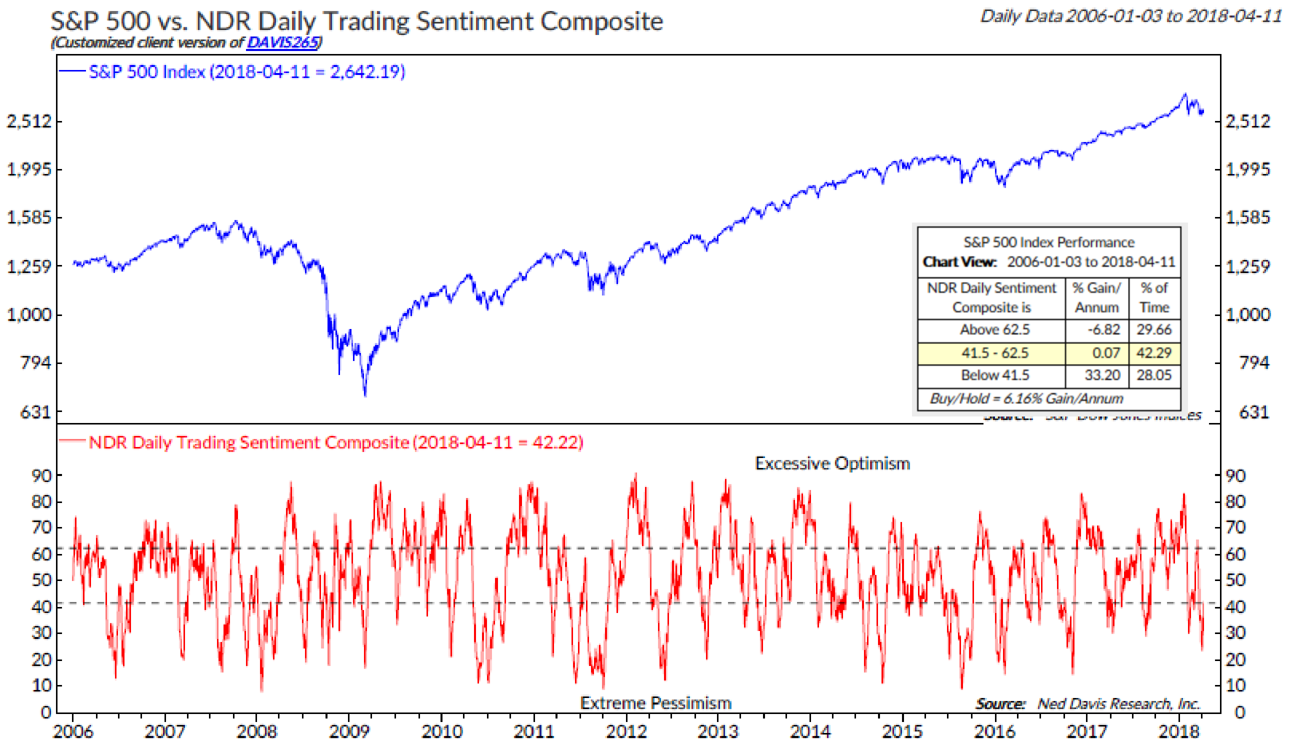
first correction. Timing the market is very difficult and calling a top is even more difficult as topping phases can last years.

Short Term Positives

The short term looks really positive after the market reset.

1.) **Tax Cuts:** UBS estimates the impact of the major tax provisions should boost S&P 500 earnings by 9.1%. We will get the 1st quarter impact starting next week.
2.) **Stock Buy Backs:** We have written several times about stock buy backs and the fact that corporations have been one of the major purchasers of stocks since 2009. As a result of tax savings, 2018 is expected to be a record year for stock buy backs.
3.) **Valuations:** In January valuations were stretched to the upside. After the shake up in the market, forward price/earings ratios are back to 16.8, which looks a lot better.
4.) **Sentiment:** Perhaps there is no better short term indicator than investor sentiment. When the public is worried, buy and when they are euphoric, be very careful. Below is a chart from Ned Davis, which shows just how predictive sentiment can be.



S&P 500 Index Performance		
Chart View: 2006-01-03 to 2018-04-11		
NDR Daily Sentiment Composite is	% Gain/ Annum	% of Time
Above 62.5	-6.82	29.66
41.5 - 62.5	0.07	42.29
Below 41.5	33.20	28.05
Buy/Hold = 6.16% Gain/Annum		

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Long Term Negatives

Despite our optimism in the short term, there is a very large list of potential negatives in the coming years:

1.) **Tax Cuts:** Yes, the tax cuts are a short term positive. However, longer term, they may possibly overheat the econonmy and ultimately force interest rates higher.
2.) **Interest Rates:** The world has become accustomed to low interest rates. We don't believe that rates are going off the chart, but a marginal move can have a major impact on both individual and corporate net cash flows.
3.) **Recession:** Many economists are predicting the next recession in the 2019-2020 time frame. This is important becasue recessions generally accompany 20+% market declines
4.) **Commodity Prices**: Oil recently hit 3 years highs. As commodity prices increase, the cost of to produce many goods increases, which ulitimately reduces corporate earnings.
5.) **Corporate Earnings:** Earnings are at all time highs and more importantly the growth rate of those earings is very high and unsustainable. There is no measure more important than earnings for stocks. As those growth rates come back to reality, stocks are likely to feel the impact.
6.) **Debt/Defecits:** While the consumer has cleaned up their financials over the past decade, the government has absorbed the burden. Tax cuts and low interest rates have been the formula to grow us out of our national debt. To date this hasn't worked.
7.) **President Trump:** We won't go there, but find this picture to be pretty reflective of how many people feel.

Our strategy remains staying the course, as long as we have tailwinds. However, we must be thinking about what things look like when the winds changes.

When Things Go South, How Do We Make Money?

Although we prefer to think with glass half full optimism, we are cognizant that the markets and economy move in cycles. This is the time to think about adding solid investments that can withstand a downturn. Below are some of our favorite ideas and the rationales behind them:

1.) **Credit (Loans):** Over the past 15 years, the number of banks in the US has been cut in half due to mergers and the financial crisis. In addition, regulation from Dodd Frank has constrained the banks from various types of lending. Many people that worked for the large banks have left and started firms doing the same type of lending the banks used to do. They are lending with money raised from investors. Like any investment, there are many variables to consider, but we generally like loans with very high lending standards and a significant amount of collateral.

2.) **Real Estate:** Historically, real estate has been a good asset class in times of rising interest rates *(see below chart)*. We believe that there are many areas of the real estate maket that are overvalued, but there are still opportunities. Low interest rates on debt and potential inflation are two very positive variables for real estate.

Rising Interest Rate Periods			Fed Funds Target Rate		Total Return During Rising Rate Periods		
Period	Start Date	End Date	Starting Rate	Ending Rate	Private Real Estate	U.S. Bonds	U.S. Equities
#1	12/31/1977	3/31/1980	6.5%	20.0%	49.7%	-5.7%	21.2%
#2	7/31/1980	5/31/1981	8.5%	20.0%	13.7%	-2.9%	13.5%
#3	2/28/1983	8/31/1984	8.5%	11.5%	22.2%	9.9%	20.5%
#4	12/31/1986	5/31/1989	5.9%	9.8%	17.6%	17.5%	43.9%
#5	1/31/1994	2/28/1995	3.0%	6.0%	7.3%	1.0%	4.5%
#6	5/31/1999	5/31/2000	4.8%	6.5%	13.2%	2.1%	10.5%
#7	5/31/2004	6/30/2006	1.0%	5.3%	41.7%	6.5%	17.8%
			Average Cumulative Return		23.62%	3.92%	18.81%

3.) **Emerging Markets:** As we talked about in our previous newsletters, there are a number of fundamental reasons as to why we like international stocks and in particular Emerging Markets. One of the most important reasons has to do with the decoupling of Central Bank policies. While the United States is slated to continually raise rates for the foreseeable future, most emerging nations have been cutting theirs.

4.) **Bonds:** Everyone is down on bonds. Rightully so, a 3% yield will most likely be eaten up by price losses this year. However, as yields increase, bonds become a more compelling investment. The main purpose for bonds in any portfolio is diversification, as the hope is that bonds go up when stocks go down. If things play out as we discussed earlier, rising interest rates may be the ultimate trigger to end the bull market. When things go south, the Fed may indeed start lowering interest rates, which would put bonds in their ideal diversification state.

5.) **Cash:** As interest rates go up, rates on money markets and short term instruments become a more attractive place to keep your money – providing some return while giving you the liquidity to be opportunistic when prices of other assets fall.

As always, please don't hesitate to contact us with any changes to your personal sitation.

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Investing in alternative investments may not be suitable for all investors and involves special risks, such as risk associated with leveraging the investment, potential adverse market forces, regulatory changes, and potential illiquidity. The purchase of bonds is subject to availability and market conditions. There is an inverse relationship between the price of bonds and the yield: when price goes up, yield goes down, and vice versa. Market risk is a consideration if sold or redeemed prior to maturity. Some bonds have call features that may affect income. Treasury bonds are guaranteed by the U.S. government as to the timely payment of principal and interest, and, if held to maturity, they offer a fixed rate of return and fixed principal value. U.S. Treasury bonds do not eliminate market risk.

The precious metals, rare coin and rare currency markets are speculative, unregulated and volatile and prices for these items may rise or fall over time. The commodities industries can be significantly affected by commodity prices, world events, import controls, worldwide competition, government regulations, and economic conditions.

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