Monthly Commentary

February 6, 2018

Super BULL; or Not

Bill Henderly, CFA, Nvest Wealth Strategies, Inc.

It takes "guts" to offer a commentary title like this, writing it during the worst turndown in two years. No, it's not "bull"; and I don't have a crystal ball to tell the future direction of the financial markets. Yet,….

January was a spectacular month for the stock market – starting strong and establishing 13 new daily highs (during 20 trading days). By the 26th, the S&P500 advanced a very strong +7.5% to start the year (an annualized pace of over +170%); concluding January with a +5.7% advance. January was the15th consecutive "up" month, and the 11th best start to a new year since 1950. Further, there were comments starting that stocks were entering a Super Bull cycle. Since that January 26th high, market volatility rose along with investor emotions. In fact, as we write this commentary, the market experienced a nasty two day combo - Friday with Monday – and since January 26th is off about -8%. This drawdown is the first -5% or more experience in 24 months (not since January-February 2016), a span of over 400 trading days. We were due for a pause that refreshes. Some consolidation should be expected. Super BULL questions – is the current market action "feeling" like "bull-ony" optimism with this commentary title; and/or, is this the start of something more sinister?

The drawdown of the moment is consistent with the recent historical surge. The pullback is appropriate, and it is likely a "pause that refreshes" from a pace that is/was not sustainable. We do not expect a swift decline in stocks to "bear" market levels (down 20%), but would not be surprised by the decline extending a bit further to -10% (plus or minus). It's never fun to get "slapped" around. Yet, drawdowns are a reminder that even great market up-trends will have their share of uncomfortable moments. Also, recall that historically February has a reputation for choppy performance. While the quick rise in bond yields (more on this in a moment) is creating the increased stock market volatility and current stock market decline, the underlying economic data remains firm. When combined with tailwinds from tax reform, stronger economic fundamentals should help push stock earnings higher. Thus, from where we sit, underlying economic fundamentals did not suddenly change.

Synchronized global growth with low inflation was the backdrop powering the rally in domestic and foreign stocks in 2017. Client portfolios continued to advance in January on these same themes - establishing new highs with the stock market. Both domestic large company and foreign stocks provided the largest performance returns for portfolios. Bonds generally held back portfolio performance as interest rates moved up (and bond prices dropped) because the economy was showing synchronized global growth.

Style	January
S&P 500	*+5.7%*
Large-Cap Stocks	+5.5%
Foreign Stocks	+5.2%
Avg US Stock Fund	+4.4%
Mid-Cap Stocks	+3.3%
Small-Cap Stocks	+2.4%
Barclays Bond Idx	-1.2%

Client Objectives (Stocks/Bonds)	January
20/80	+0.6%
35/65	+1.1%
50/50	+1.7%
65/35	+2.7%
80/20	+3.7%
95/5	+4.4%

Super Bull* or super-cycles are made from growth with moderate inflation. These are current market ingredients. There existed 3 super bull markets in modern times – the Roaring 20s, Japan Bubble years, and the US Tech Bubble – each displayed similar economic backdrops of solid growth and moderate inflation. The average economic growth during those events spanning at least 4 years was +4.5%, and the average inflation increase was +1.1%. The 3 super bull markets in modern times all ended with inverted yield curves (short interest rates rising to higher levels than long interest rates), by -200 basis points on average. So participants did have at least one very reliable barometer for when the party was nearing its end; the yield curve presently remains positive. The Roaring 20s super bull market more than *tripled* in its last 5 years, and its P/E was roughly 30x. The Japanese super bull market also more than *tripled* in its last 5 years with its P/E expanding to 70x. And, the Tech bubble (of 1990s) *tripled* in its last 5 years with the P/E *(continued…)*

nvest
WEALTH STRATEGIES
Delivering financial peace of mind.

CONTACT US:

10268 Sawmill Parkway
Powell, Ohio 43065
614.389.4646

WWW.NVESTWEALTH.COM

climbing to roughly 30x. But, did you know that each of these exceptional bull market experiences included some dramatic market drawdowns along the way?

During these 3 Super Bull markets there were 18 declines of -7% or more, with the 3 biggest declines being -17%, -19%, and -21%. During the Roaring 20s, there were 7 declines of -8% or more (including -17%); during Japan's super bull, there were 3 declines of -12% or more (including -17% and -21%); and the Tech Bubble experienced 8 declines of -7% or more (including drops of -16% and -19%). Super bull market experiences are *not* just straight up runs to "irrational exuberance"; there are often emotional moments wherein investors "feel" the bull market is dying.

The market today is supported by improving synchronized global economic growth with generally low interest rates resulting from low inflation. Economic reports around the world continue to come in on the strong side, not in any way deteriorating or signaling recession. In recent days, wage earnings are rising and creating the immediate market worry about inflation – how will the Federal Reserve, headed by a new Fed Chairman Powell, react to this early tell-tale for inflation? Will the Fed react faster with small interest rate increases; will they react too aggressively, responding too much and/or too fast? That is the current worry, creating a little interest rate hic-up. Very often, a new Fed Chair is tested early by the financial markets to determine their resolve. As mentioned earlier, bond yields are anticipating rising interest rates and Fed reaction thereto. Since the start of the year, the 10-year Treasury rate rose to over 2.8% (from 2.4% at year-end); the speed of the rise spooked investors. As rates rise, bond prices fall.

Unsurprising then that January bond performance was soft, and one might continue to expect the 35 year bull market in bonds is probably over. Because of soft bond returns resulting from fear of accelerating inflation, stock market selling over the last few days was indiscriminate. Selling was positional, likely a temporary unwind of short volatility trades, even as credit conditions remain easy. Yet, we do *not* observe a shift in the macro-economic backdrop. Indeed, 2018 will likely provide an economic growth that is better than the short-term market experience.

Ponder these recent comments by renowned individuals:

(CNBC) – "Warren Buffett urges financial optimism in his latest essay. The game of economic miracles is in its early innings." A recent NY Times lead story, "A wave of optimism has swept over American business leaders,… This newfound confidence was initially inspired by regulatory pullback; a freeze on new regulations, in particular, appears to buoy confidence." Also, "workers' paychecks are being adjusted for lower taxes (and higher take-home pay), is akin to giving nearly every worker in America a raise at the same time. Tax cuts boost economic growth." Jamie Dimon (JPMorgan Chase), "it's possible to hit 4% growth this year and 3% long term." Lloyd Blankfein (Goldman Sachs), "animal spirits are more vital, and I think a 3% economy is doable." Ray Dalio (Bridgewater Associates) stated, "a market surge is ahead. If you're holding cash, you're going to feel pretty stupid." And Jeremy Grantham (long known for bearish views) said, "I recognize that this is one of the highest-priced markets in history. On the other hand, as a historian of great equity bubbles, I also recognize that we are currently showing signs of entering the … melt-up phase of this very long bull market." Since the tax cut passage at year end, over 250 companies announced cash bonuses or raised wages for their hourly workers. And, the WSJ wrote, "the tax law is roaring through US companies, with large and small dusting off once-shelved plans, re-evaluating existing projects, and exploring new investments in factories and equipment." Evidence continues to build that we are entering a new era (after 10 years of below normal) of economic growth.

Yes, we remain constructive on growth - stock investments. Foreign stocks offer better valuation than domestic, and value styles offer better valuation opportunity than growth. The recent correction is not a set-up to get bearish and already the market is the most oversold since the 2015 Flash Crash. We should remain watchful about the synchronized global economic backdrop – watching for inflation acceleration that would trigger central bankers to respond with higher interest rates too fast and too much. The end of bull markets arrive when 3 things happen: 1) an inverted yield curve always occurs; 2) a surge in junk (high) yield bonds always signals the end; and 3) a recession typically marks the S&P peak. None of these 3 indicators exist at this time. We never experienced a recession when company earnings were growing. Interest rates and inflation are the key watching points. Each of the 3 super bull markets (discussed earlier) and other market peaks displayed these 3 triggers to bring an end to the bull run. A couple of government policy items are also appropriate for monitoring: 1) trade will be the big issue of 2018, maybe causing geopolitical risks to feel like they are rising (ie: tariffs); and 2) the age of austerity is over, with increased levels of government spending.

Peter Lynch, famous portfolio manager for Fidelity Magellan (between 1970 and 1990 when he averaged over +29%/year) recently warned, "far more money is lost by investors preparing for corrections, or trying to anticipate corrections, than is lost in corrections themselves." Maintain a longer view toward investing, keeping in mind that your investment objective was determined because it supports your financial goals. Keep your portfolio focus for the long term, knowing that short term risk disappears with the passage of time.

*Super Bowl, or Super Bull means the market is "flying high like an Eagle". Or (another wacky laughable), "foreign is cheaper valuation (better to own), and it's not time to be a Patriot."

Nvest Wealth Strategies, Inc. | ***Delivering financial peace of mind.***

www.nvestwealth.com

10268 Sawmill Parkway

Powell, Ohio 43065

Ph: 614.389.4646

Fax: 614.389.4646

Email: info@nvestwealth.com