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A Balancing Act

Summary

- ***The stock market has been in a sustained uptrend since March 2009 and is likely to continue higher over time as the new Tax Cuts and Jobs Act boosts corporate profits.***
- ***In the near-term the market is overextended in both valuation and price, increasing the likelihood that a correction will occur in the 2018/2019 timeframe.***
- ***Fixed income returns will continue to be dampened as the Federal Reserve ratchets up interest rates over the next 24 months in an effort to control inflation in a strong economy.***

The past year was one of the most extraordinary years in stock market history. The market's strength was felt by most people, including many who do not own stocks. Words such as "parabolic" and "epic" were used in the press to describe the market's vitality, and price charts of the stock market clearly showed strong momentum. Strength of this kind is always welcome to those of us who manage long-only portfolios for clients. It has meant that clients have had the benefit of a strong overall market at their backs.

But in the midst of this bountiful environment, the prudent investor must ask the unpopular questions: How long can this ever-upward trajectory continue? How far will the stock market go before we see a significant retreat? And how can I protect my portfolio from significant loss should there be a downturn?

What to Expect in 2018

The new tax bill recently passed by Congress and signed into law by the president will have an impact on the stock and bond markets in several ways, although the bill's ultimate beneficiaries may only be known over time

The permanent reduction of the corporate tax rate from 35% to 21% will mean that corporations will be able to pass along more of their profits to shareholders by way of dividends or share buybacks, or to use those profits to strengthen future earnings prospects via new investments in factories, facilities, and technologies, or by hiring new workers. The increased profit potential could translate into higher share prices. For those Americans who own common stocks, equity mutual funds, or equity ETFs this would mean a direct boost to their investment portfolios.

If, however, companies choose to keep their tax savings for some future use or to pay managers higher salaries and bonuses with no direct benefit to shareholders then the tax bill will have minimal effects on stock market gains in the near-term. The bill provides no mandates to corporations for the use of their tax savings.

Corporations currently hold almost $3 trillion in overseas accounts as a way to shelter these assets from the IRS. Under the new tax bill, companies now have an inducement to repatriate those dollars to the U.S at a low rate of 15.5%. This new incentive, in combination with lower corporate tax rates, could motivate firms to invest in expanding their businesses. As an indication of healthy business prospects, increased capital spending could give a further boost to stocks.

On the personal tax side, the new law gives a significant tax break to high income earners by reducing the top personal rate from 39.6% to 37%. While the difference may seem insignificant, the nonpartisan Tax Policy Center estimates that it will boost the after-tax income of this group by +2.4% in 2018, although the benefits decline over time. These individuals and families are more likely to invest tax savings into stocks, bonds, other investments, existing businesses, and new business ventures, than to spend it on immediate consumption. That makes this part of the tax law potentially accretive to investment returns.

The Tax Policy Center further estimates that, on average, the new tax bill will give a +1.6% after-tax pay raise, or roughly $1,200, to a broad range of taxpayers in this country, most of whom are middle class earners. This group is more likely to spend their tax savings on goods and services than to invest them for the long-term. As a result, increased consumer spending could generate higher profits for American companies, while increased consumer sentiment could translate into sustained positive investor sentiment for the stock market.

Counter-balancing the new tax code's considerable economic stimulus in 2018 and 2019 will be the Federal Reserve, which is likely to raise interest rates. The Fed's mandate is to ensure price and employment stability in the U.S. by adjusting interest rates up and down as its Board sees fit, based on economic conditions and other factors. With unemployment now at multi-year lows, and with inflation below the Fed's 2% target, the economic adrenaline provided by lower taxes over the next two years will almost surely force the Fed to increase interest rates by significant increments in that timeframe in order to prevent the economy from overheating and entering a recession. Additionally, since the tax cuts are financed by deficit spending, the Federal government will need to borrow more in order to finance the functioning of the government. That will add upward pressure on interest rates and partially offset the positive effects of the tax cuts on corporate activity.

Steadily rising interest rates will eventually have a dampening effect on the stock and bond markets as well. However, in an environment where the Fed Funds rate currently stands at 1.5% there is a low probability that equity returns will be muted solely on the basis of the current interest rate level. The Fed Funds rate is simply not high enough to impede either corporate or consumer borrowings, which are the lifeblood of the American economy. However, Fed Funds rate increases toward the 3% or 4% levels would be more influential in slowing economic activity and helping to precipitate a recession. One relevant factor among several that the Fed watches as it decides on a course of action is wage growth. That metric remains low at about 2.5%. If it accelerates materially over time, then we could expect the Fed to increase rates more aggressively.

Stock Market Valuations are High and Continue to Trend Higher

While change is the operative word in the realms of tax law and interest rates these days, the outlook for stock market valuations continues to be more of the same: persistently high.

The chart of the Shiller P/E below shows that this long-term valuation metric continues to climb higher. It now stands at 33 times trailing 10-year earnings which puts it at double its historical median value of 16 times. In other words, as a shareholder of the broad market you now have to pay $33 for each $1 of the market's earnings, versus paying $16 on average in the past for the same $1 of earnings. The market has become much more expensive, thereby raising the risk that investors will sour on stocks when they perceive that prices are too high relative to earnings. The Shiller P/E has not yet exceeded its year 2000 high, but it has gone well beyond its 2007 level at this point, necessitating continued watchfulness. As you may recall, the years 2000 and 2007 were each the starting points of deep bear markets that took stocks down by more than 50% each time.

As I have noted in my previous letters, high valuations can persist for long periods of time even as the stock market continues to rise. That's what we are seeing now.

The Probability of a Correction Is Increasing

The stock market's high and persistently rising valuations foreshadow a correction. Unfortunately they offer no definitive clue as to timing. Stock market indicators such as the Dow Jones Industrial Average or the S&P 500 Index, as well as many prominent individual stocks have also become over-extended in terms of price and now stand well above their long-term averages.

Under this scenario, the concept of "reversion to the mean" is one that is worth remembering. It is a valid and useful concept to understanding stock market trends. Over time, stocks tend to revert to their long-term average, or mean prices. A market such as the one we now have, over-extended relative to its secular mean is a market that is at risk of reverting to its mean. In other words, it is at risk of declining.

In the stock market models that I maintain, both the Dow Jones Industrial Average and the S&P 500 Index stand approximately 20% above their long-term mean values. As a conservative approximation, they could be expected to decline by 20%, plus or minus, if a correction were to occur today. While the certainty of this method is not cast in stone, it does offer a guide to anticipating the depth of a future correction.

Prudent Investing Is a Balancing Act

It's helpful to occasionally revisit the definition of the term "investment" as a reminder of the endeavor before us. Investopedia.com defines an investment as "an asset or item that is purchased with the hope that it will generate income or will appreciate in the future." In other words, investing by its very nature is a speculative act where risk and opportunity must be weighed and balanced.

Recently, I have noticed a kind of stock market euphoria among some of my fellow investment advisors. Usually I see this among retail investors, but not this time. One prominent advisory firm has ramped up their recommended equity allocation from a lofty 80% to an even loftier 85%, while another major firm has advised clients to buy riskier small caps and emerging market stocks in an effort to squeeze the last few ounces out of the stock market. If followed, both strategies would increase a portfolio's risk level at a time when the stock market is expensive. Ironically, both advisory firms expect a correction in the foreseeable future. From my perspective, these strategies lack balance.

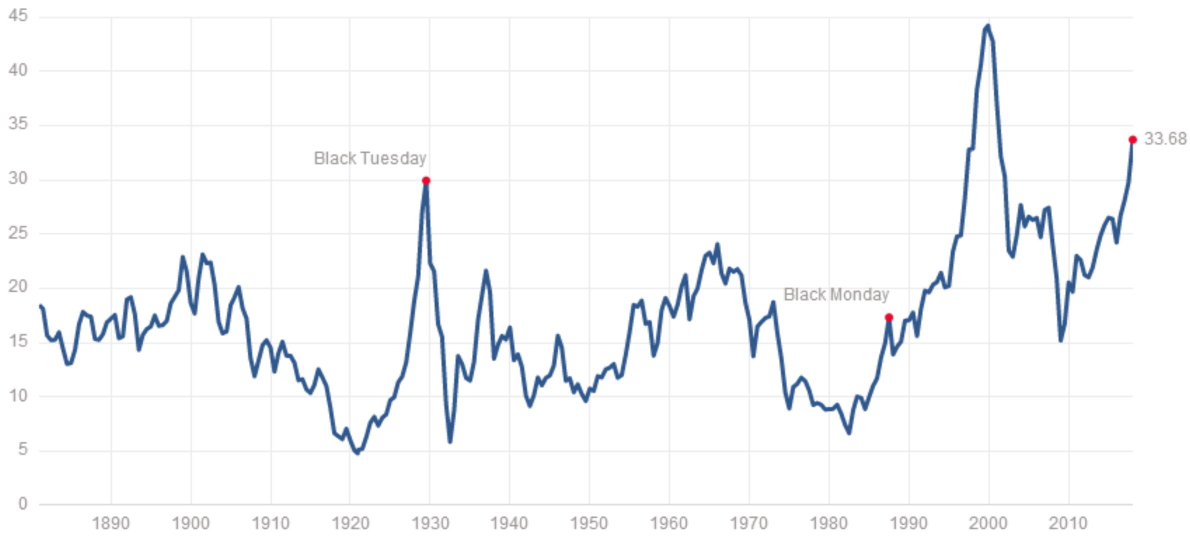
Stick to Your Knitting, and Mind Human Nature!

My view is that chasing returns prior to an anticipated correction is an imprudent exercise that is more akin to trading than investing. The more sensible approach is to be committed to a long-term, rational and time-tested process that allows participation in the market's rise while also positioning for a possible downturn. A willingness to balance the impulse for more-gains-at-any-price, with the knowledge that what goes up, must come down, is one of the pillars of sound investing.

As the new tax bill takes effect, we can expect corporate profits to rise in 2018/2019, and shareholders to benefit from increased dividends and share buybacks. With both valuations and prices currently stretched, a correction is a distinct possibility on the road to higher stock market levels.

Beyond earnings, human nature and mass psychology govern the cycles of the stock market. The laws of human nature are as immutable as the laws of physics. Both proceed in patters, with one pattern following another: greed and fear; expansion and contraction; rise and fall. The great investor, Sir John Templeton believed that "Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria". As the stock market stands today, we are in the optimism phase of mass psychology. When we reach euphoria it will be clear to all – headlines in the press, chatter at cocktail parties, banter at the office water cooler all will focus on the ease with which profits have been made in stocks. We are not there yet, but knowing human nature, we anticipate its eventual arrival.

V. Henry Astarjian



Source: multpl.com, Shiller P/E

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