



Jack Way
Vice President

“By The Way”

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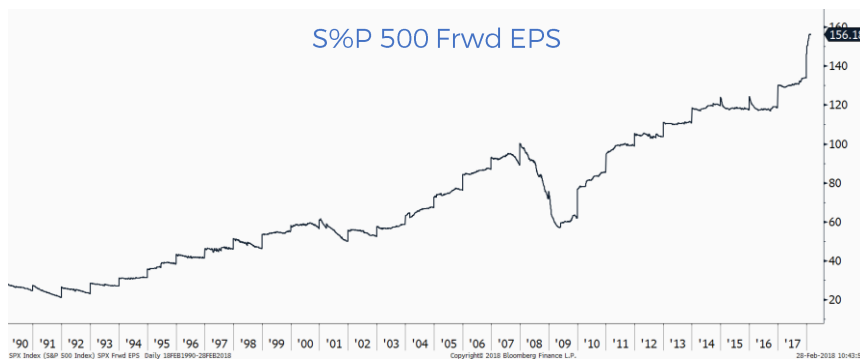
“Monetary policy has been carrying the load for years, but now we also have fiscal and regulatory policies helping to drive U.S. growth”

I quoted investment legend, Bob Farrell, in our last letter, specifically that markets don't correct by going sideways. But I don't think he, and certainly not I, foresaw the violent gyrations we experienced, and continue to experience. While we did point out that the Dow Jones and S&P indices had overextended themselves, and bullish sentiment had risen to historic highs (a sign of complacency), the 11.8% correction in the market over the course of only 10 trading sessions was a stunning surprise. There is little question the stock market had become overbought, but investment esoterica such as algorithmic trading and double inverse ETN's played a big part in the extent of this decline and the extreme intraday volatility. It was relatively easy to write last month that a 10% correction would be “unpleasant” but not negate this bull market. It has been another thing entirely to endure the reality of such savage volatility without losing one's resolve. Nevertheless, despite being shaken by recent market action, we have survived and have not, as yet, thrown in the preverbal towel. History tells us that movements against a prevailing trend are sharp and short in nature, such as we have just experienced. The current rebound has provided a measure of relief, but more time is required before we will be totally convinced that all is well. A bottoming process needs to take place which might well include a test of the recent lows on the S&P 500. We will analyze the market action during this period in hopes of divining whether a major change in trend is in the offing or a reacceleration will take us to new highs. I cautiously remain in the latter camp.

It is more than a little ironic that after years of relatively weak GDP and earnings expansion, that global economies and corporations are now experiencing much stronger growth, yet markets have become more fragile. As we have opined with regularity, much of the fuel for this bull market has come from the excess liquidity provided by the world's central banks and their efforts to push interest rates to unnaturally low levels. Consequently, many experts argue that as rates rise and monetary ease is moderated or becomes negative, it is to be expected that markets will fall in concert. I agree with that point of view, but what is worthy of debate is when (not if) the effects of higher rates will impact the economy and markets. A look at the history of the S&P 500 indicates that in fact interest rates and equities rise in concert along with the business cycle until rates reach a point that cools business and consumer confidence and a recession is foreseeable. I would suggest we are not there yet.

The factors that keep me in the bullish camp are for the most part fundamental in nature. That is to say the stock market will climb higher on the backs of much improved global economics and company earnings. The U.S. economy, in particular, is reporting GDP growth rates in the 3-4% range after years of 2% or less. There is potential for even more strength given the provisions of the tax reform bill recently passed by Congress. We are already seeing positive results as corporations have announced new bonuses, capital expenditure plans, and intentions to repatriate foreign cash holdings. Monetary policy has been carrying the load for years, but now we also have fiscal and regulatory policies helping to drive U.S. growth. Globally, GDP reports remain strong almost across the board, and forward-looking releases such as The Purchasing Managers Indices and Leading Economic Indicators continue to be expansionary and supportive.

On the corporate front we have been saying for a long time that market valuations were becoming high and monetary policy less effective and that we needed the growth of E in the Price/Earnings ratio to be much stronger and move us from a liquidity driven market to an earnings driven market. Recent results are doing just that. Consensus S&P 500 estimates for 2018 have risen to \$156 per share, up from \$145 only 3 months ago. At that level of earnings, the index P/E multiple would be in the mid 17 range, a much more attractive valuation. And while forecasting 2019 earnings is a mugs game, it is good to see consensus is estimating a further 10% growth. It was also reassuring to see that in the latest reporting period, according to the Bespoke Investment Group, 69% of companies beat earnings estimates and 73% beat on the revenue line.



Therefore, I will be paying close attention to the market as it goes through a consolidation/bottoming process, looking for renewed internal strength. Once I get some comfort we are on firm ground technically, I will rely on the strong fundamentals to take equities higher. Of course, the great caveat is that markets were strong when fundamentals were soft, so we must be cautious even though fundamentals are now stronger.

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