It's Never One Thing

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We are amused when commentators cite just one factor for a market movement because there's almost always a confluence of factors influencing the markets at any one time.

For the recent correction some are blaming the increased prevalence of passive investing which they suggest has heightened the correlations of stocks and magnified their movements—forced indiscriminate buying on the way up and the opposite on the way down. Others argue that algorithmic trading is to blame.

It didn't help that congressional leaders reached an agreement that would increase the deficit by well over $500 billion. Or that the market was dealing with a new Fed chair, Jerome Powell, who was sworn in February 5.

After a prolonged period of risk taking, the risk switch was abruptly turned off. Nearly everything was falling in the recent correction. Stocks in general declined, virtually regardless of country or sector. Even utilities and golds, normally counter-cyclical groups, along with most commodities such as oil and gold bullion, selling off too. Correlation of the S&P 500's 11 sectors was recently at its highest level since the fall of '16.

If we were forced to pinpoint the primary impetus for the correction, we'd have to blame the rise in interest rates where the 10-year U.S. Treasury had jumped from a low near 2% last September to just below 3% recently. As rates rise, bonds become a more competitive asset class to stocks. And January's hourly wage rise was 2.9%, the biggest year-over-year rise since June '09, as the labour market tightened. So, inflationary concerns surfaced impacting anticipation of even higher interest rates.

That Was Something

Prior to the correction, the U.S. market experienced a period of over 400 trading days without a 5% drop in stock prices from the previous high—the longest such streak in market history with investor sentiment at historical highs. And the ascent steepened in December and January especially after the U.S. tax bill was passed in late December and its positive implications were being priced in—forward earnings estimates for the S&P 500 spiked about 8% in just 8 weeks. And there were pockets of excesses, for example, the crypto currency market which more than tripled in about 3 months until greed turned to panic.

Profit taking took place in the stock market too as the market just moved too far too fast leaving it susceptible to decline. Once selling begins, it often begets further selling which eventually leads to an oversold condition as markets move too far too fast to the downside.

This correction was likely caused, not by one thing, but by a combination of all of the above. 2

It's Always Something

There's always something to be concerned about. The world is complex. It's our task to distill the plethora of information in order to form opinions on the direction of markets, sectors and individual securities. To deal with the complexities, we've been using our two macro models since 2010. From a bottom-up standpoint, we focus on the highest quality bargains we can find.

The market is right to be concerned with the economy, interest rates and inflation. That's what drives corporate values and in turn share prices. Interest rates have been rising, both at the administered short end, driven by central banks normalizing rates after a very long period of low rates designed to stimulate growth, and at the long end as the bond market reacts to the Fed's actions and anticipates economic excesses.

Excessive growth leading to higher rates of inflation should be the primary concern. Some early signs of this are already present with wages. And government debt levels are almost certain to escalate from lower tax receipts and higher spending that the politicians refuse to rein in. Social Security and Medicare expenditures appear much too high at half of the annual budget deficit and growing. The Congressional Budget Office has forecasted that the U.S. budget deficit is on course to triple over the next 30 years, from 2.9% of GDP in 2017 to 9.8% in 2047. The budget deficit as a percent of GDP is expected to double from '15 to '19. Only with Trumponomics would one have seen enormous tax breaks and other fiscal stimulus in the form of a massive infrastructure bill when the economy is rolling along and unemployment at a 17-year low.

The good news is that this ought to prolong this cycle even further. Lower corporate taxes and the lower U.S. dollar have made the U.S. more competitive which should also attract capital from abroad—both from repatriation by domestic companies and from foreign corporations. U.S. growth should uptick. And worldwide too. The International Monetary Fund raised its estimate for '17 global growth to 3.9% from 3.7%. There appears to be synchronized growth too with most nations around the world growing. Most central banks remain accommodative and while interest rates around the world are rising, they are still historically low and are expected to increase gradually. Global credit is also abundant. China's record-setting loan data continues to make a case for spurring global growth. The bad news is that all of this won't likely end with a whimper.

What's the risk in the meantime that accelerating economic growth creates excessive inflation? It may take some time because of the overriding disinflationary multi-year trends from prevailing demographics—aging populations—dampening consumer demand pressure and the digital age which acts in many ways to keep consumer and producer prices under wraps. While the PCE price index figures are picking up, running at 1.8%, it's still below the Fed's target 2%.

At the corporate level, revenues are rising and profit margins are at record levels, both boosting earnings and overall values. Sales and earnings results have been coming in above average rates ahead of estimates. While some of the valuations of the market favourites appear to be overvalued and scare us, those market darlings are still reporting excellent fundamentals with Netflix, Nvidia, Amazon, Tesla and others continuing to produce metrics ahead of expectations.

Overall stock market valuations are elevated—at or above fair value. So the medium-term outlook for stocks in general is not favourable. At this stage we feel that bottom-up stock picking is essential to help offset the risk of holding positions that might be impacted unduly by negative revaluations. 3

Here's The Thing

Stock market declines rarely turn into bear markets without the presence of a recession. And recessions are normally spurred on by a tightening of monetary policy—sufficient to invert the yield curve (where short rates are administered higher than long rates)—which then leads to economic declines. There are still no signs of that today.

There's a reason that what we just witnessed is typically called a correction—it's a lesser setback than a bear market, and is temporary in nature as it brings the market back down from an extended level.

Bear markets tend to begin before the economy begins to decline. That's why we constructed our macro tools to anticipate economic peaks. Since we are still mindful of the elongated economic cycle, we continue to closely monitor our proprietary tools for the next bear market. Our Economic Composite (TEC™) is not alerting us to a recession. Similarly, our market momentum indicator (TRIM™) is not suggesting an imminent bear market. Should our tools suggest caution, we would attempt to exit positions and hedge (where authorized by client accounts) in order to limit the impact of a significant market decline.

Though the monetary stimulus is waning (higher interest rates and bond sales to shrink the Fed's balance sheet), the U.S. fiscal stimulus (significant corporate tax rate reductions and accelerated deductions for capital expenditures) should help propel the economy forward making a global recession less likely and allowing us to be more comfortable about being fully invested.

It's certainly possible growth could downtick later in '18 or early '19 as the normal U.S. and global inventory cycle causes a slackening. However, any inventory correction should not lead to a recession as long as it's met with central bank easing.

So we continue to analyze companies where we see competitive advantages and expect consistent growing earnings streams—the ones whose businesses have strong operations and financials (with a view to mitigating losses) and FMVs (fair market values) that are persistently growing. And when for any number of reasons, due usually to a temporary operational setback, the share price has fallen sufficiently below our estimate of FMV, we look to purchase. And we prefer to sell when positions rise to our FMV, especially when they coincide with ceilings in our TRAC™ work because we then become fearful of potential declines.

Our preference, as long as we can find a sufficient number of undervalued companies—stocks trading 20% or more below our estimated appraised values—is to be fully invested.

We Do Know One Thing

Last quarter we noted that market expectations were high and that an outsized correction could arrive spurred on by unanticipated events. The recent correction was welcomed as it allowed us to put more cash to work because several securities we had been following fell to our buy targets. Meanwhile, earnings estimates have taken off, with assistance from the U.S. tax bill. At the same time, inflation may be picking up, and therefore interest rates too, but they remain at historically low and seemingly manageable levels. And the government authorities appear to want to react gradually to any acceleration in growth and inflation.

Who knows, as some foresee, perhaps we're headed for a global melt-up before the party is over. We aren't counting on that but are aware that it's occurred in the last few cycles as euphoria can set in prior to the peak.

Because the economic cycle is protracted and stock market valuations full, we continue to closely monitor our overall market risk tools in an attempt to peg the end to this bull market. TRAC™, TEC™ and TRIM™ were designed to predict recessions and market panics that accompany negative growth. Alerts have not yet triggered; therefore, we continue to hold shares, and buy others, as long as they're trading below our FMV estimates. We are pleased that we were able to buy a number of new positions recently which met our criteria—well managed, high quality enterprises with ever-growing earnings protected by competitive advantages, appropriately leveraged balance sheets and at sufficient discounts to our estimates of their intrinsic value—with the confidence that the current economic cycle has not yet come to an end.

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