New Albany
Investment Management

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2017, A Green Record Never Seen Before. 2018, More Red Likely

In this season of celebration of God's love, we so often see colors of Green and Red. Though these colors have a broad span of meanings in both religious traditions and the natural world, they give a very specific and immediate meaning to anyone who looks at the financial markets. 2017 has been a year of all Green, giving investors twelve months of uninterrupted monthly gains and setting a record never seen in 90 years of data. Anyone who has followed the markets for a while, knows this cannot last. Many people are asking: **When, How, and What will break the streak of Green?** The chart below shows monthly performance of the MSCI AC World Index (a broad measure of large and mid-cap stocks in 47 countries) since 1988. Assuming December is another Green month, this will be the longest stretch of Green.

Longest consecutive run of Green

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sept	Oct	Nov	Dec
2017	2.7%	2.6%	1.0%	1.4%	1.9%	0.3%	2.7%	0.2%	1.8%	2.0%	1.8%	
2016	-6.1%	-0.9%	7.2%	1.3%	-0.2%	-0.8%	4.2%	0.1%	0.4%	-1.8%	0.6%	2.0%
2015	-1.6%	5.4%	-1.8%	2.7%	-0.4%	-2.5%	0.8%	-7.0%	-3.8%	7.8%	-1.0%	-1.9%
2014	-4.1%	4.6%	0.2%	0.7%	1.8%	1.7%	-1.3%	2.0%	-3.4%	0.6%	1.5%	-2.0%
2013	4.5%	-0.2%	1.6%	2.6%	-0.6%	-3.1%	4.7%	-2.3%	5.0%	3.9%	1.2%	1.6%
2012	5.7%	4.8%	0.4%	-1.4%	-9.3%	4.7%	1.3%	1.9%	2.9%	-0.8%	1.1%	2.1%
2011	1.5%	2.8%	-0.3%	3.9%	-2.5%	-1.7%	-1.7%	-7.5%	-9.7%	10.6%	-3.2%	-0.3%
2010	-4.4%	1.1%	6.2%	0.0%	-9.9%	-3.1%	8.0%	-3.7%	9.4%	3.5%	-2.4%	7.2%
2009	-8.6%	-10.0%	7.9%	11.5%	9.5%	-0.7%	8.7%	3.4%	4.4%	-1.6%	3.9%	2.0%
2008	-8.3%	0.1%	-1.7%	5.3%	1.2%	-8.3%	-2.7%	-2.4%	-12.7%	-19.9%	-6.8%	3.5%
2007	0.9%	-0.7%	1.8%	4.2%	2.7%	-0.4%	-1.6%	-0.5%	5.2%	3.8%	-4.6%	-1.2%
2006	4.9%	-0.3%	1.9%	3.2%	-4.2%	-0.2%	0.6%	2.4%	1.0%	3.7%	2.6%	2.1%
2005	-2.2%	3.3%	-2.4%	-2.4%	1.6%	0.9%	3.6%	0.6%	2.9%	-2.8%	3.5%	2.4%
2004	1.6%	1.7%	-0.8%	-2.5%	0.5%	1.9%	-3.3%	0.4%	1.9%	2.4%	5.3%	3.8%
2003	-3.0%	-2.0%	-0.7%	8.6%	5.5%	1.7%	2.1%	2.2%	0.5%	5.9%	1.4%	6.2%
2002	-2.8%	-0.9%	4.5%	-3.5%	-0.1%	-6.3%	-8.5%	0.1%	-11.1%	7.2%	5.3%	-4.9%
2001	2.5%	-8.5%	-6.9%	7.1%	-1.4%	-3.2%	-1.7%	-4.8%	-9.3%	2.1%	6.0%	0.9%
2000	-5.5%	0.2%	6.5%	-4.6%	-2.7%	3.3%	-3.0%	3.0%	-5.6%	-2.1%	-6.3%	1.6%
1999	1.9%	-2.6%	4.4%	4.2%	-3.7%	4.9%	-0.5%	-0.2%	-1.2%	4.9%	3.0%	8.2%
1998	2.1%	6.7%	4.1%	0.8%	-2.0%	1.7%	-0.1%	-14.2%	1.8%	9.0%	5.9%	4.5%
1997	1.5%	1.2%	-2.2%	3.0%	5.8%	5.0%	4.4%	-7.1%	5.2%	-6.1%	1.4%	1.2%
1996	2.1%	0.2%	1.4%	2.3%	-0.1%	0.4%	-3.9%	1.1%	3.5%	0.2%	5.2%	-1.6%
1995	-2.2%	0.9%	4.4%	3.4%	0.9%	-0.2%	4.7%	-2.4%	2.6%	-1.8%	3.0%	2.8%
1994	6.5%	-1.6%	-4.7%	2.5%	0.4%	-0.7%	2.0%	3.4%	-2.5%	2.4%	-4.5%	0.2%
1993	0.1%	2.2%	5.5%	4.3%	2.5%	-1.2%	1.9%	4.6%	-1.8%	2.8%	-5.4%	5.2%
1992	-1.7%	-1.7%	-4.7%	1.1%	3.6%	-3.8%	0.1%	2.0%	-1.1%	-2.7%	1.5%	0.7%
1991	3.5%	9.2%	-3.5%	1.1%	2.2%	-6.3%	4.6%	-0.4%	2.3%	1.5%	-4.5%	7.2%
1990	-4.8%	-4.4%	-6.4%	-1.5%	10.2%	-0.9%	0.8%	-9.6%	-10.7%	8.9%	-1.9%	1.9%
1989	3.4%	-0.8%	-0.7%	2.3%	-2.5%	-1.6%	11.1%	-2.5%	2.8%	-3.4%	3.8%	3.1%
1988	2.3%	5.6%	2.9%	1.1%	-2.1%	-0.3%	1.7%	-5.7%	4.1%	6.4%	3.2%	0.7%

When will this Bull market end? Nobody knows "When" this bull market will end. But "How" and "What" will end the Bull market is perhaps more straight forward.

Bull markets end when an asset bubble bursts or the business cycle comes to an end. Today, many market gurus and investors alike are concerned the rapid gains in the market are creating a bubble and a crash could ensue. They cite the two previous market crashes in 2000 (Dot.com) and 2007(Real Estate). In both of these previous cases, the bursting bubble was a result of extreme over pricing, leverage, and corporate corruption. **Today however, there are no real asset bubbles (Bitcom not included) or over leveraging.** And with the heavy regulation, corporate corruption has been stymied. In fact, most of the global financial markets are quite healthy from both a leverage and liquidity standpoint, and <u>none are in bubble territory</u>. The current rise in price is broad base by both country and asset sector, and it is supported by true organic growth globally.

Thus, this current bull cycle will not likely end in a crash, but it will fizzle when it is perceived future growth will be slower and earnings growth is capped. So the big question is….**Will growth and earnings continue to accelerate in 2018?** Let's take a look at the data and its potential impact on the stock and bond markets. (Source: Charles Schwab and JPMorgan)

Economy: Economic data continues to improve with the US and Europe leading the pack.

- US Growth still accelerating and now above 3%, a level not seen since 2004. Main inhibitor to future growth is low unemployment of 3.9% which will put pressure on wages. With a tight labor market, inflation can accelerate.
- EU Growth currently at 2.2% and expected to accelerate to 2.6% in 2018. Low capacity utilization rates and high unemployed means plenty of room for growth to accelerate.
- Global Economy: 2017 growth at 3.5%; 2018 growth expected to accelerate to 3.7%. It has been a decade since the lift to the world economy was this broad based.

Market Impact: **Accelerating growth is a big support for further earnings gains. In particular, with more slack in capacity overseas, foreign markets could outperform the US. Inflation is likely to creep higher, especially in the US.**

Interest Rates: Rates are gradually rising, Monetary Stimulus declining.

- In the US, the Fed is expected to raise short term rates at least two to three more times next year to 2%. In addition, they are tightening policy by reducing their holdings of bonds which could push 10yr Treasury rates to near 3%, a level not seen in three years.
- The European Central Bank (ECB), though still keeping short rates low, is reducing its bond buying program, which will gradually reducing cheap liquidity in the long term.

Market Impact: **Rates will rise faster in the US than globally, resulting in a flatter yield curve. Potential head wind to US stock prices.**

Fiscal policy is becoming expansive both in the US and globally.

- US Tax reform is expected to pass. Biggest impact will be for businesses with the income tax rate falling to 21% from 35%. Lower taxes will give a boost to earnings and is projected to boost capital spending which in turn will spawn growth.

Market Impact: **2018 earnings will see an immediate positive effect and will be a big tailwind for stocks in the first half of the year; however, the impact on growth will not be realized until at least 2019. So the market could pause, (decline) while it waits for confirmation of growth.**

Earnings: Stock market gains have been supported by the steady rise in the earnings outlook. Earnings growth resumed in 2017, at 7.6%, after flat-lining in the preceding two years. For 2018, with the passage of the tax bill, earnings are expected to grow double digits!

Market Impact: **Strong earnings growth in 2018 should continue to boost stock prices.**

Valuation: In and of itself, **valuation never changes a market direction; it is a change in perception of the future that breaks a trend.** As Charles Schwab states: "It's all about mindset, crowd mentality and behavior, and it's clear this time is very different from the 2000 market bubble." The P/E today is 19.5 and the 10yr US treasury yield is 2.3%. In 1999/2000, the P/E ratio was about 26, and the 10-year Treasury ranged between 5.8% and 6.8%. The chart below shows the wide range of P/E ratios during different periods of inflation. Higher inflation means higher interest rates, but not necessarily lower P/E's.

1958-2016			
Inflation	Average P/E	Highest P/E	Lowest P/E
0 – 1%	16.3	20.9	11.7
1 – 2 %	17.0	20.6	13.1
2 – 3%	17.6	26.7	10.8
3 – 4%	16.0	20.7	10.1
4 – 5%	14.0	21.0	9.5
5 – 6%	14.9	20.2	8.2
6 – 7%	11.6	17.9	7.2
>7%	8.4	11.5	6.6

We are here

Source: Bureau of Labor Statistics, FactSet, Charles Schwab as of October 31, 2016.

Market Impact: **Rising earnings will help keep valuation in check.**

Current Bull not really that old: Though some argue the US bull market is long in the tooth, it could still be quite a while until the end is near. The chart below shows the length of both bull and bear markets. By comparison, the length of the current bull market (8.6yrs) is rather short relative to 18-19 yrs seen in the two most recent bull cycles.

Year	Market Milestone	Percent Change	Number of Years	Annualized Return, No Dividends	Annualized Return with Dividends
1877	Low	-	-	-	-
1906	High	400%	29.3	5.1%	10.1%
1921	Low	-69%	14.9	-7.5%	-2.0%
1929	High	396%	8.1	21.9%	28.4%
1932	Low	-81%	2.7	-44.9%	-41.2%
1937	High	266%	4.7	32.1%	38.7%
1949	Low	-54%	12.3	-6.2%	-0.8%
1968	High	413%	19.5	8.8%	13.3%
1982	Low	-63%	13.6	-7.0%	-3.0%
2000	High	666%	18.1	11.9%	15.3%
2009	Low	-59%	8.5	-9.8%	-8.1%
Now	-	196%	8.7	N/A	N/A

Bull Markets

Based on inflation-adjusted S&P Composite monthly averages of daily closes.

Source: Advisors Perspective, dshort.com

Here we are today

Investment Strategy for a new phase in the economic cycle: With fiscal policy now the main driver influencing economic growth in the US, the markets are just beginning to factor in the effects of a pro-business investment environment. It is hard to calculate at this juncture the impact of future capital expenditures, increased innovation and productivity. Though it should be positive, it will be less predictable, and hence 2018 should be more volatile. Outside the US, both developed and emerging economies still have a monetary policy leading the charge, and have a lot more capacity slack; therefore they can potentially see even greater growth than the US.

Investment Strategy: Two Changes were made: Increased exposure to foreign equities; Moved up the credit quality of bond holdings. The global markets should present many opportunities in 2018, but not without volatility. Thus a broadly diversified, global strategy is appropriate as it will help mitigate volatility. With growth expected to continue, equity exposure remains near the upper risk limit of each client's risk tolerance but with increased allocation to international markets. On the Bond side, allocation to higher quality bonds was made due to extremely narrow credit spreads (the difference between corporate and high yield).

These are my thoughts on the current market environment and investment strategy. As always, please contact me with any questions or concerns.

A special thank you to all my clients. It has been a privilege and joy to serve you!

To All, may love fill your heart and homes each day in the year to come!

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