The Investment Counsel Company

Investment Management Consultants

Quarterly Insights January 2018

As investors, we continually confront two questions: 1) what will happen, and 2) how will financial markets react? The most recent example is the tax reform rally, aka the "Trump Bump." The first anniversary of Trump's November 8th election resulted in a +21.2% stock market advance. It was the third best year ever for a change in presidential administration, behind John F. Kennedy's +26.5% and George H. W. Bush's +22.7%. "Letting profits run" continues to be the most profitable investment strategy, versus reducing or rebalancing stock exposure in response to the multitude of ongoing investor concerns. Many economists and Wall Street strategists agree that the bull market is well intact and should continue with little risk of a global recession anytime soon.

The consensus is that while 2018 may not be as strong as the spectacular rally of 2017, stocks can still finish the year in the range of +7% to +10%. Concerns continue that the market has not corrected or had any significant draw downs. Global equity markets are close to a year and a half without a 5% correction, the longest stretch in the leading global stock index 30-year history. In the U.S., the S&P 500 Index has now rallied for more than a year without even a 3% decline. That's the longest streak in 90 years of history! Thus, an increase in price volatility should be expected, yet is an insufficient reason to discourage longer-term investors. The most likely catalyst for larger stock market price swings is <u>disappointing corporate earnings,</u> temporarily falling below investor expectations. Typical corrections stemming from such an event fall into the -5% to -10% range before stocks resume their upward trend. Helping this year along is the recently passed tax reform legislation, which has the potential to boost corporate earnings in the near-term.

Although not as likely, another risk to financial markets is <u>interest rates increasing in response to rising inflation to the point where future economic growth is in jeopardy</u>. Investors are fearful because market corrections have often occurred when the Federal Reserve mismanages inflationary trends, resulting in global recessions. Even a -15% drop in stock prices would not be unprecedented under these circumstances. The Fed has clearly communicated its intent to raise short-term interest rates, five times so far during this cycle and three to four more times anticipated in 2018. However, rates are still historically low and past experiences do not reflect a noticeable impact to our economy until rates rise closer to historical norms. Currently, most data suggests that the end of this economic cycle is not in the near future, supported by low inflation and unemployment as well as solid economic growth.

An even less likely risk, but <u>no less concerning, is current domestic and global debt levels</u>. Debt in relation to the total value of goods and services produced (Gross Domestic Product or "GDP") is declining among many of the world's economies, partly due to strong economic growth. Nevertheless, debt levels remain stubbornly more elevated now than in the past. This additional financial burden weighs on long-term economic growth. Just a one percentage point increase in overall interest rates could mean $670 billion in extra debt service costs to U.S. citizens. So, the

Fed is confronting two major challenges: 1) higher debt results in lower rates of economic growth, and 2) our economy's prosperity is more sensitive to higher rates with elevated debt levels.

Avoiding complacency has always been essential to making and keeping money. This is why we must remain vigilant regarding market uncertainties in order to succeed at preserving and growing wealth. Although the future cannot be known, these are <u>three major known obstacles investors will encounter in 2018: sustainable corporate earnings growth, rising interest rates, and current debt levels</u>. The good news? With improving synchronized global economic growth and positive momentum, a healthy corporate profit outlook, and accommodative global central bank monetary policies anticipated for at least a while longer, the majority of indicators favor further stock market advances. Thus, the adage "it is a bull market until proven otherwise" seems to best sum up the base case scenario for 2018. We look forward to the inevitable opportunities and challenges in the capital markets, global economies and political environment.

On behalf of our staff, we wish you a healthy, happy, safe, and prosperous 2018!

Sincerely,

Randy Garcia
Chief Executive Officer

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10000 West Charleston Boulevard
Suite 280 • Las Vegas, NV 89135
P: 702.871.8510 • F: 702.871.4052
iccnv.com