Quarterly Insights April 2018

The Investment Counsel Company's quarterly commentary to our valued clients and other friends of the firm is intended to provide knowledge, insight, and perspective more valuable than available elsewhere. With this goal in mind, you may find surprising that the real news during first quarter 2018 was not the stock market back tracking its year-to-date progress, the Federal Reserve raising interest rates for the 6th time, or even Trump's introduction of trade tariffs; instead it was investors' reactions to the recent market correction. Many on Wall Street believed that high investor complacency existed, stemming from last year's stellar market performance together with the longest period of low volatility. They concluded that this behavioral tendency would likely result in investors reacting more fearful when normal downside volatility resumes. After all, investors' behavior is influenced not just by the magnitude of asset price swings, but their steepness as well. In other words, the quicker the price drop, the more fearful investors become. To Wall Street's surprise, investors have remained calm and held firm, leaving the equity market in a tight range at current levels without further price declines.

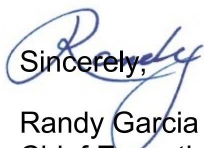
Given the market's recent performance, many investors cannot avoid asking, "Where are we going from here?" At ICC, we often say that questions of this kind are answered not because industry professionals know, but simply because they are asked. Rather than responding to the question directly, since market clairvoyance is neither a skill nor a talent, we can share with you what insightful clues history provides. Mid-term election years have been the weakest out of the four-year presidential cycles for the stock market, with corrections stretching for multiple quarters before resuming their uptrend. Historical returns in these years have averaged +7.5% since 1948 (unsurprisingly given candidates' lofty promises, pre-election years have been the best at +16.4% since 1948). Year-to-date, the Dow Jones Industrial Average's largest pullback has been -11.6% in comparison to the <u>average</u> of the largest corrections since 1950 at -13.6%. If it proves to be the biggest correction of the year, it will not only be smaller than the median, but starting one quarter earlier than usual.

On the other hand, the longer the market prolongs resuming its upward trend, the stronger the chance that lower levels may be reached before ultimately returning to the bull market's advance. Price swings for all investments are normal and should be expected, given perpetual uncertainty. Yet far more money is made in bull markets than is lost in bear markets. Thus, the big money is made by staying in the market, not jumping in and out. That's an undeniable fact. Most successful investors like Warren Buffett focus on long-term returns rather than allowing temporary losses to derail their investment strategies.

Investors are also concerned with the Fed making a monetary mistake by increasing interest rates too quickly. Our Firm is more concerned with a fiscal mistake, where excessive government debt issuance and fewer foreign buyers undo the positive economic catalysts of the tax bill. Until interest rates become an impediment to economic prosperity, growth is typically stronger than average during periods of rising interest rates. So although many believe that rising interest rates slow economic growth, this is not the case, at least right away, because Fed policy impacts the economy with a lag. When the Fed raises the fed funds rate to slow down an overheating economy, it does so in sequential steps so that growth doesn't stop abruptly. Until the Fed's policy goals are achieved, tempering growth and inflation, economic growth continues to outperform. Therefore, at this early stage of Fed tightening, stocks are likely to remain resilient in the face of higher rates.

Some investors continuously ask if this might be the end of the bull market. Most market tops are formed by euphoria, complacency, greed, and over-confidence (while market bottoms are formed by gloom and doom, panic, and fear). Furthermore, equity bear markets have occurred in or around global recessions. None of these conditions exist today. Data suggest that the global economy is in great shape. Corporate earnings in the U.S. and elsewhere are accelerating, not declining, which in turn make company valuations (price-earnings ratios) more attractive. Although many outcomes are possible, the weight of the evidence favors the conclusion that it is too soon to say that this is the end of the bull market.

We sincerely hope our perspective helps provide a clearer understanding as well as reduces uncertainty regarding the challenges we face today as investors. Our Firm is committed to successfully navigating this terrain for the welfare of our valued clients.



Sincerely,

Randy Garcia
Chief Executive Officer

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