2018 Q1 OUTLOOK

Traub Capital Management

January

2017

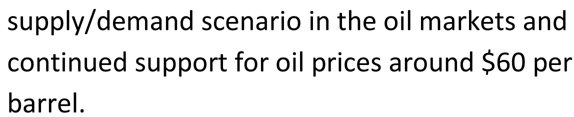
The chapter has closed on 2017. It was a very good year for stocks. The return on bonds was respectable, but below its long term average. For 2017, the Barclays Aggregate Bond Index tallied a 3.5% return, trailing its 15 year average of 4.2%. The S&P 500 Index, on the other hand, sported a 21.8% return, nearly tripling its 15 year average of 7.7%. Very much in contrast to "normal" markets, the volatility of the S&P 500 index, measured by its standard deviation, was just 5.4, somewhat less than half of its 15 year average of 13.6. The standard deviation on the Barclays Aggregate Bond Index was somewhat less, at 3.2 for 2017, but it about matched its 15 year average of 3.4. The unusually low volatility of the equity markets in 2017 resulted in no month to month declines (using the total return of the S&P 500) and at no point was the S&P 500 lower than where it started the year. A sustained increase like that seen in 2017 is very unusual.

Low volatility in the equity market index contrasted to the barrage of headline news portending imminent doom on a daily basis – North Korea, Trump, tax reform, Obamacare repeal, FED rate hikes, sexual harassment, mass shootings, Middle East, global warming, Venezuela, Trump again (and again), identity theft, Brexit – to name a few. Not to diminish the importance of these headline events, the reported economic impact was overhyped and the equity markets took the headlines in stride, preferring to react to the more economic fundamentals of interest rates and earnings growth. We see a similar story unfolding for 2018, where we are planning to dial down the headline hype and focus on the economic fundamentals – namely corporate earnings and overall worldwide economic expansion.

Earnings

Earnings in the energy sector had a major impact on overall corporate earnings growth in 2017. Compared to 2016, earnings in the energy sector were up 274%. Energy sector earnings are driven by the price of oil. The average price of a barrel of West Texas Intermediate crude oil for 2017 was up 17.4% in 2017 compared to the average price of the prior year. The oil price starts out 2018, up 15.9% over the average level for 2017, portending another major improvement in energy sector earnings.

There are political landmines in energy producing countries, starting with Iran. These landmines threaten to undermine supply from these countries. Political unrest in major oil exporting countries add to supply restrictions from the coalition of OPEC together with non-OPEC oil exporting countries and the continuing increase in oil demand worldwide, particularly from China. Together, the supply constraints and demand increase will offset the increased supply from US shale drillings. It adds up to a well-controlled



supply/demand scenario in the oil markets and continued support for oil prices around $60 per barrel.

If a 17.4% increase in oil prices for 2017 over 2016 produces an earnings increase in the sector by 274%, another 16% increase in the annual average oil price will result in another significant increase in oil and gas earnings. We would expect the earnings increase to be far less than 274% due to the very small earnings base in 2016, and the much larger earnings in 2017. The analysts' consensus for energy earnings in 2018 is up 41.5%. We believe the consensus estimate is a good one, with crude oil pricing starting the year above the $60 per barrel level.

For 2018, the analysts' consensus for overall revenue growth of the S&P 500 companies is +5.6% and overall earnings improvement is +11.8%. These consensus forecasts were made before the full impact of corporate income tax cuts can be assessed, so there is a very good chance the earnings improvement will be higher. The P/E ratio based on forward earnings is 18.4x. Since the turn of this century (i.e. 2000), the P/E ratio on forward earnings is a bit over 16x. So the current 18.4x is higher than the average since the turn of this century, but it certainly is not out of line especially considering the current historically low interest rates and low level of expected inflation.

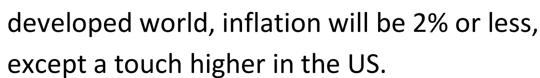
By this time next year, we are expecting continued strong worldwide economic expansion as detailed below. Further corporate revenue growth in 2019 of 5% and concomitant earnings improvements should follow. Equity prices are based on the forward outlook, so this time next year, the forward outlook should continue to be good.

We are also expecting that continued low interest rates will promote corporate borrowings at historically low interest rates, some of which will continue to support share buybacks. In addition, the reduced tax rate on income repatriated from abroad should provide fuel for higher than normal buybacks. Low levels of initial public offerings and high levels of stock buybacks will lead to an overall decrease in outstanding shares, constraining the supply of equities.

Overall Worldwide Economic Expansion

The worldwide economic expansion continues apace. At this point, we expect more rapid improvement from the world's emerging countries. For 2017, the world's GDP growth will total 3.0%, with the US coming in at 2.3%. The emerging Asia zone of China, India, Malaysia, Thailand, and the Philippines will grow at 6.4% and the Eurozone at 2.2%. For 2018, these growth rates are projected to be 3.1% for the US, 6.2% for emerging Asia, and 2.0% for the Eurozone. We track most all the economically important countries in the world and there are just a couple where growth in 2018 will not exceed that of 2017. There are no countries that are forecast to experience an economic decline. The only countries where inflation is a problem are Venezuela (at 100+%), Argentina (at 20%), Egypt (at 12.5%) and Turkey (at 10%). Throughout the

developed world, inflation will be 2% or less, except a touch higher in the US.



Interest Rates

In the US, the Federal Reserve (FED) raised the very short term Federal Funds Rate three times this year. The FED's high-end target rate began the year at 0.75% and ended the year at 1.5%. At 1.5%, the Federal Funds Rate is not high by any historical comparison and it remains well below the rates that were common throughout the 1965 – 2005 period, where the rate averaged about 6%. We believe the FED will have increased difficulty continuing to raise the short term rate to match the analysts' consensus of three or four more rate hikes in 2018. As explained in our prior Quarterly Economic Outlooks, continued gains in employment are not going to necessarily cause wage inflation as predicted by the "Phillips Curve" (an economic theory suggesting that inflation and unemployment have an inverse relationship, i.e. a tighter employment market leads to inflation). The Fed has not acknowledged that the Phillips Curve is not a valid predictor of inflation, but it will have to yield to the reality at some point. Further, the interest rates on longer term obligations, i.e. 10 Year Treasury, are generally determined by "the market" – not by a FED edict. The longer term rates remain low, reflecting the low expected inflation. As a result, the spread between the longer term rates and the shorter term rates has decreased. The FED is well aware of the economic problems that ensue when short term rates exceed the longer term rates, and we believe that the FED will be reluctant to force that to happen.

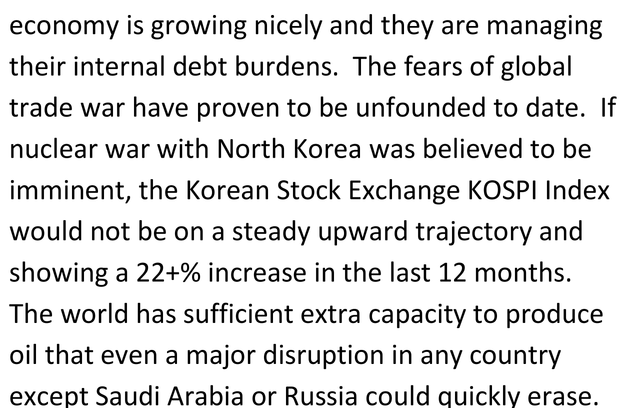
A further restraining substantial interest rate hike in the US are the low, or in some cases the negative, interest rates in the Eurozone and in Japan.

Low and rising interest rates are not positive for bonds, since the price of bonds goes down when rates go up. However, low interest rates support the equity market in two ways. First, with interest rates low, it creates an incentive to invest in stocks where the returns can be significantly better from both price appreciations as well as from dividends. Second, low interest rates encourage companies to borrow to invest in growth producing assets as well as to fund buybacks of corporate stock.

Outside Factors

The market does not react well to large, unexpected unfavorable surprises. The very large burden of subprime mortgages, coupled with "mark to market" accounting changes and slow government response to the financial crisis in 2008 was a sufficient unexpected event to trigger "The Great Recession". While the market does not like these events, the media loves them since they make great headlines that everyone reads. Hence the plethora of headlines portending impending doom that was pervasive throughout 2017. We expect the headlines to continue in 2018. Once the headlines shift to optimism it will signal that investors as a group have turned bullish, which is one of the warning signs to the next downturn.

That said, we just do not see events on the horizon which will trigger a bear market. The world is consistently showing growth. Geopolitical tension is present, but no more so than usual. China's



economy is growing nicely and they are managing their internal debt burdens. The fears of global trade war have proven to be unfounded to date. If nuclear war with North Korea was believed to be imminent, the Korean Stock Exchange KOSPI Index would not be on a steady upward trajectory and showing a 22+% increase in the last 12 months. The world has sufficient extra capacity to produce oil that even a major disruption in any country except Saudi Arabia or Russia could quickly erase.

Investment Plan

Last year, we expected a "mid-single digit increase in the overall equity markets". We also noted that we did not expect to be "right" and that if our forecast was off, the greater likelihood was for higher equity prices than we forecast. The portfolios were positioned to accommodate that possibility. With 2017 now being history, the overall improvement in equity prices did indeed come in substantially higher than our median forecast, but portfolios were mostly positioned to benefit from the higher equity prices. So our investment plan was mostly on target and clients participated in the market's great returns.

For this year, we believe continued gains are most likely, with international and emerging markets overshadowing those from the US. As mentioned above, continued economic growth, improved earnings, lack of major unforeseen events and continued corporate buybacks will fuel the gains. We do not see anything like euphoric investor sentiment on the table which would drive price earnings ratios higher, but with solid economic fundamentals, we can foresee high single digit gains in equities for 2018. Importantly, we also see equity returns in 2018 to be higher than bond returns.

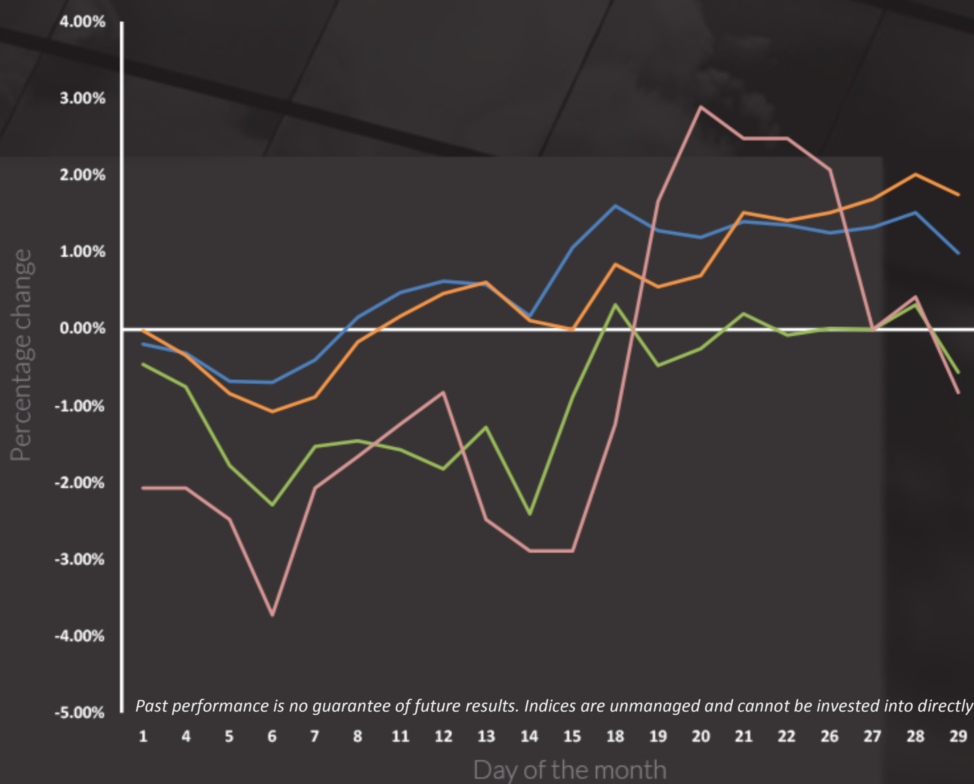
Any return from bonds will be muted, if positive at all. We expect to see small increases in both short term and long-term interest rates here in the US (more so on short-term). Higher interest rates will result in lower bond prices offsetting some of the yield and leading to returns on bond indices of 1-2%. That said, we will continue to have meaningful allocations to bonds for most clients as diversifiers and protection if our forecast is off and the market declines.

With this backdrop, our investment portfolio positioning will be a continuation of what we have done for 2016 and 2017 - positioning portfolios to take advantage of higher equity prices in the future. We are also positioned for what should be better investing opportunities than in the US for stocks in international and emerging markets (and better bond opportunities in the latter as well). At the same time being mindful of, and watching for, darkening clouds on the horizon (and looking to act before the clouds arrive), but not positioning the portfolios for them, until the darkening clouds are much more numerous. As it was in 2017, this should be the right investment portfolio positioning for 2018.

The market at a glance

December

- **U.S. Large Cap**
  (S&P 500)
  2,673.61 (0.98%) ▲
- **U.S. Mid/Small**
  (Russell 2000)
  1,535.51 (-0.56%) ▼
- **International Large**
  (NYSE International 100)
  5,792.03 (1.74%) ▲
- **U.S. Treasuries**
  (U.S. 10-year Treasury yield rate)
  2.40 (-0.83%) ▼



The market in action

- The government passed legislation that represented the most significant overhaul to the tax system in decades. The “Tax Cuts and Jobs Act” will alter main tenets of the tax code, including: lowering the corporate tax rate, raising the standard deduction, adjusting individual tax brackets, and more.
- The past 12 months saw major stock indices experience massive increases in value, led by notable indices such as the Dow Jones Industrial Average (25 percent), the S&P 500 (19 percent), and the Nasdaq (28 percent).
- In the final months of 2017, bitcoin became one of the most frequently discussed topics in the world of finance and economics. At its peak, bitcoin increased in value by over 1,900 percent since the start of the year. Ultimately, bitcoin ended the year valued at about $13,860, roughly 1,261 percent higher than its value at the beginning of 2017.
- The Walt Disney Co. bought the majority of 21st Century Fox. The deal, which was announced in mid-December, is reportedly worth over $52 billion.
- According to a recent study by NerdWallet, the average household in the US owes nearly $16,000 in credit card debt.
- In a recent report by the Wall Street Journal, about 5 million Americans are currently in default on student loans — roughly double the amount from four years prior. This represents nearly 13 percent of all outstanding student loans.
- Existing home sales in November hit an 11-year high. Sales increased by about 5.6 percent from the previous month. Some analysists believe that this information points to a recovering housing market that has been slow to regain its value following the Great Recession.

The January effect

Ever since economist Sidney Wachtel first coined the term in 1942, analysts and market pundits have been eager to talk about a seasonal market movement known as "the January effect."

In its simplest form, the January effect is the rise in stock prices over the first two weeks of each year. The rise is said to be more significant in small-cap stocks, which will eventually fall behind the gains of large-cap stocks over the remainder of the year. Additionally, the price growth supposedly sets the tone for the rest of the year — a strong January effect means a positive year is coming, while a loss in early January means a bad year.

Though there are logical explanations and repeated documentation of the effect, many individuals refute its reliability and question whether it exists at all.

Sound superstitious? There are some reasons why the January effect makes sense. The growth is largely a recovery from a supposed market drop in the last weeks of December, when investors (both private and institutional) sell off weak stocks to get them off their books and lock in losses for tax purposes. Investors then repurchase the same shares at the start of the year, causing the January effect.

Some behavioral investors believe that psychology also helps boost the January effect, as people tend to be the most optimistic during the first part of the year. For investors, this may mean putting more money into investments or taking a risk on a cheap stock that will hopefully make huge returns.

Changing tax rates are another reason the January effect is said to occur. When the government announces a raise on the capital gains tax in the upcoming year, investors are encouraged to sell their profitable investments before the end of the year to take advantage of the current tax rate. This causes December prices to fall across the board and then rise to a normal level in January.

Is the January effect real?

Historically, stocks have often risen during the first two weeks of January, and 25 out of the past 40 years have seen the S&P 500 end the month ahead of where it started on January 1. Over the total year, however, the S&P has increased for 30 of those 40 years. The truth is that the stock market, regardless of its performance on a short timeline, has historically always trended upward on a longer timeline of several years.

One of the reasons many say that the January effect cannot be real is that the market would be aware of it. The "effect" is over 70 years old, so investors have had more than enough time to learn how to compensate and, therefore, negate its influence.

Even if stock rebounds were consistent, selling assets for just a week and then repurchasing them is a foolish practice for any long-term investor. Not only could share prices increase in that time but the investor is also guaranteed to spend some money on the sale and repurchase transactions.

It is possible that the January effect provided observant investors a chance to game the market in the years before 1942; however, now that the market is more efficient and much more analyzed, seasonal "sure bets" simply do not exist. Even in the case of raising taxes, eager investors are as likely to cause the January effect in October as they are to cause it in December and January.

The best thing investors can do with the January effect is ignore it. Markets are volatile and short-term fluctuations should not affect an investor's decision to buy or sell. An investment strategy relies on the appreciation of a successful company's assets, not on the speculation of market moods from one month to the next.

Heydon Traub
h.traub@traubcapital.com

(781) 453-3929

97 Chapel Street, Suite 7
Needham, MA 02492

This January Effect article was written by Advicent Solutions, an entity unrelated to Traub Capital Management. The information contained in this article is not intended to be tax, investment, or legal advice, and it may not be relied on for the purpose of avoiding any tax penalties. Traub Capital Management does not provide tax or legal advice. You are encouraged to consult with your tax advisor or attorney regarding specific tax issues. © 2018 Advicent Solutions. All rights reserved.