Market Note

January 10th 2018

The major indices hit new highs this week with the DOW crossing 25,000. The NASDAQ followed suit breaching 7,000, and the S&P closed firmly above 2,700 despite or perhaps because of a weak job report on Friday[1]. Oil continued its relentless climb hitting a three-year high of $60.37 as measured by W&T Offshore, Inc. (NYSE: WTI) from the lows of $26.19 reached in February of 2016. (Frigid temperatures in much of the country didn't hurt).

Bonds, as measured by the Ten Year Treasury Note, stayed locked in a fairly tight range with the yield standing at 2.46%, not far off from where it began 2017. And lest we forget, Bitcoin the newest entry for the fast crowd, went from $18,732 to $11,779, closing at $16,048 on Friday and managed all of this within a three-week span[2].

However, it is not just the new highs in the stock market that are catching the attention of investors, it is the length and breadth of this bull market that began in March of 2009 that is noteworthy.

Consider:

- The current bull market is the second longest in history and if it can continue, in August of this year it will surpass the current record that stretched from 1990 to 2000.
- Stocks have outperformed bonds over the past six years, the longest period dating back to 1928 and could be poised to extend that record to seven years.
- The S&P has not suffered a 3% decline since November 7, 2016[3]. This is the longest period in the history of the stock market which is a clear indication of the lack of volatility in today's markets.

[1] Source: Barron's
[2] Source: Wall Street Journal
[3] Source: Morningstar

1525 VALLEY CENTER PKWY ■ SUITE 310 ■ BETHLEHEM, PA 18017 TEL +1 610.814.2474 FAX +1 610.814.2430

- In 2017 the S&P finished positive in every month of the year. Though we have come close in previous years, this is the first time in the history of the U.S. markets.

- The last correction in the stock market occurred in the beginning of 2016. On a historical basis, this represents an extended period of complacency.

Though we believe that the next leg in the markets will be driven more by emotion rather than fundamentals, it is prudent to consider both the positive and negative factors influencing the markets.

Tailwinds:

- The global economy is experiencing a period of synchronized growth, but at a level that shouldn't demand aggressive policy moves by central banks. Some refer to this as the Goldilocks economy, meaning that current monetary policy is market-friendly

- Interest rates on a historical basis remain low with the Ten-Year Treasury trading at 2.46% compared to the fifty-year average of 6.46%[4]. Low interest rates are critical to containing borrowing costs for business and consumers and subsequently can provide support to stock prices.

- Volatility is virtually non-existent in the capital markets.

- Corporate earnings continue to expand and with the recent tax bill it is estimated that earnings for the S&P in 2018 should increase by 14% according to Goldman Sachs or from $139 to $153 per share as forecasted by Merrill Lynch helping to support current stock valuations.

- The rollback of government regulations should further assist in increasing corporate profitability and thereby lending support to current equity valuations.

- Business and Investor confidence continues to increase lending further support to the markets.

Headwinds:

- On any measure both stocks and bonds are valued at the high end of their historical ranges. This does not indicate a correction is eminent, but is noteworthy and does point to the fragility of the markets.

---

[4] Source: YCharts

- After three rate hikes by the Federal Reserve in 2017 the spread between the Two and Ten Year Treasuries is approximately a half per cent leading to a flattening of the yield curve. The last time this level was reached was October of 2007 the previous highs for the S&P prior to the financial crisis. (A flattening yield curve is usually a precursor to a recession but not immediately.)

- The tax reform act could be coming at a time that economic growth is accelerating and could prompt the Federal Open Market Committee of the Federal Reserve (FOMC) to increase rates beyond current expectations if they believe that inflationary pressures are building. Many bull markets are brought to an end by the same thing that supported them; monetary policy. At present the Federal Reserve is projecting three interest rate hikes of a quarter of a percent each, the markets are pricing in two.

- Inflation is non-existent throughout most of the world and it is not being priced in to any of the models in a meaningful way. What would happen to market forecasts if wage or commodity pricing took hold?

- The Investor Intelligence Sentiment Survey, the longest survey of its kind, is indicating an average reading of 77% the second highest in history. Historically this indicates that returns going forward should be lower. Vanguard, among others, is calling for equities to increase at a rate of 4% to 6% over the next five years, which is modest at best, and there is a significant amount of data that supports that call.

- Given the lack of volatility and the continued rise in the markets, a correction should be expected. As investors have not experienced a significant pullback for some time, when it does come it will feel much worse than it is and could lead investors to react negatively causing additional selling.

Thoughts:

We are uncomfortably in the camp of the markets moving higher in 2018 with the same caveat that volatility will increase in a meaningful way. We would not be surprised to see a correction, but at the moment we believe that the probability of anything resembling a bear market is low and equity returns could be in the mid-single digit range by year end. Any number of things could trigger a correction at some point, from mid-term elections, to a shortfall in corporate earnings, to geo-political risk. Yet, given the underlying fundamentals the market could have the ability to recoup much of its gains and finish the year in positive territory.

A number of individuals such as Jeremy Grantham are calling for a market “melt up” similar to the late 90s when thoughtful analysis was thrown out the window and sock puppets for the newest internet company were awarded valuations of 300 times “clicks”. If that were to occur we could experience substantially higher equity prices as investors go all in. We hope that we can avoid that stage as the eventual reckoning may be disastrous for many investors and unfortunately, as is many times the case, those who can least afford the consequences suffer the worst. As history has shown us, when greed replaces fear, it usually ends in tears.

The Federal Reserve will continue to increase rates, but we believe a move above 3% is unlikely. If the Ten Year did exceed that level, equities could be more vulnerable in the near term. In the credit markets, lower quality bonds such as high yields could be more susceptible to pricing pressure as they are more equity like in their behavior and spreads are tight, but municipal bonds should continue to be supported by strong demand.

International equities and Emerging Markets still enjoy lower valuations compared to stocks here in the U.S., but the variance is shrinking. We would continue to allocate funds to these areas with the understanding that just as in the U.S. returns could be muted especially compared to the past several years.

As we anticipate the next cycle for the markets to experience lower returns and higher volatility we are exploring a number of options to mitigate those risks to our clients. Long-term these strategies could make sense but the timing of instituting them could be premature.

Closing Thoughts:

The greatest risk to our analysis and by extension our clients will be investor behavior when\if a meaningful correction occurs. The time to consider this is before it actually happens. If a ten percent correction in the markets will cause an investor to abandon their current allocation, it would be prudent to make adjustments today rather than react in the midst of a sell-off.

One of the primary reasons investors underperform the markets is due to behavior. Investors are susceptible to emotions and emotions can lead to making the exact wrong decision at the most inappropriate time. As advisors one of our jobs is to manage through investor behavior so that when market volatility presents itself we can be confident in our allocation and strategy for the long-term and with any luck take advantage of it. However, the key is for the investor to be comfortable with the level of risk they are accepting in relation to what level of risk is necessary for them to be taking.

As we stated previously, when a correction occurs it will feel much worse than it actually is and investors would be wise to use this as an opportunity to evaluate their level of risk and make the appropriate modifications if necessary. Eventually even markets such as these come to an end and being positioned properly will go a long way in protecting capital.

We would like to thank you, our clients, for your continued confidence. The markets will continue to be unpredictable, but we hope that as a firm we will remain constant in managing risk, provide excellent service that our clients have come to expect, and maintain the values on which our firm was founded. We look forward to working with you in the coming year and hope to speak with you soon.

Sincerely,

Brad Griswold	Sean G. Linder, CFA	William Velekei, CPA, CFP®
Managing Partner	Financial Advisor	Financial Advisor