CAPITAL STRATEGIES
FINANCIAL CORPORATION
Navigating Financial Security

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Financial Markets Commentary 1st Quarter 2018

Summary

The stock market's long quarterly winning streak ended in the first quarter, but the loss was less than one percent. Probably more significant than the market's loss in the quarter was the return of volatility – something we hardly saw at all in 2017. Since the market peak on January 26th the market has made more than *two dozen* daily moves of more than one percent[i]. The question for investors is whether this new more volatile period will be resolved favorably with markets ultimately going on to new highs, or whether this signifies the beginning of the end of the bull market.

The actual loss for the S&P 500 was small, -0.76%[ii]. What was so distressing about the quarter was the fact that stocks were at one point up more than 7.5%. There was almost a "melt-up" in stocks in January after the corporate tax cut was enacted, as analysts scrambled to raise earnings guidance for 2018 and afterward. Stocks shrugged off rising interest rates until the 10 year note flirted with 3% after the January jobs report; at that point, however, they began to care a great deal! After bottoming on February 9th stocks began to recover. They had erased about two-thirds of their 10% post-January 26 decline when the President announced trade tariffs. This prompted threats, retaliation and ultimately a second journey into negative territory, which is where we finished the quarter.

Foreign stocks largely followed the same trajectory as U.S. stocks last quarter. Developed markets closed with a loss of -1.53%[iii], while emerging market stocks posted a 1.42% gain. The best region last quarter was Latin America with an 8% gain, followed closely by "frontier markets" – those countries with markets too small to be included in the emerging market index. Canada and Australia brought up the rear with losses of 7.3% and 5.7% respectively.[iv] Exhibit 1 highlights last quarters broad market returns.[v]

Exhibit 1

Bonds reacted to the prospect of greater economic growth and higher fiscal deficits in the future the way you would expect – they sold off sharply. The decline was as much as -2.5% by the end of January, but as the trade war increased the chance of a global economic slowdown, bonds rallied somewhat in March. The bond index ended with a total return of -1.46%[vi]. The only broad fixed income category to post a gain was floating rate debt. High yield bonds lost a bit more than the benchmark, with longer term government and corporate bonds coming in last[vii].

Activity

We re-balanced portfolios last quarter as the market was actively punishing defensive sectors like utilities, consumer staples, and real estate primarily doe to interest rate concerns. Normally we like stable, high dividend paying equities but at this point in the business cycle investors tend to prefer more economically sensitive companies. We also used the rebalancing to lower the duration of the bond portfolio, adding more global and floating rate bonds in place of some of the intermediate term corporate debt. We also replaced a global equity fund with an international equity fund, which has the impact of raising foreign exposure. The persistent weakness in the dollar makes having more foreign exposure (stock or bond) more desirable.

Outlook

2017 was an incredible year for investors. Both U.S. and foreign markets gained more than 20%, and at no point did we experience a drawdown of 3%[viii]. At some point, we all knew that period of near market perfection had to end. Global economies are not growing fast enough to support 20% annual profit growth, and with global central banks finally reigning in credit supply, liquidity won't support

those kinds of stock price gains either. That phase of the market cycle is most likely over. From here, we can hope for further earnings-driven market gains, but price-earnings multiples (the price that investors will pay for a dollar of earnings) appears richly valued and may even have peaked. The danger is that they will shrink from here. Such an environment warrants a more cautious stance. Also, as recently as December 2016 the yield on Treasury Bills was around 0.25%. Today, after five interest rate hikes, it is closer to 1.50%. Since the yield on the S&P 500 is less than 2%, choosing to be a saver (as opposed to an investor) is once again a viable option.

In short, the combination of higher interest rates, a less friendly liquidity environment, and better competition from fixed rate investments creates a more neutral environment for stocks versus the strong tailwinds we've had in recent years. Add in trade friction and political uncertainty and arguably stocks could be poised for decline. We are monitoring the situation carefully. Technical indicators are still positive – at the margin, investors would rather buy dips than sell into strength. At long at that remains the case we are probably not going to under-weight stocks.

Commentary – Why We Haven't Turned Bearish Yet and What It Would Take

Sometimes the market goes down and investors wonder why we don't just sell everything and go to cash until things blow over. This is a good question, so I want to go over it again.

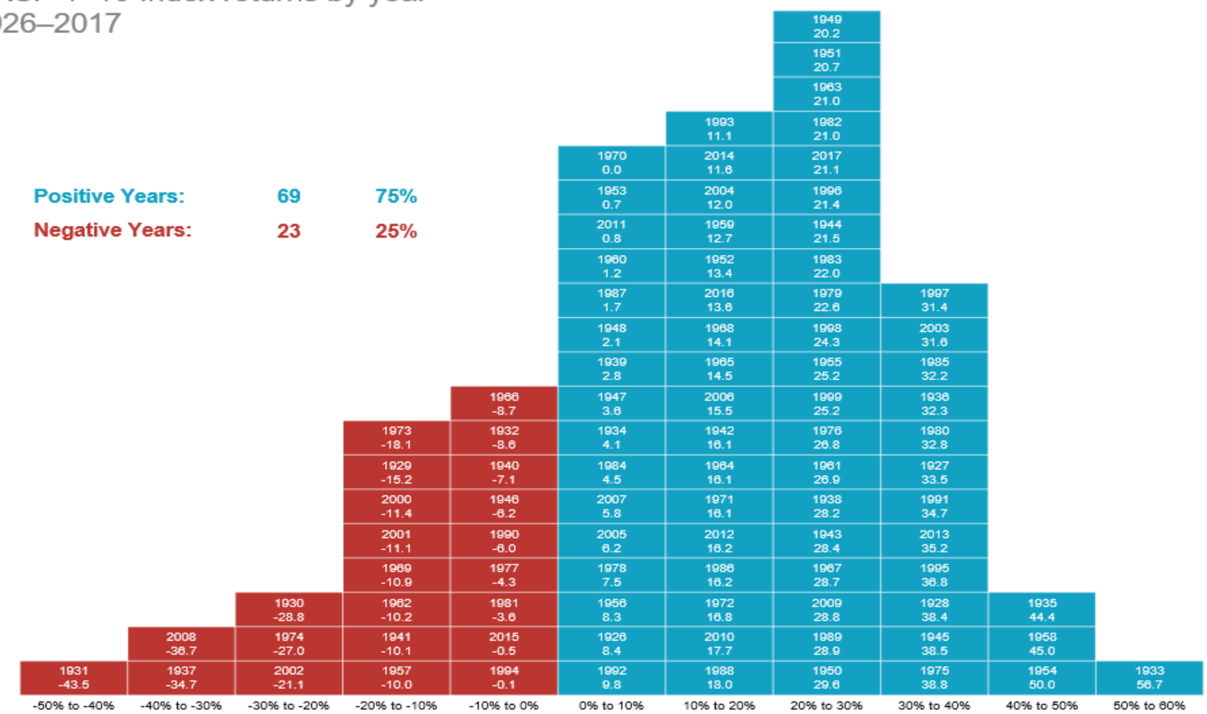
There are times every year when market conditions seem to warrant a decisively more conservative stance. Typical arguments for doing so may be based on excessive market valuation, a political event, an economic change or even the threat of military conflict. Frequently it will be an outright decline in stock prices. In my thirty-plus year career in the investment field I would guess there have been close to a hundred times I've thought about getting significantly more defensive. That said, only in about six-to-eight of those instances would that have turned out to be a good decision. The truth of the matter is that the U.S. stock market has an upward bias. Betting against it has generally not been very rewarding. If one is going to attempt to outperform the stock market by selling high and buying back lower, therefore, one must *carefully* pick their spots. The odds are strongly against successfully doing so, and there is no one that can claim they have demonstrated this skill repeatedly.

What do I mean by an upward bias? Exhibit 2 illustrates that between 1926 and 2017 annual market returns were positive 75% of the time.[ix]

Exhibit 2

Distribution of US Market Returns

CRSP 1–10 Index returns by year
1926–2017



In US dollars. CRSP data provided by the Center for Research in Security Prices, University of Chicago. The CRSP 1–10 Index measures the performance of the total US stock market, which it defines as the aggregate capitalization of all securities listed on the NYSE, AMEX, and NASDAQ exchanges. **Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results.**

Stock prices are in the long run closely tied to corporate profits and corporate profits tend to rise over time[x]. Additionally, the government likes to see stock prices rise and therefore has an incentive to take steps to both increase the likelihood of price gains and more pointedly, to arrest any significant stock price decline. Along those lines, it has been strongly believed over the past ten years that Fed Chairmen Bernanke and then Yellen would intervene to support stocks if necessary[xi]. Another structural positive for stocks is the amount of savings relative to the supply of stocks. Low interest rates have provided an incentive for companies to borrow money to buy back their stock in order to raise per share income. This creates the bullish dynamic of too much money (demand) chasing too few shares (supply), which Economics 101 tells us leads to higher prices. Finally, betting against stocks (short selling) is more complicated because shares must be borrowed prior to sale and that can be expensive.

If all of this has you feeling that stocks are a pretty good bet most of the time, you are reading this right. Since stocks have so much going for them, there would need to be several negatives in place to warrant underweighting them in portfolios. Here are some the factors that might cause us to reduce our stock weightings:

- **Valuation – we would have to believe that stocks were so overvalued such that a value-restoring market plunge was far more likely to occur before earnings could rise enough to justify current prices;**

- **Technical weakness – in other words, falling prices. More than just falling prices, in fact, but the confirmation that investors were becoming disenchanted with stocks via a drastic change in investor sentiment. This would involve stock prices making a series of lower highs and lower lows.**

- **Liquidity impairment – whether through a surge in interest rates, a recession, or a major corporate bankruptcy, this is a condition where asset holders worry about being able to sell what they own at current prices and banks worry about the value of that which they hold as collateral.**

- **Rising interest rates – because of the negative effects they have on corporate profits and price-earnings ratios. Rising interest rates negatively impact the profitability of most companies plus they make financing a leveraged portfolio more expensive.**

- **Serious economic weakness – a mild slowdown might easily be offset by falling interest rates, but typically rates can't fall fast or far enough to offset the damage of a serious recession because profits my fall below the level needed to service existing debt. Also, banks may not be willing to provide capital to other entities if they are worried about their own solvency.**

- **Global conflict – most conflicts can be and are resolved without economic damage because each side understands what it stands to lose. On rare occasions a conflict between major powers occurs because one side can no longer accept the status quo and the other side is unwilling to accommodate the other.**

The biggest problem with opportunistic selling is that there is seldom any kind of signal in terms of when to buy back. Valuation is a very relative thing; nobody rings a bell when a recession ends or liquidity conditions ease. Experienced managers may get a "feel" but that is hardly something you can quantify nor is it a recipe for a repeatable investment process.

As far as today is concerned, the most negative aspect to the broad market is that it's generally considered overvalued but it's been overvalued every month since late 2012 (with the possible exception of January and February 2016). The market is not technically as strong as it was three months ago but most measures are still positive. Interest rates are rising on a six- and twelve-month basis, but they are actually flat to lower over the past one and three months. The other concerns are just not there, though we can't rule out that the current trade spat becoming a full-on trade war.

To sum up, stocks have an upward bias over the intermediate and long term, so to warrant under-weighting stocks in portfolios, there needs to be very compelling reasons to do so. Fortunately, that just doesn't happen very often. Over time, we have adapted our processes to create a higher bar in terms of what needs to happen for us to turn defensive. We believe that has helped us to capture more of the market's upside in the recent past, and will continue to do so going forward.

4/25/2018: Addl. Comments

Yesterday was an interesting day in the stock market. The headline declines were ugly - the Dow falling 424 points and the NASDAQ off 121 - but the broad market wasn't as bad as the averages would suggest. The advance-decline numbers were about 1150 to 1950, which are really not that bad, considering that the advancers on the previous sell-offs (February 9th and April 2) were both less than 600.

The recent weakness has involved the big tech names - Alphabet (Google), Facebook, Amazon, etc. so it seems worse than it is.

I'm neutral on the stock market overall. The concern is that since the January 26 peak, we've made two lower highs (March 13th @ 2804 and April 18th @ 2713). On the other hand, the market has been making higher lows. The February 9th low of 2529 was not broken on April 2nd (2546) nor recently (2611, today). We are in a tug-of-war, it would seem. I'm not ready to conclude that this narrowing range will be broken to the down side, so I'd continue to advise waiting and watching.

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i Jill Mislinski, dShort, Advisor Perspectives April 13, 2018.
ii S&P 500 Index total return per Morningstar
iii MSCI EAFE Index (developed markets) and MSCI EM Index (emerging markets) per Morningstar
iv S&P Dow Jones Indices
v Source: YCharts.com
vi BBgBarc US Aggregate Bond per Morningstar
vii S&P Dow Jones U.S. Index Dashboard, March 29, 2018
viii Performance per Morningstar; volatility data per JPMorgan Guide to the Markets, 1st Quarter 2018.
ix Source: Dimensional Fund Advisors, Market Declines and Volatility
x According to Trading Economics, the annual increase has averaged over 7.4% between 1950 and 2017.
xi It is not clear yet what Chairman Powell would do; that might be behind some of the more recent volatility