CAUBLE & HARRE
WEALTH MANAGEMENT

12977 NORTH 40 DRIVE, SUITE 213
ST. LOUIS, MO 63141
314-576-1112 | CAUBLEHARRE.COM

Market Overview | April 4, 2018

We are doing things a little differently this quarter. This market note will arrive via email without the statement. Given the market's recent moves, I wanted to get our note out before the statement was mailed. And speaking of the statement, the format has been changed this quarter. The new format reflects most of what we are trying to accomplish, but we may tweak it in the future.

Before I discuss the markets, but partially motivated by their recent behavior, I thought I would address the following question: Why do we need to bother with equities at all? They are fine when their prices go up, but all of this volatility is ridiculous, nerve racking, insert your own adjective.

One answer might be because that is where the growth is. Okay, but why?

The underlying assumption for this discussion is that we live in a society that has a functioning economy. That means that individual participants are able to organize and invest capital in productive ventures, and they are able to retain the benefits from doing so.

As an alternative to investing in equities, you can buy bonds. Buying bonds is essentially renting your money to others for a period of time. The returns from doing this are positive, but not large. Today, the return on the 5 year Treasury Note is 2.59%. You can think of this as the rental rate for money. By buying bonds, your return will be somewhere around 2.59% per year for the next five years. Fairly stable, but small. And stable is important for a portion of the portfolio.

As an investor in companies or stocks/equities, you benefit from a rising stream of earnings. For reasons I will explain shortly, companies can increase their earnings at a rate much higher than 2.59% per year. Because of this, and because stock prices will follow earnings over time, returns in stocks have been greater than returns in bonds.

In an economy that is growing at 3% per year, the revenue of an average company may also grow at 3%. Consider a company that had $100,000 of revenue last year. Assume its expenses were 90% of revenue ($90,000) and its profit was $10,000. If revenue increased 3%, it would grow to $103,000. If expenses also grew at 3%, new expenses would grow to $92,700 and new net income would grow to $10,300, which is growth of 3%.

On average, though, companies' expenses do not grow at the same rate that revenue does. Some expenses are fixed, like a machine or a plant. The cost of the fixed assets does not change with revenue. In our example, let's assume that the company can limit expense increases to 2%. Expenses would rise to $91,800, and net income would rise from $10,000 to $11,200 or 12%.

To summarize our example, the economy and company revenue grew by 3%. Our company was able to limit expense growth to only 2%, and therefore company earnings grew by 12%. This is why company earnings can grow faster than the growth rate of the economy, and why over time, the return on stocks is more than the return on bonds.

LIZ H. CAUBLE, CFP
liz@caubleharre.com

PETER B. HARRE, CFA
peter@caubleharre.com

But why are they so volatile? Volatility is annoying, but volatility partially reflects a huge benefit to us. You could decide to open your own business, and if you could keep expense growth lower than revenue growth, you could make a good return on your capital. At some point, however, you may want to sell your company. To do so, you would have to find the right buyer, negotiate all of the terms and hopefully accomplish this during a period when the buyer would have access to the capital needed to pay you what you wanted to receive for the company. This might take months or even years.

When you buy a publically traded equity, you could decide to sell Monday, and you could have your cash on Wednesday. The positions are very liquid. The ability to sell at anytime means that everyone else can sell also, for any reason. They can sell because they need the capital to spend, or they might sell because they are fearful. Some investors can have a long-term focus on earnings growth, and some might be buying a particular stock (or the market as a whole), because it is rising in price, regardless of earnings. This is the reason for the saying that the market is a voting machine in the short run, and a weighing machine in the long run.

To summarize again, we buy equities because companies have the ability to grow their earnings faster than overall economic growth, and because of this, over time, the value of equities (the return) increases at a higher rate than the return of bonds.

We limit the percentage of a portfolio that we invest in equities because of the potential for short-term volatility. We want to stay in the annoying range and not venture in the debilitating fear range. That is the sophisticated version of asset allocation policy.

During the first quarter of 2018 returns on domestic stocks, international stocks and bonds were all negative. Bonds were the worst of the lot with the Barclays US Aggregate Bond Index down 1.4%. international stocks, measured by the MSCI AWCI ex US index were down 1.2%, and the S&P500 was down 0.8%.

Markets have moved a bit lower in April, or at least the S&P500 has. It has only been a couple of days, but international and bonds have stayed about where they ended the quarter. Because of the drop in the S&P500 Monday, international stocks are back in the lead for the year. Most notable, because of the flattish markets but continuing increases in corporate earnings, valuations are now back to the 25 year historical average.

In my opinion, this a good place to be. The underlying economy is strong. Operating earnings for the S&P500 in the just completed 1st quarter are expected to be 18% higher than a year ago. As of today, the expected earnings a year from now are expected to grow another 21%. There are issues affecting market sentiment (like potential trade wars), but there are usually concerns, and I am more content dealing with concerns while at historical valuation levels rather than stretched valuation levels.

If you review the last 10 bear markets, at least one of four elements are present during those times. None of those four elements are currently present. They are: recession, commodity spike, extreme valuations and an aggressive Fed. I would argue that the Federal Reserve is currently not being aggressive. I suppose they could become so, and since there is a new Chairperson, the market can think about that risk as an uncertainty.

There is certainly some current uncertainty with regard to trade policy. I offer the following thought. Imposing tariffs is a major fly in the ointment of an 'everything is fine' attitude in the market, which is needed to support high valuations. High valuations have now been eliminated, primarily through high earnings. My observation of reactions to new policy initiatives is that hyperbolic statements from the administration have been met with hyperbolic responses from observers. The truth often ends up being somewhere in the middle. This source of uncertainty is the same source that brought us tax reform and a more productive regulatory environment. Over the next month or two, earnings will take center stage. The investment from tax reform has only begun. The returns from that have yet to be harvested.

No one can predict what the markets will bring in the near term. We thought that valuations would come down, and they did. I would be surprised if the market decided that valuations needed to be below normal this year, in the face of rising earnings. That takes a fair amount of fear which I don't perceive yet. I am not advocating for 20% returns this year for equities. I do think that equity returns could easily outpace bond returns in 2018.

Please call with any questions or concerns.

Regards,

Peter B. Harre, CFA