April 20, 2018

Q1 2018 Commentary: …a pause that refreshes

Just like that, the extended record of calm in the stock market came to an end. While there were only 8 days last year in which the S&P 500 traded up or down by 1% or more, there were 23 such days in the new year's first quarter alone. While a more volatile stock market may not feel very good following such a smooth ride last year, it will ultimately be to our benefit.

In the aftermath of tax cut legislation and strong fourth quarter earnings, the stock market surged higher by more than seven percent in January. However, unexpectedly high January employment costs reported in the first week of February triggered concerns about inflationary pressure and the threat of a more aggressive rate hike timeline by the Fed. These concerns, along with an increased fear of trade wars breaking out on multiple fronts, turned investors cautious and the stock market gave back its January gains in February and March. For the quarter, the S&P 500 finished with a modest 0.8% loss, the first negative quarterly return after nine consecutive quarterly gains.

Interest rates pushed higher, and like the stock market the primary driver was the fear of inflationary pressure. The Federal Reserve chairmanship was assumed by Jerome Powell who appears set to continue along the course set by his predecessor, Janet Yellen. As long as the economy continues on its current trajectory, interest rates will continue to inch toward a neutral policy. Long term rates have been drifting higher and the US 10-year treasury yield moved 0.40% higher in the first quarter to settle at 2.80%. The Federal Reserve seems committed to a controlled and well telegraphed interest rate policy that will not upset financial markets. However, rising rates will be a headwind for bond prices and was the cause for modest losses in the bond market. The aggregate US bond market index fell by 1.5% in the quarter.

Rising stock market volatility is a welcome change. Larger swings in the stock market is advantageous to our investment process. As a contrarian investor, we rely on systematically taking advantage of investors overreacting to market news or a company's short-term problems. For the past few years there have been very few significant downward moves in stock prices. Historically, the stock market has experienced a 10% correction around once per year. We just experienced our first 10% correction in two full years. Sasser Investment Management anticipates and plans for making changes to portfolios during these times that allow us to increase the quality of our holdings and buy stocks at attractive prices. In the present environment, we are seeing considerably more potential opportunities than we have in some time and believe this will lead to favorable returns going forward.

Whatever may be happening in Syria, North Korea or Washington DC, it is not having a major impact on financial markets. Investors simply do not believe these situations will have any significant impact on corporate earnings and neither do we. Our focus will never stray very far from what is happening to corporate earnings because earnings drive stock prices. At this point, the earnings news is all good. All eleven economic sectors in the market will have revenue and earnings growth for the second quarter in a row. First quarter results are now estimated to grow by more than 17%. The S&P 500 is trading at sixteen times expected earnings, which is a comfortable market valuation. The current bull market is getting long in the tooth, but we see no reason for it to end any time soon.

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