October 18, 2018

Q3 2018 Commentary: "healthy normalization"

Best quarter for stocks in five years. Let that thought settle in for a moment. The bull market that is now in its tenth year continues to churn out positive returns. Despite the extended bull run, signs of market excesses are hard to find and market mavens continue to remain skeptical of the bull market's endurance. Indicative of the skepticism, the Investment Company Institute reports that investors are still pulling money out of stock funds and stock ETFs. Last quarter, $51 billion was withdrawn from these funds. Still, the stock market continues to climb the wall of worry. One worry in particular has everyone's attention, rising interest rates. The 10-year US treasury yield rose to 3.06% on 9/30 following the Federal Reserve's rate hike in the last week of the quarter.

As good as the quarter was, October has been the reverse. Large growth stocks and technology stocks have come under sharp selling pressure. Still, it is hardly time to abandon stocks. The stock market is doing what it does; it fluctuates. The path to higher prices is not a straight line. In recent years we have become so accustomed to a tranquil market, that a few bad days sparks an overwrought reaction. However, many stocks in the S&P 500 have already been going through a correction. Currently, more than seventy percent of the S&P 500 stocks are down by more than 10% for the year and many are down by more than 20%. Corrections have been few and very far between over the last five years. The current retreat is the opportunity we have been waiting for to put cash into the stock market at attractive prices.

We are not beginning a bear market. The US economy is unequivocally in a strong position. GDP growth was 4.2% in the 2nd quarter and the Blue Chip Economic Indicators consensus estimate for the 3rd quarter calls for 3.4% growth. Unemployment is a very low 3.7%, while an average of 190,000 jobs are being added to the economy each month and wages are growing for workers. The Federal reserve is raising rates, however it is only moving from accommodative to neutral monetary policy. JP Morgan Chase CEO Jaime Dimon called it a "healthy normalization" after years of artificially low rates. Rate policy will continue to be measured and not something that will derail the economy. In a series of speeches, Fed officials have confirmed their belief that the US economy is strong and inflation remains well contained. Fed Chairman Powell projects that unemployment can remain under 4.0% and inflation at 2.0% for the next three years. If inflation remains in check, Fed policy will remain at neutral and we will continue to enjoy a good investment environment.

There are issues that are concerning, but they remain just that. It is too soon to say whether slowing global economic growth, higher tariffs and production costs, or rising interest rates will stifle the economy. However, agreements with Mexico and Canada on trade and the potential meeting with the Chinese in November bodes well for the trade situation. The economy appears strong enough to handle these headwinds. Meanwhile, the surge in corporate earnings continues. The strong economy, the boost from the corporate tax cut pushed year-over-year earnings growth to 24% in the 2nd quarter. Growth in the 3rd quarter is projected for 19%, and the 4th quarter is estimated at 17% before moderating to 7% in the 1st half of 2019. Because earnings have been so strong, the stock market valuation has actually gone down since the beginning of the year. The state of the economy and prospects for further earnings growth, raises our conviction for a good stock market going forward albeit with more volatility.

436 14th Street, Suite 1118 Oakland, CA 94612 / P: 510.835.0960 / F: 510.722.2266
www.sasserinvestments.com