What a difference a few months can make.

2017 finished on an up note for stocks. Congress had just passed historic tax reform, and the economy was humming along. January of 2018 saw an even bigger increase of bullish investor sentiment. It seemed like nothing could derail the mighty S&P 500, which gained 5.2% for the month! At that rate, we were on our way to a 60% plus year! Then something strange happened. In early February, average hourly wages ticked up, from about 2.5% to 2.9%. The yield on the ten year Treasury bond was rising (and the price falling) from 2.4% at the beginning of the year to almost 2.9%. Suddenly, everyone worried about rising inflation, the nemesis of bonds. Stocks began to fall very quickly, from SPX 2872.87 on 1/29/18 to a low of 2532.69, a drop of 11.8%. The sharp drop was exasperated by the collapse of a trading strategy called "short volatility". Basically, some investors were betting that the stock market was never going to deviate from the nice, predictable upward incline of the last several years. They were selling a kind of fire insurance, which for the past several years had been as profitable as picking hundred dollar bills off a money tree. Wall Street even created ETFs, or exchange traded funds so the little guy could get in on the action (imagine that!). Some of these ETFs lost 90% of their value overnight. Caveat Emptor.

Things began to stabilize in February, if you can call daily swings of hundreds of point's stability. At least it was not going straight down. Then, in early March the market got a new thing to worry about. Completely out of the blue, the Administration announced a series of trade tariffs on steel and aluminum. After a couple of weeks of wrangling and pleading by our trade partners, many countries were eventually exempted from the tariffs. The markets began to stabilize. Then the Administration announced new tariffs of $50 billion to be levied on China. Predictably, China responded with $50B of tariffs on U.S. soybeans, pork, fruit and other products. The Administration threatened to slap on another $100B—and so on. Lost in all of this is the fact that the original "source" of the market's fears in later January—higher bond yields, has all but dissipated. The ten year yield has grinded lower since then, as people worry about a trade war and an economic slowdown.

Markets can handle good news and bad news, but they hate uncertainty. It's virtually impossible to predict where we are going in the very short term. Longer term, things look pretty good. Valuations, as expressed as the P/E multiple on expected 2018 earnings, have come down to around 16.50 times. With inflation below 2%, this is a reasonable level. Interest rates will likely rise, but until the yield on the ten year treasury exceeds 5.0%, there is a strong historical bias towards positive one year returns in the S&P 500. Currently at 2.8%, we are a long way from 5.0%.

Lastly, just as late January showed excessive enthusiasm for stocks, the past several weeks have shown extreme pessimism and FUD-Fear, Uncertainty and Doubt. In the topsy-turvy world of markets, this is a good thing. Markets rarely accommodate the crowd.

The thing to keep in mind is that long-term, stocks have returned a high single digit percentage. Some years, like 2017, the number was 22%. Other years it will be more modest or even negative, as the multi-year average returns to the mean. Keeping focused on your long-term goals will keep you from making emotional mistakes which can cost you big money.

Regards,

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