

# CORRECTIONS = MARKET MEDICINE

Volatility returned in size to start the new year. It wasn't unexpected. We titled our annual Outlook piece Mean Reversion. It is the backbone of our 2018 investment strategy. The new year began with the Stock Market seriously extended. Without any sort of correction in 2017, stocks precipitously propelled higher with some reckless abandon. There was no healthy back and filling. There was no breather. When that happens, the inevitable correction tends to be larger, quicker and more violent on the way down. There were simply more excesses to correct. The Market tends to get ahead of itself. That's where corrections serve a purpose. That's what has been taking place in February and March. A significant streak was broken. Q1 2018 was the first quarter in ten that was a decliner. The S&P 500 had been up in nine consecutive quarters. The last decline was Q3 of 2015. It has been a remarkable run. We see the correction continuing a little longer. It's normal and it's healthy. It's not much fun though.

## SIZING UP THIS BULL

This Bull Market just entered its 10th year. It is the second longest and second largest since World War II. It trails only the Dot.com Bull which lasted 9.5 years and gained over 400%. The Dot.com Bull brought full-blown euphoria in the 1990's and asset prices were excessively inflated led by many unprofitable companies. It's quite different from today's Bull, which is not cheap by any stretch, but it is not exceedingly expensive either.

A little euphoria started creeping in towards the end of last year, but the correction erased it immediately. Importantly, the fundamental backdrop is healthy right now. Both corporate earnings and the global economy have accelerated in growth. Earnings are slated for double digit growth again in 2018, on the back of strong demand and lower taxes. The Market engine is quite strong. It's really the first time this has happened in a decade. Global Markets had been previously propped up by cheap money from central banks. They are now operating under their own strength. We believe there is more life yet for this Bull. Whether it ultimately outdistances the Dot.com Bull in price is still being debated.

A strong engine is still susceptible to flying debris. That's certainly the case with the growing issues in Washington and around the world. Stocks are driven by earnings and economic growth. But they are certainly influenced by politics and geopolitics. The uncertainty heading to the midterm elections in November and the various geopolitical issues around Russia, North Korea and Iran will remain a nagging overhang. The Market has started paying attention.

## FED MATTERS

There is a new leader at the Fed. His name is Jerome Powell. Mr. Powell faces a completely different situation from his predecessors. The economic acceleration has brought some inflationary pressures for really the first time in the cycle. The Stock Market started the year hitting new, all-time highs. Powell's job now is to take the foot off the gas pedal and tap the brakes a bit. The Market is sniffing that out. It continues to recalibrate the faster growth and the rising price of money. This is a new development which has created a bumpy transition.

## FREE TRADE OR FAIR TRADE?



Fears of a full-blown trade war infected the Bullish Market tone. It's all about free and fair trade and the White House continuing to shake things up. China has invested mightily and has become a leader and innovator in science and medicine. The big concern today is intellectual property and high-tech. The U.S. is ready to take a harder line against China where intellectual property is concerned.

The prospects of the US and China launching protectionist moves threatens the health of the global economy. It would have a serious negative impact on American companies with substantial revenues abroad. Tech and Industrial companies top the list. These have been the sector leaders for the Stock Market, so it is no surprise, the prospects of a trade war led to their declines. Importantly, Consumers would feel the pain in higher import prices. It's a biggie for the US economy. Nobody wins in a trade war.

### TECH UNDER FIRE



Silicon Valley has become extremely powerful over the years, and in the case of the Facebook privacy incident in March, that power has been abused. The Digital Age has grown these large Titans of Tech. Amazon knows what you buy. Google knows what you search. Facebook knows what you share. It doesn't cost you much, at least in monetary terms. The greatest expense: your privacy. There are growing outcries for regulation and perhaps breaking up of the Tech Titans. Microsoft had a similar situation a decade ago. Facebook is in the hot seat now.

The US government could weaken these powers. Tech stocks have been super powers too. It's been a crowded space. The Market is getting rattled with uncertainty. This definitely clouds the visibility for growth in high-tech. We think it resolves itself with a positive outcome. But it won't happen without more risk and negative rhetoric. Tech needed to correct. Tech is the fastest growing sector, but earnings are facing some risk. That's new. Tech is also the largest sector in the S&P 500, by a wide margin. We aren't convinced that the correction is done.

### NEW WORLD ORDER



China plays by a different set of rules. They aren't concerned about privacy and don't even pretend to be. China has their own set of Tech Titans. And they are sort of hybrid companies that are very powerful with state backing. Their names are Alibaba, Baidu and Tencent, among others. These are China's versions of Amazon, Google and Facebook. They are innovating like Silicon Valley start-ups with the strong backing of the Chinese government with ideas of a digital space race for dominance in the 21st century. Innovation does not reside solely in the United States.

We still like Emerging Markets. These are a basket of international countries who are experiencing faster economic growth and possess younger demographics. They are the future consumers where wealth is being created and expanding. Emerging Markets are cheaper in valuation, growing faster and pay larger dividends than the US Stock Market. They've also trailed in performance and are playing catch-up. Foreign countries are moving forward with trade deals without US participation. That is new and will have serious implications for years to come. As our Bull Market matures, the Bull Market overseas is just getting started, in our opinion. It's investable.



We are long-term investors who are equipped to deal with short-term issues. This has us still on the defensive as we move into Spring. We view corrections as quite healthy, as short-term pain leads to long-term gain. It's mean reversion. We just want to make sure that short-term issues don't turn into long-term issues. It's never easy. We don't think that's the case right now, and plan to buy the weakness. But if the facts change, so do we.