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ASSET MANAGEMENT

THE END OF THE BEGINNING?

"Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria."
-Sir John Templeton

At the outset of 2017, I think it would be fair to say there was a general sense of guarded optimism around the prospects for equities. "Guarded" because stocks were already expensive after a furious post-election rally, and the US Federal Reserve was poised to raise interest rates at least two to three times in 2017. Beyond that, the economy continued to stumble along at an unspectacular 2% +/- growth rate. We read a lot of predictions for 2017, but nowhere did we see anyone calling for a 20% return on the S&P 500 nor 37% in emerging markets. As they say in the sporting world, that's why they play the game.

The opening quote above is well known in the investment world and has proven remarkably accurate over the years. Certainly things couldn't have looked any worse in the spring of 2009 when this current bull was born. Throughout the past 8 years there were many doubters and naysayers with respect to the longevity of the stock markets rise. Currently, there seems to us a widespread view that this bull market still has legs and there is little on the horizon that might cause it to stumble. In fact, 2017 was the least volatile year for US equities over the past 50 years!

Optimism reigns and, admittedly, it's hard for us to find much fault with the current economic landscape. There's been strong, synchronized global growth throughout 2017 lifting economies and markets around the world, and the pace of growth is poised to expand in 2018. We offer below a brief summary of global returns and 2017 GDP, highlighting the delta between developed and emerging market growth rates.

Region	Q3 GDP %	'17 Stock Mkt Return (USD)	Region	Q3 GDP %	'17 Stock Mkt Return (USD)
US / S&P 500	3.2%	21.8%	China / Shanghai	6.8%	15.9%
Eurozone / Stoxx600	2.6%	26.8%	India / INDA ETF	6.3%	36.0%
Japan / Nikkei 225	2.5%	25.6%	Indonesia / EIDO ETF	5.0%	19.4%

Source: Bloomberg; GDP data annualized rate through 2017 Q3.

Outside of this crazy phenomenon called Bitcoin, we're hard-pressed to find a broad euphoria around stocks. According to the Investment Company Institute, through the first 11 months of 2017, investors pulled $41 billion from domestic equities and invested $362 billion in bonds. Hardly euphoric.

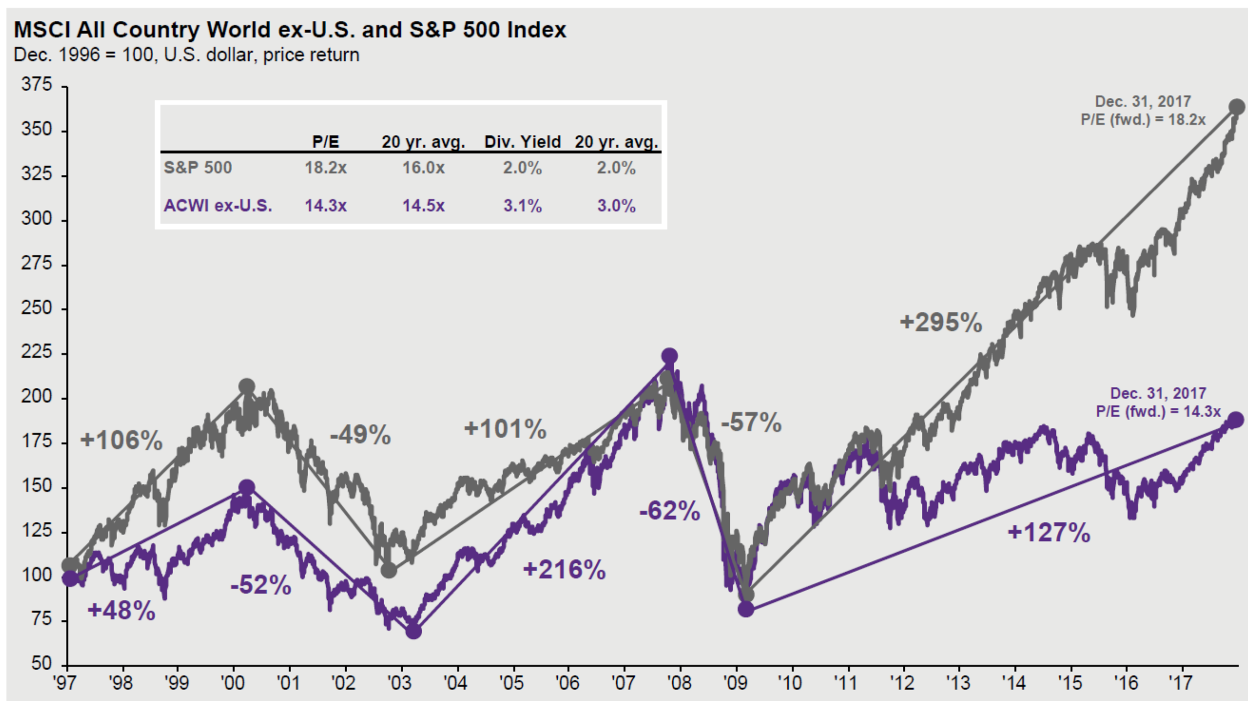
Speaking of euphoria, we're getting asked a lot by clients about Bitcoin and cryptocurrencies in general. By our lights, it's hard to assign Bitcoin any of the traditional properties associated with a legitimate currency. It's hardly a store of value given its wildly fluctuating price and illiquid nature. It isn't used as a medium of exchange by anyone we know – excuse me sir, how many Bitcoin is that shirt in the window? Lastly it fails the unit of account test, again due to its price volatility and difficulty converting it into goods and services. In short, we're not sure what it is, other than a highly speculative trade that has captured the

animal spirits of a large swath of the tech cognoscenti. While this current mania is likely to end badly, we do think we're in the early stages of legitimate cryptocurrency development. Stay tuned.

Turning back to the real world of supply, demand and fundamentals, we see a reasonable chance of an economic bump here in the US resulting from the tax reform act passed in late 2017. Most individuals in the US will likely see a higher paycheck in the coming weeks. Corporations will reap a windfall with new lower tax rates and the repatriation of cash formerly held overseas. The great hope is that these companies invest that cash in both human capital and property and equipment. Since the tax bill was signed into law, over 50 major US companies, including AT&T, US Bancorp, Southwest Airlines and Comcast have already announced worker bonuses and increased capital budgets resulting from its passage.

We think all the rancor and political discourse around the bill is taking away from the economic reality of what stimulus amounting to potentially 1% of GDP might do to corporate earnings, not to mention employee earnings. We've seen estimates of $10 per share in incremental earnings for S&P 500 companies, which would certainly help rationalize the heady prices of US stocks and potentially drive US and global markets higher (See our Q3 CIO Letter where we discuss the prospects for a "melt up").

As much as we believe US equities will fare well in 2018, we are fonder of both international developed and emerging market stocks. Both provided outstanding returns in 2017, with developed markets up 25% and emerging up 37%. We feel this is just the beginning of a longer term trend favoring non-US equities over domestic. For starters, most valuation measures tend to favor global equities over domestic. Secondly, long-term growth prospects in countries like India, China and much of southeast Asia are far superior to those here in the US. Lastly, the relative performance of domestic versus international stocks tends to move in 7-10 year cycles (see chart below). The years prior to the Great Recession saw substantial outperformance by non-US equites. Subsequent to the '08 crash, US stocks have widely outperformed. We think 2017 may have marked the turning of the cycle back in favor of international.



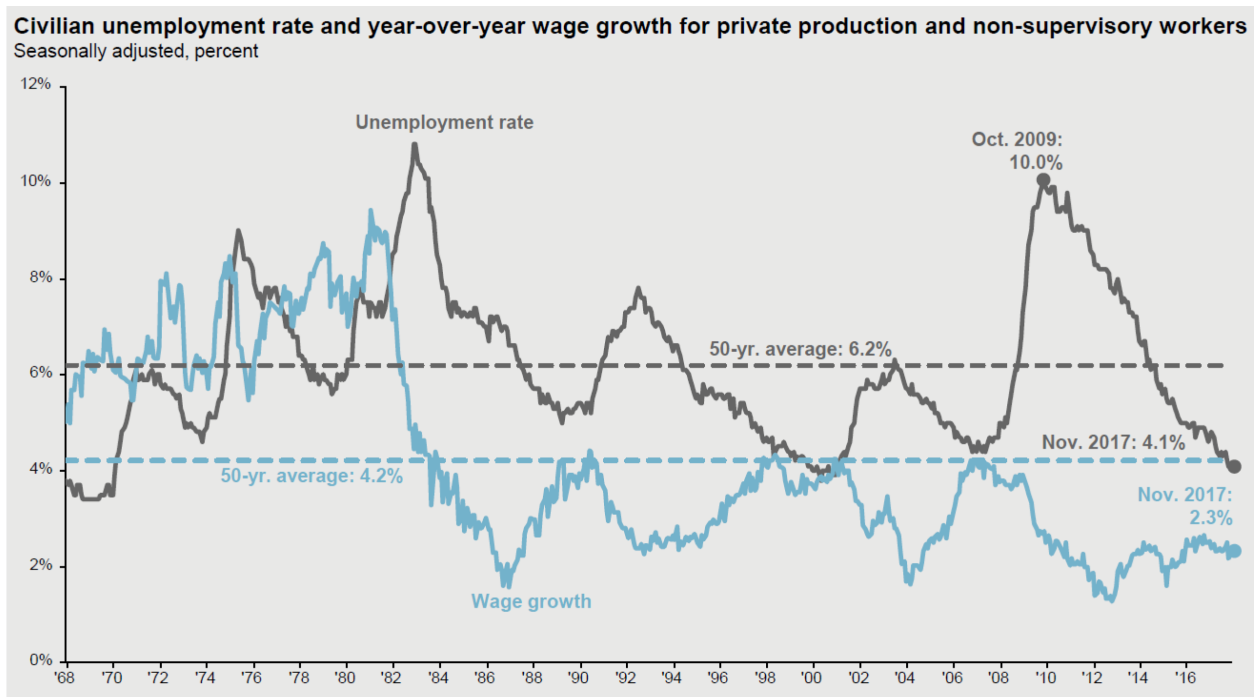
Source: MSCI, Standard & Poor's, FactSet, J.P. Morgan Asset Management.

A survey of the risks to our forecast finds three main challenges to our moderately bullish equity thesis. First, and most importantly in our eyes, is an inflation surprise that forces the Fed to raise domestic interest

rates more quickly than they otherwise would like. The FOMC has been remarkably transparent in its communication on the course of future rates. It currently sees 2 to 3 hikes in 2018, although the market is currently taking the under on that one. Should inflation spike unexpectedly, causing the Fed to move more aggressively, it's likely that equities both here and abroad would suffer.

Secondly, as geopolitical tensions heighten, specifically with regard to North Korea, investors will likely seek to reduce risk and flock to the safety of Treasury securities. This would be a negative for risk assets in general and likely lead to equity declines.

Lastly, and we would assign the lowest probability to this outcome, is an unexpected recession. Although the yield curve continues to flatten, typically a harbinger of recession, we think the stimulus provided by the new tax plan will push the odds for a recession off into 2019 or 2020. Although the current economic expansion is somewhat long in the tooth, we don't see anything getting in the way of continued economic growth for the foreseeable future. In a year or two, we think the impact of higher interest rates will start being felt in the US economy and growth could slow.



Source: BLS, FactSet, J.P. Morgan Asset Management. Past performance is not a reliable indicator of current and future results.
Guide to the Markets – U.S. Data are as of December 31, 2017.

The Great Interest Rate Conundrum

The above chart neatly encapsulates the Fed's current problem. Remember, its mandate is twofold: Full Employment in the context of Stable Prices. By these measures, it's doing a bang-up job. However, it would also like to target 2% annual inflation. Here's where it gets tricky. Despite historically low unemployment, wages aren't going up much. And, without wage inflation, try as it might, the Federal Reserve will be hard pressed to trigger broad price inflation in the US economy.

As we've discussed in past letters, the Fed has been far more successful at triggering asset price inflation. Now, however, with a concerted albeit deliberate effort being made to shrink its $4 trillion+ balance sheet, the Fed stands a reasonable chance at nudging market interest rates higher. Challenging this effort the past few years has been massive demand from investors for fixed income securities. Domestically, pension funds and insurance companies have been big buyers of US debt, including Treasuries, corporates and

mortgage-backed securities. Internationally, foreign investors have been enthusiastically buying US bonds due to the sizeable yield pickup over their own sovereign debt.

With the US 10-year Treasury note yielding about the same as it did one year ago (despite 3 interest rate hikes!) it will likely take a significant move in wages and overall labor costs to send inflation meaningfully higher. As strange as it sounds, this might prove to a good thing for the beleaguered savers in the investment world – those poor souls just looking for a safe but reasonable return on their capital.

Summary

The recent tax reform act is a game changer for investors. Lower marginal tax rates for individuals and corporations will lead to a huge injection of liquidity into the US economy. With the rest of the world cruising along just fine (thank you China), the additional stimulus in the US could send global equities meaningfully higher. This may not happen without some disruptions first, so don't get too comfortable. Should interest rates surge, all bets are off and you can throw our bullish thesis out the window. However, in the current environment of steady growth, low volatility and low interest rates, American businesses should continue to grow earnings handily and the Goldilocks market should survive another year.

Happy New Year,

Larry Whistler, CFA
President/Chief Investment Officer
January 2018

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