Graybill, Bartz & Associates, Ltd.

COMMENTARY

February 2018

Following gains of over 5% for each of the Dow Industrials and the S&P 500 during the month of January, markets finally experienced a sharp and sudden 10% correction in February. This correction was not unexpected and, in fact, follows the cautionary comment we made in our year-end letter that "we would certainly not be surprised by a correction of this magnitude sometime in 2018." Of course, we had no way of knowing that this correction would be upon us in just a matter of weeks.

While we have written often that markets had simply gone for too long with too little volatility, the catalyst for the sudden change in momentum was the February 2 report of the January employment numbers. The report revealed the creation of 200,000 new non-farm jobs and also indicated that average hourly earnings for private sector workers rose by 2.9% from a year earlier, the largest increase since June 2009. The tightening labor market (unemployment of 4.1%) and rising labor costs caused bond investors to take the threat of inflation more seriously and the anticipated rise in interest rates rattled stock investors. The benchmark 10 year U.S. Treasury note saw its yield climb to 2.88%, a four year high. That day, February 2, saw the Dow Industrials decline by 2.5%, and the previous benign trading volatility which characterized 2017 and January 2018 gave way to a violent pattern of daily swings in equity prices. On Monday and Tuesday, February 5th and 6th, the Dow swung 1,596 and 1,167 points, respectively, the two largest intraday ranges in history. Although ascertaining the primary reasons for this level of volatility is not totally transparent, programmatic trading by hedge funds and others appear to have contributed to these violent daily swings.

At the lows of last week markets had reached the definition of "correction territory," a decline of 10% or greater from a peak level, before rebounding over the past several sessions. This decline was accompanied by a sudden rise in bond yields as well as declines of at least 10% for most international equity markets. Once we get past this period of negative sentiment, we expect the market to return focus on the positives that have most recently driven equity prices higher. Foremost, and front and center, is the game changing impact of the reduction in personal and corporate income taxes which went into effect January 1, 2018. It is already having a significant impact, particularly on corporate behavior. The reduction of the top corporate rate from 35% to 21% is obviously increasing the bottom line for most companies, many of which have already responded by paying bonuses to employees. Furthermore, the repatriation of cash held abroad can be brought back to America at a reduced one-time tax rate of 15.5%. This sets up a bevy of possibilities for shareholders who would benefit from this repatriated cash for share buybacks, increased dividends, increased capital spending, and mergers and acquisitions.

For most of the time since the market bottomed in March of 2009, the Fed has been the primary agency carrying the burden of restoring our economic health. Congress was ineffective in implementing fiscal policy that was needed to have the economy grow at a faster rate. With the implementation of the new tax package, the Fed now finds itself in a tricky position. Stimulus from the tax package is coming at a time when we are essentially at full employment and the economy is growing at a 2½% to 3% rate. With hints of accelerating inflation, the Fed needs to raise interest rates at a pace that does not allow it to fall behind the curve, but not so much that it pushes the economy toward a recession.

Previous to this recent decline, stock prices had responded very favorably to better than expected earnings. Companies in the S&P 500 are expected to produce 4Q revenue growth of 7.5% and earnings growth of 13%, well above recent results. Since year end, analysts have increased their outlook for 2018 earnings by an additional 6%, with overall growth expected to be about 14%, year-over-year. Although we tend to agree with much of the commentary about the historical richness of stock prices, we also believe that the revisions in the tax code, the repatriation of offshore cash, and the reduction in growth inhibiting regulations will provide the fuel to power equity prices higher. Furthermore, with the correction that has taken place, the forward looking price-earnings rate of the S&P 500 has declined from 18.1 times to a current 16.5, thereby offering better value for investors.

In terms of portfolio activity, and as discussed in our year-end letter, we took advantage of the year-end strength in prices to reduce or eliminate several positions and to bring our overall equity weightings modestly lower. We have already made some new acquisitions on days of large market declines and will continue to evaluate new growth and income opportunities. While the exceptional level of volatility has subsided in recent days, there is an expectation that markets are unlikely to return to the period of historically low volatility experienced in 2017. Nevertheless, we expect the market's focus to turn back to the strong outlook for economic growth and corporate earnings.

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