Graybill, Bartz & Associates, Ltd.

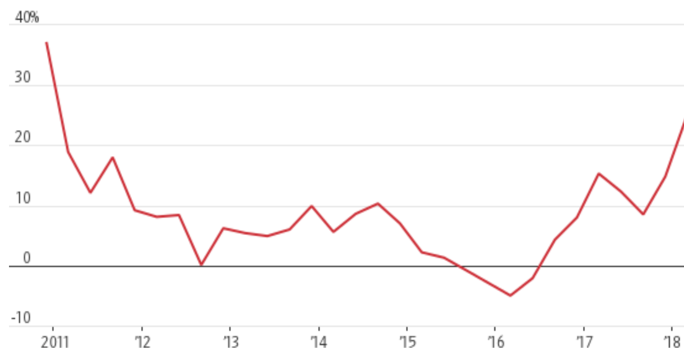
COMMENTARY

May 2018

The broad market correction that began in February continued for the month of April, albeit with far less volatility than in the previous two months. Markets ended the month near where they started, demonstrating that the correction has moved into a new phase of correcting "in time" rather than "in price." While recent volatility demonstrates how quickly investor sentiment can change, this low-volatility, sideways movement should be deemed "healthy" market action, as the correction has now been contained at a level above the February 9th lows for three months.

Turning to investment fundamentals, it is clear that recent lackluster performance cannot be attributed to poor earnings reports. As expected, and as discussed in our previous quarterly letter, this quarter's earnings results have widely exceeded expectations. Powered by a reduction in the top corporate tax rate from 35% to 21%, 1Q after-tax earnings for S&P 500 companies are tracking to a gain of 25.3% as noted in the nearby chart.

Year-over-year per-share earnings growth



Note: Most recent quarter reflects reported results for 61% of firms and analyst estimates for the rest.
Source: Thomson Reuters

According to the *Wall Street Journal*, it is estimated that more than half of the combined net-income growth reported by 200 large public companies for the first quarter resulted from a decline in their effective tax rates. The projected 1Q earnings gains would mark the seventh straight quarter of per-share profit growth and the strongest gains in more than seven years. In addition to the strong earnings growth, revenues for the S&P 500 1Q are expected to rise by 8.0%, comparable to the 4Q gain of 8.3%, which, again, would be the fastest rate since 2011 and the seventh straight quarter of growth. This strong level of revenue growth demonstrates that gains are not entirely the result of tax cuts as taxes impact earnings but not revenues.

The overall strength of corporate America has obviously been reflected in the performance of the equity markets. However, the tax overhaul appears to have had a more modest impact on the economy to date. 1Q gross domestic product grew at a 2.3% rate, slower than the pace at the end of 2017. Strong capital spending by business offset a slowdown in consumer spending. It should be noted, however, that 1Q results in recent years have been the weakest quarter of the year which some attribute to weather and measurement

problems. This is reflected in current estimates for GDP growth to exceed 3.0% for the balance of the year.

The stall in equity prices comes at a time when various headwinds are weighing on investor confidence. Rising interest rates, tariff concerns and their implication for world-wide economic growth, mid-term elections with possible Republican losses in Congress, and the Mueller hearings are among the most prominent issues searching for clarity.

Among these concerns, the path of interest rates probably has the most direct impact on equity prices. The flattening of the U.S. Treasury yield curve has caused some consternation among investors. An inverted yield curve – in which short-term rates rise above long-term rates – has a strong record of being a precursor of recession. Short term rates have exceeded longer-term rates before each recession since at least 1975.

Recently, the gap between two-year and ten-year U.S. Treasury yields reached its narrowest point since 2007 at 42 basis points. If current trends were to continue, the yield curve could possibly invert as early as 2019. For this to happen, the Federal Reserve would likely have to pursue an aggressive program of raising short-term rates to head off a strong upward movement in inflation caused by an overheating economy. We view this scenario as unlikely in the near term, as any increase in inflation measures or economic strength should be reflected in a continued rise in long term interest rates, concurrent with any Federal Reserve action.

Considering last year's 20%+ equity returns, it is reasonable to expect more modest gains this year as stocks retreat to a historic trend line. The better than expected earnings growth along with the retreat in equity prices have gone a long way towards improving the valuation of stocks. While the price earnings ratio for the S&P 500 approached 20x at its peak, this elevated level largely "priced in" the impact of accelerating growth and tax reform. Given higher earnings and lower stock prices, the market today sells for approximately 16x estimates for 2018 earnings. While it is always difficult to discern how much of the future is already reflected in today's price levels, we are encouraged by recent market action and fundamental company results.

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