New Highs Are Nothing New Redux

Greetings!

Based on your feedback, I've been working hard to reduce the wordiness of my letters. The drawback is that I must explain things less thoroughly. For those of you who want "more," please call me for a discussion.

The following represents my beliefs.

Feeling Better?

The Markets Were Fairly Flat for Nearly 2 Years

We experienced:

- A broadly flat **2015** – and
- **~10 months** of nearly flat markets in **2016**, before markets began to "grind higher" (as measured by the Dow Jones Industrial Average – DJIA) (1)
- After ~18 months below the highwater marks, markets began to make new highs in late 2016 – just before Thanksgiving.
- After underperforming for 7 of the last 8 calendar years, foreign stocks have broadly been outpacing domestic stocks this year (as measured by the MSCI EAFE index and DJIA). (2)

The Markets Have Broadly Made Lots of New Highs

The media likes to count the number of new market highs – but keep in mind, if the market rises a fraction of 1 point above a previous high, it is a "new high." As I've written a number of times:

- Although past performance cannot guarantee future results, new market highs have been related to an ever-expanding economy, over many years
- "New highs are nothing new."

Larry, Are Stock Prices "High?"

For many people, hearing, "The markets have made new highs," is interpreted as "stock prices are 'high'." They may be; they may not be. It depends on valuations.

Stock Valuations

1. First of all, valuation has almost *nothing* to do with timing, or market direction!
2. Generally, higher valuations imply lower potential future "expected" returns and vice versa (3)
3. Generally, valuations have to do with the prices of stocks – in relation to profits that companies can produce (aka "prices in relation to earnings")
4. Valuations are, by many measures, slightly above average historical levels (4)

5. There is, generally, an inverse correlation between interest rates and market valuations. In other words, when interest rates are low, stocks tend to trade at higher valuations and vice versa
6. I believe valuations look rather reasonable – particularly when considering the current level of interest rates
7. I believe interest rates will continue to be at historically low levels for quite a long time, but no one knows for sure.

On Corrections
Since:

- A correction is a **10%+ fall from a previous highwater mark** – but, *in hindsight*, we learn it was just an interruption – the bull market then continues its "grind" higher
- We've averaged about 1 correction per year over the last 100 years, or so (but they haven't happened *each* year – we've had 2 in the last 7 years)
- It is nearly impossible – for *professionals* – to "dance around" a correction, so why would investors allow the media's incessant "we may be due for a correction" refrain to take-up space in their head?

When a reporter is opining about the potential for a "correction," I believe you should change the channel!

By the way: The two major corrections over the past 7 years (**2011 & 2015-16**) were associated with a potential global economic crisis that *could* have put the sluggish U.S. economy into recession, but did not. (5)

What Causes a Bear Market?
A bear market, or downward trending prices – 20% or more – off of recent highwater marks, is almost always caused by an economic recession (i.e. a downturn in the economy). This is not to be confused with a "correction."

Larry, What Does the Calendar Say About an Economic Recession? Are We Due?
If you look at the length of the current economic expansion, we may be "due" according to "the calendar," but economic cycles may not always follow calendars.

Economic Growth Continues to be Sub-par

1. As I've written before, U.S. economic growth has been subpar – we've been growing at about **2/3** of the normal historical rate of economic growth. This means that, although it doesn't "feel good," slow economic growth may allow an economic expansion to last longer than average, as cycle-ending inflationary pressures and bubbles may take longer to build
2. Although an economic expansion could end at any time for any number of reasons, and U.S. stocks can fall to much lower levels – even from valuations that

might seem reasonable at a market peak, I believe the economic expansion may continue for some time to come. Why?

3. We currently have "synchronized global economic growth" – i.e. most of the economically important economies of the world are growing.

North Korea

Regarding North Korea, I believe it is no one's interest for the situation to escalate to a war scenario. I believe N.K. is using their leverage to bargain for economic relief. Also, Kim feels threatened and is looking to insulate himself from being forcibly removed by outside forces. China *could* force Kim to stand down, but fears the collapse of the regime. In addition to a potential refugee problem, China fears a unified Korean peninsula – with an American presence on China's border. I believe the most likely outcome is a Cold War-like stand-off. While anything could happen, worst case geopolitical outcomes rarely come to pass.

In summary:

- Although past performance cannot guarantee future results, historically, stocks have broadly outpaced inflation by a wide margin, over many years
- Stocks can broadly perform very poorly for long periods of time
- Many investors have a portion of their assets invested in stock-oriented investments in an attempt to offset the deleterious effects of inflation on the buying power of our money
- Investors should have *that* amount in stock – as a percentage of all financial assets – which we can live with through good and bad cycles
- Setting our stock to bonds/cash ratio should *not* be done based on a "calendar." This is something we discuss during our financial reviews.
- Although things can change at any time, we currently have "synchronized global economic growth." I'll write more on this soon.

I hope you enjoyed your summer! Let us keep our eye on the horizon!

Thank You!

Also, I'd like to thank all of you for your patience and understanding, as we executed our transition to Eppolito Financial Strategies – and our relationship with Raymond James Financial Services.

Best!

Larry Eppolito
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Sources:

1. Advisor Perspectives
2. Riverfront Financial
3. Mauldin Economics
4. Investor's Business Daily
5. Wall Street Journal
6. Boston Globe

Footnotes:

1. Dow Jones Industrial Average (DJIA) is an unmanaged price-weighted index comprised of 30 leading U.S. stocks. Always use the full name on first reference. Thereafter, the Dow or the acronym DJIA is acceptable.
2. MSCI EAFE index is an unmanaged index that is generally considered representative of the international stock market. These international securities involve additional risks including currency fluctuations, differing financial accounting standards, and possible political and economic volatility.
3. Generally, an "expected return" is a subjective evaluation of the potential for stock returns in the future – as compared to historical broad market returns. It is largely based on today's market valuation level. The higher the broad market valuation

level, the lower the expected future potential return – and vice versa. Past performance cannot guarantee future results.

4. S&P 500 P/E multiples are at ~19.5x this year's expected earnings and ~17.1x 2018 earnings estimates. Valuations can change at any time. (Source: Investment Strategy, Jeffrey D. Saut, Raymond James & Associates, 9/5/2017)
5. There were two corrections, each due to sharp downturns in Chinese markets (August of 2015, and December to February of 2016). Many market experts consider this one correction ("2015-2016"), as each was due to the same cause – and they happened fairly close together.

Important Information

The S&P 500 is a market value-weighted unmanaged index of 500 widely held stocks that's generally considered representative of the U.S. stock market.

International investing involves additional risks such as currency fluctuations, differing financial and accounting standards, and possible political and economic instability. Also, investing in emerging markets can be riskier than investing in well-established foreign markets. There is no assurance any of the trends mentioned will continue in the future. Investing involves risk and investors may incur a profit or a loss, including the loss of all principal.

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