THE LONG RUN

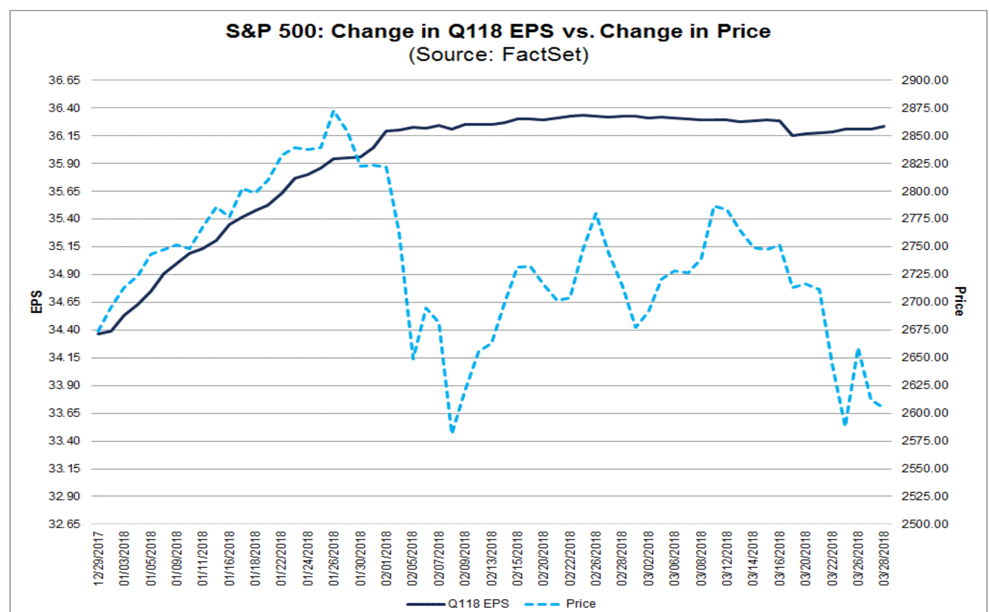
Reynders, McVeigh Capital Management, April 2018

"Excess generally causes reaction, and produces a change in the opposite direction, whether it be in the seasons, or in individuals, or in governments." - Plato

Analysts and participants may have gotten ahead of themselves as the market rocketed forward in the last quarter of 2017 and the early weeks of 2018. In hindsight, their optimism is understandable. This is especially true given the increasingly synchronized growth in economies around the world last year, the passage of the Tax Cuts and Jobs Act of 2017, and the promise of a more expansive federal budget in 2018. To have such extraordinary stimulus administered so far into an economic expansion with unemployment at decades-long lows is the kind of sugar hit that can lead easily to speculative excesses. The parabolic rise in Bitcoin in this period might have been a fair signal that greed had overwhelmed fear in the market.

There is certainly cause for excitement as we enter earnings season for the first quarter. Underlying earnings growth has been strong across many sectors in recent quarters, and GDP growth around the world remains solid – with 4th quarter GDP growth in the United States raised from an initial reading of 2.5% to a final reading of 2.9%. Add to this the economic benefits of the new tax bill, which go directly to bottom line earnings for many U.S. domiciled companies, and you have the recipe for gaudy earnings numbers. Already impressive growth expectations have pushed even higher this quarter. FactSet reports that the median 2018 full year earnings per share estimates for all of the companies in the S&P 500 has increased by 7.1% since December 31, 2017. This marked the largest increase in the annual earnings per share estimate for the index over the first three months of the year since FactSet began tracking this measurement in 1996. FactSet estimates that total year-over-year earnings growth for the S&P 500 will be 17.1% in the first quarter of 2018.

Growth in stock market prices over the last five years has outstripped growth in earnings for the S&P 500, leading to a significant increase in price-to-earnings ratios. So, by the beginning of 2018, prices in the market were already anticipating significant growth ahead. The chart below shows how investors were suffering from the "Disease of More" in January of 2018. (Pat Riley, the coach of the 1980 NBA champion Lakers, coined the term "Disease of More" to explain the collapse of the Lakers the year after their championship. Riley described how his players had lost their focus on the fundamentals of the game in a quest for "more," i.e., more money, more individual playing time, and more fame. He



suggested their success and, specifically their desire for even more individual success, planted the seeds of their eventual failure.) Day after day in January, analysts raised their earnings estimates for the S&P 500, and day after day many investors followed suit by pouring money into equities. The market legged up in a chase for even higher returns after a blockbuster 2017 during which the S&P 500 delivered better than 21% in total return. As soon as the estimates for earnings growth leveled off, however, many of those same investors who were so eager for more may have realized that, like Pat Riley's Lakers, they had lost track of fundamentals, and the market corrected.

Of course, there is a bit more to the story. President Trump, whose economic policies in 2017 had been supportive of earnings growth, began to introduce policies in 2018 that were potentially detrimental to some companies – and to the longer-term health of the U.S. economy. The President's protectionist approach to tariffs and the potential for a full-blown trade war with China certainly seemed to spook the markets. In addition, many economists shared deep concern that the expansive tax cuts would balloon deficits – putting even more pressure on future generations to manage the country's increasingly heavy debt load. (To add fuel to the fire: The Congressional Budget Office recently announced that it now estimates that the 2018 deficit will be $242 billion larger than it had projected just last June.) Concerns about inflation and a potential sharp rise in interest rates choking the economy moved other investors to the sidelines. These grounded fears have – finally – given some balance to a market that would benefit from corrective action to consolidate some of the extraordinary gains that we have witnessed over the last few years.

We warned in our January Long Run that stocks were "anticipating an awful lot of good news" and have been extremely active over the last year rebalancing accounts, trimming high flying stocks, raising cash and locking in some gains in balanced accounts, and reallocating some dollars to growth opportunities trading at discounts to market leaders. This work – done during a period when the market was hitting continual highs – gives us some opportunities now as the market corrects and individual companies come on sale.

As earnings reports come out this season, there will likely be a deeper divide between winners and losers. We will learn more about just how strong the global economy may or may not be, and we will begin to see data that will help us to sort the companies that are experiencing real revenue growth and earnings growth from those that are manufacturing growth on paper with earnings adjustments based on policy promises. And, once again, as in most periods of consolidation and correction, fundamentals will matter.

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In company news, three new employees joined Reynders, McVeigh in the first quarter of 2018. We hope you will join us in welcoming: Max Gruber, Data Management Associate; James Jurgens, Trading Assistant; and Sheevani Patel, Compliance Manager.

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121 High Street, 4th Floor, Boston, MA | Phone 617. 226.9999 | www.reyndersmcveigh.com