WESTLAKE
PRIVATE WEALTH MANAGEMENT

Quarterly Market Missive
January 2018

Last year was one for the record books. Excluding dividends, the S&P 500 advanced a healthy 19.4% in 2017, but more impressively, did so with negligible volatility by consistently notching gains every month of the year for the first time in history. Developed international and emerging markets equities participated as well, gaining 25% (MSCI EAFE) and 37% (MSCI Emerging Markets) respectively. But the more things change the more they stay the same - 2018 got off to a torrid start as well, with the S&P 500 rising a quick six percent and hitting record highs to start the year. In fact, the S&P 500 has made as many new highs in January (13) as it did during the entire decade of the 2000s.

What's going on? Are the fundamentals *really that good*? And is the rally we've been enjoying in stocks over the last 14 months *sustainable*?

Fundamentally – yes, the macro-economic environment appears to be *that good*. The global economy began accelerating toward the end of 2017; in fact, global GDP growth surprised even most economists as its pace was considerably better than what was forecast only months earlier in the year. With tax rates falling, regulations reduced and monetary policy still loose, growth trends are expected to continue into 2018 and we have the distinct possibility of 2017 and 2018 being the best back-to-back years of global growth in more than a decade. The rest of the world's economies are joining in as well, gaining steam that doesn't appear likely to run out anytime soon. On the earnings front, corporate profits are likewise accelerating: as of this writing, 156 S&P 500 companies have reported fourth quarter 2017 results – 81% have beaten earnings estimates on 17.8% growth and 85% have topped sales expectations on 8.4% growth. According to Factset, since the recent tax law passed analysts have raised their 2018 earnings estimates more rapidly than at any time in the past decade.

But the key question is whether the stock market's trajectory is sustainable. As we all know, macroeconomic and corporate fundamentals are the key drivers behind stock performance, and as long as those fundamentals remain intact, the uptrend in asset prices should continue. However, regardless of the strength of those fundamentals, markets rarely move in a straight line. And with the recent gains elevating investor sentiment we must remember that sentiment can be a fickle thing. We watch the Ned Davis Research Crowd Sentiment Index, which is a composite of seven sentiment gauges and recently hit an all-time high. We also keep an eye on the CNN Fear/Greed Index, another widely-followed sentiment indicator, likewise flirting with all-time highs. So we take a realistic view - at these levels, with volatility uncharacteristically low and enthusiasm elevated, the markets may be priced for perfection and it may take very little to force a correction. Any disappointment or surprise could be met with greater volatility and selling than we've seen in the recent past.

There are fundamental risks we're watching as well: with the 10-year Treasury yield surging over a half a percent since last summer analysts are beginning to debate how much further rates can rise before beginning to drag on stocks. Economists are also discussing how the accelerating economy may impact inflation trends, with rising inflation perhaps pushing the Federal Reserve into a more aggressive monetary policy than investors currently anticipate.

Despite these concerns, we believe that any pullback would remain within the context of a secular bull market and strong economy and thus would likely be short-lived. In fact, after the run of the last 14 months, we would view a pullback as a healthy thing. As we've said before however, corrections are hard to call and even harder to trade. No one knows for certain when they'll occur and very few have the mechanics or discipline in place to take advantage of them. Our best strategy is to reassess and remain close to our objectives, rebalance periodically, and remind ourselves that we're investors, not speculators. We also need to remember that on average, the market has corrected 10% every year since 1900.

In conclusion – the economy and corporate earnings growth are accelerating into the New Year and we join most economists and analysts in anticipating positive returns on the year, however we're mindful that equities are largely priced for perfection and the possibility of a midcourse correction is elevated.

As always, we wish for the very best for you and your families in the year ahead, and we thank you for your continued trust and confidence in us.

James H. Dryden, Director
January 30, 2018