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October 2018 Commentary

"Stocks Poised To Gain On Election Day"

So said the headline over a recent article examining the three potential outcomes of next month's Congressional elections, and their possible effects on the economy and the markets.

By many reckonings there are really only two probable outcomes in November: either the Republicans maintain control of both houses of Congress, or the Democrats take control of the House. The third, and least expected outcome, is the Democrats win both the House and Senate.

The spoiler alert is that while two of the three outcomes could lead to some short-term market volatility, in the long run there are other factors with much greater impacts on both the markets and the economy.

Rather than considering politics, we first think of economic policies, and how those policies may affect the fundamentals of corporate earnings, economic growth and inflation. Each of these factors will influence how markets evaluate the future. At present the S&P 500 is up 4% YTD and the Dow Jones Industrial Average is up 2%, with the three aforementioned factors indicating the bull markets will be sustained.

The key initiatives of President Trump have been corporate tax reform and regulatory relief. According to our research these two initiatives alone have created a 25% increase in year-over-year corporate earnings, which in turn have driven the strong markets this year. We believe that earnings growth and inflation expectations are still highly favorable for equities, and that interest rates are still historically low despite the Fed's tightening moves.

Another factor we consider is trade. Tariffs and trade policy have a significant impact on valuations and market actions, but decisions in this arena rest largely in the executive branch and we expect the president's "speak loudly and carry a big stick" diplomacy will continue regardless of which party controls Congress.

While we have as a firm taken some risk out of many portfolios and introduced short-term Treasury bills to counteract events should the unexpected occur, stocks continue to represent our largest allocation. That is because we believe the underlying strength of the economy, and many of the drivers of growth, such as e-commerce, financial technology and biotech, will overwhelm short-term reactions to midterm elections.

Finally, a few words about the recent market drop.

As unnerving as any sell-off can be, such corrections tend to be short-lived when they occur during periods of strong economic growth. In such an environment, history has shown that markets typically got back on their feet rather quickly and continued to rise again.

Of course there is no guarantee historical market patterns will repeat themselves, but that is exactly what happened earlier this year. The S&P 500 peaked in late January, fell 10% by early February, then re-tested its low in April. After that it climbed steadily until this week.

Thus we believe the sell-off we experienced is more like a market correction after a strong rally than the beginning of a bear market. Our expectations for U.S. economic growth, interest rates and risk have not changed much from a year ago. We think the U.S. remains in a strong position relative to the rest of the world, and that in this environment of a fundamentally strong economy a sell-off is not a reason to abandon our sound, long-term investment plans.

Grant and I very much appreciate your business, and we welcome the opportunity to meet with you to discuss your investments.

Grant

Grant E. Buce

Jamie

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