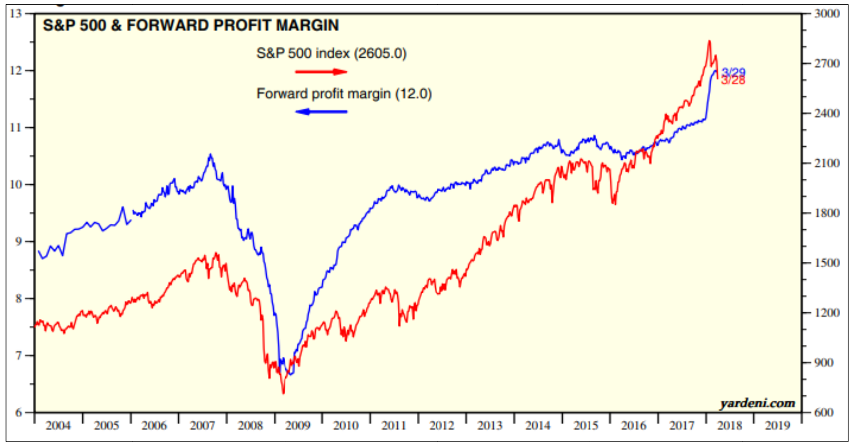
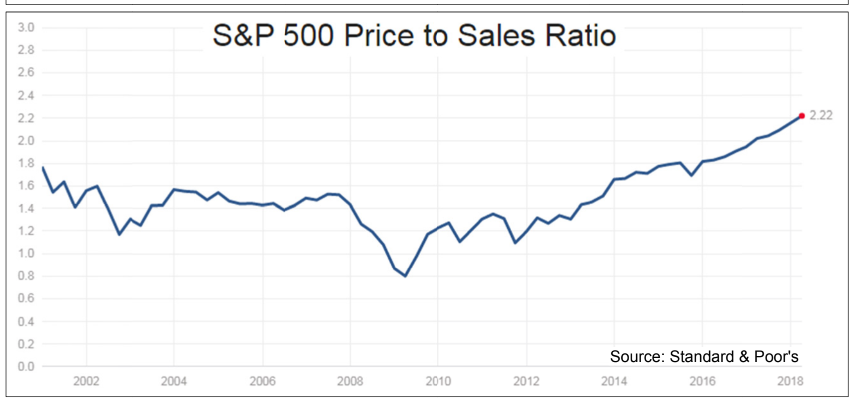
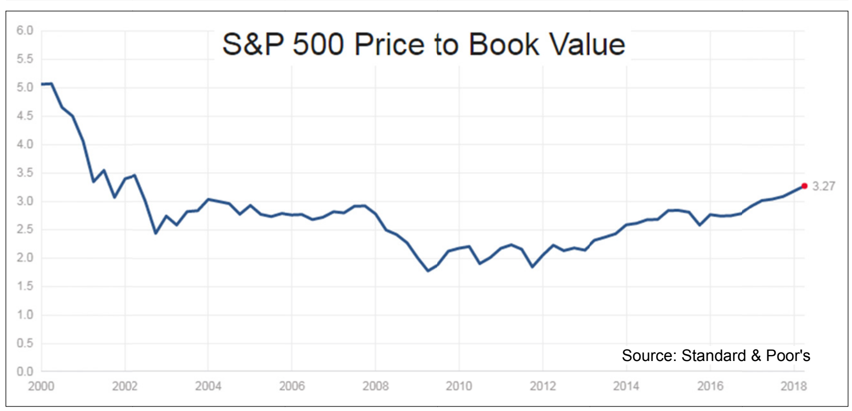
The Long & Short of It
Quarterly Newsletter
First Quarter 2018

Can We Buy Yet?
After reaching record highs in January, Mr. Market swiftly delivered a 10% correction on concerns about rising interest rates. Much of that loss was recovered until the last three weeks of the quarter, when uncertainty grew over tariffs and the potential for a broader trade war. Returns were overall close to flat and despite the correction, the average equity investor stayed well ahead for the past 12 months.







The stock market remains at historically high valuations. Earnings metrics are the least indicative of this fact due to the corporate tax reduction boosting 2018's estimated earnings when compared to 2017's earnings. While currently priced at 24.5x 2017 earnings, the market is selling for only 18.8x expected earnings for 2018.

When the rapid improvement in earnings slows, investors may find P/E ratios a little high. This is especially likely if the one-time tax impacts for 2018 are larger than expected and earnings flatten or slightly decline in 2019.

In addition, investors will look to other valuation measures when the recession comes. These metrics—such as book value, sales, or dividends—do not respond as quickly to short-term economic growth or tax cuts. Less economically sensitive, they suggest that stock valuations are currently quite rich. This lack of fundamental support outside earnings leaves open the possibility of significant downside in the next bear market.

Uncertainty Underestimated
Investors like growth, but they also like stability and predictability. The prior administration's policies were designed to sacrifice some growth in order to promote economic stability and more equality of outcome. The current administration has ushered in a massive shift, including extensive regulatory rollback, significant tax cuts, and large fiscal stimulus. Stock market pricing reflects that investors optimistically believe the stability will continue while enjoying added economic growth.

An important part of this solution is that investors expect the Federal Reserve to offset the administration's policy shift with a "gradual" tightening of monetary policy which includes shrinking the Fed's balance sheet on an unprecedented scale. What could possibly go wrong? Plenty.

Firing all the guns at once means something big is likely to happen as the zombie economy revives. Inflation and other risks that were held down by the prior administration's policies cannot remain benign in the face of so much change.

Five-year US Treasury rates have doubled about 1.3% to almost 2.6% since the election. Increased inflation expectations comprised only 0.4% of that rise, while real (inflation-adjusted) returns rose by a very healthy 0.9%. If the balance subsequently leans more toward a change in inflation expectations, the market will not be so kind to investors. A bad outcome would be if the economy simply grows more quickly, eventually causing inflation. Worse yet, a trade war could increase inflation with slower unit sales.

There has typically been little to worry about until the yield curve inverts. Too many market observers and investors seem to be watching only for yield curve inversion, which gives our contrarian bones cause for concern. This time could be different, so watch for risks like the trade war or other disruptive influences.

One risk is that the American economy just isn't what it used to be, that it doesn't respond to policy shifts in a remarkable way. So far, this argument is winning the day. Numbers for economic growth continue to drift as if little has changed. The initial estimate of 5.4% GDP for the quarter was reduced to 1.8%, and expectations for consumer spending and equipment purchases were marked down significantly.

But to all of this, we say: "Patience, Grasshopper." Remember that policy takes time to be decided, written, enacted, and implemented. It then needs time to take effect and for that effect to be reported. Though much has already changed, there is more to come.

For example, consider the new appointee to lead the FDIC, Jelena McWilliams. She is a deregulator and there are a number of regulatory changes on tap to encourage lending by banks that would be approved soon after her appointment. If the changes prove successful, there will be another bump in lending that brings future consumption into the present. This creates a temporary increase in growth that will have to be walked back when the next recession arrives.

While history would say there is one more run left in this bull market, there seems to be limited upside at this time from a pricing perspective. There are few companies we can find with compelling valuations. Our research is built for moments like these. We will remain very selective and in a moderately-to-significantly defensive position until opportunities present themselves. We appreciate your vote of confidence and will work hard to continue earning it, one investment at a time.

Amy Abbey Robinson, CIMA
amy@robinsonvalue.com

Charles W. Robinson III, CFA
charles@robinsonvalue.com