Stegent Equity Advisors Investment Letter

Stegent Equity Advisors, Inc. January 2018

How Long Will the Sweet Spot Last?

After a solid third quarter, investors began to wonder just how long the market could run without a healthy pullback. But those bracing for a market correction got caught flat footed as markets found a way to keep powering ahead in the fourth quarter. Domestic equity markets surged in anticipation of tax relief, emerging markets and commodities feasted off synchronized global growth, and developed international markets cooled off a bit but still ended the quarter with sizeable gains. Bonds and cash managed to post minor positive returns to round out another great quarter for asset markets.

As the books closed on 2017, many world equity indices ended the year delivering very robust gains of more than 20%. A glance in the rearview mirror confirms that 2017 was a great year for building long term wealth. But forward-looking investors now have the challenging task of deciding whether 2017 was a good as it gets, or if the good times will keep on rolling in 2018.

Base Case

Despite the calendar flipping, not much has changed at the start of 2018. We are entering the New Year in a sweet spot for asset markets, where increasingly synchronized economic growth and low inflation are supportive of earnings and stock prices. Additionally, in the U.S., corporate America just received a booster shot via tax cuts that some thought would never make it through a polarized political landscape. The stock market is beginning the year showing signs of being overbought, but looking beyond any potential short-term corrective activity that could unfold, cyclical technical conditions are currently firing on all cylinders—trends are strong, and there are currently no red flags that would suggest the foundation of this bull market is about to deteriorate. Internal measures of the buying and selling pressures on stocks currently confirm the positive message coming from other areas and suggest that the bull market in stocks should persist for the next few quarters at least.

Valuation is still one fly in the ointment, since it continues to imply the likelihood of subpar long-term returns from current lofty levels of broad stock indices. But as pointed out before, valuation is a poor timing indicator, and there are still good reasons to believe that other cyclicals factors will likely matter more to stock prices over the next few quarters. The valuation backdrop is serving to keep a lid on how much risk we are willing to take at this stage of the cycle, but without a catalyst it’s not a reason to stop participating in the current bull market until other evidence begins to deteriorate. Given our constructive outlook, we are looking for playable themes to start 2018.

Playable Themes

As we search for good investment ideas in 2018 there are several themes that may present opportunities over the coming quarters.

Theme 1:The Rise of Business Spending

Earnings have been extremely strong across the globe and business confidence has been steadily improving. Thanks to record profits, along with certain provisions in the tax bill, it appears that business spending is poised to pick up in a meaningful way this year. This could have implications for sector rotation in terms of providing a nice tailwind to sectors that typically do well when business spending rises like industrials, technology, and energy. We are already overweight all three, but may continue to augment positioning there moving forward.

Theme 2: Tax Beneficiaries/Losers

The tax reform that was passed at the end of 2017, while politically controversial, will certainly benefit corporate America and should inject a bit more life into the economy, earnings and the stock market as a result. With the primary feature being a big cut in corporate tax rates, companies that currently pay higher taxes are poised to receive a disproportionate benefit to future earnings. Some of the winners include financials, smaller companies, and consumer-related companies that will enjoy significant tax relief. We will continue to look for other beneficiaries of the tax bill that could receive a boost this year.

Theme 3: Value Over Growth

Growth stocks have dramatically outperformed value stocks in recent years, but the landscape may be starting to shift in favor of value again. The growth universe is heavily weighted in health care and technology, while value indices are mostly concentrated in financials and energy. We currently are underweight financials and energy, but are considering tilting further toward the value segment of the market that appears cheaper and that should benefit if the synchronized global growth backdrop remains firm.

Theme 4: Higher Interest Rates

The combination of solid global growth, a Federal Reserve raising short-term interest rates and late cycle inflationary pressures beginning to percolate should cause interest rates to gradually rise from their current low levels. A rising rate environment has implications for equities and bond positioning. Financial stocks are among the most direct beneficiaries if yields rise, and utilities, REITS and other high-yielding sectors should continue to lag the market. Bond positioning in this scenario would imply being below the benchmark in terms of interest rate sensitivity. This can be accomplished by owning less bonds, by selecting shorter maturity bonds, bonds that have floating coupons and owning more cash-like vehicles than the benchmark. We are already positioned for this coming into the year, but are prepared to make further adjustments as necessary.

Theme 5: The Return of Volatility

It's not a stretch to assume that markets are likely to exhibit higher volatility this year compared to last. Bull markets are usually prone to at least one or two healthy declines during any given year, but in 2017 downdrafts were virtually nonexistent and were extremely shallow when they did occur. While last year's environment was pleasurably calm in retrospect, it doesn't seem realistic to expect that market fluctuations will continue to be as muted going forward. If volatility does revert to more normal levels, it won't signal the end of the bull market, even though it might feel like it to investors after such a tranquil period. So long as the overall weight of the evidence remains constructive, market corrections should be viewed as buying opportunities.

Risks to the Base Case

Despite a positive backdrop at the moment, the critical question that investors must wrestle with is how long can this goldilocks environment for risk assets last? If the economy is in fact transitioning towards its late stages, as appears to be the case, there is the possibility that the current economic sweet spot begins to turn sour later in the year due to accelerating inflation expectations. Ironically, a better growth profile and low unemployment rate combined with a very late cycle fiscal stimulus could finally begin to stir inflationary tendencies that have been dormant for many years. An increase in inflation expectations could trigger either a major selloff in bonds, or a shift to a more aggressive pace of interest rate hikes by the Federal Reserve.

If markets begin to detect any hints from the Fed that they're about to adopt a more hawkish approach, that could potentially become a game changer for the investment outlook by signaling that it's time to scale back to a more defensive posture. There is some additional uncertainty related to this possibility because of a change in Fed leadership that takes place in February. While the nomination of Jerome Powell as the new Fed chair has been well received by markets so far, there are still some risks due to how little is known about his communication style or abilities once he takes the reins of the most important global central bank. Lastly, if inflation in wages begin to rise at a faster pace, that could begin to cut into corporate profit margins that have been solidly expanding due to the combination of accelerating revenue growth along with subdued input cost pressures.

Outside of inflation, there is always the chance that the global growth story doesn't hold up. First quarters have been unusually weak for the past several years thanks in part to extreme weather-related issues, and while 2018 seems poised to buck that trend, it is possible to have another relapse in growth. Any growth disappointment would come at a time where economic expectations have been ratcheted higher in recent months, leaving a lot of room for disappointment if the incoming data underwhelms. Beyond the U.S. one of the biggest risks to the global growth story comes from China.

The resurgence of emerging markets economies was a big positive over the last year, and has helped to reinforce the synchronized growth profile that has developed. For the last few years China has been slowly trying to root out excesses and corruption in its economy, and they recently announced a new policy of favoring the quality of growth instead of the previous emphasis on the quantity of growth. There have been signs of cooling in certain parts of their economy recently, and while it doesn't appear to be particularly concerning for now, there is a risk that they commit a policy mistake that causes a more meaningful slow-down that reverberates through markets.

As in years past there is the potential for geopolitics to disrupt markets due to important elections around the world in 2018, a lingering risk of trade protectionism and ongoing tensions surrounding North Korea. There is also the potential for a black swan, which by definition would be something that no one is currently expecting and therefore not currently discounted by markets. There are those who believe that the bitcoin bubble may unwind and produce unintended consequences in 2018. In any case, the historical evidence suggests that most negative geopolitical events turn out to be fleeting for markets and are best used as buying opportunities. Nevertheless, we must keep an eye out for developing risks that could seriously alter the course of the current bull market.

Conclusion

As the expansion and cyclical bull market continue to age, our time frames for forecasting are becoming more compressed. We currently expect at least a few more quarters for the bull market to run, not withstanding some corrective activity that is likely to break out at any time. But the outlook becomes murkier as we look out into the second half of 2018 and beyond, and there is potential for risks to intensify as the year progresses. As always, the appropriate level of equity exposure through our mutual asset allocation decision will be the mechanism we use to guide our decision making. And while the evidence remains healthy, we will stay invested and do our best to capture healthy market returns during the current cycle. But we realize that the good times won't last indefinitely, and given an aging cycle and poor valuations we'll be proactively looking for warning signs that the cyclical sweet spot is about to turn sour.

And as always, we are grateful for the opportunity to continue to serve as your trusted advisor.

Loyd J. Stegent, President
Stegent Equity Advisors, Inc.