Times Like These—Redux

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On February 9, 2016 we wrote and distributed a piece entitled *Times Like These*. In the face of the worst opening for stocks in history, we argued for investors to hold their ground. To use the weakness to upgrade the quality of their holdings as we were doing in our client's portfolios. Since that piece (which almost literally marked the bottom in the market) the S&P 500 is up 50.3% including yesterday's landmark sell-off (in terms of points) on the Dow Jones Industrial Averages.

On Monday, January 29, 2018, I appeared on CNBC's Closing Bell (click here for link to segment) and suggested we would welcome what we perceived to be a long overdue correction. The global stock market has not experienced a correction for 16 months. That is unsustainable. If markets only went up (think Bitcoin) everyone would be an investor. We got our sell-off and we may see more. But we do not believe this is the end of the bull market. Today I appeared on Fox Business News with Maria Bartiromo (click here for link to segment) and said we would be adding to some holdings today (we did) and would use further weakness to be adding to the high quality names we hold in Equity Income and Equity Growth. Recall that we had been trimming holdings all year as stocks became further and further over weighted in our portfolios due to price appreciation.

That said, we wrote to you about our Diversifiers Portfolio we created to have very low correlations to global equity markets and little if any correlation to rising interest rates. In anticipation of volatile equity markets and rising interest rates we reduced our equity overweight by 5% and took another 5% from our fixed income portfolios.

In the near term, the sell-off in equities is close to 10% bringing the market price-to-earnings ratio to a more reasonable 17x 2018 earnings. Earnings estimates for the year have been revised up from +11.9% to somewhere between +17.0% to +20% in 2018. That simply means that the market can return decent double-digit performance without multiple expansion. And that is sustainable as long as the economy continues to grow along with corporate earnings. The dollar's weakness will only enhance the earnings in the large multi-nationals we hold. We are watching the things the market is watching: wage pressure, rising interest rates, and inflation.

But don't mistake this sell-off as the beginning of the end. I was on the floor of the NYSE yesterday when the market was dropping in 100 point increments. It is the trading algorithms, and the leverage ETFs that drive that kind of crazy volatility. And, still while it was the largest point drop for stocks it was not even close on a percentage basis.

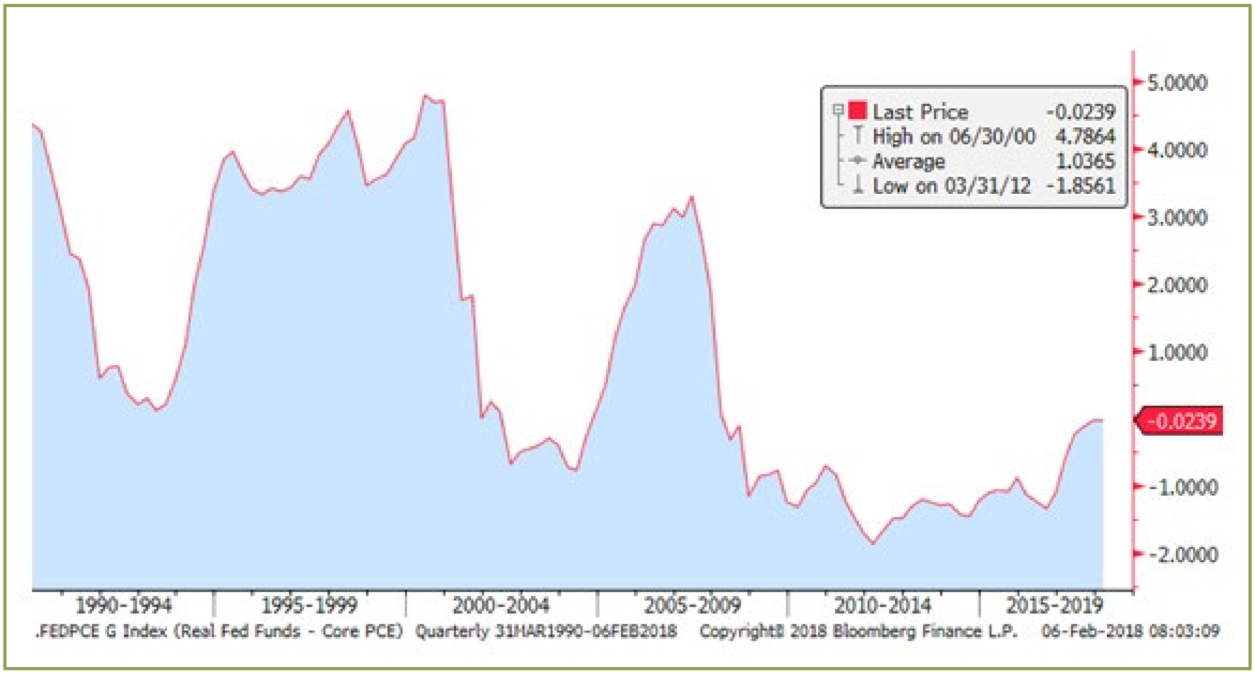
And now a word about bonds from my colleague Paul Dickson.

"Hey, stop blaming interest rates for the stock market sell-off"

A common refrain one hears is that the recent rise in interest rates, and the threat posed by the Federal Reserve continuing to tighten monetary policy, is to blame for the recent stock market weakness. In part, this argument posits that as the Fed takes away the proverbial punchbowl the economy is set to slow, dooming the outlook. But looked at objectively, interest rates remain quite accommodative with short-term rates negative in real (post-inflation) terms and long rates just barely positive by that metric. If anything, monetary policy remains quite loose from an historical perspective and do not reflect an economy that is approaching a 3% rate of growth and 2% inflation. Not that that growth rate looks sustainable over an extended period, and that knowledge may well color the outlook, but for the short-term interest rates should be seen as playing a supportive role, not an adverse one. There are plenty of other reasons for a market correction that don't implicate interest rates.

The chart below shows that the short rate set by the Federal Reserve has been negative since the financial crisis and continues to be so today, albeit with a narrowing gap.

Real Fed Funds Rate Adjusted for Core PCE Price Index



In terms of managing a rising rate environment in our fixed income portfolios, we've been shedding interest rate risk by lowering our duration and seeking market segments that are less correlated to rates or the components of the major bond indices. We're underweight long securities as well as mortgages and are very overweight Asset Backed securities and step coupon bonds in both corporate and US Agency markets. Consumer loans and insurance linked securities round out our strategy as some of the most uncorrelated of assets.