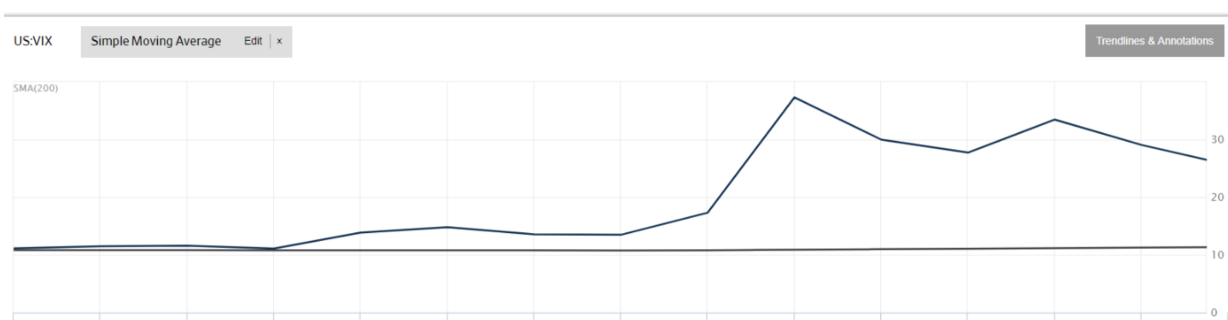
AS THE OLYMPICS CONCLUDE, WILL THE MARKET GO DOWNHILL OR WILL IT JUMP?

The opening ceremony of the 2018 Winter Olympics began on February 9, 2018. It's unfortunate this wonderful ceremony was preceded by the first stock market correction (drop of more than 10%) since 2016. Now, as the Olympics are coming to a finish, will the stock market reverse its angst and bring us new highs? In the week ending on February 9, 2018, the stock market's fear gauge, known as the VIX, rose as to levels as high as Yuzuru Hanyu was off the ice when he won the Olympic figure skating event. This coincided with the stock market falling out of the sky, like 2018 Olympic ski jumping gold medalist, Kamil Stoch. In 2018, will the market go downhill like Michaela Shiffrin or boost upwards like Shaun White?



MIKAELA SHIFFRIN MAY WIN THE POPULARITY CONTEST THIS YEAR – MORE DOWNSIDE FROM HERE

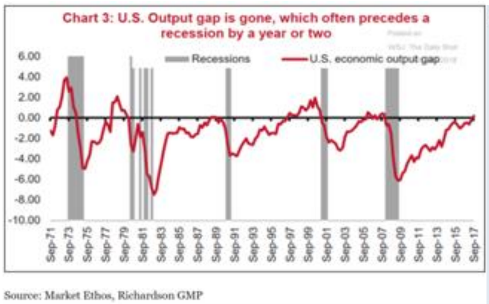
When it comes to skiing down a mountain, Mikaella Shiffrin is one of the fastest in the world. Currently, investors are beginning to question the long-term sustainability of this secular bull market. After the sentiment (or risk attitudes of investors) within the stock market has rolled over, similar to what we saw at the end of January, the market may head downhill at a pace only Mikaella Shiffrin could match. For this reason, it is important to look at the objective data, and establish realistic expectations for the stock market over the next two years.

One observance that has caused investors think twice about the durability of this bull market, is the movement of the 10-year treasury yield (the interest rate investors demand for buying U.S. debt). This yield is on the brink of breaking out through a long-term resistance point. In the past, this has been a harbinger to all three recessions of the past 30 years, including two other market corrections.

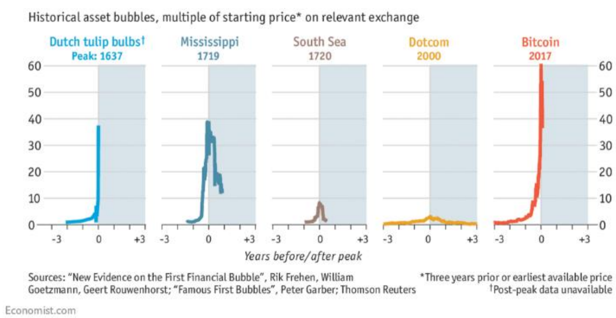
We have also observed record outflows from popular ETFs (exchange traded funds) that seek to track the S&P 500 in the week ending 2/9/2018. These record outflows should make investors wary about current levels in the stock market. Especially, when witnessing the reaction of these ETF owners as they sell out of their investments at the first signs of market disruption. Another troublesome development is the closing of the U.S. Output Gap[1]. To the layman, this means that economic productivity has moved beyond its long-term potential, which usually occurs at the end of economic cycles. When this happens, it can be difficult for the economy to move forward without triggering inflation spikes. This may cause rates to move further upward, creating market panic, and so on. In December 2017, the personal savings rate was only 2.4%.[2] This was the lowest we have seen this number since 2005. When the savings rates are this low, investors are spending at capacity. If consumers' wages do not adjust accordingly, they are faced with a difficult decision. They can either take on additional debt, or, they can

[1] Market Ethos, Richardson GMP, WSJ. September 2017.
[2] Saint Louis Fed, U.S. Bureau of Economic Analysis. December 2017

slow their spending. Both outcomes will inhibit future growth and the market may panic. As you can see, a fair amount of evidence exists to support continued downward momentum with stock prices.

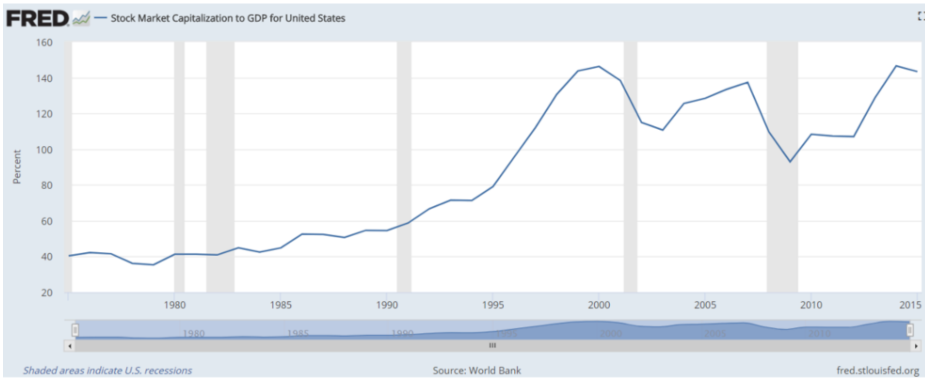


Stock market peaks tend to coincide with euphoric behavior by stock market participants. This euphoria is ubiquitous in the market today. We can witness these actions by observing investors chase returns of cryptocurrency stocks, cannabis stocks, and other popular trends. More evidence of euphoria is exhibited by looking at the debt balances of margin accounts, where investors borrow against their brokerage accounts to buy additional stock. Simply put, investors are leveraging their portfolios to increase their returns. The debt balances of these accounts were almost 300 billion, a new record high.[3] If investors were not extremely confident with the stock market, why would they take on liabilities to enhance their returns only if the stock market continues to rise?

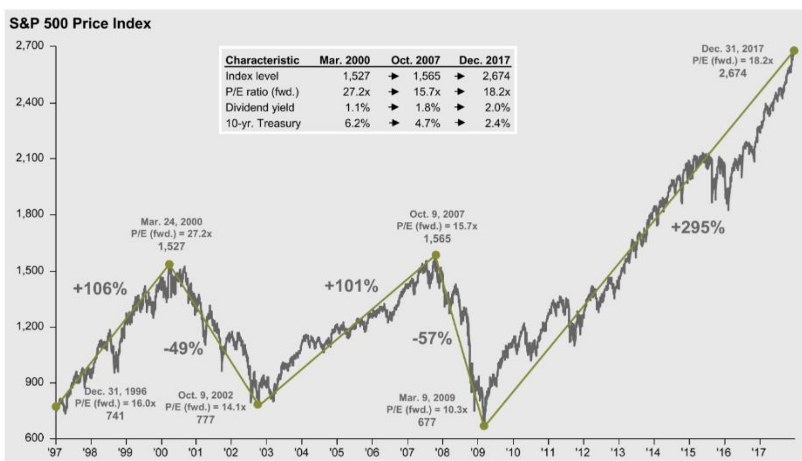


Finally, stock market capitalization as a percentage of gross domestic product is over 140%. A development that we witnessed in both the bubbles of 2000, and the Great Recession in 2008. Like the newest Olympic event, big air, it can be fun as you rise. But if the economy falters, the drop is that much more severe from higher levels.

[3] Haver Analytics. December 2017.



The developments that I have listed above are certainly worrisome. It is difficult to predict when the market will reverse its course and exhibit a downward trend. As the economist John Keynes once said, "Markets can remain irrational longer than you can remain solvent." Some investors have shown aspects of overconfidence bias. Meaning they may think their portfolios are rising due to their skill at selecting securities. For those demonstrating this bias, take a step back and remember the S&P 500 is up 295% from the low of 2009.[4] In times like these, it can be easy to confuse brains with a bull market. The markets don't always go up, so investors should reassess their portfolios to ensure their investments are aligned with their long-term objectives.



Source: Compustat, FactSet, Thomson Reuters, Federal Reserve, Standard & Poor's, J.P. Morgan Asset Management.

ON THE FLIP-SIDE, SHAUN WHITE HAS SPUN HIS WAY TO VICTORY ONCE AGAIN – THE MARKET COULD BOOST HIGH THIS YEAR

At 31, Shaun White is considered old for the sport of snowboarding halfpipe. But his did not stop him from taking home the gold this year. Comparisons can be made with this current bull market. Going into its ninth year, this bull market is old by historical standards, and on its way to become the longest

[4] J.P. Morgan Guide to the Markets. December 31, 2017.

bull market in history. However, bull markets don't end because of old age, the usually die from excesses.

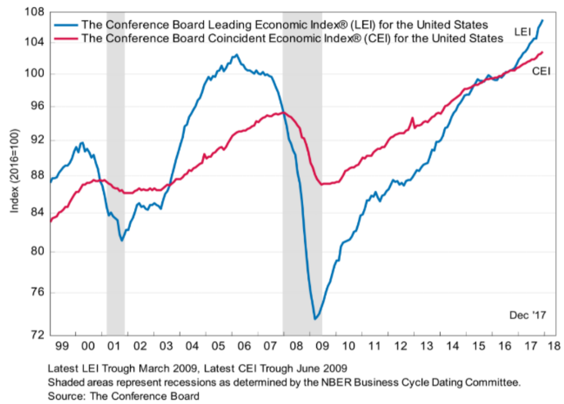
The stock market has been calm since the last correction, which started in November of 2015, and lasted until February of 2016. Before we become too startled that this expansion is coming to an end, it is important to recognize that this recent correction not coincide with negative fundamentals like the correction of 2016. If the fundamentals remain strong, should we be worried?

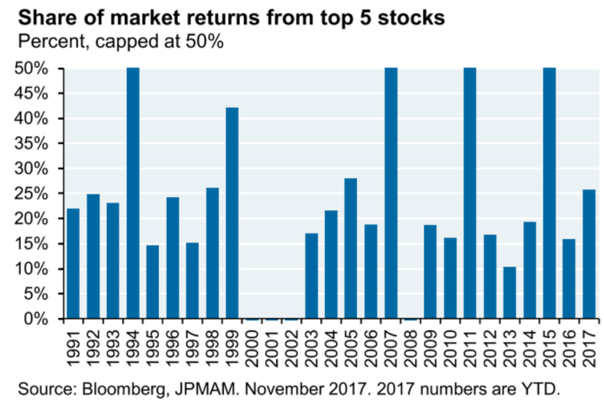
To answer that question, let's look at the fundamentals of the economy and stock market today. First, credit spreads, or the additional compensation demanded by investors for holding riskier debt assets, are at historic lows.[5] Quite different from the correction of 2016, where credit spreads expanded at a rapid pace. Historically, when credit spreads spike, there's a good chance the stock market may be turning for the worse as bond investors tend to pick up on the risk before equity investors.

In addition, GDP had stalled in 2016, at only 1.2% (annualized) for the second quarter of 2016. Now, GDP appears to be chugging along at a healthy clip of 2.5%.[6]

To increase investors' anxiety, the Leading Economic Index, and its subcomponents, were beginning to show signs of stress. This index is forward looking and has an impressive record of predicting recessions. This sheds light as to why investors may have been worried in 2016. Currently, the Leading Economic Index is hitting new highs the indicator is flashing green.[7] A positive signal the expansion may continue. Past downturns have also been preceded by weak market breadth, meaning only a few stocks were responsible for the rally leading into the crash. In 2015, the five stocks contributed 50% to the return of the S&P 500. In 2017, that number was barely above 25%.[8] A sign this market rally has a good foundation.

[5] Saint Louis Fed. February 2018.
[6] Trading Economics, U.S. Bureau of Economic Analysis. January 2018.
[7] The Conference Board. January 25, 2018.
[8] Bloomberg, JP Morgan. November 2017.



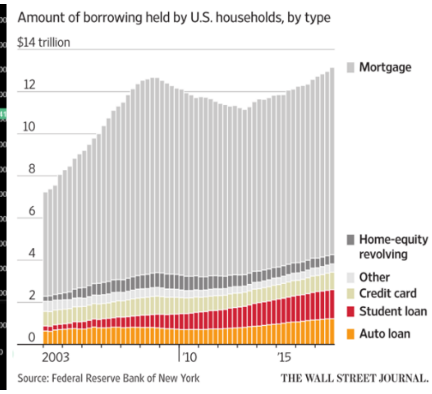


Prior to the recent selloff, the S&P 500 was trading at what some would call expensive valuations. Prior to the correction, the price investors were paying for each dollar of earnings was over 18 times the estimated earnings over the next twelve months. After the correction, the multiple fell to only a little over 16 times estimated earnings.[9] Now, those investors have less of a reason to be startled over valuations. Further easing these fears, is the increase in earnings of companies in the S&P 500. In the fourth quarter of 2017, earnings have increased 15.2% over the prior year.[10] Better yet, earnings estimates for 2018 have increased 7% since January 1st. This is the biggest increase in expected earnings since FactSet began tracking them over 22 years ago[11]. When earnings within companies of the S&P 500 are increasing, investors can feel somewhat optimistic since the changes of a bear market (drop of more than 20%) in the next 12 months are slim. Small businesses have become incredibly optimistic. This is apparent when observing the NFIB Small Business Confidence Index, which is trading near record highs. These businesses surveyed have explained deregulation, tax cuts, and an improving economy have spurred their outlook.

Contrasting with The Great Recession (2008), household balance sheets are healthy. In fact, household borrowing, albeit high, is at 67% of gross domestic product. In 2009, borrowing was 87% of GDP.[12] Finally, the price action of the market is showing bullish momentum. Recently, we observed a "swing-

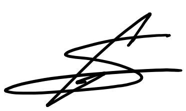
[9] Morgan Stanley Research, Thomson Reuters, FactSet. February 2018.
[10] FactSet. February 16, 2018.
[11] FactSet. February 16, 2018.
[12] Federal Reserve Bank of New York, WSJ. January 2018.

low" pattern on February 12th. By this, I mean the market is showing us it believes that the recent sell-off may only be temporary, and the price action points to continued gains.



The Olympians of 2018 have levered their natural abilities, trained, exercised, and have become the best in the world at their event. In competition, sometimes elite skills and countless hours of training is not enough. These Olympians must also show metal strength when it counts, and when the whole world is watching. The stock market has a way of testing our confidence and skills. For many, this has been the case over the past month. During these times of uncertainty, it is important to stay focused on your long-term goals and the objective data. It is easy to become emotional and make irrational decisions. But don't allow emotions to jeopardize your financial health.

I wish all of you gold medals in 2018,



Grant Glenn, CFA, CFP®

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