The Collision of Hope and Reality

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Investor emotions are running high…and with good reason. Nevertheless, we still must try to factor these emotional responses into our investment strategy in order to avoid being caught on the wrong side of a large market move. Pent-up emotions are like a coiled spring, threatening to drive the stock and bond markets up (or down) by a quick 20-30%. The value of our dollar, likewise, can be quickly affected, depending on the outcome of several short term issues.

Short Term Considerations

At the risk of being redundant, let me summarize these short term issues:

1. Trade War. The trade negotiations with China are especially critical because they involve the #1 and #2 economies in the world. Currently, the Chinese economy is on the brink of a serious decline. A failed trade negotiation would push China into the proverbial ditch along with all of its suppliers around the world.

2. Brexit involves another large and important part of the global economy. A rough and contentious Brexit, pitting Europe against the U.K., brings with it the risk of implosion for the European Union and its currency. The ripple effect from such an outcome would undermine the terms of many trade and business relationships, and threaten the solvency of several banking institutions in Europe.

3. Debt Levels. The existence of a record level of global debt ($147 trillion) is overhanging investor attitudes as any failure in trade negations or Brexit could threaten credit markets around the world with a series of defaults.

4. American Politics. The Democrat victory in the House election has served to rivet media attention on the progressive wing of the new majority. Advocates for a wealth tax, a 70% income tax rate, or lifting the "cap" on Social Security taxes provide enough food for defensive investor attitudes and plans. We are already witnessing a dramatic movement of people and businesses from higher "tax and spend" blue states to red states. We can only guess what people will do with their money if we adopt a wealth tax or 70% income tax level. We are certain, however, that market results will be negative.

5. GEO Politics. The North Korean discussions, Iranian negotiations, Russian interference, and Chinese military build-up all stack up as a wet blanket over investor confidence resulting in even higher cash reserves.

In contrast to any or all of these issues is the current robust strength of the American Economy. Resolution of one or two of these worrisome issues could have a large and immediate effect on markets. An agreement with China and a smooth Brexit could fuel a market "melt-up" which could take us to 30,000 on the Dow Jones Industrial Average. Conversably, a failure in trade discussions, and an "ugly" Brexit could quickly take us to the 18,000-20,000 levels of the "Dow." The indeterminable outcome of these critical issues explains our very cautious allocation of the assets in your portfolios. As events unfold, you can expect us to rapidly change your exposure to stocks and bonds to either capture the upside or avoid the downside. Hence, our present outlook could best be described as neutral...and waiting.

Longer Term

Aside from short term volatility tactics, our most critical discipline is the constant search for value. This exercise is important to you in that it helps us avoid "overvalued" assets and to buy undervalued investments on your behalf. Over time, if we can successfully confine our investment activities to under or reasonably valued securities, the investment result will speak for itself.

Presently, Wall Street is in "earnings season," with companies reporting 4th quarter and full-year results for 2018. This 4th quarter is the last quarter reflecting a 21% corporate tax rate compared to a 35% tax rate last year. Companies have now enjoyed a full year (four quarters) of increased earnings momentum, with the lower tax rate functioning as the "wind at their back."

Analysts covering these individual companies on behalf of their employers, are beginning to extrapolate future earnings projections from the rapidly improving results through the four quarters of 2018. These extrapolations are largely responsible for the overall high expectations for 2019.

It is important to understand the role of these analysts on Wall Street. Typically, these analysts work for mutual funds, brokerage firms, hedge funds, banks, and insurance companies. Accordingly, there are significant investment dollars following their buy/sell/hold recommendations. For the analyst, it is important to be right, and for the reporting company, it is important to maintain a good relationship with analysts, for they will affect the price of the stock for shareholders.

Companies usually manage their communication with Wall Street analysts through their own stockholder relations departments. The corporate philosophies surrounding these communications vary "all over the lot." Typically, the good companies tell it like it is, while others are always painting glowing outlooks.

Corporate earnings results are usually released along with a statement of guidance, projecting results going forward.

Over the last few days we have observed several corporate earnings reports where full-year and 4th quarter earnings results beat expectations. The guidance looking forward however, fell short of expectations. In these cases, the reaction on Wall Street was negative, resulting in sharp, immediate stock declines of -5% to -20% in one day. Clearly, analysts' expectations were too high, leading to disappointment for shareholders. Conversely, companies reporting better than expected 2018 results along with a benign or better guidance enjoyed stock reactions to the upside of between +5% and +10%.

Obviously, the analysts have been surprised more often than not. We believe that few analysts really understand the macroeconomic workings of a tax cut and how that tax cut actually effects earnings and earnings growth. To us, the drop in the tax rate represents a one-time adjustment to a new level of earnings. It should not affect the internal growth rate of a company except indirectly to the extent that the tax cut effects the overall economic growth rate.

Furthermore, Wall Street analysts seem to have a more difficult time being accurate and identifying value at turning points in the economy. Thankfully, their inaccuracies present us with value opportunities. Do not be surprised if we add to some stocks that decline and reduce positions of others that have moved into "overvalued" levels. We believe Wall Street earnings projections are too high and will lead to more disappointment in the months ahead. Naturally we will be very discerning when making purchases.

The times are challenging, but we believe our multi-tiered investment approach is especially suited to these times. The opportunities created by the inefficiency of markets at turning points should give us an advantage. Pay attention to the news as we are in very interesting times. Above all, your continued confidence and trust is most important to us.

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