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Capital Management

March 2018 Client Note

As discussed in last month's newsletter, we've entered choppier waters. Trump's chief economic advisor Gary Cohn resigned, and the S&P 500 tumbled 40 points almost immediately. However, stocks didn't stay down, and blowout unemployment numbers sent markets upwards, to end last week firmly in the green. The trend appeared to continue, until Trump fired his Secretary of State Rex Tillerson yesterday, which negatively affected markets. Continued rumors regarding import tariffs bled into the Asian trading session today. So, what happens next?

Sorting through the noise, our focus for the month is on interest rates and their effect on stock market valuations. After years of historically low interest rates, the tides are turning. We've seen economic growth/higher inflation, combined with Trump's economic policies that are throwing a lot of money at an economy (that really didn't need much stimulus to start). Toss a bunch of money at an overheating economy with minimal unemployment and strong consumer confidence, and it should lead to an upward wage/price spiral. To ease this inflationary threat, the Fed is expected to react by raising interest rates. What's the significance? Interest rate hikes can have large effects on the economy and the stock market. Here's how:

> ***Higher interest rates lead to less corporate spending on expansion.***

> Consider a company who has entered the market of selling watches. To expand, it must purchase a new factory by taking out a $1 million loan. This new factory will increase yearly profits by $50,000. In a low interest rate environment of 1%, the company only has to pay $10,000 in interest per year. This is great for the company, which pockets $40,000 each year. However, consider a high interest environment of 5%, where the company must pay $50,000 per year interest. Since the company is just breaking even, they would decide against taking out the loan and expanding their business. Thus, higher interest rate environments can be suppressive to economic growth. When companies spend less on expansion, the economy slows down, and the stock market has a hard time putting in new highs.

As we touch on frequently, most stocks are overvalued. The historical average PE Ratio of the S&P 500 is about 15x, and it is now currently trading well over 20x. With interest rates on the verge of breaking out to the upside and stocks trading at all time highs, has the perfect storm arrived? Only time will tell, however there are several things we keep in mind during times like these:

1. **Time in the market vs. Timing the market:** Attempting to "pick the top" of the stock market is a proven way to underperform over time. With a long-term time horizon, the stock market is one of the best places to grow wealth.
2. **Be prepared:** By maintaining a portion of our portfolios in the form of cash, we are prepared to take advantage of a stock market correction. This is usually the best time to buy and we are strategically positioned to endure downward pressure.
3. **Focus on buying value:** There are mispriced and cheap stocks to buy in all market conditions. By staying away from expensive tech stocks, we are forgoing short-term profits, for long-term stability.

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