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Category: Market Update

QFC Market Update

"Don't Let Short Term Noise Disrupt Long Term Objectives"

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Last Friday the Dow Jones Industrial 30® as well as the Standard & Poors 500® had significant point drops which was the third down day of the last five. The losses which occurred on Friday will make headlines, and words like crashed, plummeted, or plunging may be used. For the Dow, the drop was 665.75 and is one of the largest point moves in its history. While large point moves may make headlines, it is not what is most important.

The Dow reached its last high on January 26, 2018 at 26,616.71. This morning it now stands 1,095.75 lower. In years past, a thousand point drop could be concerning, but not today. This represents a 4.12% drop from the recent high. While the decline may continue this week and there may be more days where the declines could be 100, 200, or 400 points or more, it is to be expected if this is the start of a normal correction. Corrections normally occur annually but with no set schedule; and never knowing what the trigger may be, they can be worrisome and sometimes frustrating.

It is hard to say whether this move will reach the definition of a correction, which would be a ten percent drop from the recent high or in this case a drop of 2,662 points in the Dow. Over the years, there have been a number of false starts to a correction, which is why trying to time the market rarely works. It has also been over two years since the markets have had a five percent decline from highs, where normally there are multiple five percent declines each and every year. Going so long without a five percent drop can allow investors to forget what is normal.

There are a couple of events which could be considered this move's trigger. The first is related to the increase in the 10 year Treasuries yield and the speed of their move higher. As most investors have been painfully aware, interest rates have been low for an extraordinarily long time. For businesses, this is favorable, since it impacts the rates they pay on their debt. The lower the rate, the less interest expense they incur and thus higher profits are generated. While the ten year Treasuries only reached 2.84%, they opened 2018 at 2.46% per the US Department of the Treasury. Compared to the past, this is still extremely low; however, the markets are concerned of the potential impact higher rates may have on the economy and corporate profits.

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The second could be the Federal Reserve itself. This agency sets the Fed Funds rate and is expected to increase that rate three and possibly four times this year from the current range of 1.25 - 1.50%. It is thought each move will be only a quarter point, the same as the three adjustments which occurred in 2017. The unemployment report released last week was considered strong; and while good news, once again the market took good news as potentially bad news since this may encourage the Federal Reserve to increase rates more quickly or significantly. In additional to how the Reserve may respond, the outgoing Chairman, Janet Yellen expressed her thoughts on the value of the market saying, "Well, I don't want to say too high. But I do want to say high," Yellen said on CBS's "Sunday Morning" show. Add the fact Jerome Powell is the newly appointed Chairman; and with the change in the position and not knowing exactly how he may lead the Reserve, the markets may be showing its nervousness not appreciating the unknown.

The above may have been the trigger for the recent move downward, but the items driving the markets have not changed. The U.S. economy remains strong with low interest rates, unemployment remaining in the low four percent range, pro-business political environment, and for the first time in years, many of the international economies are also growing.

During the last eight years corporations have been getting their balance sheets in order, and it is my thought the upcoming increase in interest rates will have less of an impact on corporate profits. Historically, an increase in the Fed Funds rate would be seen in the markets anywhere from six to twelve months later. With so many corporations refinancing and locking in longer term notes, a change in the Fed Funds may take much longer before a significant impact on the economy is seen. If an increase in rates does not impact corporate profits as soon as expected, then any price drop due to an increase in interest may reverse itself.

Lastly, the tax legislation passed will have an impact on corporation profits. For those corporations paying the old rate of 35%, they will now be paying 21%. This represents a drop in the top rate by 14%, but more importantly it is a 40% reduction in tax expense. This savings will translate to a significant increase in earnings per share (EPS) and the stock price. The shareholders of every profitable public company now owns an even more profitable company and did not have to spend a dime to acquire this added profitability.

Here is how the tax reduction will impact the EPS. If the EPS was $2.50/share under the old tax rate and they were paying 35% Federal taxes, their profit before taxes was $3.85. By applying the new tax rate, the EPS after the new tax rate is $3.04, a 21% increase in corporate profits. There are two major items which drive stock prices higher, an increase in a company's EPS or the expansion of the price to earnings ratio (PE). An expansion of the PE is where a company which trades at 16 times earnings, now trades at 18 times earnings. The 21% increase in EPS is the maximum that could occur from the tax changes, in this example. Each corporation may take different actions with this extra cash flow

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from issuing bonuses, increasing wages, expansion of product or territory, increasing their dividend or stock buyback programs, or an increase in research and development. Regardless of its use, what is certain is the added cash flow will vary and impact many other businesses.

Even though the stock market has been increasing especially during the last twelve months, corporate profits have also been increasing. At one point during the most recent period of reporting, 80% of all companies reporting exceeded the expected results, 12% met expectations, and the remaining failed to meet earnings projections. Had the markets increased in value in the absence of increasing profits, then clearly the markets would be considered overvalued and a pull back should occur. But the increase in profits are real, and the results thus far are before the positive impact of the new lower tax rates.

In moves like we are experiencing, even quality stocks find themselves caught in the sell off which creates opportunities. We hope to take advantage of some of these unexpected values and opportunities in the market. It is also beneficial to remember portfolios are diversified and the long term objective during short term blips in the trend.