Lodestar Investment Counsel, LLC
150 S. Wacker Drive, Suite 3050
Chicago, IL 60606

Telephone: 312.630.9666
www.ldstr.com

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MARCH 31, 2018 INVESTMENT MARKET COMMENTARY

After a furious rally in January, stocks turned tumultuous and ended the quarter slightly down. The initial pullback in February was set off by rising inflation and interest rate concerns, while the more recent tantrum resulted from apprehension over a brewing trade war with China. 2018 began with tremendous enthusiasm for an economic revival, with capital goods and technology stocks leading the charge, while 'boring' consumer staples and most everything interest rate sensitive moved lower. Remarkably, by quarter's end some of America's most successful and iconic companies had fallen by double digit percentages, as investors became increasingly focused on owning high-flying technology issues. Indeed, at its recent peak, technology accounted for more than 25% of S&P 500 market value, and the five largest components of the index are all tech stocks. This 'fabulous five' currently comprises 15% of the S&P, more than the entire financial, health care or industrial sectors, and also accounts for 40% of the NASDAQ 100 Index. **As reflected in the chart below, the last time technology was so impactful on stock returns was in 2000, at the height of the Internet bubble. In our view, this concentration reflects one data point of budding excess.**

In past reviews we have noted that an unintended consequence of the global 'easy money' policies since 2009 has been to encourage excessive risk taking; to wit, many investors have bought stocks for years with little concern for valuation or potential downside. With conditions changing, and monetary policies tightening, it is likely that greater focus will be placed on investments with reasonable valuations that provide more compelling risk/reward profiles. This shift in perspective will be welcomed and is long overdue.

The Markets May Be Normalizing…

Financial conditions appear to be normalizing, with inflation and interest rates moving higher as the economy strengthens. The US Federal Reserve has raised its benchmark rate to 1.5%, and plans further increases this year. Business friendly policies have bolstered consumer and business confidence, and most economic

measures, both here and abroad, are improving. In aggregate, corporate earnings are expected to rise approximately 15-20% this year, with some of this figure attributable to recent tax legislation. The US dollar has weakened for five consecutive quarters, helping many American companies with global operations. **We are hopeful that 'normal' is here to stay, resulting in strong companies being rewarded, the weak punished, bond investors able to earn a reasonable return, and attention to risk once again assuming its rightful place in the investment equation.**

…But Be Careful What You Wish For…

Until recently, global central banks maintained interest rates at unprecedented levels that bore little connection to inflation or other key variables. In addition, buoyant financial markets have outpaced underlying economic fundamentals, evidenced by GDP growth in the US averaging less than 2% over the past decade. Despite substandard corporate profits, exceedingly low interest rates and the promise of sustained support from the Fed stimulated P/E multiple expansion (i.e. the prices investors were willing to pay for stocks). **It was only a matter of time before 'easy money' programs would be rolled back, and this process is now underway. Not surprisingly, the shift in monetary policy adds uncertainty and considerable volatility.** In recent weeks, bourgeoning inflation, strong economic activity worldwide, historically high asset valuations, rising interest rates, and additional political (trade) and policy (higher rates) risk resulted in the most volatile investment atmosphere in many years. While this transition to more normal conditions will be uncomfortable at times, it is necessary for the long-term health of financial markets.

…And Be Mindful Of Reliable Indicators

The popular market narrative, reinforced by considerable positive data, is that 1) current stock market weakness is simply part of the return to a more rational world, 2) the economy is solid, but not so strong as to force central bankers to increase rates too quickly, and 3) earnings are expected to be robust, justifying current valuations. **Beneath the surface, however, the bond market may be telling a different story;** specifically the relationship between the yields on 2 and 10-year treasury securities. The spread between these two typically widens when economic conditions are strengthening, and narrows during more difficult periods. This indicator has been narrowing for many months, and is currently at its lowest point since 2007. **This development is significant for investors because recessions often follow 'inversions' of the curve – when the 2-year yield is higher than the 10-year yield.** Such an inverted yield curve may not happen, but it is a telltale sign that we will be monitoring.

After an extraordinary period of almost eerie calm, recent turbulence in the financial markets may be disturbing, though should not be surprising. This is how investment markets are supposed to act, with uncertainty being reflected in prices of stocks and bonds alike. **Historically, it has paid handsomely to avoid grossly overvalued investments, regardless of how exciting the stories may be. Rather, focusing on high quality assets offered at reasonable prices has been a rewarding strategy.** While this discipline has been somewhat out of favor in recent years, we believe its time tested tenets are essential to long-term investment success.