HORAN CAPITAL ADVISORS
Investor Letter
Spring 2017
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“October: This is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August and February.”
– Mark Twain

A “Stable” Quarter

It feels prudent to begin this letter by reminding investors that stock market investing is indeed a risky venture…..at least in the short-run. However, prior to March 21st, the S&P 500 went 109 straight days without closing down more than 1% en route to a 6.07% gain for Q1 2017. The first quarter market gains also came with unusually low volatility as measured by the VIX; the key index for measuring short-term volatility. Pundits have largely attributed the steady post-election market climb to the pro-growth policies of President Trump, but that does little to explain the even stronger performance in international markets. Developed international markets (represented by the MSCI EAFE index) ended the quarter up 7.39% and emerging markets, which presumably would be hurt by President Trump’s protectionist policies, were up 11.49%.

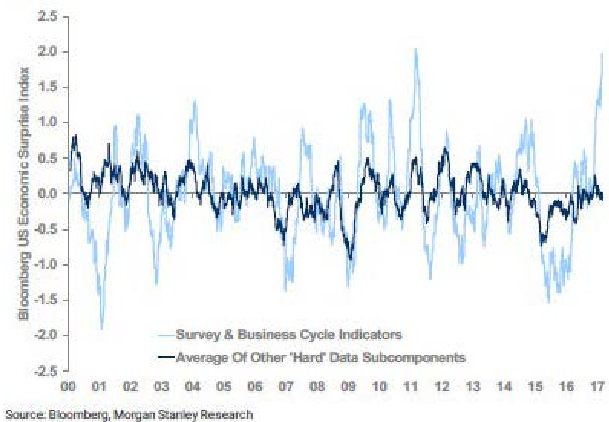
In our Winter 2016 Investor Letter, we began by commenting on the financial/economic similarities between December 31, 2015 and December 31, 2016. We cautioned then that using these similarities to predict short-term movements in the market was a fool’s errand, and the subsequent market performance has proven this to be the case. Our Spring 2016 newsletter began with the heading “A Volatile Quarter” to describe a market that fell over 10% as the VIX climbed to a high of 32; one of the highest levels in 5 years. Q1 2017, however, reached its VIX high of 15 in the last week of March as the S&P 500 experienced only four down weeks in the entire quarter. Despite the abundant similarities to 2016, the market could not have reacted more differently to begin this year.

Benjamin Graham, known by many as the father of value investing, once said, “In the short run, the market is a voting machine but in the long run, it is a weighing machine.” The market has clearly “voted” optimistically to begin 2017, but time will tell if the fundamentals support this “vote” in the long-term weighing machine.

Hard vs. Soft Data

Another way to quantify the votes of the people versus the weighing of the market is to look at hard versus soft data. Hard data represents realized economic results in sectors like labor, housing, retail, etc., while soft data consists of positive or negative responses to both business and consumer surveys. The soft data (voting) tell us what consumers and businesses think about the current environment and prospects for the future, and hard data (weighing) tell us what is actually happening in the economy. Eventually, the hard and soft data must reconcile with one another.

As the chart to the right shows, the soft data is currently surprising to the upside far more frequently than the hard data. The market has continued higher largely based on improved consumer and business sentiment measures, but the underlying hard data has yet to follow. In order to resolve this discrepancy, positive economic data must catch-up to the soft data, or consumer and business sentiment will likely worsen. The first scenario would help to validate current P/E Ratios (valuations) for the market, while the second scenario could result in a market pullback as investors reduce equities to favor safer assets. Recent good news was delivered by the strong March ISM manufacturing report which indicated hard data may be catching up.



Source: Bloomberg, Morgan Stanley Research

The current discrepancy between hard and soft data in the U.S. appears to be a global theme. Sentiment measures in Europe are above historical averages and continue to climb as shown in the chart below. These increased sentiment measures come despite the fact Euro-Area industrial production rose a tepid 0.5% in the most recent (January 2017) reading. Once again, these "gaps" between the two types of data tend to resolve themselves over time, but the catalyst for such a resolution is unpredictable. Disappointing readings on economic performance or certain legislation have the potential to weaken the widespread confidence supporting the market.

source: European Commission services

Buy the Rumor, Sell the News?

The old investing adage, "Buy the rumor, sell the news" comes to mind in light of bullish sentiment and the recent market advance. We experienced strong returns in 2016 as well as the beginning of 2017. Some argue bullish economic data would only justify current valuations rather than push the market higher, whereas expectation misses may result in market declines. Limited upside with significant downside potential would seemingly indicate a perfect example of where buying into the rumor (increasing sentiment) and selling just prior to the news (economic data, legislation, etc.) could prove beneficial. While this seems like a tempting game to play, we would once again caution against this as just another form of market timing. Market timing of any form tends to chip away at returns for long-term investors, and market timing in this specific case ignores some very important variables.

Though at first glance the downside risk of domestic markets may appear elevated, this analysis ignores the current economic environment. It is important to remember that markets do not exist in a vacuum and are necessarily affected by their surroundings. After considering the economic environment, it appears possible that markets may not be overvalued and may indeed be accurately pricing in the future improvement of so-called hard data.

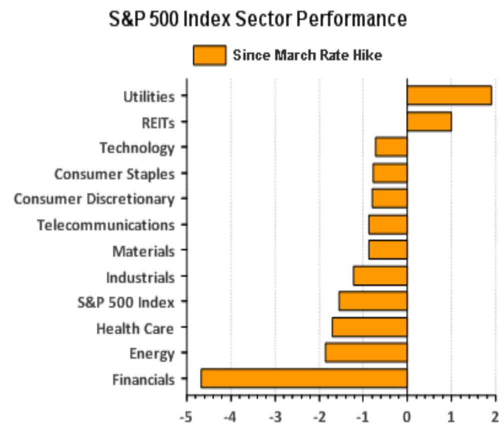
1958-2016			
Inflation	Average P/E	Highest P/E	Lowest P/E
0 – 1%	16.3	20.9	11.7
1 – 2 %	17.0	20.6	13.1
2 – 3%	17.6	26.7	10.8
3 – 4%	16.0	20.7	10.1
4 – 5%	14.0	21.0	9.5
5 – 6%	14.9	20.2	8.2
6 – 7%	11.6	17.9	7.2
>7%	8.4	11.5	6.6

We are here (2 – 3%)

Source: Bureau of Labor Statistics, FactSet, Charles Schwab as of October 31, 2016.

The chart at left indicates that given current inflation rates in the U.S., the market may be fairly valued. With current inflation tracking around 2% and a forward P/E for the S&P 500 of 17.7x, the market may be reasonably valued in the context of today's environment. This "fair" valuation coupled with analysts' consensus calendar year 2017 S&P 500 earnings growth of 10.9% could indicate an equity rally with more room to the upside. Given the economic context of low interest rates and low inflation, the market appears slightly less expensive.

Interestingly, however, the "buy the rumor, sell the news" adage has proven effective in some recent instances. Specifically, it has worked out reasonably well for the Fed rate hikes. The Fed raised rates again in March, making this their third rate hike off the zero lower bound. Increased interest rates should be detrimental to high dividend paying sectors like utilities and REITs as their yield becomes relatively less attractive, and should be very beneficial for the interest rate sensitive financials sector. Somewhat predictably, REITs dramatically underperformed in the weeks leading up to the rate hike and financials marginally outperformed the rest of the market (Utilities unusually outperformed leading up to rate hike). More importantly, however, after the actual hike took place, Utilities and REITs were by far the best performing sectors while the financials sector was the worst. The actual "news" of the Fed rate hike had the exact opposite effect of what market participants typically expect. This indicates the market may have already "priced in" the effects of the hike well before it actually occurred. There could be a similar effect for the overall market for events like the promised tax overhaul, but it is rarely profitable for investors to speculate on these events.



All Eyes on Politics

In the search for a "catalyst" to either promote faster economic growth or weaken the always-fickle business and consumer confidence, investors continue to focus on the global political landscape. With the U.S. elections behind us, the focus domestically is now on Republicans' effectiveness in implementing their agenda. Healthcare legislation and tax reform are center stage. Changes to the Affordable Care Act have already proven to be challenging. Changes to the tax code will likely have the broadest effect on both the domestic economy and financial markets.

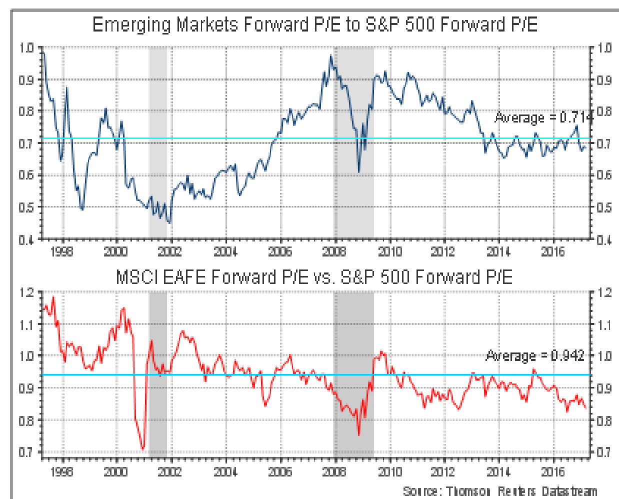
Internationally, the populist movement continues and the future of the EU hangs in the balance. The U.K. triggered Article 50 on March 29, formally beginning the BREXIT process. This will be followed by two years of negotiations as the U.K. re-establishes its own political and trade agreements rather than those negotiated by the EU. The tone set at the beginning of these complex negotiations (friendly or adversarial) will be an important component of the arduous path that lies ahead. In France, the well-publicized Presidential election will take place in the second quarter. Much of the global attention is a result of the unexpected success of Marine Le Pen and the National Front party. Le Pen has run on an anti-EU, pro-nationalist platform and is widely expected to come in first or second in the first-round

polls while then losing in the subsequent final election. Her success has forced other candidates to acknowledge the widespread anti-EU attitude of French voters. A surprise victory by Le Pen would be a shock to the EU establishment on par with BREXIT.

It is important for investors to keep in mind the market is separate from politics. The first quarter was a great example of this. It is difficult to recall a more politically volatile atmosphere than the one experienced at the beginning of 2017. From the protests of the inauguration, Supreme Court confirmation hearings and culminating in the recent "postponement" of voting on The American Health Care Act, the first quarter brought political uncertainty and numerous contentious moments; however, the market continued higher with almost no volatility. The market is undeniably affected by politics and legislation, but investors often overestimate the short-term connection between the two.

Client Portfolios

We used buying opportunities in the first quarter to incrementally add to international equity in client accounts. We did this largely by repositioning the developed international exposure and re-entering emerging markets. As the chart at right shows, both emerging and developed international equities appear undervalued relative to domestic equities. Though we remain long-term bullish on U.S. equities, the first quarter presented an attractive opportunity to gain diversification benefits through increased international exposure. Our client fixed income allocations remain short-term in nature as we avoid taking on additional interest rate risk during a period of rising rates.



Conclusion

Investors can always find worry in the markets. It is important to remember, however, that the market often manages to climb the proverbial "wall of worry" for far longer than expected. As the opening quote states, there is no safe time to "speculate" in stocks. We work with our clients to "invest" for the future rather than "speculating" on the near-term market movements.

Thank you for your continued confidence in HORAN Capital Advisors. Please be sure to visit us at www.horancapitaladvisors.com

Warm regards,

HORAN Capital Advisors

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