HORAN CAPITAL ADVISORS

Commentary

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The Return of Volatility – The Importance of Fundamentals

February 6, 2018

Unwelcome, Unpleasant, Inevitable. The recent spike in volatility has certainly caught the attention of investors over the past several days and as corrections go, the market drop has been quick and sharp. Many market observers have commented that the sell-off has been reasonably orderly but exacerbated by quantitative trading programs and the deleveraging of institutions. As our clients have read in prior commentaries, we have been expecting some form of market correction, but one never knows exactly when and how this will occur. What precipitated the beginning of the sell-off?

- Friday's employment report was stronger than expected with a key headline of a 2.9% increase in year-over-year average hourly earnings for workers.

- An unemployment rate of 4.1% is viewed as near 'full employment' and faster wage growth (consumers account for 70% of GDP) can lead to corporate earnings pressure and higher inflation.

- The Atlanta Fed has a GDP forecast measure called GDPNow which has been reasonably accurate historically. GDPNow is predicting Q1 2018 GDP growth at 5.4%. This would represent the fastest rate of U.S. economic growth in many years. Questions have been raised whether the Fed is "behind the curve" on raising short-term interest rates; thus, resulting in a faster pace of growth in inflation. If so, a faster pace of interest rate increases by the Fed could be necessary and this could inhibit economic growth.

- Higher interest rates eventually lead to broader competition for stocks. The 10-year U.S. Treasury yield has increased from 2.02% in early September to almost 2.9% last week and 2.76% this morning. Yields have dropped in the last few days as demand grew for safer assets, given the flight from equities.

- U.S. stocks were trading at a valuation levels (price to earnings ratio or P/E) around 18.5x forward earnings prior to the sell-off. This is slightly above the long-term average for P/E levels. Stocks tend to trade at higher P/E multiples when inflation and interest rates are lower. With higher wage growth, faster economic growth and maybe higher inflation, P/E multiples could adjust lower through declining stock prices. In fact, as we write this commentary, P/E multiples have fallen back to near their historical long-term average of 17x earnings. Importantly, consensus estimates for U.S. forward-looking corporate earnings growth are estimated to advance a robust 15% for 2018 as compared to 2017.

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The S&P 500 Index is up 34% over the last two years on a total return basis and down less than 1% for 2018 through February 5th. The average S&P 500 intra-year decline going back to 1980 is 14%. A double digit market decline has not occurred since February 2016 or nearly two years ago.

Our decision-making process is based on economic and market fundamentals and importantly, global fundamentals appear intact despite the recent sell-off. In fact, U.S. and global economic growth has accelerated. The rate of positive change in recent U.S. growth is significant and may have surprised many pundits and economists. Wages are moving higher and interest rates are normalizing. Many investors are assuming that recent positive economic numbers will influence sudden and material changes by the Fed. However, we believe the Fed will act far more calculated than this volatile market would suggest.

The recent sell-off is part of a normal cycle. A move lower is healthy for markets as it purges many who trade on speculation and/or momentum and not fundamentals. We do not see the economy as close to tipping into a recession, and we believe this pullback will provide a healthy adjustment for long-term investors and will likely provide some good opportunities.

While short-term market volatility, albeit a normal function of the equity market, does not instill comfort for investors, we continue to take the patient, disciplined and long-term approach to investing. Please do not hesitate to contact us with questions, comments and concerns. We welcome your call.

Respectfully,

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