SFE INVESTMENT COUNSEL

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Quarterly Commentary

We believe the recently passed Tax Cuts and Jobs Act may prove to be a significant benefit to domestic equities, in two ways: higher after-tax business earnings provide relief to investor valuation concerns; and economically, higher business cash flows combined with higher after-tax consumer cash flows provide more firepower to drive the economy forward. The only question is how much of that benefit is already reflected in higher stock prices. On balance, we are cautiously optimistic about the stock market in 2018.

Of course, the domestic economy is already on firm ground with annual GDP growth now closer to 3% than 2% for several quarters running. The global economy is enjoying a very rare synchronized expansion with all the major economies strengthening. Europe is doing better today than since before the financial crisis. China's growth seems to have stabilized near 6%.

Given this background, equity markets responded very favorably in Q4 with the S&P500 up 6.9% and finishing 2017 up 21.8% for the year. The technology sector was up almost 40%; differences amongst indexes primarily reflect differences in the allocation to high-growth technology names. The question which haunts us is whether that rise has been overdone. Valuations are at the upper end of the historic average and the speed with which the rise in Q4 took place was unnerving.

Nevertheless, we do subscribe to the tenet that bull markets don't die of old age. What could be the trigger for a correction? For 2018, we are framing our risk perspective around interest rates and inflation. We believe the most likely risk to equity markets in 2018 would be an unforeseen rise in inflation that unexpectedly pushed long-term interest rates up significantly. This would also force the Fed to more aggressively raise short term rates. Bonds would also do very poorly in this environment. Given a jump in interest rates, shorter maturity bonds would see less downside than longer dated bonds. In a similar way, more conservative value investments would see less downside than high PE growth investments.

But history teaches that the trigger will more likely be something we haven't foreseen. We are therefore not unalloyedly optimistic. We will continue to invest in the companies we believe in, but we are likely to keep a cash cushion in accounts to permit buying after a downturn.

To reiterate, we continue to believe that underlying earnings growth trends will continue into 2019 so long as the interest rate environment remains supportive. Of course, many things can change, but 2018 is starting off with some positive surprises. Who would have thought that North Korea would be attending the Winter Olympic Games in South Korea?

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