KANAWHA
CAPITAL MANAGEMENT

7201 Glen Forest Drive, Suite 200 / P.O. Box 18490 / Richmond, Virginia 23226 / (804) 359-3900

ON GUARD FOR COMPLACENCY

October, 2017

As summer transitioned to fall, investors continued to shake off potentially troubling headlines, propelling stock prices to new highs. Neither natural disasters nor hot air from North Korea seemed to hold the market back.

Long live the bull

Although it is eight years old, the bull market has shown few signs of losing steam. The 2007-09 crash set the stage for the running of this bull. With that stock selloff aggravated by a global financial crisis and then a devastating recession, the S&P 500 Index did not return to its prior levels until 2013.

So while some commentators seem concerned about the rally's relatively long duration, the old saying that a bull market does not die of "old age" or "natural causes" rings true. The rebound was tied to the depth of the selloff and propelled by a favorable monetary climate and significant profits recovery.

Moreover, bear markets (corrections of 20% or greater) tend to coincide with recessions. Stocks typically start turning down beforehand. On average, the S&P 500 hit a peak six months prior to the start of each of the seven recessions experienced since 1970. But the lead times were highly variable.

Conditions ripe

Recessions are inherently difficult to predict, but current economic signals do not suggest an imminent downturn. Rather, many indicators point to above-trend and *broadening* economic growth globally. The OECD forecasts that all forty-six economies it tracks will grow this year, a feat last seen in 2007. The OECD Composite Leading Index recently rose to its highest level in three years. And global industrial production and trade volumes are up 4% and 5%, respectively, both multi-year highs.

BCA Research notes that financial conditions in the United States have eased considerably this year in spite of the shift in Fed policy. Specifically, lower bond yields, narrower credit spreads, a weaker dollar, and a rising stock market should be growth tailwinds. And changes in financial conditions typically lead economic growth by six to nine months.

But caveat emptor

While the current economic climate appears mostly favorable, investors should still be on guard. Market participants face many uncertainties these days. The potential impact of central bank policies, geopolitical tensions, and political dysfunction makes quite an unpredictable brew. So far, the pickup in global economic growth and a corporate earnings recovery have mitigated these existential threats in the minds of investors.

Indeed, despite many headline risks, the stock market has been remarkably calm this year. As of mid-October, only one in twenty trading days had witnessed a one percent market move (up or down), the fewest in thirty-five years. And there have been no days that closed with a two-percent change.

The Chicago Board Options Exchange volatility index, or VIX, has been hovering around historically low levels. Imputed from the price investors are willing to pay for S&P 500 options, this metric is known as the "investor fear gauge". Lower anticipated market volatility translates into lower-priced stock options. So the current VIX level implies that investors see a tranquil market.

But the VIX should be viewed as a sentiment measure. It does not indicate what volatility will actually be, only what investors *think* it will be. And in any event, it is important not to conflate low volatility with low risk.

Survival of the fittest

Andy Grove, the pioneering co-founder and CEO of Intel, famously wrote that "Success breeds complacency. Complacency breeds failure. Only the paranoid survive." As witnessed in prior cycles, the longer stocks move up, the more investors expect high returns, viewing them as an entitlement.

Behavioral economists, who study how emotions impact decision making, would attribute this phenomenon to the "recency effect": the tendency to extrapolate one's current experiences into the future. Growing investor complacency, in the form of high valuations, may end up threatening the bull.

By most valuation measures, stocks have been trading at fairly lofty levels; not in bubble territory, but on the higher side of historical averages. However, in the context of the ultra-low interest rate environment, stock prices seem more reasonable. Warren Buffett himself reiterated this view in an interview earlier in the year. But he also went on to point out that "…the risk always is that interest rates go up a lot, and that brings stocks down."

The Federal Reserve has had a sizable impact on financial markets over the last decade. The bank's zero interest rate policy has made stocks very appealing compared to other asset classes. Many investors have not been willing to accept zero returns on cash and other safe instruments. The quantitative *tightening* on which the Fed has embarked has no historical precedent. Although long-term rates show no sign of spiking, the ultimate impact of the Fed's policy shift remains unclear, particularly with the selection of the next chairman up in the air.

Crack the code

Fiscal policy initiatives could also influence financial markets over the next few quarters. The administration has struggled to enact substantive policy measures amid pushback by elements of its own party. The focus has now shifted from health care to tax reform. The failure to replace Obamacare is not necessarily indicative of what may result on the tax front. Removing an entitlement program will always be politically challenging. But changes to the tax code — especially when the emphasis is on tax *cuts* — will generally face much less opposition.

In late September, the White House along with Congressional Republicans from the House Ways and Means and Senate Finance committees released their *Unified Framework For Fixing Our Broken Tax Code*. The plan contains some specific provisions but leaves many aspects to Congressional tax writers. The highlights:

For individuals, the plan proposes to:

- Collapse seven marginal tax rates to three (12%/25%/35%)
- Double the standard deduction
- Eliminate most itemized deductions
- Repeal the Alternative Minimum Tax
- Repeal the estate tax

For businesses, the plan proposes to:

- Reduce the corporate tax rate from 35% to 20%
- Limit the small business tax rate to 25%
- Repeal the corporate Alternative Minimum Tax
- Lower the tax rate (one-time) on repatriated cash
- Allow full expensing of equipment and machinery investments

Boon for corporate America

Stocks had rallied sharply immediately after the election on hopes of a pivot towards pro-growth fiscal policies. Tax cuts, such as those envisioned in the Republican framework, could have a salutary effect on the economy's growth rate. However, the overall impact would likely be both modest and fleeting. The multiplier effect presumed by tax-cut proponents over the years has frequently been too rich.

Nevertheless, tax policy changes could have a meaningful impact on corporate earnings. The non-partisan Tax Policy Center estimates that the proposed reduction in tax rates could save corporations $2 trillion over the next decade. To the extent these savings are not earmarked for additional expenses, they will obviously increase earnings per share for publicly-traded companies.

Meanwhile, the incremental cash flows from higher earnings along with funds repatriated from overseas could be used to increase dividends and repurchase shares. So the corporate profits story remains intact for now. Assuming inflation stays contained and interest rates rise only gradually, the fundamental backdrop for stocks should be positive.

Mood swings

The market's current mood is certainly not paranoid, but nor is it euphoric — and that is a healthy sign. Today's sentiment cannot be equated to the unbridled optimism that prevailed at that last two market tops. Investors seem largely aware of the uncertainties they confront and recognize that valuations are somewhat stretched. Modest pullbacks (5%-10%) can obviously occur at any time. But such reversals are normal and the price of admission.

Some longer term perspective is also in order: As of this October, ten years had passed since the stock market's last peak, just prior to the *Great Recession.* What followed, of course, was the worst crash in generations. However, in hindsight, if one had invested in the S&P 500 at that high point — the worst possible moment — *but held on,* one would have doubled his money today (including dividends), ten years later.

Whatever the cycle, the point is not to blindly buy, hold, and hope; rather, to construct a portfolio with an appropriate mix of risky and non-risky assets and the luxury of time to wait for stocks to recover when they turn down.

— Christopher J. Singleton, CFA, Managing Director

October 18, 2017