Lowe, Brockenbrough & Company

January 2018

2017 Review

"...As for stocks, valuations are stretched but probably fair as long as rates don't rise above 3%, something we're not forecasting. We continue to expect positive but below average returns from here. From where we sit, things have gotten more interesting, so we're gripping the wheel a little tighter."

Those were the last two sentences of our 2016 fourth quarter report - basically lukewarm and getting cautious. Revisiting forecasts is reliably humbling. The S&P 500 actually returned nearly 22% led by the Technology sector's stunning 34% return. Mega-cap stocks like Apple and Amazon were up over 50%. Even Walmart rose over 40%. International stocks soared 27%. No history of 2017 will use the terms lukewarm or cautious. But that's how we felt at the end of 2016, and we had lots of company. Things have certainly changed; broad sentiment undeniably improved as the year wore on and the rally strengthened. Have investors gained confidence or just been beaten into submission? Yes.

There had been widespread concern that this underwhelming economic advance would simply die of old age or be buried by some unwelcome eruption, political or otherwise. Turns out, the global economy accelerated this year. The U.S. has clocked two 3% real GDP quarters in a row and Europe and Japan are stronger than anyone would have wagered. For the first time since the Great Recession, we have a synchronized global expansion. Suddenly, the economic cycle doesn't look so old. It may have taken an implausible amount of time and monetary effort to get here, but that is largely irrelevant to how much longer the cycle can run. Like dogs, we breezily forget how long we waited. This must be especially galling for those investors who believed the advance was nothing more than a reckless binge (engineered by the Feds of the world) that would leave a nasty hangover in the wake of fading monetary stimulus. They are now coming to terms with a bull market feeding off a backdrop of a coordinated global economic expansion, growing profits, low inflation, very low interest rates, and now, tax cuts. Volatility has collapsed; pullbacks are slight and fleeting. This market gives no quarter. Traders call it the 'pain trade' - being forced to buy relentlessly higher. So investors have gained some confidence, but there's submission as well.

We've repeatedly counseled that this unusually subdued cycle could have an unnaturally long life. That conviction and the relentless rise in profits have kept us in the game. The two are strongly connected. Powerful economic expansions sow the seeds of their demise as confidence results in excessive and unwise investment. Witness the last two booms and subsequent busts. This time around, and even after nine years, we don't see excesses. Companies are remarkably profitable, but their cash flow hasn't been religiously reinvested. In fact, investment growth has trailed earnings growth in nearly every quarter of this expansion. The explanation: it is likely a combination of a more sober investment climate post the Great Recession, the near monopolization of some of our largest industries, and the offshoring of production to less costly locations. Depressed reinvestment isn't a panacea, but for an indeterminate period it will push margins and profits higher, keep valuations tolerable, and prolong the cycle.

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2017 Review *(continued)*

This bull has another distinguishing feature: a significant number of our leading companies appear to have attained a kind of near monopoly/uber-competitive status. Their sales growth, margins and profits flout historical norms. These mostly tech giants aren't burdened by large reinvestment requirements or serious competition, and they produce, heretofore, unheard of amounts of free cash. The words superlative and juggernaut come to mind. Investors are spellbound, and these stocks are literally dragging the indices to higher highs. And while it goes against our nature to pay up for perfection, we've done it in a few instances and are lucky we did. We're not taking a bow; it doesn't take brains or courage to go with the herd. Eventually, though, we'll need some of both to buck this thing, but that's a process (a little here, a little there), not a date in time.

So where are we? There are signs that investment spending is picking up, so this cycle could end traditionally: boom then bust. But excess takes time. The Fed is raising rates - a red flag, traditionally. In this instance, though, they are just trying to get back to something that resembles normal. We still believe long rates will have trouble getting above 3%. We guess we're in the sixth or seventh inning, the beginning of the end.

As for expected returns, we're certifiably blind to the short term and can only reasonably guess at the long term. If you were expecting imprecision, you won't be disappointed. Our forecast derives from a set of very basic questions. Are profits depressed? No. Are valuations depressed? No. Is sentiment depressed? Nope. Can interest rates go a lot lower? No. And, finally, is the Fed easing? No. They are, in fact, tightening. While the New Year is a time of hope and promise, we must report that all signs still point to below average long term returns. But if it's any consolation, the beginning of the end of any good party is rarely boring. Inhibition ebbs and stuff happens.

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