VERITY

Asset Management

Commentary

January 2018

Going into 2017, investors were faced with a rather stark dichotomy. Given the seemingly unprecedented political change and uncertainty, there were two very different ways of looking at the path ahead for equity markets - both reasonable, despite being on opposite ends of the spectrum. Rarely is there such a clear sense that, “markets could move sharply higher, but they could just as easily turn sharply lower”.

The Presidential election night a couple of months earlier had perfectly framed the breadth of this uncertainty. As the outcome became clear, markets dramatically illustrated to investors in a few short hours the potential extremes, with equity futures first plummeting into the wee hours of the morning before reversing and surging higher into the new day.

Presumably, the precipitous move down reflected fears of economic disruption, and the equally dramatic move up found its alternative impetus in the potential economic benefit of prospective tax cuts, reduced regulation, and infrastructure spending.

We now know that markets took the path higher in 2017. And despite the fact that some took a rather cautious approach, investors who went into 2017 appropriately positioned for their personal circumstances and tolerance for risk should generally feel good about their year. The majority of aggressive equity investors did very well; the typical balanced investor also did well; and even conservative, risk-averse investors should take considerable pleasure in knowing they achieved in most cases solid returns without abandoning reasonable caution in a very uncertain and potentially dangerous investment environment.

So how should investors now approach 2018?

Most of the risks discussed in recent commentaries remain in play, but it would not be at all surprising if the market continues to run. With that said, it is important for investors to recognize that, at this stage, things could become trickier, in part because they could become more emotional.

First, some quick background – U.S. economic conditions have continued to improve and are by most measures in very solid territory, with no indications of a recession on the near horizon; global economic conditions are similarly favorable; interest rates are still supportive of economic expansion; and the new tax cut should provide some near-term tailwind, regardless of the debate over longer term effects. As noted in past communications, a rapid rise in interest rates could become a concern, as could a shortage of labor – but, at the moment, none of these things appear to be having a materially negative impact.

There are also potential political issues – it’s impossible to know the market’s reaction should something substantive arise from the Russia probe, unlikely though that may seem, or should the political sands appear to shift as we approach mid-term elections.

For now, though, the primary driver of these markets may simply be capital flows – simple supply and demand – as dollars from both U.S. and overseas investors seek equity positions amidst the diminished supply of stocks in circulation after years of corporate buybacks.

The market's sharp acceleration into the new year is raising some eyebrows. A few months ago, we made the case that the duration of this economic expansion and this bull market are not in themselves causes for concern, and that valuations, while stretched, were not in legitimate bubble territory given the low interest rate environment and the pace of expansion of corporate profits. At that time, the market seemed to be continuing to climb the proverbial "wall of worry", with various fears and concerns helping to limit excessive enthusiasm. Now, for whatever combination of reasons, the market is showing the very real potential of a "melt-up", characterized by excessive enthusiasm and very rapid acceleration in prices. The current January surge could end up being nothing more than a January surge, but if we find ourselves in a genuine melt-up, that would change the equation.

This is where the emotion can come into play. In a melt-up, things can get stupid. For investors, It's nice to see account values rising, so long as they remain calm. But investors can become greedy - rather than being happy with the gains they are making, they panic at the thought of the gains they are "missing"; they don't want to be left behind. Pick your own way of expressing it, but the point is, it can become emotional – and in investing, emotion is dangerous.

Now, as much as ever, be clear about your personal plan – your intended, well-reasoned market positioning. In this, your personal advisor should be an invaluable asset. If markets melt up (or move down), stick with your plan. Be comfortable with the gains that come from your chosen positioning. Also bear in mind that, as valuations climb and prices accelerate, risks increase – a 15-20% decline could happen in the blink of an eye without necessarily signaling the end of the long market expansion. Understanding the risk, if you like the market's overall risk/reward scenario and elect to play the upside by leaning a little further into equities, that may not be unreasonable – but don't get stupid. Remember the old Wall Street adage, "Bulls make money; bears make money; but pigs get slaughtered".

If nothing else, the ride will likely become much bumpier as we move through 2018, so stay buckled up.

This material contains forward looking statements; there is no guarantee these outcomes will be achieved. All investing involves risk of loss, and there is no guarantee that strategies which may have been successful in the past will be similarly successful in the future.