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Investment Outlook

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The Market Shrugs Off Lots of News and Little Action

As we enter into the last month of Q3, all eyes should be focused on the return of Congress to Washington for a final attempt at passing a budget and enacting tax reform before the close of 2017. Instead, the focus has been shifted to any number of items that we would put far down the list of priorities for investors and the markets: Repeal and Replace, Building a Wall, Tampering by the Russians, Pardoning Sheriff Joe, Defending and Condemning Free Speech, Rewriting U.S. History, Hurricane Harvey. While these subjects are important to many, especially those in the media, they have yet to directly impact the economy and the markets. However in the aggregate, they pose a threat to distract Congress and the Administration from their work in the areas of fiscal and foreign policy. The completion of that work matters very much to investors, especially with the mid-term elections a little more than a year away.

News or Noise?

So far, the market has shrugged off a number of events dominating the headlines. Meanwhile, data pointing to a slow resurgence of global growth and a rebound in US corporate earnings has provided the impetus for the major indexes to remain near their record highs. In our view, this reflects a high degree of optimism regarding completion of the majority party's economic agenda as well as dealing with the threat from North Korea. These are newsworthy items for investors. Success, or the lack of it, in these endeavors has the potential to significantly move the markets higher or lower. Beyond that, the rest of the news appears to be just noise as far as the markets are concerned.

Whether that's because so much of what the administration and the media have communicated to their audiences has proven to be irrelevant to the economy is anybody's guess. However, when looking at the market's reaction to these "events," we think that idea has merit. The skittishness we saw in the markets of recent years has seemingly been replaced by a rational resilience to headline risk. We're seeing a new investor perspective in the markets that places value on events that actually impact the economy while dismissing much of what is monotonously reported as "news you need to know."

That's the tagline that still persists in the wake of 2008 where the media had us believing that Greece could crash the European economy and that, in turn, would send China into a downward spiral. The end result would see an economically vulnerable US caught up in the vortex and Game Over for the global economy. That proved to be a delightful piece of fiction that nevertheless triggered a number of market corrections and a mini-bear market as it was written. Lesson learned: the news that matters to investors should be viewed through the lens of what's truly important and impactful to the economy and the companies within. That distinguishes rational investing from pure speculation.

What Matters to the Markets

In our most recent Outlook, we voiced our skepticism over the Repeal and Replace approach to overhauling

Healthcare. We expected to see a compromise within Republican ranks that would result in passage of a bill that would only prolong the agony of watching a different version of Obamacare implode. Instead, we were pleasantly surprised by the vote in the Senate to dispense with a hollow Repeal and Replace strategy, allowing Congress to move on to the next item on the agenda: Tax Reform.

As THE critical component to formulating fiscal policy, investors are keenly focused on when we might see a tangible result there. Hopefully, that might be accomplished prior to the summer recess of 2018 and well in advance of the mid-term elections. The outcome should define the extent of the market's advance over the next several years. It's our view that investors won't take kindly to a failure in laying the path for a longer-term economic expansion. Running a close second in importance is reigning in North Korea. Economic sanctions and a U.N. resolution are a good start, but the recent lobbing of a missile in Japan's direction indicates that more will be required, posing the risk of a trade war with China. That's the real news that carries weight for us as investors.

Regardless of the relentless stream of tweets and events triggering "outrage" around the globe, the major indexes remain within 2% of their record highs. The Russell 2000 small-cap index lags a bit with a 4+% decline. That divergence can be attributed to a flight to quality in the form of mega-cap stocks of companies with household names. They're the darlings of the Dow, NASDAQ, and S & P 500: The FANG stocks (Facebook, Amazon, Netflix, Google) along with Apple, Boeing, Microsoft, and others. We've also seen a significant divergence among some sectors within the indexes, based on factors that affect their target markets and profitability. That would explain the rotation of capital flows from sectors such as Energy and Telecom to Tech, Healthcare, and Foreign. All in all, stocks have proven to be surprisingly resilient in the face of news that several years ago would most likely have peeled 10% or more off the averages.

Today, the pendulum has swung away from skittishness to a level of investor complacency that many in the financial media now say has set the table for the next Big Downturn. If we've learned anything over the past 25 years, it's that the stock market rarely fulfills widely touted expectations. No doubt, a good number of investors appear to be more confident of the market's long-term future than in past years. We think a broadening of the recovery in the global economy warrants it. A stimulative US fiscal policy would offer a big assist in that department. Many pundits in the negative camp overlook the fact that, while some asset classes are treading in bubble territory, the risk associated with those bubbles has migrated from the financial system (the banks and government) to the public and private equity/debt markets. Unlike 2008, any future losses in the markets should accrue to investors rather than bank depositors and taxpayers.

That's an indication that structural risk has been displaced by the more familiar cyclical risk to the economy and that the next recession and bear market will likely resemble those prior to 2008. The markets will almost certainly stage a correction in the next year, but absent an event of global proportions we think chances for recession and a bear market are negligible through 2018. That said, this stock market has done a good job of pricing in perfection for a number of index-leading companies like those mentioned above. We've recently taken profits in some highly-appreciated, over-weighted positions with possibly more to come. We'd suggest that investors remain patient, take profits where warranted, avoid chasing prices to unsustainable levels, and learn to live with the by-product of a little too much cash for a time as we await real news about the things that matter to the economy and its markets.

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