One of the constants in capital markets is the element of uncertainty. This year has been nothing but evidence of market uncertainty. Having said that, we would like to continue our prognosis of the markets using our proprietary market model's projections for the next 12 months.

We ended our March 2018, "Market Correction" article with the following:

Following are crucial fundamental variables relating to the US economy :

a. ***The US GDP is expected to grow at approximately 2.5-3% for 2018.***
b. ***Corporate earnings are expected to grow at 20% for FY 2018.***
c. ***Unemployment is expected to remain low; currently at 4.1% (Full employment).***
d. ***Inflation is contained (~2%) and will not put undue pressure on interest rates.***
e. ***Tax reform will add to corporate confidence, which will fuel corporate spending.***

We believe that these fundamental economic variables will not be derailed by the recent rhetoric from the Trump administration. By Trump's rhetoric, we mean the change in Trade practices, particularly the recent trade tariffs imposed on China.

This recent correction of over 7% in the month of March, 2018 could be an opportunity to add to existing positions.

Since the market lows of March 2018 (S&P 500: 2,580), the S&P 500 has gained approximately 9.5% (S&P 500: 2,827 as of August 2nd, 2018).

In retrospect, the February-March 2018 market correction was a buying opportunity. Since then, most of the fundamental variables have held their promise and so has the market. One thing is for sure, we are going to experience some sort of slowdown or hiccups along the way. The question is how deep and how long could these corrections be?

No one can accurately answer that question, but we would like to discuss aspects which are critical to the economy. We believe that these factors are crucial in any economic cycle but particularly pertinent in the current environment:

1. US Interest Rate Environment.
2. US Gross Domestic Product (GDP).
3. US Corporate Earnings.

We will focus on the Interest Rate aspect, as we believe it to be the most important and pressing issue currently.

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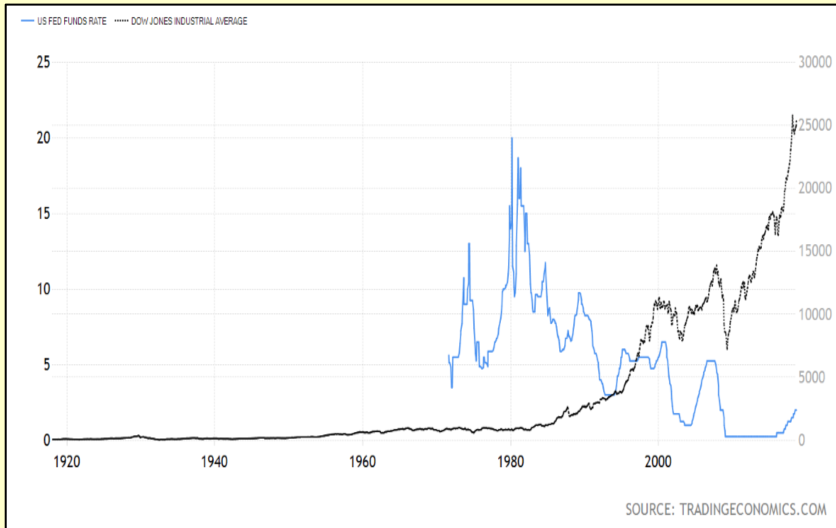
Below is a chart illustrating the long-term US Fed Fund Rate (rates the US Federal Government charges banks). This rate is the basis for the cost of capital that applies to aspects of business and commerce. A crucial point to recognize is that interest rates have been on a decline since the 1980s.

Chart 1[1]



Interestingly, the Dow Jones Industrial Average (DJI), a proxy for the broader market, has gained significantly during this time. It does not take a genius to recognize that a declining rate (low cost of capital) environment is favorable for economic growth and in turn the capital / stock market.

After almost 3 ½ decades, we are moving into a paradigm that most of us are not familiar with. The Federal Open Market Committee (FOMC) has increased rates 7 times since 2016. Fed Fund rates have moved from virtually 0% to now 1.75%-2.00%. In addition, the FOMC has indicated that they are cognizant of the US economic growth and will continue to carefully raise rates to a reasonable level and reduce the debt on their balance sheet.

Chart 2[2]

Date Start	Int. Rate Low	Date End	Int. Rate Peak	Total % Chg.	S&P 500 Peak	S&P 500 Trough	S&P 500 Return	Recession / Crisis
2/1/1957	3.3	10/1/1957	4.0	18.86%	7/1/1957	4/1/1958	-12.72%	Recession / During
5/1/1958	2.9	9/1/1959	4.7	60.27%	8/1/1959	3/1/1960	-7.37%	Recession / 2 Mo. Later
7/1/1965	4.2	9/1/1966	5.2	23.33%	1/1/1966	10/1/1966	-17.35%	Vietnam Starts
3/1/1967	4.5	5/1/1968	5.9	29.30%	9/1/1967	3/1/1968	-7.01%	Recession
8/1/1968	5.4	5/1/1970	7.9	45.94%	12/1/1968	7/1/1970	-28.89%	Recession / During
11/1/1971	5.8	8/1/1973	7.4	27.37%	1/1/1973	12/1/1974	-43.36%	Recession During
11/1/1973	6.7	8/1/1975	8.4	24.81%				
12/1/1976	6.9	3/1/1980	12.8	85.59%	9/1/1976	3/1/1978	-15.79%	Oil Crisis
6/1/1980	9.8	9/1/1981	15.3	56.65%	11/1/1980	7/1/1982	-19.37%	Recession
5/1/1983	10.4	6/1/1984	13.6	30.64%	10/1/1983	7/1/1984	-9.88%	Recession
1/1/1987	7.1	10/1/1987	9.5	34.46%	8/1/1987	12/1/1987	-26.84%	October 1987 Crash
12/1/1989	7.8	9/1/1990	8.9	13.39%	6/1/1990	10/1/1990	-14.78%	Recession
9/1/1993	5.4	11/1/1994	8.0	48.51%	1/1/1994	4/1/1994	-5.45%	Asian Contagion
10/1/1998	4.5	1/1/2000	6.7	47.02%	8/1/2000	10/1/2002	-42.47%	Recession / Tech Bust
6/1/2003	3.3	5/1/2006	5.1	53.45%	7/1/2007	3/1/2009	-50.21%	Recession / Financial Crisis
12/1/2008	2.4	4/1/2010	3.9	59.09%	4/1/2010	7/1/2010	-9.82%	Euro Crisis
10/1/2010	2.5	2/1/2011	3.6	40.94%	2/1/2011	9/1/2011	-11.15%	Debt Ceiling Debate
7/1/2012	1.5	1/1/2014	2.9	89.54%	7/1/2015	2/1/2016	-9.70%	Brexit/Taper Tantrum
7/1/2016	1.5	2/1/2018	2.9	93.33%	2/1/2018	???	???	Trade Wars
Mean				43.84%			-20.15%	
Median				43.44%			-15.29%	

The adjacent Chart 2 shows the impact of increasing interest rates on the S&P 500 index, which can be viewed as a proxy for US broad based markets.

The data goes back six decades and clearly shows a negative correlation between rising rates and market decline.

The biggest decline was experienced during the dot.com bust in 2000-2003 and the financial debacle during 2008-2009. Obviously, there were other factors that attributed to these respective market declines and economic recessions. Having said that, we can not ignore this uncanny negative correlation of the markets to interest rates.

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[1] Source: www.tradingeconomics.com

[2] Source: https://www.youtube.com/watch?v=fkmAJvRdYW8

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If we look at the positive side of the economic equation, we can infer the following:

1. US GDP is growing at or above 3%, and we believe that a 2.5-2.75% per annum growth is sustainable.
2. US Employment scenario is positive and is expected to stay at favorable levels.
3. US Corporate profits have been growing healthily over the last few years.
4. Interest Rates are still at low levels which is favorable for economic growth.

Despite such positive parameters, our Market Model is suggesting that the markets are fully valued and could end the year at current levels.

To conclude, we would be very selective with new investments at current market levels. It would be prudent to focus and pay attention to security selection at these levels. We would also recommend that investors start to gravitate towards value investments as growth-oriented securities seem to be valued for perfection.

In other words, we would suggest that investors wait and watch for opportunities to present themselves as opposed to chasing performance. Sometimes, patience is a virtue…

PLEASE REMEMBER: Each investor is unique and should invest to complement their respective financial conditions and objectives.

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