December 2018: Market Correction!!!

We concluded our October-November 2018 Newsletter with the inference:

"To conclude, we believe that the current market correction has created opportunities for investments in US equities. We would suggest that investors add to high quality dividend paying companies, especially in the Energy, Healthcare, Telecom and Consumer Staples sectors. It's opportunistic to buy when everyone is selling and harvest gains when everyone is buying…"

Major US market indexes declined into correction territory in the month of October 2018. Most US based indexes declined approximately 8-9% in October 2018. The month of November experienced a 3-4% recovery, during the first week but gave up all the gains subsequently and fell into negative returns for the month.

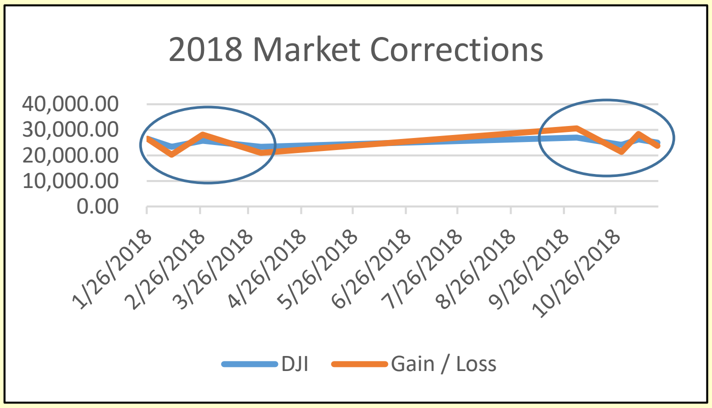

Table 1[1]

Date	DJI	Gain / Loss	Gain/Loss (%)
1/26/2018	26,466.00		
2/9/2018	23,360.00	(3,106.00)	-11.74%
2/27/2018	25,735.00	2,375.00	10.17%
4/2/2018	23,344.00	(2,391.00)	-9.29%
10/3/2018	26,951.00	3,607.00	15.45%
10/29/2018	24,144.00	(2,807.00)	-10.42%
11/8/2018	26,279.00	2,135.00	8.84%
11/19/2018	24,990.00	(1,289.00)	-4.91%

There have been two noticeable corrections so far this year. Major Market indexes (we have used the Dow Jones Industrial Average (DJI) for this illustration: Table 1 and adjacent Chart) lost approximately 10-12% from January 2018 to the beginning of April 2018. The markets then gained approximately 15% from April to the beginning of October 2018. Subsequently the indexes have lost approximately 10%. The net loss for the DJI for the year 2018 is approximately 6% as of the last week of November 2018.

Major areas of concern in the current economic environment:

1. Federal Government is reversing its easy monetary and fiscal policy.
    a. Interest Rates are on the rise.
2. Decelerating Real Estate Environment.
3. Decelerating US Corporate Earnings.
4. Market Valuation.

[1] Source: CGAM, LLC

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Fed Fund Rate:

Fed Fund Rate (FFR): FFR is the interest rate set by the Federal Open Market Committee. This rate determines the cost of capital in terms of mortgage rates, corporate loans, short term financing rates etc.

Table 2[2]

	Actual 2018 1Q	2Q	3Q	4Q	Forecast 2019 1Q	2Q	3Q	4Q	Actual 2016	2017	Forecast 2018	2019	2020
Real Gross Domestic Product [1]	2.2	4.2	3.5	2.5	2.3	2.6	2.5	2.3	1.6	2.2	2.9	2.7	2.2
Personal Consumption	0.5	3.8	4.0	2.8	2.2	2.9	2.6	2.5	2.7	2.5	2.7	2.8	2.2
Inflation Indicators [2]													
PCE Deflator	1.9	2.2	2.2	2.1	2.3	2.4	2.7	2.7	1.1	1.8	2.1	2.5	2.4
Consumer Price Index	2.3	2.6	2.6	2.4	2.4	2.6	2.9	2.9	1.3	2.1	2.5	2.7	2.6
Industrial Production [1]	2.5	5.3	3.3	3.6	2.4	4.2	1.2	4.0	-1.9	1.6	3.8	3.2	2.8
Corporate Profits Before Taxes [2]	5.9	7.3	8.0	6.2	5.6	1.8	0.5	-0.8	-1.1	3.2	6.9	1.7	-2.4
Trade Weighted Dollar Index [3]	86.3	90.0	90.1	92.0	91.0	89.3	88.3	87.0	91.5	91.1	89.6	88.9	84.5
Unemployment Rate	4.1	3.9	3.8	3.7	3.7	3.6	3.6	3.5	4.9	4.4	3.9	3.6	3.3
Housing Starts [4]	1.32	1.26	1.22	1.29	1.30	1.31	1.32	1.32	1.17	1.20	1.27	1.31	1.34
Quarter-End Interest Rates [5]													
Federal Funds Target Rate	1.75	2.00	2.25	2.50	2.75	3.00	3.25	3.25	0.52	1.13	2.13	3.06	3.19
Conventional Mortgage Rate	4.44	4.57	4.63	4.90	5.05	5.15	5.25	5.30	3.65	3.99	4.63	5.19	5.23
10 Year Note	2.74	2.85	3.05	3.30	3.45	3.55	3.65	3.70	1.84	2.33	2.99	3.59	3.63

Forecast as of: November 7, 2018
[1] Compound Annual Growth Rate Quarter-over-Quarter
[2] Year-over-Year Percentage Change
[3] Federal Reserve Major Currency Index, 1973=100 - Quarter End
[4] Millions of Units
[5] Annual Numbers Represent Averages

It can be observed in Table 2 (highlighted row) that the street is expecting FFR to increase to approximately 3.25% by the end of 2019.

Mortgage Rates[3]:

Table 3 illustrates the difference in the monthly mortgage rate based on the expected FFR. We have used a range of 4.75% to 5.25% for the 30-year Fixed Mortgage rate. The average home price in the US is approximately $270K-$280K. Again, we have used a much higher mortgage loan range ($500,000-$700,000) to gauge the sensitivity of monthly mortgage payments to an increase in rates.

Table 3[4]

Mortgage Amount	Mortgage Rate:4.75%	Mortgage Rate:5.00%	Mortgage Rate:5.25%	Monthly Pmt Difference (5.00%-4.75%)	Monthly Pmt Difference (5.25%-4.75%)
-$500,000	2,597.95	2,672.97	2,748.99	$75.02	$151.04
-$600,000	3,117.54	3,207.56	3,298.79	$90.02	$181.25
-$700,000	3,637.13	3,742.16	3,848.59	$105.02	$211.45

Currently, the average Mortgage holder pays approximately 17%[5] of their income as mortgage payment. This number was 21% in 2001 and 24% in 2007; prior to both recessions, in 2000-02 and 2008-09 respectively. In addition, the mortgage rates in 2001-02 and 2008-09 were 6.5% and 5.5-6% respectively. The difference between the three levels of mortgage interest rates is noticeable, but not significant enough to be a catalyst for a recession.

Corporate Earnings:

1. US corporate earnings are expected to peak by the end of 2018 and start decelerating at the beginning of 2019.
2. Subsequently, earnings growth is expected to have negative growth in Q3 and Q4 of 2019 (As shown above in Table 2).

[2] Source: www.wellsfargo.com , [3] Source: CGAM, LLC, [4], [5] Source: Wells Fargo (Insight Reports)

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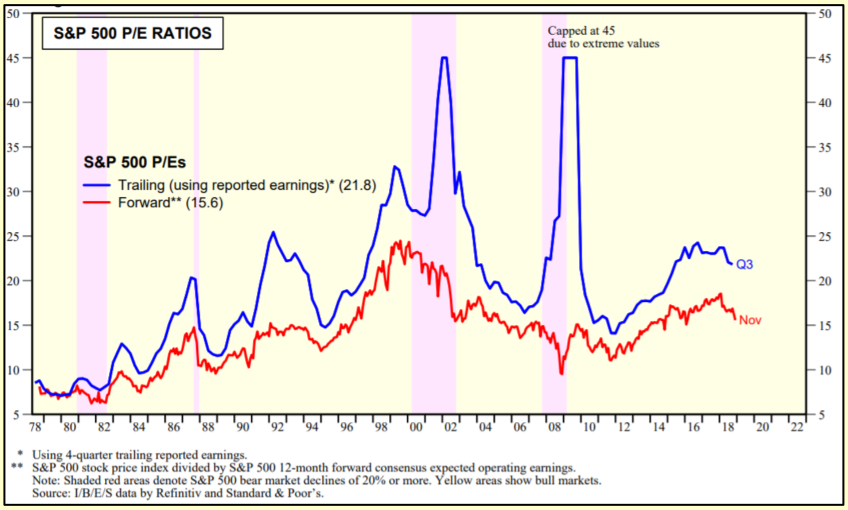
3. It is no mystery that corporate earnings are the most important ingredient for the direction of the stock market. Corporate earnings were cut in half from the beginning of 2008 to the beginning of 2009. During that time the markets lost almost 45-55% (depending upon which index is considered: ***S&P 500 lost 54% from August 2007 through March 2009***[6]). It was only after the earnings started to rebound that the markets stabilized and started their ascent.
4. We believe that the US corporate earnings will not be able to continue their extraordinary growth, that has been experienced over the last three to four years. On the same token, we must realize that earnings are still benefitting from the tax reform, a growing economy and a strong US consumer. We can expect to experience a deceleration in the rate of growth on earnings. We believe that even though earnings will decelerate in 2019, the annual growth rate will be in the range of 7-9%.
5. We also believe that the US GDP will benefit from global growth. Disposable incomes across the globe are increasing, creating opportunities for the US to increase exports in sectors which include, Healthcare (Pfizer, JNJ, Bristol-Myers etc.), Aeronautics (Boeing, Northrop Grumman, Rockwell Collins etc.), Heavy Machinery (United Technologies, GE, Cummins, etc.), Consumer Durables (GM, Ford, Whirlpool, etc.), Consumer Staples (Pepsi, Coke, Altria, Procter & Gamble etc.) and retail (Amazon, Walmart etc.).

Market Valuation:

Chart 2



1. The adjacent Chart 2 shows the S&P 500 index's trailing and forward (12 month) Price to Earnings (P/E) ratio.
2. P/E is a gauge of investor sentiment. During good times, we can experience expanding P/Es and vice versa.
3. It can be observed that the trailing P/E for the S&P 500 was in the 30s and mid-20s, before the recession in 2000 and 2008 respectively.
4. The shaded pink area shows recessions and a market decline of 20% or more.
5. The current S&P 500 P/E is approximately 18, and the forward P/E is 15.50.
6. Even though the current level of S&P 500 P/E is above the four decades mean of approximately 15, it is not at alarming levels, which would indicate a recession.

[6] *Source: Data from www.financeyahoo.com*

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Fair Market Value:

1. Currently, the companies that comprise of the S&P 500 are expected to generate approximately $162 in combined average earnings for the fiscal year 2018.
2. Based on our analysis, we believe that earnings could reasonably grow between 7-9% in 2019. This would translate to average earnings in the range of $173-177.
3. As mentioned above, the average P/E ratio for the S&P 500 for the last 4 decades is about 15-16. At a mid-range of earnings estimate and a reasonable P/E ratio of 16-17, we would reach an inference that suggests that the S&P 500 could gain between 6-12% over the next 12 months. The lower end of the market growth projection is derived by using 7% earnings growth multiplied by a P/E of 16. Similarly, the higher end of the returns projected are based on 8% earnings growth times 17 P/E. Even though models are error prone, we believe that at reasonable earnings growth, the markets are not over valued at current levels and still have room to grow.

Investor perception:

Every market cycle is initiated, magnified and reversed by aggregate investor sentiment. Obviously, we cannot and should not ignore the fundamental aspects of the macro economy and the individual factors affecting respective companies.

Having said that, it is humans who ultimately translate those variables to make their final investment decisions. The satirical, but rather true nature of investors can be observed in the adjacent chart[7] "Investor Psychology Cycle".

It is up to us as investors to recognize which phase of investment cycle we are in. Again, if we could do that accurately and act on it prudently, we would all be Warren Buffett.

<u>Conclusion: We have experienced a great Bullish market phase since the beginning of 2009. Investors have gotten used to seeing dips that quickly reverse and have proven to be great buying opportunities. This year has experienced two noticeable corrections that jolted investors into rethinking the real possibility of a recession. Having said that, we believe that the US GDP growth, favorable employment and earnings strength should bolster the markets for the foreseeable future. As mentioned in our previous Newsletter, we would reiterate that this is an opportunity for investors to add to quality companies in the area of Healthcare, Industrials, Financials and Information Technology.</u>

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

[7] Source: http://www.dividendcake.com/lottery-stock-market-make-choice/

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