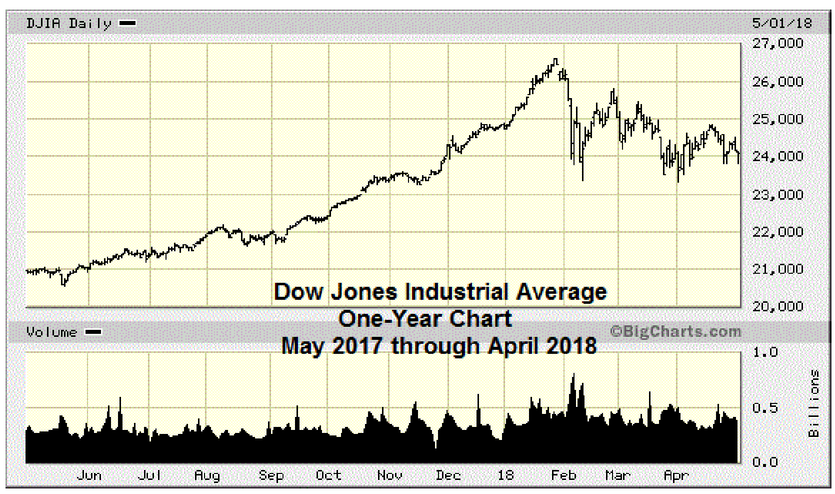
American Heritage Financial

May Update **May 2, 2018**

As Good as it Gets?

Considering just how miserable and extreme the weather has been in 2018, one thing that can be predicted with confidence is that weather **will** be getting better over the next few months! The stock market, too, has had a pretty miserable time of it this year and many think the high water mark set in January may be as good as it gets for the year. The market, however, may prove more difficult to predict than the weather.

April marked the third month of the current "correction" although it was slightly less painful than the preceding two months. Due to a drop the last day of the month, April ended with a tiny gain of about 0.3% in both the Dow Jones Industrial Average and the S&P 500 Index. That leaves those benchmark indices negative by 2.3% and 1.0% for the year, respectively. April was also kinder as lower volatility and a brief mid-month rally reduced anxiety and improved investor sentiment.



April's real importance was the onset of first quarter earnings announcements. Through the end of the month, about one third of companies have reported and *"great expectations"* for stellar earnings announcements have been wildly exceeded. Thus far, 80% of all companies exceeded their expected earnings numbers and, even more impressive, it now appears earnings for the first quarter could be as much as 25% higher than the comparable period a year ago. The strong numbers have been driven mostly by strong top line (sales) growth but favorable currency comparisons and cost controls also helped.

Many, but not all, stocks reporting impressive earnings beats have been rewarded with positive price reactions. And, as could be expected in this nervous environment, stock prices are getting crushed when companies miss expectations. Even some of the stocks that reported great numbers have seen poor price reactions. The best example is Caterpillar—and it is also an example of the underlying struggle that stock prices face in this near perfect environment. Cat's sales soared 33% in the first quarter and were about $80 million higher than expected (at $12.15 billion). Earnings were $2.82 per share compared to analysts' estimates of about $2.11. While the stock rose four points early the day of the report, the price reversed by mid-morning and closed down ten points; a 14 point turnaround and a loss of 6% on the day. The problem? The CEO made reference to the possibility that margins in the first quarter may be at a "high water mark" and he voiced concerns about headwinds of higher commodity prices and a stronger Dollar.

Many companies have voiced similar, usually subtle, comments about future earnings growth. Inflation is already ticking higher and higher costs are expected to become an increasing problem. Oil prices are significantly higher than a year ago and steel and aluminum prices were on the increase even before tariff talk kicked in. Wage growth has remained subdued in spite of the super low unemployment rate. But wage growth, as well difficulty in finding qualified workers, could be a drag on profits into the end of the year.

The economic expansion will enter its tenth year in July and seems to fit the ***"As Good as it Gets"*** mold. This long, slow recovery has been like a tortoise for nine years but it is beginning to look like the tortoise is on a sugar high. GDP growth in the first quarter was reasonable at 2.3% but that number was solidly better than the 2.0% expectation and, due to one-time and unusual drags in the first quarter, the rest of the year appears certain to generate economic growth at or near the magic 3% range. As mentioned above, employment is also amazing. The latest unemployment reading is 4.1% and economists are confidently predicting it will move below 4% soon and some are predicting a 3.8% unemployment rate by yearend. But those great numbers are not expected to continue into 2019. For example, we are already at what is considered “full employment.” The unemployment rate could drop into the mid-3% area but that would match lows not seen since the early 1970’s and demographics make further improvement near impossible.

With the bull market and an economic expansion both about nine years old, there is no denying that this cycle is long in the tooth. (Only one bull market and two economic expansions, since 1920, have lasted longer.) Valuations are still reasonable—especially after the correction of the past three months and the recent great earnings numbers. But, investors are always looking into the future and that is why caution is prevailing. They see headwinds which could at the least reduce stock gains, if not lead to lower prices.

Of course there are other issues for the market to worry about other than pure earnings and economic numbers. Political uncertainty continues to contribute to the volatility with trade fears and midterm elections on one end and tax cuts, deregulation and repatriation on the other. Federal Reserve goals for inflation, growth and employment are all attained or within reach, making it near certain they will continue pushing up short-term interest rates. And, concerns of a military conflict continue, although possibly those concerns have moved to a different spot on the globe.

Taken all together and this mixed, uncertain outlook does give investors reason for caution. At the least, expect lower returns over the near term as the economic expansion plays out and markets settle. We also expect value stocks will begin to perform better than the high growth companies that have dominated market leadership in recent years. Still, the current economic environment is extremely positive and earnings are strong. It is premature for all but the extremely cautious investor or the most aggressive market-timer to hide under a rock. It is a time to review and possibly adjust—but stick with your long-term investment plan.

Best regards,

Ted Ingraham

EGI Financial, Inc.
American Heritage Securities, Inc.

Questions or comments?

Email us at: ahs@egifinancial.com or call 330-535-0881. Visit us at www.EGIFinancial.com