ICR® 4th Quarter Newsletter – January 2018

The fourth quarter looked much like the rest of 2017 with stock markets around the world continuing their march higher. The S&P 500 rose another 6.1% to finish the year up 19.4%. The technology sector continued its impressive performance by gaining 9.0% to finish the year up 38.8%. However, the gains were broad-based as no sector finished negative for the quarter and only energy and telecom finished the year in negative territory.

Foreign markets provided a similar story as the MSCI EAFE index rose 3.9% and the MSCI Emerging Markets index gained 7.1% in the fourth quarter. A nearly 10% decline in the value of the U.S. dollar index over the course of the year provided U.S. investors with an extra tailwind for their overseas investments. A devaluation of the dollar makes foreign investments more valuable when they are converted from the foreign currency back into dollars. Indeed, in dollar terms, foreign developed markets gained 21.8% and emerging markets surged 34.4% in 2017.

As expected, the Federal Reserve raised the federal funds rate by a quarter of a percent in December and continued to project three more rate hikes in 2018. In November, President Trump nominated Jerome Powell to be the next Chair of the Federal Reserve when Janet Yellen's term expires in February. The markets largely approved of the nomination as Powell is viewed as a known quantity after having been a Fed governor since 2012 and serving as a Treasury official under George H.W. Bush. He is also believed to generally agree with the current path of monetary policy and is, therefore, unlikely to deviate much from expectations – a quality the markets usually appreciate.

In December, Congress passed the long-anticipated "Tax Cuts and Jobs Act" and President Trump signed the bill into law. The new provisions of the tax code will reduce corporate and individual tax rates and provide for a reduced tax on the repatriation of profits held overseas by American companies. These measures are generally viewed as positives for the already-impressive earnings of corporations and could prove to be the fuel needed to push this bull market even further. With valuations stretched, earnings will have to continue to improve to justify current stock prices. Indeed, the Cyclically-Adjusted Price to Earnings ratio (CAPE), which uses the past ten years' earnings, indicates the only time the S&P 500 has been more highly valued was during the dot-com bubble of the late 1990s. Even before the stock market crash of 1929, the CAPE ratio was lower than it is today. On the other hand, the forward P/E ratio, which uses analyst estimates for future earnings, suggests that stock valuations are much closer to – but still above – historical averages.

Valuations and Bubbles

So are we in a stock market bubble? There are certainly some signs that point to that possibility, such as the CAPE ratio mentioned above. But, some argue that a higher-than-normal CAPE ratio may be justified at this stage. First, since CAPE draws from the past ten years' earnings, the Great Recession – and the large decrease in corporate earnings that accompanied it - is part of the data set. As that period of time begins to roll out of the ten-year average earnings, the denominator for CAPE will begin to rise and could bring the ratio to a more reasonable level if earnings continue to be robust. Another common argument is that low real interest rates justify higher valuations. That is, if bonds are providing a low return, stocks become more attractive by comparison for the investor deciding between the two asset classes. Of course, the current low interest rate environment could be a temporary condition rather than a permanent structural change, which means higher stock valuations would only be temporarily justified.

The degree to which things might be different this time remains to be seen, but we can still look to history as a guide for the base-case given the circumstances. With all the talk of whether the stock market is overvalued or even in a bubble, one point that most agree on is that **valuations are not good predictors of short-term market performance**. Overvalued markets can – and often do – become more overvalued before reverting toward historical levels. However, **valuations have been a more reliable gauge of longer-term stock market performance**. Higher starting valuations are usually associated with lower returns over the next five, ten, or fifteen years. (The correlation gets stronger the further out one goes, by the way.)

Whether the long-term CAPE average of 16.6 is still useful is up for debate, but at 32.3 at the end of 2017 – and rising since then – the stock market is certainly at elevated valuations, even if there are some rational justifications for it. At the current level, the stock market has never produced positive real returns over the next ten years. Of course, we're in almost uncharted territory since the only other time valuations were this high was during the tech bubble of the late 1990s which was marked by excessive speculation and euphoric buying of companies with little or no profits. At the very least, this market lacks some of the more subjective characteristics of that bubble, like hot stock tips dominating cocktail party conversation. (If that happens at your next party, please do let us know.)

So, what to do with this information? On the one hand, valuations are stretched which bodes poorly for long run returns, but on the other hand, the economy and corporate profits remain strong, which could give the bull market more room to run. We believe the current environment warrants caution due to high valuations, but that asset prices may continue to benefit from the strong economic conditions. Our goal is to provide a prudent investment process which balances valuation concerns with what we consider to be reasonable investment opportunities in an improving global economy.

As always, we are grateful for your confidence and support, and we look forward to discussing any questions or concerns you may have.

Sincerely,

James A. Heine

James L. Cobb

Market Report (as of 12/31/17)

Index	**2017 (%)**	**3-Year Annualized (%)**	**5-Year Annualized (%)**
S&P 500	19.42	9.10	13.39
Dow Jones Industrial Average	25.08	11.52	13.53
U.S. Aggregate Bond Index	3.54	2.24	1.10
MSCI EAFE (Foreign Index)	21.78	4.93	5.04

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