viewpoint

MARSHALL & SULLIVAN

Marshall & Sullivan, Inc. / Registered Investment Advisor

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Different Years

What a difference a year can make. At the end to 2017, our economy was firing on all cylinders: new tax cuts had been enacted, unemployment was down, inflation was low, and the average S&P 500 company was projected to grow its earning at 20% in 2018. After being up over 20% in 2017 the S&P 500 continued its climb and was up another 5% by the end of January 2018. Fast forward to the end of 2018 and the Markets are down 8% for the year and had a pullback of almost 20% from its high. International markets experienced similar activity. They were up over 25% in 2017 and down over 15% in 2018.

What changed? Fundamentally, nothing. The US economy is continuing to grow in the 2-3% range. There is little inflation. Corporate earnings are expected to continue to grow in the 7-9% range in 2019. Unemployment is at an all-time low. The Federal Reserve is projecting more of the same and even retail sales for Christmas hit new records.

The only things that has actually changed are the perceptions and emotions of investors. The news is littered with headlines that suggest the world is in turmoil:

- Trade war with China
- Presidential Twitter wars
- Government shut down
- New Congress
- Federal Reserve rising rates
- Military pulling out of Syria
- Recession fears after 8 years of growth

All of these items have led to a buyers strike and our current market pullback. It is important to remember that pull backs in the market are normal. In fact, not having a single pull back over 5% during 2017 was actually abnormal.

Since 1945 the S&P 500 has had over 116 pullbacks of 5% or more. That works out to about 1.5 per year. A majority of declines, 78 of them, were in 5-10 percent range with the average recovery time being about one month. Declines of 10-20 percent, 27 of them since 1945, had an average recovery time of approximately three months. So, pullbacks of 5-20% are not uncommon, occurring frequently during the course of a normal market cycle. While they can be emotionally unnerving, they will not generally undermine a well-diversified portfolio and are not necessarily signals for panic.

The reason for this pullback is different from ones in the recent past. During the dotcom boom and the 2008 financial crisis, stocks had grown very expensive. The historical average price earnings ratio for the market is 17. In the past, 20% market corrections typically occurred with P/E ratios in the low 30s – nearly double the historical average. This pullback occurred with the markets P/E ratio at its historical average. After this pull back the market is trading at 14 times trailing earnings which is a 21% discount from fair value.

Not only is this pullback different for the market, it has been different for Marshall & Sullivan. One of our sell disciplines is to liquidate positions when they become overvalued. During past corrections we would be sitting on a large portion of cash because we would have been selling companies whose price earnings ratios had gotten to high. With the market fairly valued prior to the pullback we do not have as much cash to spend in our portfolios as we did after past 20% market sell offs.

This has been a little frustrating for us. There are a number of companies that have become cheap. A couple we have added to our portfolios. As we see market sentiment change we will look forward to adding a name or two to your portfolios. At this point we would rather pay more for a company as it recovers instead of trying to catch a falling knife.

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We now have a Portal!!

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