StraightTalk
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All Quiet on the Financial Front

The title of this month's newsletter is clearly a play on the classic novel, All Quiet on the Western Front, by Erich Maria Remarque, but is meant as a nod to the eerie calm with which the stock market is greeting today's headline news. Screeching newspaper and website headlines, and blinking red and orange alerts on every network and cable news channel will typically induce some ill-advised behavior from many participants in the stock market. However, the last several months have seen the least volatile trading patterns in more than a decade.

I often say that politicians crave the spotlight, but it's a shame that investors watch the show. We all know that ultimately fundamentals drive the prices of the great companies in our portfolios, but sometimes the scare tactics of the media overwhelm logic, and emotions take over. Interestingly today, the opposite seems to be the case. In a period of time when we have had the most unpredictable of actions from our democratically elected leader, investors seem to have shrugged off the accompanying headlines. The easiest way to measure this lack of emotional response is to watch the Volatility Index, frequently referred to as "the Vix." The Vix gives us a clear picture of when (and how much) fear spikes into daily trading in the markets. In 2015, the Standard & Poor's 500 Index moved more than one percent on 29 percent of trading days. So far this year, price swings of more than one percent total less than 4 percent of trading days. And the Vix corroborates this, finishing May at the lowest level in fourteen years. (Source WSJ.)

This sense of calm would be notable at any time, but is particularly so today, with every Washington move being detailed and dissected by the news. For his part, President Trump has provided ample fodder for the 24 hour news spin cycle – but something is causing the markets here and abroad to tune out the nightly echo chamber of dire predictions from "experts" on TV. The share prices of the great companies here and around the world are jumping around less than they have for much of the recent past, and that's a good thing for all of us.

This makes intuitive sense, since the assets of these great companies - an oil company's number of rigs, or a search engine's algorithm, or a tech company's sales of touch screen phones - don't really change much from day to day. What should change day to day is an investor's perception about the cash revenue those company assets will generate in the future. And how often does a piece of today's news fundamentally alter that future outlook? The answer, of course, is rarely. This is why I categorize so much of what is breathlessly judged and predicted daily by the news media as short-term noise, which should not alter our long-term plan. It has been so long since most market participants have behaved like those of us who choose not to react to headline news that this may seem a bit strange to some of you, but it has actually happened before.

The late Sir John Templeton famously said, *"Bull markets are born on pessimism, grown on skepticism, mature on optimism, and die on euphoria."* Many long-time market participants have added to that wisdom, concluding that there are actually six stages to a bull market.

Stage One is often referred to as "Shock and Fear." This is the stage when it appears that all hope for your portfolio is lost, and the drumbeat of negative news and falling prices will never stop. Of course, they will, but not until the last short-termer has cashed out his chips and given up. In this stage, the bull begins, but very few are aware of it.

Stage Two is the "Guarded Optimism" part of the cycle, in which people's worst fears fail to materialize. In other words, once again, the world does not end as predicted, and there is a glimmer of hope as stock market prices begin to move up, sometimes quickly, as they did between 2009 and 2012. This is also often referred to as a recovery, in the sense that the market is not breaking new high ground, but rather is recovering from the panic selling. This stage of the cycle gives way to “Enthusiasm," which is Stage Three.

In the early part of this stage, a couple of things happen together: the economy begins to get better, which typically coincides with improving earnings, and this better backdrop allows for improved enthusiasm in the marketplace. *I believe this is where we are currently.* As earnings move to new highs, and prices follow, the price-to-earnings ratio expands, and all of the bears who were wrong about the world ending the last time begin to beat their drums about a coming calamity certain to end life as we know it. Late in this stage, the public begins participating in the stock market again, having been on the sidelines for over half of the bull market run. This mass entrance back into the market drives prices meaningfully higher, and the first hints of speculation begin, leading us from “Enthusiasm” to “Exuberance.”

The transition to Stage Four exuberance is less about the fundamentals changing, than it is about investor’s changing attitudes. As confidence builds, investors are overtaken by joy, amazement, and the feeling that nothing can go wrong. All of the pitchmen on television that were hawking gold and silver coins, “no risk" guaranteed investments, and lakefront property as alternatives to the stock market, suddenly are now the spokesmen for day trading investments that are compounding at 20% per year. In the late part of this stage, P/E ratios become very stretched, and the number of initial public offerings increases.

Stage Five is known as “Surrealism,” in which the underlying value of those initial public offerings becomes questionable, stocks no longer trade on fundamentals, and the public’s impression of the economy is better than the economy itself. This is also the stage where people begin to hear stock “tips” from their barbers, waiters, and taxi drivers.

Stage Six is the market-topping stage known as “Disillusionment.” As surrealism ultimately causes the stock market to roll over, prices begin to decline, and disillusionment sets in. Professional investment managers begin moving to higher quality names in the portfolio and building cash, but the investing public holds on to those shares of Pets.com or Webvan only until they go back up to where they bought them…which, of course doesn’t happen. Thus begins a new bear market, and the bad news drumbeat comes back in full force until prices bottom and the first stage of a new bull market begins again.

As I mentioned above, it is my belief that we are in the midst of Stage Three. This is, without a doubt, the most maligned and mistrusted bull market of my lifetime. I see incredible reasons to be optimistic all around me, and yet most folks I talk to just don’t believe that the economy and the world can be good again, never mind making America great again. If you could have told someone born in 1937 when they were a young adult that we would not only catalog all of the knowledge that mankind has ever possessed and accumulated, but be able to access it with a few taps on a keyboard, you would have been met with a look of utter disbelief.

However, our lives are moving from accessing information just using keyboards and phones, to soon having every electrical appliance connected to the web. This has been dubbed “the internet of things” and the ways that it will change our lives cannot be overstated. A recent McKinsey report projects that by 2025, the internet of things will have an economic impact of over $2.5 trillion in manufacturing alone. The report also indicates a potential savings of between 3-5% in operating costs across all industries. Think of the benefits of web-connected power grids, transportation, and waste systems across our nation, or connected thermostat controls and security systems, and wearable technology allowing instant internet access in our homes. These will all be a reality sooner than most think, and the economy will function better as a result of them.

So, if we are just in the early part of Stage Three, with an improving economy, growing earnings, and the beginnings of improving enthusiasm, and the stock market wants to take a few months break from the news cycle, I say let it. We should all sit back and enjoy the coming stages over the next several years.