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VIEWS FROM CAMELBACK MOUNTAIN

The Correction Continues – What is and is NOT Happening

We last wrote to you almost five weeks ago on October 11th with our observation that the U.S. stock market appeared to be heading into another correction. Volatility and weakness have continued. Today we would like to address what is happening and more importantly, what is not happening.

Two months ago, investors thought everything was fine and market indices were hitting new all-time highs. We have now experienced a dramatic change in investor and market perceptions. To some, the glass was half-full and now it is half-empty and leaking badly.

The market is down primarily because of concerns that higher interest rates will derail economic expansion and possibly lead to a recession soon. Mind you, there is little evidence to support this concern. GDP growth will likely exceed 3% this year and unemployment is at a fifty-year low and likely to improve further. We expect GDP growth of 2.5% +/- in 2019.

Some are also concerned about falling corporate earnings. Earnings in 2018 will be up more than 20% over 2017. We expect strong growth to continue into 2019 and would not be surprised to see earnings improve by more than 10% over 2018's all-time high. These results sound just fine to us.

Certain investors are concerned about a global trade war. New agreements have been reached with Canada and Mexico and prospects are good for agreements with Europe and Japan. China remains a real problem, but we believe China has too much to lose and will therefore agree to some changes before too long.

Some are concerned that a change of power in the House of Representatives will increase uncertainty. Actually, divided government with one party controlling the House and the other the Senate, traditionally bodes well for the economy and financial markets because it limits extreme legislation by either party.

There are some real concerns. The high-tech momentum driven market "darlings" have finally started to fall. The so-called FANG stocks are now all down at least 20%. These were heavily owned by hedge funds and other short-term speculators. They are being hurt and this will likely cause a wave of hedge funds closing their doors. Investors that own high quality, rationally priced technology stocks may have to wait for three to six months for valuations to recover.

Some market participants are now hopeful that the market correction will cause the Fed to put future rate increases on hold. We believe this is unlikely because the Fed is eager to get back to a neutral policy after more than ten years of intense market manipulation. The Fed rate hikes have been minor increases applied very gradually. We believe the economy and most U.S. corporations will manage just fine even if rates rise another percent or two, over the next couple of years.

We think this is a normal short-term correction and that investor sentiment and the markets will recover in three to six months. Stocks are trading at about 16x our conservative estimates for 2019 earnings on a sustainable basis, not including extraordinary items. We think this is a fair price considering interest rates, inflation, and likely economic growth. We are starting to see some more attractive opportunities, but we want to let the markets calm down before we suggest any purchases.

We hope to send you more encouraging news with our annual New Year's letter.

As always, if you have any questions, please call any of us here at L. Roy Papp & Associates. All of us wish you and your family a joyous holiday season.

Best regards,

Harry Papp
Managing Partner
November 21, 2018