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Weekly Market Review

***e*Research Corporation** is pleased to provide a review of the markets by Eddy Elfenbein of **Crossing Wall Street**.

Mr. Elfenbein introduces his commentary with the following quote from Urban Carmel:

"Stock market: a place where events with a <1% probability are discussed >90% of the time."

Read Mr. Elfenbein's analysis and market comments on the following pages.

Information about **Eddy Elfenbein** and **Crossing Wall Street** is provided at the end of this article. You can also learn about **Crossing Wall Street** by going to its blog website at: http://www.crossingwallstreet.com/.

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Bob Weir, CFA
Director of Research

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January 12, 2018

Crossing Wall Street: Weekly Market Review

by Eddy Elfenbein

BW: We have taken only an extract of Mr. Elfenbein's latest weekly article. If you wish to read the entire article, which includes stocks in his recommended portfolio, there is a link provided below.

The year 2018 is picking up where 2017 left off. The market has risen for seven out of eight days this year. In fact, this is one of the best starts to a year in market history. That S&P 500 is already up 3.5% this year, and we are not even at the Super Bowl.

The good news is that the economy continues to do well. We are probably growing at the strongest rate in several years. Very soon, we are going to get a lot more evidence for stronger growth as the fourth-quarter earnings season beings. This looks to be a good one for corporate America, and expectations are high.

In this issue of *CWS Market Review*, I want to focus on the upcoming earnings season. I always want to look at the impact of tax reform on the stock market. I will also discuss the recent uptick in long-term yield.

The Impact of Tax Reform on Our Portfolios

As we know, the stock market has been in a good mood lately. Actually, it has been this way for close to two years without interruption. On February 11, 2016, the S&P 500 closed at 1,829.08. Since then, the index has advanced 51.3%. Not only that, it has been a very stable market as well. Since March 2016, the S&P 500 has spent exactly one day below its 200-day moving average.

Part of the reason for the buoyant outlook is tax reform. Last month, Congress passed and President Trump signed a major tax bill. I won't go into the wisdom of the policy proposals, because that is a political decision and not what we focus on around here.

I do, however, want to make a few comments about the change in corporate taxes and how it impacts investors. The tax law lowers the corporate rate from 35% to 21%. Effectively, what that means is that the U.S. government is a silent partner in every American business.

Previously, they had an odd relationship with the partners, because the government owned no part of the business, yet they were entitled to 35% of the final cash flow. All the other shareholders got the other 65%.

With this new law, the shareholders' stake rises from 65% to 79%. They get an extra 14% at no cost. Imagine if you had a silent partner who said to you, "here, take my 14% and you don't owe me anything." Of course, that is not literally what has happened. But effectively, it is pretty darn close.

This is a huge benefit for shareholders. It is almost like, overnight, you got 20% more shares of all your stocks.

I tend to be skeptical of any models that try to determine a fair price for the entire market. This is an instance where the entire climate has changed. If I were a modeler, I would have to update several of my variables (and not a few of my constants).

As good as this is for shareholders, and it is good, we should keep in mind that the government may easily change its mind at some point. The political climate, alas, is ever fickle.

Keep an Eye on Rising Long-Term Yields

Last Friday, the government reported that the U.S. economy created 148,000 net new jobs in December. That was less than expected, but the trend is still very much intact. The unemployment rate stayed at 4.1%. The important number is that average hourly earnings were up 2.5% for the year. That really needs to increase. Higher wages means more shopping means more profits.

While inflation has remained quite low, I have started to notice that long-term interest rates have gradually crept higher in recent weeks. This week, the 10-year broke above 2.5%. One more push, and the yield can easily touch a three-year high.

Some of this is due to the improving economy. As cyclical stocks improve, that is usually matched by a rise in long-term rates.

What happens is that investors shun lower-risk bonds and rotate into higher-risk stocks. That is also part of the reason why defensive sectors like consumer staples have sat out this latest rally.

We will get the first look at Q4 later this month and I think it will be a good report. We might even top 4% growth.

Some of the rise in long-term rates is related to the Fed's aggressive posture. The central bank sees three more rate hikes this year. The futures market has priced in a rate hike in March (68%) and a second by September (71%), but they are currently divided on a third (45%) by December.

The reason why the rise in long-term rates is important is that it is a crucial factor in stock valuations. Whenever someone asks, "are stocks expensive?," the proper answer is "compared to what?"

In terms of risk, stocks are closest to long-term bonds. That means that higher yields from bonds provide tougher "competition" for stocks. (This is why so many market models use long-term yields as an input variable.) If stocks want to compete for investors' money, they may have to lower their valuation. This does not necessarily mean lower prices. It just means that prices will rise less than earnings.

Mind you, we have not reached a breaking point yet. Long-term yields are still quite modest. But there is some math involved, and stock valuations cannot hold out forever—even with tax reform.

The key takeaway is that the market is taking a more relaxed attitude toward risk. This is not necessarily a bad thing. Marginal assets serve an important purpose.

When the 10-year yield was 1.4%, as it was 18 months ago, stocks were an easy call. Heck, even if they went nowhere, you were still getting a 2.2% yield. But what happens if the 10-year gets to 3%? Or 4%?

In 1994, the bond market tanked, profits soared, and stocks were flat. That is another way of saying valuations plunged. Sometimes the bear growls, and sometimes he does his work in silence.

Next Week

The stock market will be closed on Monday in honor of Dr. Martin Luther King's birthday. Dr. King would have been 89. We'll start to get some big-name earnings reports next. The industrial-production report is due out on Wednesday. On Thursday, the housing-starts report comes out.

Be sure to keep checking the blog for daily updates, and I will have more market analysis for you in the next issue of *CWS Market Review*!

- Eddy

BW: In the rest of the newsletter, Eddy reviews the earnings announcements of the companies on his Buy List. You can read about them and the entire article by clicking on the following link:

http://www.crossingwallstreet.com/archives/2018/01/cws-market-review-january-12-2018.html

Named by CNN/Money as the best buy-and-hold blogger, Eddy Elfenbein is the editor of Crossing Wall Street. His free Buy List has beaten the S&P 500 for the last six years in a row. This email was sent by Eddy Elfenbein through Crossing Wall Street.

BW: Information on Eddy Elfenbein and Crossing Wall Street follows on the next page.

ABOUT THE AUTHOR

Welcome to Crossing Wall Street

I started this Web site to help individual investors. I have to admit that I *love* the stock market. I think I must be an addict. In my opinion, the stock market is one of the greatest inventions in history. The stock market is simply the most consistently successful way to make money over the long term. Even after the financial crisis, stocks have still beaten every asset category over the long haul—bonds, commodities and real estate.

While the stock market may bounce around from day to day, and even month to month, the long-term trend has always been higher. Over the last 35 years, stocks have gone up 35-fold. And since the end of World War II, the stock market is up an amazing 120,000%. I wish I had been around! That was the beginning of an American financial revolution. Today, weare at the beginning of a *global* financial revolution. That is why I think the next 70 years will be even better.

The key to doing well on Wall Street is actually very simple: Buy and hold shares of outstanding companies. But too many investors never learn this valuable lesson. Or if they do learn it, they learn it the *hard* way. That is where I come in. I want to help investors avoid the mistakes that separate successful investors from those who always find themselves spinning their wheels.

There are lots of pitfalls on Wall Street. From shady companies that are more popular than they are profitable to a mutual fund industry that is more interested in its fees than serving investors. Todayis investors must be careful.

At Crossing Wall Street, I give investors my free and unbiased view of the market. I probably analyze dozens of companies every week. I am always looking over income statements and balance sheets. I've spent several years collecting my list of the best companies to own. This is my current Buy List. I've included a description of each company and its current share price. These are the ones that I make the most effort to follow on the site, but please feel free to ask me my opinion on any stock. I don't receive compensation from any of the stocks I recommend. Also, I don't "short" any of the stocks I criticize. At any time, I may own the companies on my Buy List. All of the information on this site is free and unbiased. I also have a section for Frequently Asked Questions that will help you learn more about Crossing Wall Street.

Please feel free to e-mail me. I enjoy getting feedback from investors. I am happy to give you my opinion on any stock or investing in general. I should warn you that I cannot give out personal portfolio advice, but all other topics are fair game. You can also check out some of my favorite links.

- Eddy Elfenbein

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