CenterState Wealth Management

A Note to Our Clients

February 9, 2018

- While it was difficult and somewhat unsettling to watch the Dow Jones Industrial Average suffer through two 1000+ point drops this week, leaving the DJIA and the S&P 500 -8.8% and -9.1% below their respective peak levels on January 26 to today's close, we view the decline in stock prices over the past two weeks as a normal and healthy, albeit sudden, cleansing in the market. Investors need to keep in mind that the stock market had not experienced even a -5% decline since February 11, 2016, a period of extremely low volatility during which the major market measures advanced 46.2% to 61.8% to the end of 2017.

- The majority of that advance occurred after Donald Trump was elected president on November 8, 2016. We viewed the advance in stock prices to roughly August as resulting from the sharp recovery in operating earnings starting in 3Q 2016 and from Hillary Clinton's defeat which squashed the tax increases and new growth inhibiting regulations which were on the horizon if she had gained the White House.

- The advance in stock prices since September, including the blow off top to January 26, were directly related to optimism regarding the passage of the tax package signed into law in late December. Investor sentiment turned somewhat euphoric about the permanent corporate tax reform -- a very positive outcome in our opinion -- and the individual portion of the tax package -- a mixed bag of tax adjustments which are marginally positive for most households, but which does create an array of winners and losers depending upon your zip code, however.

- Over the last two weeks, investors turned their attention to the risks that the tax package posed for the economy and the financial markets. Namely, to what extent would the late cycle fiscal stimulus impact the outlook for inflation by pulling demand forward and flaming wage pressures? What is the likely response of the Federal Reserve to the tax package? Finally, what are the implications for the federal budget deficit and Treasury yields?

- While we expect the tax package to provide only a moderate amount of near term stimulus to the economy, inflation fears were heightened by the reported 2.9% year-on-year advance in average hourly earnings in the January employment report compared to the prior month's reading of 2.5%. A deeper look at the report indicated that wages may not be rising at a threatening pace, however. The report showed that wages for nonsupervisory workers, who account for about 80% of employees covered in the report, rose just 2.4% year-on-year, in the same range that has prevailed for several years. A decline in the average workweek appears to have distorted the gain in wages for supervisory workers.

- As for the Federal Reserve, time will tell how it responds to the passage of the tax package, but we believe the still low rate of inflation, driven largely by structural changes -- think worldwide sourcing of goods and comparative price shopping facilitated by ecommerce and the internet -- will keep the central bank from moving to a policy stance where it needs to tighten monetary policy in an inflationary environment. To the extent that is true, the Federal Reserve will continue to gradually raise interest rates at a pace which the economic expansion can tolerate.

- Lastly, we have been expecting longer maturity Treasury yields to rise a touch this year, with the yield on the ten-year Treasury note taking a run at 3%. Currently, the ten-year Treasury is yielding 2.85%, up from 2.41% at the end of 2017. A larger federal budget deficit and the Federal Reserve shrinking the size of its investment portfolio will require a higher yield to clear the market of the supply of new Treasury securities. Remember, however, that higher yields will offset some of the fiscal stimulus from the tax package and the aging baby boomer generation has a growing demand for fixed income, helping to keep a lid on the rise in Treasury yields.

- We warned in recent *ISS's* that valuations on common stocks had risen and likely could not rise much further. Two things have brought valuations down. First, is the continued rise in operating earnings which for all of 2017 look to have grown 16.8%, with 4Q 2017 operating earnings higher by roughly 20% over 4Q 2016. Taken with the recent pullback in stock prices, the trailing four quarter price-to-operating earnings ratio on the S&P 500 has fallen from 22.6x at year end to 21.1x at today's close, roughly its same level as on the day of the presidential election.

- No one knows when the current correction will run its course, but it will. Once the decline in prices makes stocks a better buy, investors will step in and buy and stock prices will resume their climb as the fundamentals for the economy, earnings, and low inflation remain solid. Equity valuations, momentum, and sentiment got stretched in late January and a pickup in volatility and a reversal in sentiment over the past two weeks resulted in the sudden and volatile selloff.

- Thinking soundly about your investments can save you from making the mistakes many investors made during the corrections in 2011, 2015 to early 2016, and/or during the last bear market in 2008-09. Investors who bailed during those downturns in stock prices permanently lost money and likely never regained their losses as stock prices recovered. The current decline in stock prices only raises the dividend yield on the companies in which we invest. We look at the current correction as an opportunity to invest, not as a time to turn away from the well thought out investment game plan you are following. This is what a buying opportunity looks like.

Joseph T. Keating
Chief Investment Officer

Pierre G. Allard
Portfolio Manager

The opinions and ideas expressed in the commentary are those of the individual making them and not necessarily those of CenterState Bank, N.A. The statistical information contained herein is obtained from sources deemed reliable, but the accuracy of such information cannot be guaranteed. Past performance is not predictive of future results.

CenterState Bank, N.A. offers Investments through NBC Securities, Inc. (NBCS"). NBCS is a broker/dealer and a member FINRA and SIPC. Investment products offered through NBCS (1) are not FDIC insured, (2) are not obligations of or guaranteed by any bank, and (3) involve investment risk and could result in the possible loss of principal.