ARS INVESTMENT PARTNERS

THE OUTLOOK

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Making Sense of the Market's Appreciation

The rising equity market is being met with a level of skepticism from the average investor that would normally be associated with a much less positive economic backdrop. Given the many concerns we have heard expressed about valuations and elevated market levels, we thought it would be appropriate to share a brief note to discuss why we expect the market advance to continue, notwithstanding the potential for a pullback at any time. In this Outlook, we share our thoughts on why investors are so skeptical, why the market appreciation should continue, and how investors should position themselves to benefit. For our regular readers it is worth noting that the positive views for 2018 as expressed in our 2017 Outlooks have not changed and in fact have been reinforced. We expect corporate profits to increase supported by a synchronized global economic expansion with subdued inflation. It is particularly noteworthy that this market rise is being driven by rising corporate earnings rather than just an expansion of price/earnings (P/E) multiples which often is a characteristic of the later stages of a market advance.

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Why are investors so skeptical?

"In times of rapid change, experience could be your worst enemy."
- J. Paul Getty

While a healthy dose of skepticism is always appropriate when investing, the post-financial crisis period has created an economic and market environment with little or no historical precedent and one which has been confusing for investors. Yet most investors rely on past experiences and historical references to reinforce their views, positive or negative, of the current situation as hindsight provides the highest level of clarity. While we also use our past experiences to frame our views, we believe that the distinct characteristics of the current environment make historical comparisons less relevant. At the same time, we fully appreciate the factors that have made it difficult for market participants to feel confident. Below we highlight some of the key issues weighing on investor sentiment and distracting investors from the many opportunities being presented today.

The distinct characteristics of the current environment make historical comparisons less relevant

Globalization and Technological Advances – the rate and magnitude of change brought about by globalization and technological advances is so great that most market participants are challenged to adapt, and these changes are requiring more rapid adjustments in the global system. For many, keeping up with the rate of change is overwhelming.

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Geopolitical Dynamics – The unconventional political setting is challenging the norms, fueling populism and nationalistic sentiment. Political dysfunction and frustration with the flawed efforts of governing institutions are all too common themes in many developed nations pressuring existing political parties to reassess their platforms. Many find this environment unsettling and some believe it has to end badly for the West, the country and the market.

The uneven distribution of the benefits of the economic recovery has resulted in growing income inequality and education/skills gaps globally

Social Concerns – The uneven distribution of the benefits of the economic recovery has resulted in growing income inequality and education/skills gaps globally. This type of wealth disparity fosters growing social unrest. As technology displaces old industry jobs, older workers are being increasingly challenged to adjust. This is occurring as the United States is reaching full employment and as the developed economies are seeing unemployment rates decline as well.

Unconventional Monetary Policy – Following the most accommodative period in its history, the Federal Reserve is attempting to normalize monetary policy by gradually raising interest rates and shrinking its balance sheet. Given the historically low level of interest rates and limited room for central banks to stimulate economic activity if needed, they must put themselves in a position to effectively respond to a future recession. Therefore central bankers in working towards normalization must, at the same time, be careful to extend the business cycle. This will also buy time to reduce national debt as a percentage of GDP.

Why should the market appreciation continue?

"This game of economic miracles is in its early innings. Americans will benefit from far more and better 'stuff' in the future. The challenge will be to have this bounty deliver a better life to the disrupted as well as to the disrupters."
- Warren Buffett, as reported in Newsweek, 1/5/18

An earnings-driven market typically reflects a stronger economy and therefore is on sounder footing than a P/E-driven market

The strong market appreciation in 2017 that continued in January of this year can be attributed to two main factors - accelerating corporate earnings growth and a synchronized global economic expansion that has been stronger than many anticipated. Bear in mind that an earnings-driven market typically reflects a stronger economy and therefore is on sounder footing than a P/E-driven market. The corporate earnings outlook is being further supported by repatriation of cash held overseas and in some cases lower regulatory burdens. This is occurring even before the much-needed investment in infrastructure has been made. Corporate earnings and global growth are benefiting from several factors including:

Pent-up Demand – One of the consequences of the financial crisis was that deleveraging became a priority over consumption and capital spending. We are now seeing pent-up demand translate into higher spending by both consumers and businesses thereby increasing overall economic activity.

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Unprecedented Monetary Policy Support – Although monetary policy in the developed world has begun to tighten, it remains accommodative by historical standards. While gradually lessening, the accommodative monetary conditions should remain in place for an extended period.

U.S. Tax Cuts – The tax changes, with accelerated depreciation for capital spending, are positive for earnings and economic activity in the U.S. and abroad. Moreover one aspect of the new tax rules that is not getting as much attention from equity investors is that the changes to interest deductions should push companies that can to reduce debt, strengthen their balance sheets and increase equity values. Unfortunately, not all companies will have the financial wherewithal to reduce their debt burdens and will lose some of the benefits of interest deductibility. This will set up a key point of differentiation among businesses in the next 12-24 months.

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Technology – Companies are taking advantage of technology to grow more efficiently. It is enabling companies to do more with less, reduce input costs and focus on productive growth.

How should investors position portfolios to benefit?

"The rate of change has never been this fast, and yet will never be this slow again."
- Justin Trudeau, Canadian Prime Minister in his Davos speech.

The economic conditions we have written about for over a year should continue, notwithstanding an exogenous geopolitical event or a temporary pullback in the market. In our opinion, the investment outlook for 2018 remains positive for U.S. equities, especially those that are leading the aforementioned transformation. Our ongoing portfolio strategy has three areas of focus – high-quality growth, high-quality dividend payers and opportunistic investments. The emphasis remains on selecting companies benefiting from disruptive technologies, rising defense spending, changes in the financial and healthcare industries, increasing U.S. consumer spending and the shift to a more service-oriented global economy led by China and India. We believe that investors continue to underappreciate the power of this technology cycle as comparisons to the past are just not valid as it is not a PC-driven cycle anymore. Mobility, the Internet of Things, 5G, artificial intelligence, machine learning, and the dawn of quantum computing are changing the supply/demand and pricing dynamics of the industry. The advent of these technologies is also changing the way businesses operate making historical comparisons inappropriate. These advances are going to require a significant increase in capital expenditures by companies to effectively compete going forward. For instance, Verizon just announced its plans to spend $35 billion over 5 years to implement a 5G network. In the healthcare sector, the combination of technological advances in research and demographic trends remain powerful drivers making this sector among the best performers this year.

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We expect to see a continuation of merger and acquisition activity, while companies continue to reengineer their balance sheets and refine their business models to compete in the new world. We continue to concentrate on companies that are gaining market share, maintaining or improving profit margins, increasing free cash flow, restructuring to gain more efficiency, increasing pricing power and/or growing dividends. Companies with strong balance sheets that can more aggressively invest in the future growth of their businesses should be more highly rewarded as will those with the ability to repatriate large overseas cash balances. U.S. small capitalization companies also stand to be significant beneficiaries of further improvements in the economy, tax reform, strong consumer spending and increases in capital expenditures. We remain cautious on fixed income investments given the risk/reward dynamics, a less accommodative monetary policy stance by central banks, gradual rate increases from the Federal Reserve and a high and rising federal budget deficit.

We expect to see a continuation of merger and acquisition activity, while companies continue to reengineer their balance sheets

Notwithstanding our constructive view of the Outlook, it is always prudent to be mindful of risks and what could go wrong, and there are several potential risks that we monitor as we wrote in our most recent Outlook. Key economic indicators are already sitting near the high end of their traditional ranges. There are also headwinds to growth such as the Federal Reserve interest rate increases which have led to higher borrowing costs for consumers. Energy prices have also been on the rise, and consumer spending has been outpacing growth in personal income. With these and other concerns in mind, we continue to focus on those companies best positioned to benefit from the intermediate to longer-term outlook. The equity markets almost always focus on the short-term rather than the secular trends, so we would suggest clients not let headline issues distract them from the opportunities being presented by a positive outlook and economic dynamics in the world today.

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