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INVESTOR INSIGHT

CPR Investing 15237 S. 19th Way Phoenix, AZ 85048
www.cpr-investing.com info@cpr-investing.com
Office: 602-616-2200 Fax: 480-237-7954

Stocks – Long Term Expectations

Ben Graham said "In the short run the stock market is a voting machine, but in the long run it is a weighing machine." Even today, stocks get pushed around day to day by emotions, false perceptions and trading schemes. But over a decade or more it is all about earnings and shareholder compensation, which tend to grow at steady rates. What can we expect from these two factors?

Historically earning growth has accounted for about half of the stock market's total return. Growing numbers of big technology disruptors may boost the markets rate of earnings growth, given how these firms have robust revenue growth and a higher tendency to be acquired. However, depending on how much market share is lost by traditional firms, this favorable effect caused by the tech companies may be partially, fully or even more than offset by the reduced earnings growth at disrupted firms. Historically, earning growth has been responsible for about 6-7% growth. However, going forward I believe a more conservative expectation is 5%.

Reform, dividends and stock buy backs remaining strains the S&P 500 dividend plus buy back yield has been over 4%. Going forward, those companies which are profitable, but are disrupted by tech firms, may choose to boost shareholder compensation in order to support their stock. Also, your more mature tech firms are more likely to become big dividend payers as they reach levels where their profits are no longer needed for expansion. I believe this factor will continue to add growth 4% to future stock returns. Bottom line, a long term annual growth rate of 9% is a reasonable expectation for the U.S. stock market. Historically, stocks have exceeded inflation by 7% points per year. I feel they will continue to do that, going forward.

Now on another note, let's look not at the behavior of the markets, but those of the individual investor. If you have been to London and ridden the underground train, you most likely have heard the statement "mind the gap." This important safety tip from across the pond is also applicable to investors; in fact ignoring it could be detrimental to your portfolio.

From a portfolio standpoint, the gap is the "behavior gap" which is the underperformance of investors relative to the markets. The gap exists because investors tend to buy high and sell low. It is easy to see how this phenomenon plays out in the realm of investing. Typically an investor will buy equity when it is performing well and as a result, the equity will continue to perform well. This means investors continue to buy more and more of the equity at higher prices. Likewise, when equity begins to falter, money tends to flow out of the equity as stockholders begin to sell. This selling continues as the equity continues to decline in price. This behavior runs counter to the key theme of successful investing: buy low and sell high.

This tendency for individual investors to revert to buy high sell low is particularly notable when markets are volatile. Thus as volatility begins to creep back into the market, it is important for investors to stick to their plan and maintain a well-diversified portfolio. Trying to time the market will only increase your turn over and your trading costs while increasing the rule of buying high and selling low.

Because of this two of the key concepts of our investing approach for our clients is to (1) follow well defined purchase and selling rules in both bull and bear markets. (2) to build a risk minimized portfolio using different strategies that have relatively low correlations with each other while still paying attention to sector and industry corrections.

To conclude, let me take a look at the current market outlook. In previous months, the reigning fear was rising interest rates and the potential for more aggressive rate hikes from the Feds. But in June, that all changed as our focus became on looming trade wars. An all-out trade war would most likely lead to a recession and a bear market. However, at this time we are not in a trade war yet. The two main components of a trade war are tit-for-tat tariffs and the unwillingness to negotiate. Hopefully President Trump's record tariffs were imposed to bring about serious negotiations with our trading partners.

Will this strategy bring our trading partners to the negotiating table or will it ignite a full blown trade war? Only time will tell, but there are two factors in favor. First, we are far less dependent on exports then other countries. In regards to Europe, 27% of their goods are exported. China's export percent is 21%, while the United States is only 12%. This means tariffs will inflict more pain on Europe and China then on the United States.

The second factor is the strength of the U.S. economy relative to the rest of the world. China's stock market is already in a bear market, down 20% from its January highs. In Europe, the expected expansion of their economy has not materialized and in fact appears to be slowing. Meanwhile the U.S. second quarter GDP is expected to increase sharply from 2% to 4.5%. I am skeptical it will be that robust but even if it is around 3%, which gives us room to absorb some slowdown in the economy if a trade right is protracted.

In summary, the odds favor a resolution of trade issues rather than an all-out war. That being said, I would expect more volatility in the markets while the uncertainty lingers. As we all know, stock markets do not like uncertainties. So until these trade disputes are finally resolved, expect stocks to zig and zag as prospects for resolution wax and wane. The outlook for the U.S. economy remains solid; valuations here became more favorable and over the long haul stocks provide us our best opportunity for financial success.

As always, please do not hesitate to contact me with any questions or concerns. Have a Blessed Day!

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