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January 22, 2018

To Our Clients, Partners, and Friends –

We begin 2018 with an answer to the question that is on everyone's mind: no, we cannot say for sure what's going to happen in the stock market (and neither can anyone else). Years of experience, education, and training inform us that markets are cyclical. We know that company valuations are high and the business cycle is in a mature phase. We know that interest rate movements and the eerie absence of inflation loom on the horizon. We also know that for every indicator which tells us that markets will correct, there is an equally convincing indicator telling us otherwise.

Both expert opinion and common sense are starting to sound like a broken record. Investors internal monologue has escalated from whispering to screaming, "what goes up must come down"—the market has other ideas.

2017 was certainly better than expected. It was so impressive, in fact, that it was the most consistently positive year of at least the last 30 years. The MSCI All-Country World Index has measured aggregate equity returns across the globe since 1988. 2017 was the first year on record that every single month had positive returns[1]. Carrying that momentum forward, the S&P 500, the Dow Jones Industrial Average, and the Nasdaq Composite indexes all hit six record highs in the first six trading days of this year[2].

This is leaving nervous investors in a perpetual state of paralysis. Those holding cash continue to hold cash for the fear of buying in high. Those invested stay invested for the fear of selling as the market keeps rising. Both carry an expectation of the future. While we are not in the business of making predictions, there are three things that we believe investors can expect in 2018.

Thing #1: 2017 will affect how you feel about 2018

This is typically true of any investor, but everyone reacts differently to the same situation. The incredible growth of 2017 will leave some individuals overconfident and others gun shy. When and if stocks to start to fall (even a little), it will be easy to convince yourself that a crash is imminent. Since the 1960s, the average time from a peak in an up market to the trough in a market correction and back up again has been approximately 3 years[3]. This is important to keep in perspective, as patience and discipline are paramount at market extremes.

[1] Schwab Research Team, "The Big Picture Heading into 2018", *Schwab Market Perspective*, December 8 2017
[2] Michael Kahn, "Stocks Are Priced for Perfection", *Barron's*, January 10 2018
[3] Rob Williams, "Market Volatility: What If You Don't Have Time to Recover?", *Charles Schwab*, March 9 2016

For some individuals, 2017 has reinvigorated the urge to invest in the next-best-thing. The cannabis industry is "budding," no-name tech start-ups are expanding overnight, and cryptocurrency is spawning a movement to fix a broken system. A recent Wall Street Journal article titled "Bitcoin, Ignorance, and You" reminds us that financial literacy and confidence usually have little to do with one another. Remember that diversification is about spreading risk and achieving a targeted return over a long period of time. Simply because a stock, fund, or strategy skyrockets doesn't mean you should have owned more of it.

Thing #2: Luck and skill will be hard to differentiate

Especially over the short-term, this almost always holds true. Determining luck versus skill becomes even harder when the stock market just keeps chugging along. The CBOE Volatility Index or VIX, a measure of market price fluctuation, is brushing lows set nearly a quarter-century ago[4].

In contrast, T. Rowe Price recently reported that stock correlations are at their lowest level of the past 25 years. While the market as a whole is quiet, independent price movements are widely dispersed. This environment will have many proclaiming a "stock pickers' market," as portfolio managers will tout their ability to intelligently buy or sell holdings (with impeccable timing).

It is important to remember that the market is a zero-sum game. For every portfolio manager who buys a stock, another is selling—only one of them can be right. A wide dispersion can lead to a great portfolio management process producing subpar results and a terrible process performing phenomenally.

Thing #3: Something will happen that makes no sense

Okay, this one seems obvious—markets are always surprising to some degree. Simple cause-and-effect relationships do not exist as every "cause" can be traced to several effects. This leads to broad disparities in the predictions of experts, unforeseen risks, and inexplicable results (see: Thing #2).

While the actual outcome for each may vary significantly, we anticipate the following items to be front-and-center this coming year –

- **Earnings** – Ned Davis Research Group believes there is a 55% chance that earnings announcements in 2018 will be less than expected[5]. This could pose a challenge to maintaining the current levels of economic momentum, especially if the bloated tech sector is the driver.
- **Inflation** – Stock multiples (P/E ratios) tend to drop once the Consumer Price Index crosses above 2%. We have not seen the CPI at this level since mid-2008[6]. A tight labor market and interest rate increases continue to apply pressure, but inflation has remained stagnant.
- **U.S. Dollar** – A weakening dollar in 2017 helped global markets and commodities maintain relative buoyancy. The dollar is typically affected by inflation and interest rate movements, both

[4] Jason Zweig, "Investors, Stop Worrying Why Nobody is Worrying", *The Wall Street Journal*, July 21 2017
[5] Ned Davis Research Group, "2018 Outlook", *Market Digest*, December 2017
[6] Joshua Brown, "The I Word", *The Reformed Broker*, January 2 2018

of which remain uncertain. However, a strengthening dollar could put pressure on corporate profit growth.

- **Taxes** – A repatriation holiday included in the tax overhaul could boost demand for dollars as companies move profits stashed overseas back to the U.S. A tightening labor market could also force that the tax savings to be invested in wage hikes, spurring more inflationary pressures.

It is important to remember that market conditions have an impact on expectations. The emotional response to a drastic movement (up or down) in an historically placid market will be greater than the same movement in a more turbulent time. Armed with this knowledge, the intelligent investor will not allow an unforeseen short-term outcome to change the long-term strategy. Therefore, our mantra for 2018 is “expect the unexpected.”

We hope you enjoyed our comments. If you have any questions, please do not hesitate to contact us. We welcome the opportunity to discuss our thoughts in greater detail. Thank you for your continued confidence in Planning Capital Management.

Sincerely,

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