

The Advisor

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Market Update – *First Quarter, 2020*

THE STOCK MARKET by measure of the price of the S&P 500 index and the Dow Jones Industrial Average had a banner year in 2019, up 29% and 22%, respectively. It was the best year since 2013 for the S&P 500. The Barclays U.S. Aggregate Bond Index returned 9% while commodities and precious metals also enjoyed strong returns. A combination of healthy U.S. economic data, low inflation, easing trade tensions and an accommodative Fed proved to be a delicious recipe for an “everything up” environment in 2019. In this instance, the old adage that *markets will climb a wall of worry* was proven correct. Take a look at some of the pieces of the 2019 wall. It is easy to see why the market soared, right?

Trade War	Economic Slowdown	Negative Interest Rates
Earnings Recession	Brexit	Central Bank Action
Hong Kong Protests	U.S. 2020 Election	Aging Bull Market

Many investors believe the phenomenon of climbing the wall of worry is because the problems facing the market are manufactured to some degree, even imagined. The truth is the problems are real, but they each carry varying degrees of impact and all of them are solvable, if not entirely then at least in the narrative surrounding their impact.

For illustration purposes, look at the Trade War. On the surface, it is hard to argue an escalating and protracted fight between the U.S. and China would benefit the world. The market response was to selloff. That was an appropriate reaction.

Next, the debate of how serious of an impact the fight would actually have pushed the market into a volatile trading pattern, up and down. Again, that was an appropriate action with the understanding that new information and analysis will always shape future growth and earnings projections. Then came the news of a Phase 1 trade agreement or quasi-truce and the market shot higher, rejoicing at the prospect of stability, if not resolution. And, so goes life climbing the wall.

Several blocks of the wall remain the same as the market continues to climb in the first quarter of 2020. Challenges around trade will manifest into global economic concerns, stoking fears about corporate earnings. This will put the spotlight squarely on the Fed and global central banks' monetary policy. Continuing down that path, concerns about global bond yields, GDP and inflation are just around the corner and they lead directly into the depths of arguably the most important market question – valuation.

Warren Buffet famously clarified the term value when he stated that price is what you pay, value is what you get. So, let's examine what you get right now in the market. On the top left of the next page is a chart from Topdown Charts. It shows the historical Z-Score, also called a standard score, of the S&P 500 blended price-to-earnings ratio compared to its equity risk premium. In English, that means the chart is showing how far away these two valuation measures are from the average. Above the center line is *Expensive* and below the line is *Cheap*. I'll spare you the suspense ... the S&P 500 is expensive on an absolute basis. It is not in the nosebleed section of the late 90's or early 00's but it is roughly one standard deviation above the average which is not cheap.

The equity risk premium (the amount the market pays in excess of a risk-free investment, such as a U.S. Treasury bond) is still at an attractive level. Therefore, on the one hand, the S&P 500 looks expensive, but yet, it is still paying an attractive premium to investors as compensation for taking on equity risk.



Keep in mind, valuation is a slippery slope mainly because the stock market is a discounting mechanism. It tries to predict a real-time value today on what the future will hold tomorrow. That is not an easy task and why the market can undergo severe bouts of irrational behavior, which causes valuation to look expensive or cheap at any moment, depending on what metric is being applied. We stress caution in overly focusing on the short-term. History, as our guide, shows that the long-term view is more accurate and therefore more rewarding for the patient and disciplined investor.

What about the age of this old bull market? For that analysis let's take a creative turn to the story of two singer-songwriters, Robert Earl Keen and his good friend Lyle Lovett, who co-wrote *The Front Porch Song* while they were students at Texas A&M University. As the story goes, Keen rented a house along Church Street in College Station, and the front porch became a regular gathering place for hanging out and playing music. Lovett would pass by regularly, often times stopping to listen, and one day he was invited up to the porch. From there, the rest is history. The song begins:

*This old porch is just a big old red and white Hereford bull
Standing under a mesquite tree in Agua Dolce, Texas
He just keeps on playing hide and seek with that hot
August sun*

He's sweatin' and a-pantin'

'Cause his work is never done

It is not hard to draw comparisons to today's market by simply changing a few words in the song. From our viewpoint, this old bull market's work is not done. Yes, January marks the 128th consecutive month of overall growth for the economy, the longest economic recovery on record. However, we don't believe age is a primary factor in determining the direction or returns of the market. There is no clear evidence that bull markets die purely from old age.

We remain optimistic for 2020 and recognize that economic data, corporate execution and growth estimates must continue to materialize in order for this market to climb higher. We do caution that stocks will not go up forever. Periods of volatility and decline are coming. This is normal and presents opportunity to capitalize when the market misprices good companies.

To our clients, thank you for the opportunity to serve your investment needs and please do not hesitate to contact us if you experience any material changes in your personal situation or would like to discuss any specific matters.

To our other readers, if you would like a complimentary review of your investment accounts or any other financial matters, please do not hesitate to contact us. As fiduciaries, we will happily provide you with an unbiased opinion based on your specific situation.

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