PRIVATE ASSET MANAGEMENT, INC.
WEALTH STRATEGY ADVISORS
PARADIGM

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We feel that with the recent market fluctuations, coupled with the passage of tax reform in December, it would be helpful to veer from our typical Paradigm content and provide some market commentary.

The three main takeaways from this Paradigm are:

1. Stock markets are now closer to reasonably valued than you might believe.
2. The interplay between inflation, interest rates, earnings, and valuation levels over the next 12-18 months is likely to lead to continued market volatility.
3. As always, make sure your portfolio reflects your long-term needs, so any near-term volatility does not throw you off course.

S&P 500 Index Decline

We will use the S&P 500 to discuss market declines. **Reset your mind to the fact that the index is now up roughly 1% for 2018.** The index started the year at 2674, shot up over 7% by January 26, promptly declined by 10% over the next two weeks, and has recovered nearly 5% in the past week.

This matters more from a psychological point of view more than you might realize. We believe it is easier to make poor decisions if you focus on the wrong data. When markets are volatile, declining, and you are thinking short term, your conclusions and actions may not be in sync with your long-term plan.

Tax Reform and Earnings

Tax reform passed in December 2017. Corporations benefitted from the reduction in the corporate tax rate and from other provisions. **These benefits are real.** They will result in a one-time boost to earnings of 6%, 8% or maybe as high as 10%. Whatever the figure, in an environment where we tell clients that long-term earnings growth is 5% per year, a one-time 6% to 10% bump is clearly material.

Combining long-term growth with the one-time bump means that 2018's earnings are expected to be 15% higher than 2017's. This growth combined with a market that is virtually flat in 2018 means that valuation levels have declined to more reasonable levels.

Earnings growth in 2019 will benefit, too. Currently, projected earnings growth is 7% to 9%, again, above the long-term expected average of 5%.

Inflation, Interest Rates, and Valuations

Even before tax reform, the Federal Reserve telegraphed increased federal funds rates and fewer bond purchases. Both led to expectations that borrowing costs (mortgages and corporate debt) would trend higher. This thought process resulted in a belief that rising interest rates would put a cap on valuation levels.

Currently, the same issues exist, and increased inflation has been added to the mix. In fact, it was this inflation scare that started the markets' decline, though the 7% rise in January made selling easier for many.

This interaction between inflation, interest rates, and valuations will remain and will continue to cause major short-term stock market swings.

We can't move on without acknowledging that many bond funds are likely to experience low returns in 2018 and, perhaps, in 2019. Remember, bond funds are part of a well-diversified portfolio, plus they helped in mitigating portfolio declines when the various stock markets declined 10%, as we have just seen.

Know Your Goals

A portfolio that reflected your goals at year end still reflects your goals after the wild ride of the past six weeks. The ride has clearly been bumpy, but the swings have been nothing like 2007-2009. To paraphrase one commentator, "The markets have been tested, but you have not been."

This six-week period is a great example of why we recommend regular meetings. The reassurance of the current situation benefitted some while others were comforted to know how their portfolio weathered the turbulence.

Update your thinking on market levels and market valuations while keeping your thoughts constant regarding your goals. This will allow you navigate markets near term and long term.

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