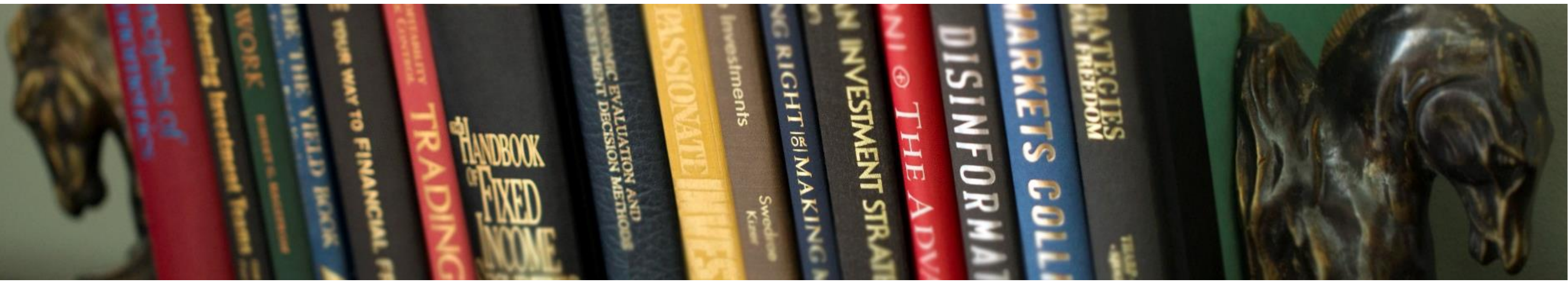
AVALON PERSPECTIVES

Avalon Market Update

October 12, 2018



If the business does well, the stock eventually follows.

-Warren Buffett

As of market close on Thursday, October 11 the S&P 500 has declined 5.4% week-to-date and almost 7% from the late September closing high. While this kind of stock volatility is not out of the norm and global stock markets are behaving better so far today, we wanted to take a moment to update you on our thoughts regarding the markets and underlying fundamentals.

The proximate cause of this stock market sell-off is the increase in long-term yields with the 10-year U.S. Treasury yields reaching 3.23% at the end of last week, the highest level since 2011. Higher yields on bonds and short-term cash now provide a better competitor to stocks. In the wake of the financial crisis, we were in a long abnormal period when the dividend yield of the S&P 500 was more than short-term interest rates. There were even significant periods when the dividend yield was higher than the 10-year Treasury yield! Now both these rates are in their more normal position of being higher than the almost 2% dividend yield of the S&P 500. The good news is that we don't expect a spike in interest rates, but rather a rise in yields consistent with economic growth. In addition, the recent rise in yields has primarily been for a good reason, economic growth, rather than an increase in inflation expectations.

We believe investors should expect a more normal amount of volatility from stocks versus what we experienced when interest rates were at their ultra-low levels. History shows that since 1928 the S&P 500 has experienced a 5% decline on average about every two months and a 10% decline every six months. Also, to further put it into perspective, on average the S&P 500 has experienced intra-year declines of almost 14% since 1980 despite going on to post annual gains in over 75% of those 38 years.

Despite the recent volatility, the underlying fundamentals of both companies and the U.S. economy remain strong in our view. The third quarter corporate earnings season is beginning in earnest today and we expect another strong result with earnings growing more than 20% year-over-year. This would be the third straight quarter with earnings growth of more than 20%. It is also important to note that this growth is not just due to the recent corporate tax cut as sales at S&P 500 companies should grow at a high single-digit rate in the third quarter as well. While earnings and stock prices can deviate significantly over the short-term, the growth in the value of stocks over the long-term has been a reflection of their earnings.

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The U.S. economy continues to grow at a robust pace which should support our corporate earnings expectations. In addition, the U.S. labor market is strong which should bolster wage growth and consumer spending. Our economic growth is likely slowing from its torrid pace, but we see very little risk of recession in the foreseeable future. While there are a few trouble areas in the global economy, the economies outside the U.S. are growing at a solid pace. Please see our recently published Q3 Avalon Perspectives from our Chief Economist, Sam Rines, for more about our economic views and the risks we are monitoring closely.

Summing it all up, stock volatility is likely to be with us as we enter a more normal interest rate environment. Also, the underlying market and economic fundamentals remain strong and should support stock valuations though we certainly continue to monitor the situation closely. Despite the underlying interest rate environment, high-quality bonds did provide their typical haven as stocks sold off in the first four days of the week. Volatility in and of itself is no reason to exit stocks or change our investment recommendations, but it certainly makes sense to work with your client advisor to make sure your asset allocation is consistent with your goals and risk tolerance if you are feeling uncomfortable.

Please don't hesitate to reach out if we can be of any help and thank you for being a client.

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Co-Chief Investment Officer

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