



**July 2018**

When most of your life is spent reading and analyzing the markets and the economy it is easy to lose track of the fact that everybody else doesn't share your interest or passion for either. All of our interests influence how we interpret the information that we consume on a daily basis. When you don't focus on the financial markets, your sensitivity to certain aspects of the economy can be skewed. It is harder to see long-term trends and keep things in perspective. I have noticed a number of clients recently worrying about things that I viewed as inconsequential. It took me a while to realize that from their perspective, these issues are a big deal because it is news to them. I want to tackle some of the misconceptions that are swirling around about the economy and the stock market. Most of what I have read recently is factually correct but many times the facts are plucked out of context and is the cause of the consternation with clients during steady economic growth.

**“Gas Prices are spiking”**

I have had a few people point to the “spike” in gas prices as a reason to be worried about our economic growth. The average price of a gallon of unleaded gas in the United States has moved approximately 21% from 2017 to 2018. That is huge and scary. The price of a gallon of unleaded gas has fallen 17.6% over the last 5 years in the United States... wow, that is great news. Over the last 10 years the price of a gallon of gas has gone up a total of 2%, about the same as inflation. My view - not a big deal

**“Inflation is becoming a problem”**

The rate of inflation has increased a little more than 10% over the last couple years. A 10% increase in inflation sounds scary but inflation increased from approximately 2.0% to 2.2% and the 50 year average for the core CPI is 4.0%. We are a long ways away from inflation being a problem. This is certainly a situation where the headline misinterprets the numbers.

**“The markets are too high”**

Regardless of which market you are trying to analyze, the price of the market doesn't really tell you much. If I were to tell you that I am 6 tall, you would probably look at me with mild amusement. You would hope that I misspoke and worry that I was a bit “touched” in the head. Saying that you are 6 tall doesn't make sense but if I stuck a unit of measurement after 6, then things start making sense. ie: 6 decameters, 6 feet, 6 hands, 6 shaku, etc. The markets are making new highs but we measure that price in relation to earnings and profitability and both are growing at a healthy rate. This doesn't mean that markets can't or won't go down but it does mean that there is underlying growth in the value of the companies that make up the stock market and there is no reason to assume that since it is up that it must come down. By that line of thought, we should be at the same levels that we were 100 years ago.

**“Rising mortgage rates will kill the real estate market and hurt the economy.”**

This note is often accompanied by worries that subprime mortgages are on the rise and both facts are again taken out of context. Mortgage rates are up. The average 30-year fixed-rate mortgage is up from 3.47% in October of 2016 to 4.57% June 2018. Again, we are looking at a

32% increase but again these rates are about half of the historical average. The 40-year average on a 30-year fixed rate mortgage is 8.05%. Yes, rates are going up but we have a long way to go before we get back to normal. As long as the rate of the increase isn't too fast and as long as it follows a predictable path then things will be fine.

**“Household and corporate debt is on the rise.”**

This is true as well but again, misleading. Household debt has risen slightly but income has experienced a faster increase. Debt payments as a percentage of income is at a 38 year low. Corporate debt has also increased slightly but this is a function of companies buying their stock back and using debt to do it. Companies do this when rates are low and when they feel that their stock is undervalued. Corporations are issuing long-term debt and locking in the current low rates before rates get back to normal levels.

**“Employee wages are not keeping up with inflation”**

This falls under the “yet to be determined” category. Historically employee income doesn't start increasing dramatically until the unemployment rate bottoms out. Going back to 1970, the unemployment rate was approaching it's low point as income started to rise. If this hold true in this case, employee wage growth should start accelerating over the next few quarters.

I could go on but I hope that it is obvious that most of the “weak” or “worrisome” economic points can be explained and at this point in time, aren't bad. The fact is that the S&P 500 is currently trading at 16.1x forward earnings and that is inline with the 25-year average while paying slightly higher than average dividends. The companies that make up the S&P 500 have the highest operating earnings per share in almost 20 years and they are on an upward trend. Year to date, consumer staples and telecom have performed poorly, both are down 8.5% and financials are down 4.0%. The S&P 500 is up slightly (1.52%) this year but the second six months is where we will see this year's performance. We have held slightly higher cash allocations in many of our more conservative accounts but that excess cash will be invested over the coming weeks. Volatility will continue to test our resolve but the U.S. stock market still presents substantial opportunities for growth and profit. I said this in the last letter but it bears repeating, “Investors should avoid the temptation to confuse politics and investing. The investment climate is great and conditions continue to improve.”

In addition to my last statement, also avoid chasing returns. I am currently adding money to some of the underperforming sectors. This is not an indictment of the companies that we are selling. It is simply rebalancing to maintain proper diversification.

Happy 4th,

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President