Fourth Quarter 2017 Commentary

Now that 2018 is upon us, it is interesting, if not instructive, to examine what transpired last year in the stock market. No amount of natural disasters or Washington drama (more on that below) could stop the bull parade in Wall Street, and the long string of record highs for both the S&P 500 and the Dow Jones Industrial Average that was the norm through the entire year continued in the final months of 2017.

The S&P 500 advanced 6.6% in the fourth quarter, ending the year just below 2,700. Not to be outdone, the Dow was up 11.0%, closing within spitting distance of the insignificant, but psychologically satisfying, level of 25,000. In the new year, those marks have already been eclipsed and, as of this writing, the S&P 500 has enjoyed its best start of the year since 1987.

A Tumultuous Year

The past year will be remembered as a tumultuous period, marred by natural disasters, political scandals, and geopolitical tensions. Mother Nature wreaked havoc in the U.S., leaving a path of destruction from coast to coast. An extraordinary procession of Atlantic hurricanes caused major damage in Texas, Florida, and Puerto Rico. Wildfires in California scorched hundreds of square miles, destroying thousands of homes and commercial buildings. Other smaller, but still expensive, weather events made 2017 the costliest year on record for natural disasters, with an aggregate price tag of over $300 billion. The National Oceanic and Atmospheric Administration noted that the U.S. experienced a record 16 separate events whose damages exceeded $1 billion.

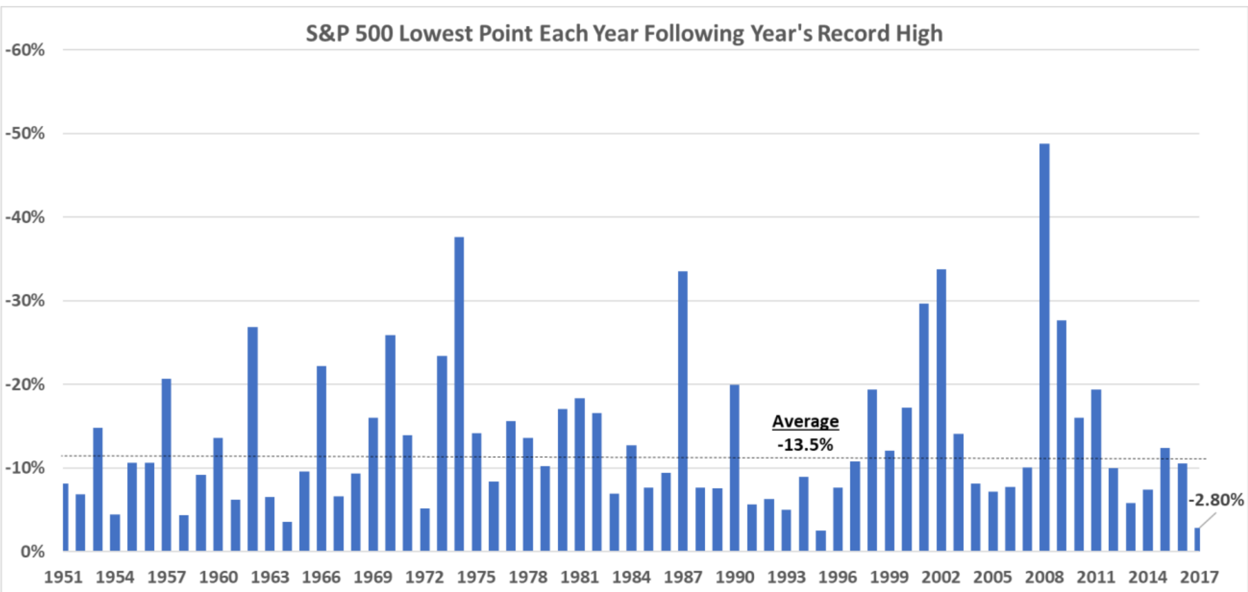
Washington, for its part, produced more drama and intrigue than a tawdry soap opera. From congressional investigations to a special counsel prosecutor to insulting and provocative tweets, the news coming out of our nation's capital does not seem fitting for the most powerful country in the planet, but is more reminiscent of a political pulp fiction novel. If a first-class novelist were to concoct a story where, in the first year of an administration, all of the following top officials would quit or be fired—Health and Human Services Secretary, National Security Advisor, Chief Strategist, Chief of Staff, White House Press Secretary, Office of Government Ethics Director, FBI Director, Deputy Chief of Staff, Acting Attorney General, U.S. Census Bureau Director, Deputy Assistant to the President, and two different Communications Directors—he or she would be laughed out of the room by the book publisher, who would denounce the book as too outlandish. But as the saying goes, truth is stranger than fiction.

On the geopolitical front, the world watched in horror as tensions with North Korea escalated. The isolated and secretive regime, led by the tyrant Kim Jong Un, fired 23 missiles during 16 tests in the year. On July 4 it conducted its first ever successful intercontinental ballistic missile (ICBM) test. In September, the country conducted its most powerful nuclear test to date, while in November it upped the stakes with the launch of a new missile that could reach any point in the U.S.

What, Me Worry?

Against the backdrop of all this depressing news, the market did its best Alfred E. Neuman impersonation, ignoring all pundits and roaring ahead. At the start of the year, a group of Wall Street strategists expected the S&P 500 would rise an average of about 5.5%, according to an analysis by Birinyi Associates. When the ball dropped on New Year's Eve, though, the S&P 500 had soared 21.8% for the year, after achieving 62 record closes, the most since 1995. The Dow did even better, returning 28.1% and reaching 71 record closes, setting all-time records.

The strong market returns for the year have come coupled with an optimism and complacency that is almost unprecedented. For the first time in history, the S&P 500 posted a positive total return in every single month of the year. However, the median daily market move was just 0.18%, the smallest on record, meaning that the year saw nearly uniform smooth sailing in the upward direction. The largest peak-to-trough drawdown was 2.8%, the second-lowest ever:



source: Yahoo! Finance. Inkwell analysis

To be sure, the market's ascent, while more pronounced and much less volatile than many, including us, would have guessed, is not entirely irrational or illogical. Corporate revenues and earnings have continued to grow at a decent clip. Interest rates, while having increased somewhat, continue to be close to historic lows. The economies of all 45 countries tracked by the Organization for Economic Cooperation and Development (OECD) are expected to expand for the foreseeable future.

Additionally, we can add the passing of the tax cut bill late in the year to these positive developments. A cut in the U.S. corporate tax rate from 35% to 21% is significant to the bottom lines of Corporate America, especially for those firms whose main business is conducted domestically. After all, imagine that Uncle Sam was a silent partner in company whose stock you own. Previously he allowed you to keep only 65% of total profits, but now he has increased that to 79%—an improvement of 21.5%. And it came for free, courtesy of the U.S. Congress.

Conclusion

At the beginning of the 20th century the Dow Jones Industrial Average stood at 66. If you were an investor back then and we would have told you that over the next 100 years there would be two world wars, a flu epidemic that would kill at least 50 million people, a U.S. President resigning in disgrace, an oil crisis, and about 20 recessions, would you have been enthusiastic to invest in the stock market? Well, over those hundred years the Dow rose to 11,497; counting dividends, that amounted to a rise of about 10% per year.

2017 saw something similar. The U.S.—and the entire world—saw its share of disasters, yet the economy, and the stock market, kept chugging along. It remains to be seen if the optimism from the past year abates, continues, or grows into euphoria in 2018.

Sincerely,

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