Morris Capital Advisors, LLC

Investment Commentary
September 30, 2017

The "What Me Worry" Market

Those willing to date themselves will remember the heyday of MAD Magazine and its poster child, Alfred E. Newman. His goofy, gap-toothed, freckled face and bad hair often graced the cover, with the "What Me Worry" tag line. Just a quick glance told you that he indeed had much to worry about. And yes, our markets today seem to be displaying this same unfounded "What Me Worry" attitude.

Think back to the beginning of the year and consider that the stock market had rallied on apparent investor enthusiasm with the election of Donald Trump. Stocks seemed to embrace an outsider in the White House, a Republican congress, and the potential for change. Tax reform, health care reform, and regulatory reform were all a real possibility.

But if you knew that Trump would fail to reform health care (2 times), it would be months before a tax reform proposal began to materialize, and that his protectionist leanings would strain relations with economic trading partners, you would understandably expect weakness in the financial markets. A White House in disarray, repeated turnover in key positions, non-stop media attacks, midnight tweet storms, and a dangerous escalation of tensions with North Korea would add additional pressure. Fed interest rate hikes and a reversal of quantitative easing measures would also reduce support for the markets, while successive devastating hurricanes, growing separatist movements in Kurdistan, Catalonia, and California; and contentious negotiations surrounding Brexit and NAFTA would increase the potential for financial market dislocations.

But it has been just the opposite. Over the first nine months of the year the stock market gained almost 15%, better than results in the first three quarters in all but 4 of the past 20 years; while the 2-year Treasury yield increased, the yield on both the 10-year and 30-year US Treasury declined, generating impressive positive returns. Stocks have moved steadily higher with limited volatility. The stock market has not had a drop of more than 2% in months, and in 2017 the S&P 500 has had less than 10 days when that index moved up or down more than 1%, compared to more than 50 days on average per year, post WWII. The last memorable decline stretches back to the Brexit vote when the market declined more than 5%, but that drop was reversed in just two days before moving to new highs in less than two weeks; and Brexit was just one of several recent events where market participants misjudged the outcome and were surprised at the strength of the reaction rally (think Presidential election).

Maybe investors have decided that they just won't worry, they will buy the dips and all will be fine. But unbeknown to most investors, they have continued to benefit from the inflow of foreign central bank liquidity from the Bank of Japan and the Swiss National Bank. By the beginning of this year the Swiss had accumulated more than $63 billion of US stocks, up from $27 billion just two years ago. The inflow has continued throughout the year to the point where the SNB now has accumulated holdings in more than 2,500 US stocks. A reduction or reversal of this buying could significantly impact our markets.

As this impressive market move continues complacent investors may be ignoring warning signs. Stock valuations are overextended based on many traditional measures, while excess market liquidity has spilled over from stocks to real estate, tangibles, and crypto currencies. Initial coin offerings are raising more than $1 billion every two months based on nothing but expectations. Bitcoin, one of the original cryptocurrencies, is up 256% this year alone. Investors seem to be willing to invest without a real concept of the inherent risk. Their complacency reflects a fear of missing out, or the belief that central bank liquidity will ultimately bail them out.

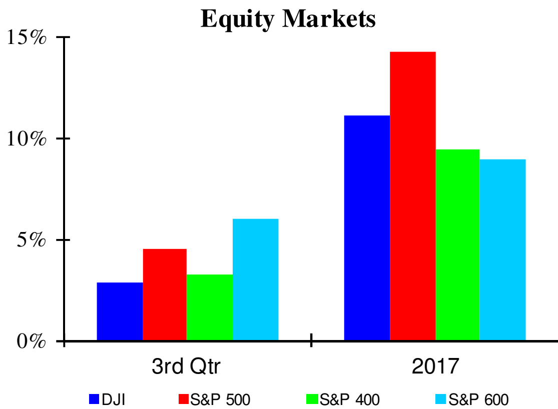
We worry that the steady move upward in the face of so many potentially unsettling events will only serve to increase the magnitude of a correction when it comes. The financial markets have the potential to trade irrationally for extended periods of time but ultimately fundamental valuations prevail. Markets always seem to surprise on the upside as well as the downside so we believe that it is impossible to call the top. As a result our approach is to remain invested but do so in a way that relies on fundamental valuations. We continue to seek companies with strong earnings and free cash flow, with solid balance sheets and good management. We invest in the stock of those companies only when we think that the share price is attractive relative to those factors. It is an approach that has performed well through all types of markets and is one that we believe can take some of the worry out the investing process.

Sincerely,
Daniel A. Morris

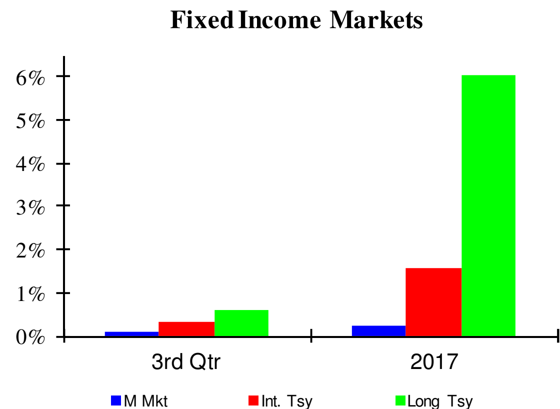
Market summaries on reverse page

Morris Capital Advisors, LLC

Market Summary
September 30, 2017



For much of the summer of 2017, stock markets seemed locked into the pattern that has prevailed for much of the year: declining yields, anemic economic growth and favorable liquidity all conspiring to propel growth oriented mega cap stocks in a relentless push to higher levels. In early September, however, investor risk appetites seemed to change considerably. On the geopolitical front, a summer of sabre rattling by President Trump and the leader of North Korea seemed to quiet down. And in Washington, the President and Democratic leaders cut a deal to avoid an October government shut-down, which in turn raised the prospect for action on tax reform. Risk-oriented stocks sharply outperformed from that point, especially small cap stocks, leading them to close the quarter with higher returns than large cap stocks. Economically sensitive issues outpaced more defensive sectors.



Yields on longer-term Treasury securities declined for much of the quarter, as bond market investors sought safety in the face of mounting geopolitical risk ad Washington gridlock. Those fears appeared to vanish in early September, as the North Koreans backed off a threatened missile launch, and a deal between President Trump and Democratic leaders avoided a near-term confrontation on the debt ceiling. By quarter's end yield levels had snapped back to where they began the quarter. In spite of a fair amount of volatility, bonds barely returned their coupons in the quarter.