April 2018 – Time to Cash Out?

"More money has been lost trying to anticipate and protect from corrections than actually in them."
– Peter Lynch

"I have a new philosophy. I'm only going to dread one day at a time."
– Charlie Brown (Charles Schultz)

Volatility Returns

Large movements in the market are now occurring frequently. The basic question many are asking is: Should we continue to ride the market or take some money off the table?

We have commented many times that timing the market is futile, but we also are all human, and the joy of a gain does not offset the pain and anxiety caused by a loss. If we sell, we generally have a large tax bill since we have had years of price appreciation. This becomes a real loss. Likewise there is no guarantee that the market will continue to decline or, more importantly, that we will have good timing as to when we get back in. The "get out/get in" mentality is almost certain to result in lower overall returns. Almost always it is better to just ride it out with a well-diversified portfolio.

There are many important issues facing our country. In no particular order, and not trying to be complete, the issues include: national security, equality, healthcare availability and affordability, public education, deficits, the environment, fair trade, regulation, and immigration. Whenever anyone expresses an opinion on these issues, there is no shortage of criticism of such opinions. Many times in hearing this criticism it is difficult to tell whether such criticism is even trying to be constructive. Non-constructive criticism taints all criticism and, as we have seen, results in almost silly exchanges more akin to playground taunts rather than trying to solve these very real issues.

Markets loathe uncertainty, and if you view the news, it seems there is no common ground or just straight forward reporting of facts. News sources do not seem to be able to agree on basic facts or truth anymore. Our country is divided on seemingly everything from if trade is good or bad, if immigration is good or bad, or if capitalism is good or bad.

Other countries take advantage of this perceived weakness and try to exacerbate it as Russia has done with Facebook, infringing upon neighboring countries and inserting itself in the Mideast. Clearly China has not always been a good citizen. Expansion in the South Pacific and lack of respect for the property of others are two examples. Iran continues to foment problems in the Mideast, Africa and North Korea. Africa and Latin America have a long history of corruption. The United States and Europe are not perfect but generally the Rule of Law is followed.

All this affects the market.

It is, however, useful to look at several fundamental factors underlying the economy.

The U.S. economy continues to grow. GDP appears to be growing at a rate of about 3%.

(713) 572-3366 | (713) 572-8771 Fax
3555 Timmons Lane, Suite 600 | Houston, Texas 77027
www.callahanadvisors.com

Congress passed new tax legislation in 2017, lowering tax rates on individuals and businesses. The details of this legislation are well beyond the scope of this letter; however, a few observations are in order. These rate reductions are just now being felt in the consumer pocketbook. This should drive continued economic growth.

Lowering the corporate tax rate to 21 percent will increase earnings going forward. Indeed, the biggest part of tax reduction goes to corporations. This benefits both shareholders and employees. Many companies have already announced employee bonuses and higher starting wages.

What benefits accrue to shareholders? Companies (and the shares held by investors) will have increased earnings and cash flow that can be used for capital investment, repayment of debt, increased dividends and stock buybacks. All of these benefit prospective share prices.

Most companies are providing guidance on the impact of the lowered tax rate on their business. Expect more of this news as companies report results for the first quarter.

Stocks don't appear overvalued or at risk for a major correction. There are exceptions of course, but most stocks are fairly valued. The S&P 500 is expected to earn about $146 in 2018. As we write this, it means the average stock in the S&P trades for 18 times this year's earnings. Stocks are not cheap by any measure but it is certainly not a bubble and there are good companies that sell at a reasonable price.

We continue to emphasize stocks that pay dividends and, most importantly, companies that increase dividends every year. A growing dividend is an indication of a healthy company. Dividends are an important component of total return from stock and the reduced tax rate should make it easier for companies to increase dividends.

In summary, we believe that investors should generally remain invested in equities. While it is not realistic to expect the returns experienced in 2017, we believe that rising dividends combined with moderate price growth will provide good returns in 2018.

Thank you for your continued trust in Callahan Advisors and for allowing us to be of service to you.

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