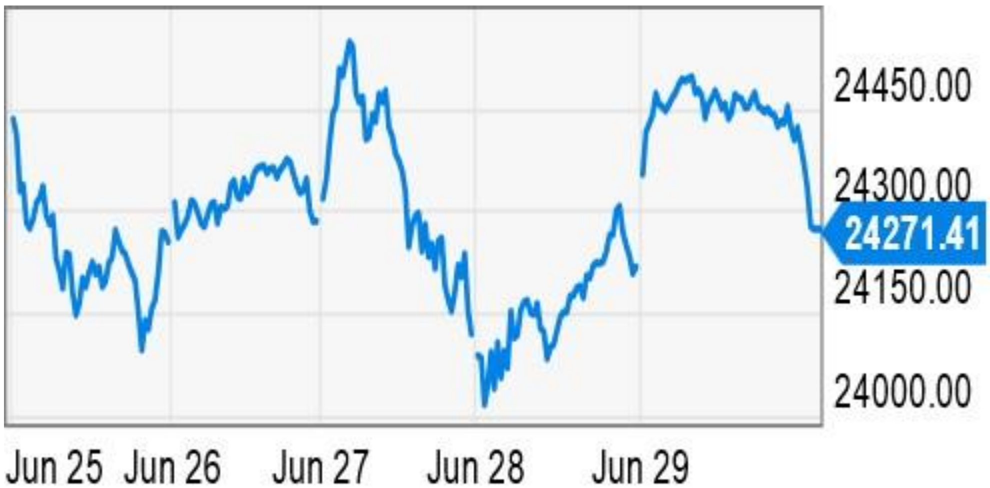
The Outlook: June 29, 2018

This week's market: confusion, anxiety and general fogginess . . . as usual.

Confusion, anxiety and general fogginess are almost constant features of the investment world—but this week was Exhibit One, along those lines. Here is the Dow, day by day:



If that isn't a picture of an anxious market, it's hard to imagine a better one. Proceeding to the "confusion and fogginess" part of the picture, we investors were faced with a remarkable number of threatening headlines and news items this week, many of them having nothing much to do with one another. But they all shared one thing. What they implied, on the surface, was often sharply different than their underlying facts, or their likely meaning for the future: "confusion and fogginess," indeed. Here are a couple of the boldest of the week's headlines:

- **"China Stocks Plunge into Bear Market on Trade-War Fears!"**

  Sure enough, there was the Shanghai Composite, down 20% from January highs, which is the dictionary's definition of a bear market. Of course the "Trade War" nightmare is a fearful one for many corners of the investment world, because it's easy to imagine global economic devastation, but uncommonly hard to figure out the details: just how the devastation will occur; in which countries and which products; and how or if the market's normal adaptive behavior will cushion or eliminate the threatened damage. (Naturally, most analyses pay no attention to that "normal adaptive behavior.") The investment world is vast, and thankfully there are always deeper thinkers who are also deeper diggers into the facts. Some of those, after a day or two of such headlines, observed that China's general economic growth has been in an ebb phase lately, slowed by the government's fairly determined policy to curb bad lending. China has a great deal of bad lending to curb, and the government's historically unusual actions to control it inflict pain; but it's hard to deny that success would be a very good thing for that economy, in the long run.

  The best remark of all came at the end of an exhaustive Journal article listing all the possible ways the Chinese "Bear Market" might be warning the rest of us that Armageddon is around the corner:

"There is not a lot of long-term money [in China] — it's short-term reactive," said Stuart Rae, chief investment officer Asia-Pacific value equities, AllianceBernstein. "You should not react to the short-term news. Earnings growth has not changed much, yet valuations have got cheaper."

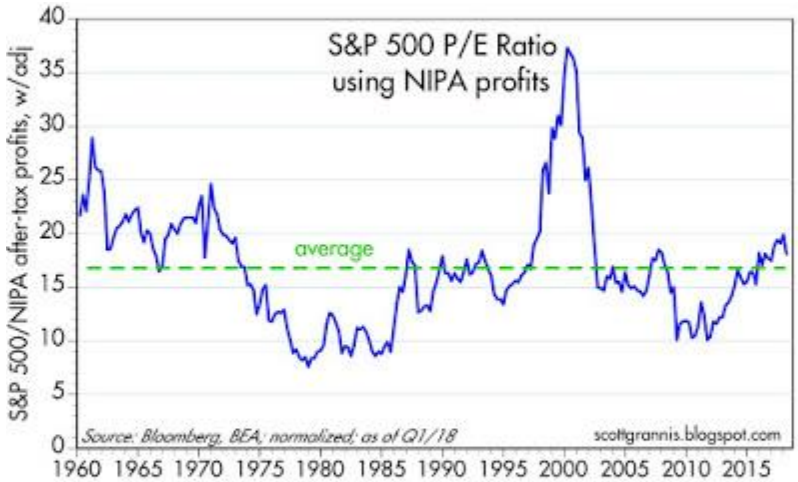
Hmm. We needn't descend into general remarks about demographic affinities for gambling. But Mr. Rae has a lot of company among those who've consistently warned outside investors that China's market is very often a wild ride.

- **"Immigration Debate Might Bring Down the EU, or Angela Merkel!"**

  The possible collapse of the euro and/or the European Union has been one of the market's recurring nightmares for at least the last 5 years. First it was Greece; then the rest of the "PIIGS" nations, all with too much debt. A funny (but normal) thing happened over the 5 – 6 years since Greece terrified the EU and the world. With a great deal of pain, both Greece and most of the "Portugal, Ireland, Italy, Greece and Spain" group made impressive progress toward financial strength and health. Like most slow, steady movements, that progress seemed nonexistent or hopeless years ago; but today, looking backward, it's perfectly clear.

  So the backdrop to this week's EU Summit, at which its more-or-less open immigration policies were heading for a big political fight, was not fragile, teetering financial weakness but moderate strength. The fight was resolved the way many political arguments are—especially in Europe, we'd say—with a seemingly agreed-upon policy change on the surface, with a lot of fogginess about just how the policy might be put into effect. The euro, the EU and Ms. Merkel will be back to fight another day, it seems.

Meanwhile back home, economist Scott Grannis ended the week with perspective on the supposedly dangerous U.S. market and fragile economic recovery:



The top picture is historically remarkable. Corporate profits stand at 10% of GDP, far above the 50-year average of 6%. They began that rocket rise as the Calamity ended, 10 years ago. U.S. CEO's, as Outlook has noted more than once, reacted with world-class speed and determination to the Calamity, vowing to protect their companies from any risk of a repeat, and use that strength to build a path toward the future. For 10 years, their quarterly earnings reports have overwhelmingly shown the bosses delivering on their promises. The most important result, from our investment point of view, is the bottom chart: valuation levels which are not silly, dangerous or excessive by any realistic definition.

A market filled with dangerously-valued stocks ought to crouch in fear, indeed, at the kinds of nightmares seen in this week's headlines. If the companies beneath those stocks are loaded with debt and struggling to bring in enough cash, it's not a matter of "crouching in fear;" it's more like "running for our lives." But the companies beneath the stocks, and the careful valuation of the stocks themselves, are at the opposite end of that range: not struggling, but rock-solid financially; not valued up there with the sun, moon and stars; but more like a cross between Death Valley and sea level. Companies and stocks on firm ground can endure quite a few nightmares; wait for the market to eventually wake up; and continue moving ahead. At Outlook we think that's the clear picture of the investment world today, rather than the confused, foggy picture drawn by those headlines.

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