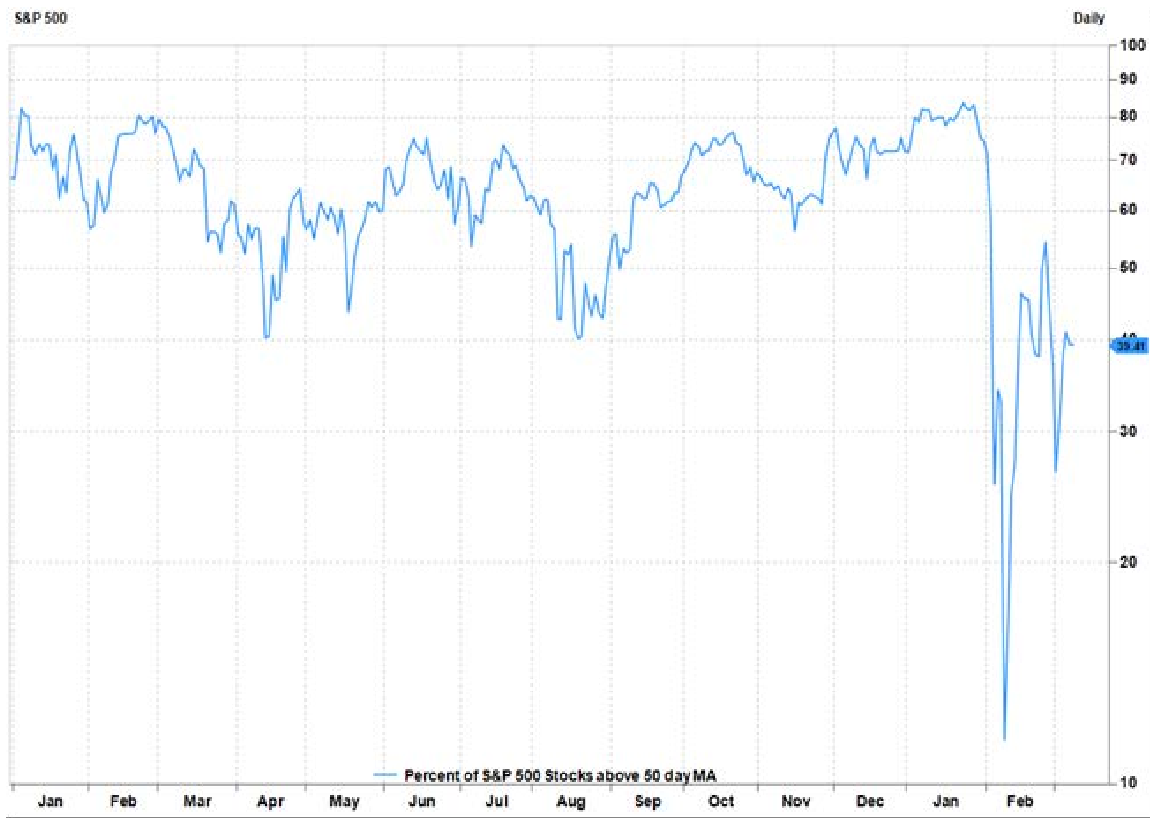
Chemung Canal Trust Company and Capital Bank, a division of Chemung Canal Trust Company

Investment Outlook, March 2018

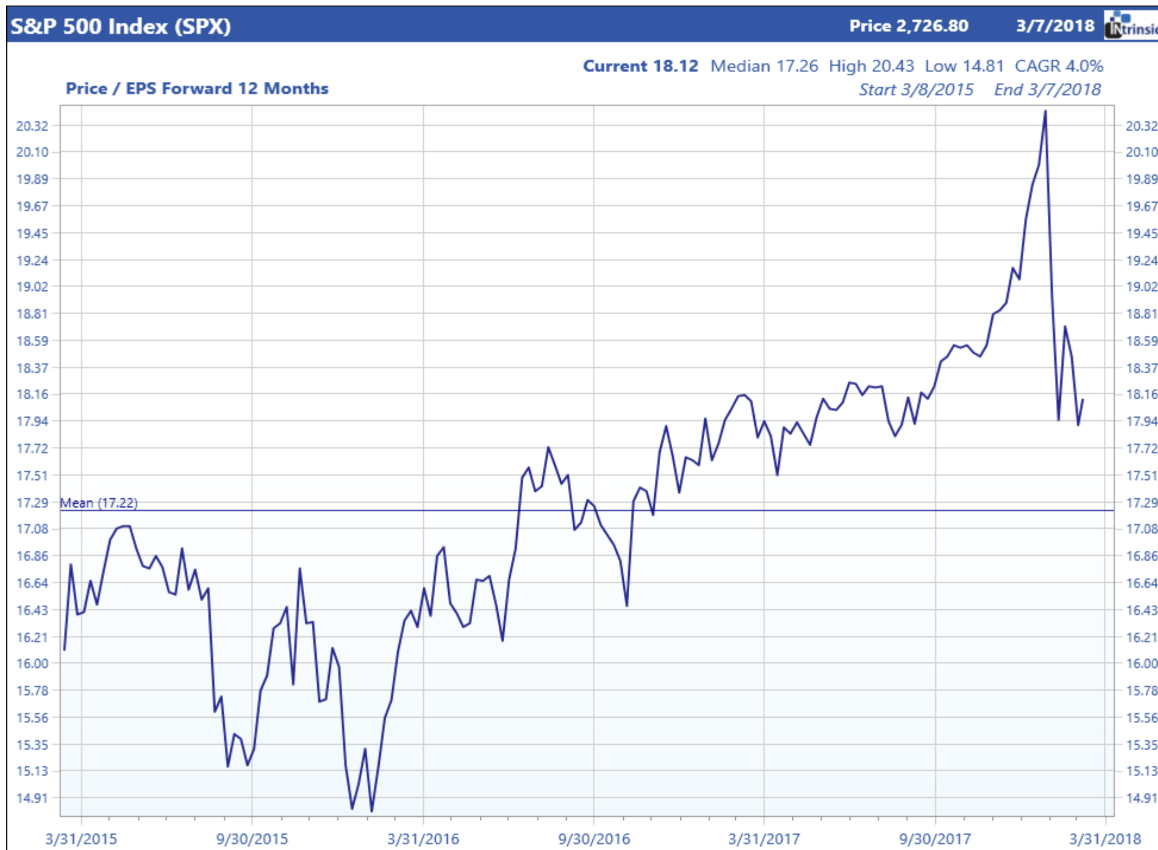
Although the U.S. equity market has rebounded smartly from the correction that began on January 26, we expect that a return to the low volatility environment we experienced in 2017 is unlikely in the near term. The more recent rebound from the late January – early February decline has been so rapid and so strong, that too many analysts are saying that the correction might already be over. However, history suggests that deep sell-offs such as the one we experienced require a multi-month trading range to materialize before the market can move higher.

Technically, the market remains weak, with the S&P 500 continually stalling near its closely watched 50-day moving average. Breadth remains anemic, with just 45% of the individual stocks that comprise the Index trading above their respective 50-day moving averages (chart, below). That indicator was hovering above 80% in the period prior to



the onset of the correction. The premature relief implicit in the analysts' consensus, against the backdrop of such weak technical indicators, suggests that perhaps not enough pain has yet been felt for this correction to have had the required cleansing effect on investors' expectations. In other words, we remain cautious for the near term.

Still, there remains too much to like, fundamentally, to get overly skittish, or to expect that any further short term weakness is other than an ongoing correction in a long term bull market. The earnings outlook remains constructive, and forward indicators of economic activity are supportive of sustainable growth through the end of 2019. The decline in stock prices, along with the increased earnings estimates due to the tax cuts enacted last year, has brought price/earnings ratios back into line from their excessive pre-correction levels (chart, below). At 18 times forward earnings estimates, stocks are



neither cheap nor dangerously overpriced in historical terms, but they are certainly more reasonably valued than they were at the beginning of the year. And, as we have pointed out in previous *Outlooks*, stocks are not overvalued relative to interest rates. One way to measure this is to simply invert the price/earnings ratio and, instead, divide earnings by price. Thus, the current price/earnings ratio of 18.1 implies an earning yield of 5.52%, which compares favorably to the current 10-Year Treasury yield of 2.89%. Not only is the current earnings yield spread of 2.63% over the 10-Year Treasury yield well above the mean spread of the last 40 years, that spread has actually been *negative* for 20 of those 40 years!

The major risks to our generally optimistic long term outlook are, as always, external. This was driven home by the President's recent imposition of tariffs on steel and aluminum imports, and the market's immediate and harsh reaction. The goal, apparently, is to defend jobs domestically in those two industries, particularly in the Rust Belt. The

problem is that far fewer workers are employed in the steel and aluminum industries, than are employed in industries that depend on steel and aluminum. Ohio, for example, has 11,000 workers directly employed in the affected industries, but has 400,000 workers employed in industries that use steel and aluminum. In fact, the Rust Belt receives 20% of the nation's steel and aluminum imports, much of it going to the critical automotive and metalworking sectors. Then there are the negative effects to the country's coastal areas that receive these imports. One in every eleven jobs in South Carolina depends on the state's 4 seaports. And the list goes on.

In addition to the direct, economic impact of such policies, there is the equally serious perceptual issue of the apparent impulsiveness of the change in policy, followed by the abrupt resignation of the President's chief economic advisor, Gary Cohn, a fervent advocate of free trade. We make this point mindful of the fact that the market's generally strong performance since the 2016 election is largely due to investors' perception of the President as understanding of, and supportive of business. Free trade is supportive of business as it creates jobs and keeps prices low, including the prices of raw materials like steel and aluminum. Protectionism, on the other hand, may be good electoral politics, but its economic effects are uncertain, at best.

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