KIM: Start of 2017 a welcome mirror image of 2016

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The following is an excerpt from Kirr, Marbach & Co.'s first quarter client letter, available at www.kirrmar.com.

What a difference a year makes! Stocks tumbled out of the starting gate in 2016, with the S&P 500 experiencing a harrowing plunge of 11% between New Year's Day and February 11 (the **Dow Jones Industrial Average ("DJIA") closed at 15660, a two-year low**).

Investors had plenty of reasons to have their confidence shaken in the first quarter of 2016, as headlines blared U.S. stocks had their worst start to the year in history. The possibility of an economic hard landing in China and further devaluation of the yuan, oil free-falling 50% and weak manufacturing data led to fears of a global recession.

As usual, this brought market pundits trying to become famous for calling the next crash out of the woodwork. RBS, a major global bank, advised its clients to "sell everything," predicting a "fairly cataclysmic year ahead." Wow!

Fast forward to the first quarter of 2017, when the DJIA closed above 20,000 on January 25 and broke the 21,000 barrier on March 1. Oil and other commodity prices rebounded strongly off their lows. Not only was there no global recession, the world is now in the midst of a synchronized growth spurt. Consumer and CEO confidence ("soft," attitudinal measures) have surged and "hard" economic data has started to confirm.

Unfortunately, the first quarter celebration was mostly limited to larger-capitalization and "growth" stocks. Bespoke Investment Group examined returns for the Russell 3000 Index by market-cap decile, which showed performance was driven exclusively by the 600 largest stocks (i.e. top two deciles), as the 1200 smallest stocks (i.e. bottom four deciles) were negative.

We think smaller-cap stocks are poised to do better, as they tend to 1) have less international exposure (a risk under threats to globalization) and 2) pay higher effective tax rates (they have fewer ways to shield income and should benefit if taxes are lowered).

Our positive investment thesis and outlook for 2017 remain firmly in place. We believe stock prices follow corporate earnings. The U.S. economy and corporate profits showed signs of accelerating *ahead of* the election, so we believe the ***post-election rally has been well-supported by improving fundamentals***.

Some pundits have referred to the rally as a "Trump Bump," which presumably puts the stock market at risk of a significant correction if the new administration is unable to quickly deliver on campaign promises related to lower corporate tax rates, repatriation of cash trapped overseas, increased infrastructure spending and a less burdensome regulatory environment. While these initiatives would enhance profits, the U.S. and global economy have already been strengthening and the outlook for profits is improving.

Even with stocks at record highs, valuation is reasonable. When inflation is high, earnings are worth less than when inflation is low. The "forward P/E" (i.e. Price/Next 4 Quarters of Earnings) for the S&P 500 is 17.6, just average (range of 10.8-26.7) for 1958-2016 under current inflation of 2-3%. In other words, stocks would have to advance and/or earnings decline fairly dramatically to get to a worrisome condition.

We recognize there are always risks, here and abroad, known and unknown. Global financial markets are subject to violent downdrafts for any or no reason. Still, we believe the preponderance of the evidence points to higher stock prices and decent returns for the year.
