Morris Capital Advisors, LLC

Investment Commentary
December 31, 2017

Catch-22 Revisited

The satirical novel by Joseph Heller, Catch-22, exposed the absurdity of bureaucratic systems, especially in the military. The novel, set during World War II, revolves around the experiences of Captain John Yossarian, a B-25 bombardier in the fictional 256th Squadron, who desperately wants to finish his tour of duty and get home safely. The "Catch-22" is the logical absurdity that the only way to get out of flying more combat missions is to be crazy, but since only a crazy person would want to fly more missions, anyone asking to be relieved of flying cannot be crazy and therefore must fly more missions.

I previously used the Catch-22 to describe the markets in December 2009. Stocks were riding a wave of economic stimulus, up substantially from the lows set during the financial crisis of the previous year. Given this impressive move, there were real concerns that the markets were overextended, that investors were overestimating the potential for an economic rebound, and that interest rates were poised to rise due to a massive increase in government borrowing. Now, eight years later, the S&P 500 is up more than 140% from those levels and we are confronted with a similar quandary.

Those who think that it might be crazy to invest in this market can look at history as a guide. The stock market has been on an unprecedented streak. Since the end of 2009 it has been a steady ride upwards, with only a couple of corrections of 10%, and the most recent of those corrections was almost two years ago. The rally has outpaced economic growth, taking valuations well beyond the levels where we started. In December of 2009 the normalized PE ratio of the S&P 500 was just over 15, with expected earnings growth of 10.7%, and a price to cash flow multiple of 12. Now, those same measures are a PE of more than 23, with similar expected earnings, and a price to cash flow over 20. In addition, the total stock market today stands at 150% of GDP, a level that historically portends trouble. Investor optimism also seems exuberant with volatility measures at all-time lows and crypto-currencies generating astounding gains driven by speculative fervor.

Those who think that it is not crazy to invest in stocks right now can make a compelling case, as well. First, and foremost, is the belief that the economy is gaining momentum after the anemic recovery from the financial crisis, creating jobs without sparking excessive wage growth or inflation. This limits the upward pressure on interest rates and allows the Fed to be cautious as it continues to normalize rates and trim its balance sheet, reducing the chance of derailing the recovery. While there is concern that shrinking central bank balance sheets will remove a source of liquidity, sovereign wealth funds have continued to buy stocks, in many cases using leverage to enhance returns. These purchases have increased on a pace where the investment arms of Norway and the Swiss National Bank hold significant positions in our stock markets and show no sign of letting up. Continued buying pressure from index fund investors and defined contribution plans also provide a steady flow of cash into the stock market, and investors who have stubbornly remained on the sidelines have cash balances that could eventually push stocks higher, or come in to "buy the dip" in the event of a pullback.

In addition, we believe that stocks will continue to react favorably from the dual benefits of tax reform and reduced regulation, both of which have a real long-term impact. Stocks gained strength last year as regulations were rolled back, and the regulatory rollback should continue this year. Now, with the passage of tax reform, take home pay for most workers will rise which should translate into increased spending or investing. In addition, corporations are announcing new employment and investment initiatives, reinvesting tax reform benefits back into the economy. Analysts have responded by raising profit expectations, and the combination of stronger economic growth and improved profitability will provide fundamental support for stocks. Companies that generate top line revenue growth and translate that growth into stronger earnings and cash flow provide excellent investment opportunities. The goal of our investment process is to invest in those companies at attractive valuations in a diversified portfolio with a long term investment horizon. It is a conservative approach that can generate reasonable returns and maintain your sanity.

Sincerely,
Daniel A. Morris

Market summaries on reverse page

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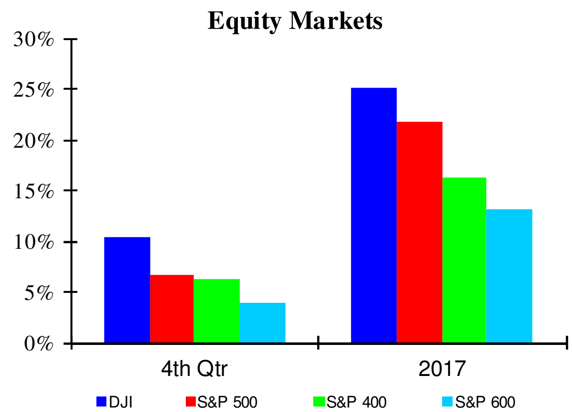
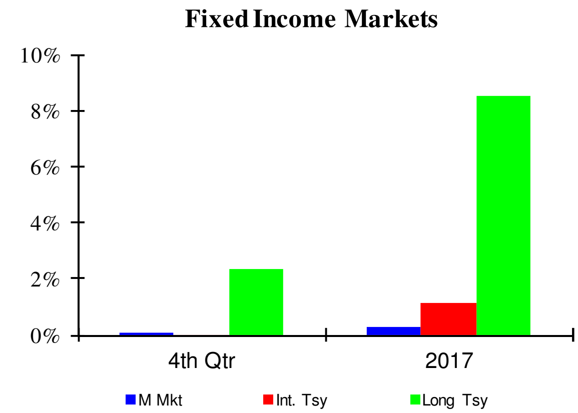
Market Summary
December 31, 2017



Stocks markets closed 2017 with very strong returns, resuming the pattern that prevailed for most of the year. Mega cap stocks outperformed small cap stocks, and growth outpaced value. 2017 offered the best returns since 2013, and one of the best years on record. As the quarter closed investors were enjoying solid earnings growth, a modest economic acceleration, full employment, low interest rates, low inflation, and the prospect of significant tax reform. 2018 will have a very tough act to follow.



The Treasury markets were fairly quiet during 2017's fourth quarter. Yields on long dated maturities declined somewhat, while short - maturities were flat. A well broadcast increase in the federal funds rate did nothing to disturb the market's tranquility. However, with longer-term yields declining the yield curve did narrow somewhat. Many observers consider a flat yield curve as a precursor to economic weakness, so the fixed income markets were giving very different signals than the exuberant stock markets.