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

Investment Outlook, February 2018

The Standard & Poor's 500 Index rose 5.6% during the first month of the year, driven by upward revisions to future corporate earnings due to the tax cuts that were enacted in December. S&P earnings for 2018 are now projected to be 17% above last year's results, with almost half of that gain attributable to lower tax rates. Early estimates for 2019 are that earnings will rise another 10% above 2018's level. In addition to rising earnings, stocks also benefited from an improving economic backdrop, as growth is accelerating both in the U.S. and globally.

The S&P had actually risen 7.5% during the month, before beginning a sell-off in the last week of January that has now extended into the current month. Following Monday's 4% drop, the S&P 500 is down more than 7% from its late-January high. Prior to this sell-off, the market had gone 13 months without a decline of even 3% from any previous high, and had experienced only 4 trading days with a decline of 1% or more.

It is far too early to tell whether or not this is the beginning of a more serious and extended market decline, but we would argue that a market correction is not only overdue, but necessary. The S&P had risen 55% since its last correction of 10%, which occurred between August 2015 and January 2016. In addition to the recent steep rise and extended valuations, there have been growing signs of excessive optimism in recent weeks. The *Investor's Intelligence* Bull/Bear Ratio, a commonly used contrarian indicator, has reached its most bullish state since 1987, and inflows to equity mutual funds over the last 4 weeks were at their highest level in at least 15 years. It appears that the fear of incurring losses has been replaced by what Warren Buffet has described as FOMO – the Fear of Missing Out.

We have spoken in the past of the "Wall of Worry", that innate caution that seasoned equity investors possess that keeps expectations low and enough cash on the sidelines to fuel future gains. But it is apparent from the sentiment and cash inflows that the Wall of Worry has been washed away by a rising tide of optimism. The last correction is too far in the past to serve as a useful reminder to investors who are coming late to the party.

Whether a correction occurs now or later, we are confident that it will remain a normal correction of 10-15%, and will not be enough to bring this bull market to a halt. Bear markets, as they are defined, normally exceed 20%, and are commonly associated with either recessions or bubbles. As to the former, there is not even the first indication that a recession is likely in the foreseeable future, as nearly all of the leading economic indicators have strengthened in recent months. And as to the latter, the rapid rise in prices in January, following 2 extraordinary years of gains, is still not enough to approach what one could define as a "bubble" in stock prices. To qualify as a bubble, valuations have to become detached from reality, as occurred in the dot.com bubble of the late 1990s or the housing bubble of 2007-2008.

Because the January run-up in the market was matched almost exactly by an identical increase in future earnings expectations, stocks were left at valuations that were virtually unchanged from where they were prior to the passage of the Tax Cuts and Jobs Act. At its January peak, the S&P was trading at 18 times the upwardly revised 2018 estimates. While this multiple may be high on the basis of historical norms, it is not a level from which bear markets have ensued. We would also note that at current levels, stocks are not overvalued relative to bonds.

Whether or not what we are experiencing at the moment becomes an official correction (defined as a decline of 10% or more), investors should prepare themselves for a more volatile market than that we were blessed with for most of the last 13 months. High expectations leave little room for disappointment, and the calm markets of 2017 are more the exception than the norm. We believe that it is more important than ever to aggressively diversify portfolios, not only to lower risk, but also to take advantage of lower valuations and other opportunities in a globally inter-connected economy.

Joseph J. Tascone	Michael D. Blatt, CFA	Michael S. Lares,CFP
Senior Vice President &	Vice President &	Vice President &
Senior Investment Officer	Portfolio Manager	Portfolio Manager