Continue to focus on the "signal," ignore the "noise"

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

In 2017, investors who focused on the "signal" of improving fundamentals (i.e. synchronized growth of U.S. and global economies, strong earnings growth and still low inflation) and ignored the "noise" of the fire and fury emanating from Washington, North Korea and seemingly everywhere else were amply rewarded with a steadily rising and uncommonly tranquil stock market.

We believe fundamentals continue to support higher stock prices and offer the following investment "themes" for 2018.

1) The corporate tax cut (reduction of statutory rate of 35% to 21% and 100% first-year expensing of capital expenditures) and pro-business agenda from Washington will lead to stronger economic growth, corporate earnings and business investment.

There is room for debate on the long-term impact of tax cuts on interest rates, the deficit and the dollar, but the short-term effect of the reduction of the statutory rate on the economy and corporate profits should be positive and direct.

The U.S. had one of the highest corporate tax rates, so the reduction to 21% will allow U.S. corporations to compete on a more level playing field. The ability to expense 100% of the cost of capital expenditures should also spur investment, which will benefit both the purchasers and sellers of capital goods.

Finally, there is anecdotal evidence businesses have started loosening their purse strings and spend/invest cash they had been hoarding or using for stock buybacks because of increased confidence in the economy and a likely rollback of regulations.

2) Smaller companies should benefit most from the corporate tax cut.

Smaller/domestically-oriented companies bear higher effective tax rates than large, global companies because they have fewer tax reduction/avoidance tools available to them. It follows they will benefit most from the reduction in statutory rate from 35% to 21%.

3) The U.S. stock market's steady, uninterrupted run of record highs in 2017 is unlikely to be repeated in 2018.

According to Bespoke, 2017 was the first calendar year in history where the S&P 500 saw positive total returns for each month. Not only was the trend straight up in 2017, there were no setbacks along the way. It wasn't too long ago 2% up or down days weren't uncommon, but there wasn't a single one in 2017.

Further, not only did the stock market not suffer a 10% pullback at any point, it didn't experience a 5% or even 3% pullback, either. In fact, the S&P 500 hasn't had a 3% pullback from a high in more than 409 calendar days going back to November 4, 2016, the longest streak on record (going back to 1928). It's obviously been even longer since the S&P 500 had a 5% pullback, more than 539 days (the second longest stretch after the 593-day stretch that ended in August 1959).

According to Crandall, Pierce,, since 1900, 5% corrections have occurred about 3 times a year and 10% corrections about once a year, so we're long overdue. Just remember corrections are a normal part of the stock landscape and nothing to fear. Headlines and talking heads are noise to be ignored. As Bespoke says, "investing based on the headlines is only profitable for the people buying from you or selling to you."