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ASSET MANAGEMENT

SCALING THE WALL OF WORRY
Q2 CIO LETTER

"Nothing is more responsible for the good old days than a bad memory."
-Franklin Pierce Adams

Increasingly our clients have been reaching out to us with concerns about the markets, the economy, politics and the world in general. Nine years into the second longest bull market on record (only surpassed by the tech-fueled rise from 1990-00) and investors have yet to fully embrace their good fortune. A commonly used expression in our business is that markets like to "climb a wall of worry" – hence the title to this missive. In other words, there's the signal and the noise, and markets are pretty good at obeying the former and ignoring the latter while for the average investor this can be difficult.

I recently gave a presentation to a group of individuals entitled *Is This As Good As It Gets?* and shared with them our four top concerns as of July. In order, we have 1) equity valuations, 2) the yield curve, 3) global trade issues, and 4) what we call the "Trump uncertainty premium". In this note I'll touch on all four and attempt to explain what we should be worried about (the signal), and what is merely noise and should be promptly ignored (90% of what you see and hear on social media!). They all matter to one degree or another, but in decidedly different ways.

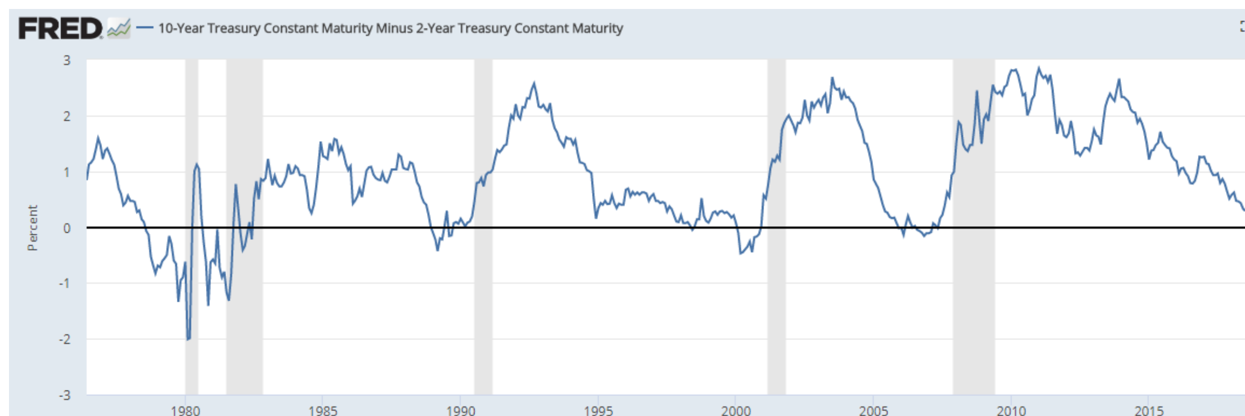
Equity Valuations

Back in our October 2017 CIO Letter I shared with you a chart showing the so-called Shiller P/E ratio going back to 1880 (find it here). The chart shows a current Shiller P/E (instead of valuing stocks against the last 12 months earnings, or current 12 months earnings, you measure stock prices against a cyclically-adjusted 10-year average) that is at its second highest point ever at 32x earnings – exceeding 1929 and only eclipsed by the year 2000. Scary, right? Sort of, we would say. This measure has poor short-term forecasting powers, meaning it doesn't necessarily tell us the market will crash next year. It does, however, exhibit strong longer-term impact, meaning its very likely equity returns over the next 5-7 years will be below average.

When we dig into the math behind the number, however, (and we'll spare you the boring details), we see that the current Shiller P/E incorporates earnings from 2008 and 2009, two decidedly awful years. And, it doesn't incorporate 2018 or '19 earnings, which should be excellent. Based on what we believe the S&P 500 will earn in 2018 (about $148/share) and 2019 (about $160/share), the Shiller P/E should drop meaningfully on its own over the next year and a half, falling out of the danger zone into a more historically normal range (albeit, still above a long term average). Based on the $148 earnings number for 2018, the S&P 500 is trading at 18.8x (non-Shiller) multiple, which is above average, but not alarmingly so. Certainly in an era of historically low interest rates it can be seen as very reasonable.

A lot of this earnings surge is the result of the 2017 tax reform act, which lowered the corporate income tax rate from 35% to 21%, encouraged capital expenditures, and required firms to repatriate foreign sourced profits (profits earned abroad that had been held overseas to avoid onerous US taxation). The impact of this fiscal stimulus is massive – estimated at around $800 billion, and should become more visible in the second half of 2018 and first half of next year. It could push US GDP growth up above 3.0%, which in a $20 trillion economy is a heck of a lift.

The Yield Curve
The 2-year Treasury note currently yields about 2.58% while its longer-dated cousin, the 10-year Treasury note yields 2.86%. The range of yields between these two securities is commonly referred to as the "yield curve". Going back to 1977, the 10-year Treasury note has yielded on average 1.00% more than the 2-year Treasury note. Right now the delta is .28% and falling. Why is this significant? Because, prior to each of the past 6 recessions the yield curve has gone flat, or inverted (see chart below – the shaded areas represent periods when the economy was in recession). And with the Federal Reserve committed to raising short-term interest rates two to three more times over the coming year and the US Treasury issuing massive amounts of short-term debt to finance ongoing budget deficits, we're likely to continue to see upward pressure on short-term interest rates.



Source: St. Louis Federal Reserve Database

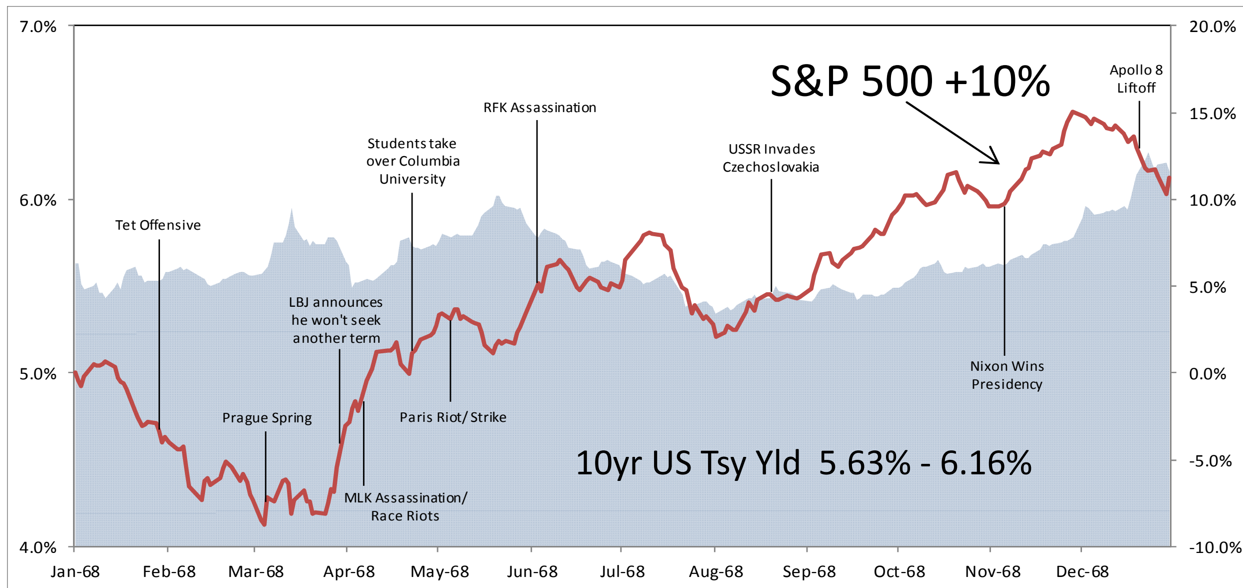
According to the National Bureau of Economic Research, the average business expansion in the US since 1945 is 5.5 years. The current expansion began in June of 2009 and is now going on 9 years. It won't surprise us if we eventually see a pullback at some point in the next 2 years – but likely later rather than sooner. The aforementioned fiscal stimulus from tax cuts will likely buy us another year or two of growth. Our friends at Strategas Research Partners put out a piece recently showing that the equity market peaks on average 8 months after the yield curve inverts while a recession typically begins 17 months after inversion. Knowing this, we'll be keeping a close eye on the 2/10 spread and react accordingly.

Trade
The biggest risk to our semi-bullish thesis is global trade and the increasing odds for an all-out trade war. What started as a "dispute" has evolved into a "skirmish" and risks becoming a "war" if cooler heads don't prevail sometime soon. The U.S is pushing back, rightfully, against a long history of trade abuse mainly by China, and President Trump (presidents in the US historically have had a lot of latitude to act when it comes to trade) is aggressively pursuing reforms. At this point, we feel the outcome scenario is somewhat binary: China backs down and new, fairer trade rules are established (the optimal outcome), or it all comes to a head and ends with a large-scale series of tariffs and import duties greatly restricting the free flow of goods around the world. It's a gamble, and at this point we're not sure the outcome.

Suffering most from all this is the emerging market sector, which happens to be the area of the global equity market we (were) incredibly bullish on. After returning 38% in 2017, the MSCI Emerging Markets Index has fallen -7% in 2018 (and over -15% from its January high), with the Shanghai Composite leading the way down over -16%. At this point, compelling valuations and higher economic growth rates are keeping us committed to the space, but should trade talks deteriorate from here, we would likely switch into capital preservation mode. Emerging market equity returns are currently below average on a rolling 3, 5, 7 and 10-year basis. While we don't need a wholescale fix of all the issues currently plaguing these economies, we simply need things to be "less bad" than they currently are and these stocks will have a lot of room for recovery. We remain cautiously optimistic at this point.

The "Trump uncertainty premium"
The so-called *wall of worry* has many rungs. Some have been extant for ages while others are relatively new. To say our current president causes angst among a subset of our clients would be an understatement (and as an apolitical newsletter, I will acknowledge an equal number that applaud his every move). Social media is a relatively new platform for the delivery of information, and like many new things, we're discovering it can be used for good and for bad. "Fake news" isn't really fake at all, it's real. Really fake I mean. Bad news sells better than good news. Combining our unconventional presidents fondness for communication with an ability to reach hundreds of millions of people in a nanosecond, it's no wonder market volatility is creeping higher.

1968 – A turbulent year



2018 not only marks the 50th anniversary of my humble birth, but also one of the most turbulent years in American history. In 1968 the US had over 500,000 troops in Vietnam versus a little over 10,000 in Afghanistan today. A major turning point in that unpopular war occurred in late January with the Tet Offensive. Following closely after that came the assassinations of the leading civil rights activist Martin Luther King as well as the leading candidate for the Democratic nomination for President, Bobby Kennedy. Race riots occurred across the US with cities on fire and students taking over college campuses. The USSR invaded Czechoslovakia crushing the Prague Spring movement. Nearly all of France was paralyzed by a widespread strike following student/police clashes. And Richard Nixon was elected President in November. Talk about a tumultuous year – it kind of puts today's issues into a slightly different perspective. And yet, through it all, the S&P 500 managed to grind out a 10% return. Oh yes, and the 10yr Treasury yielded around 6%!

The point of all that is when we really think about the issues of today, things really aren't so bad. Don't get me wrong, we have issues, and folks on both the left and right have legitimate concerns. But all in all, we're in a pretty good place. (If any of you are looking for a good summer read – and it may take you all summer to read it – I would highly recommend Harvard Professor Steven Pinker's new tome Enlightenment Now: The Case for Reason, Science, Humanism and Progress. It's an uplifting and data-driven look at the progress the world has made over the years and after reading it I found it hard to argue with the assertion that this is the greatest time in history to be alive.) Markets have a way of working through social issues, wars and politics and investors would be wise to try and ignore the noise and focus on the signal.

Summary
The Tax Cuts and Jobs Act of 2017 will have a profound impact on corporate earnings in 2018 and '19. Unemployment is at 4% and US GDP should grow north of 3% this year. Interest rates remain historically low. The yield curve is still positively sloped, but less so as each month passes. Stocks aren't cheap, nor should they

be given the above. Emerging market equities are cheap – as they should be given the negative sentiment around the sector. As we approach the fall, all attention will turn to the midterm elections. Can the Democrats take back the House? Typically the party in power loses seats during midterms.

A lot of uncertainty exists currently – or many rungs on the proverbial wall of worry. Most of the answers to the conundrums above can be known only *ex post*, not *ex ante*. US equity markets have had a heck of a run. We think they could eke out another good year or two before taking a breather. This isn't something to fear, however, just something to expect at some point. It may be a good time to review your investment goals and objectives and ensure your current financial plan is still appropriate for you. As always feel free to give us a call and share your questions or concerns with us. We'd be glad to try and help. If you don't have any concerns, good for you! Go to the beach or play some golf. Its summer after all and for those of us in the northeast the clock is ticking. Enjoy the great weather while you can. We'll do the worrying for you.

Happy Summer,

Larry Whistler, CFA
President/Chief Investment Officer
July 2018

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