December 5th, 2016

Prudence in investing isn't optional…
One of the strongest held beliefs in investing is the adage that uncertainty acts like kryptonite for equity markets, in that it dampens the confidence an investor can have in forecasting future outcomes. This year more than any other in quite some time puts that philosophical view under assault, with equity investors growing confidence in brushing aside unexpected outcomes to events that, going into them, foreshadowed the exact opposite reaction.

The most recent reaction came on the heels of this past weekend's "no" vote to the Italian referendum which was intended to streamline the governing ability of Italian leaders – namely reducing the layers of government in Italy's political sphere by drastically reducing the power of the Senate. Bottom line is that Italy voted against having the federal government gain more control at the expense of less power at the regional level.

The "no" vote should come as a surprise to no one as this was expected in many of the polls going into the referendum (how about that, the polls actually got one right), but once again it's the market's cavalier reaction that is the surprise.

So this is now the third time in 2016 that investors were looking down the barrel of an unstable political event that was advertised to trigger a risk averse market response, but the exact opposite happened. More of a surprise than the conditional response that has become customary in markets this year is the speed at which investors are diving in to take advantage of any weakness – after the June Brexit vote it took two days before investors jumped in, after the surprise Trump victory it was less than twelve hours before the buying panic took off, and after yesterday's results were clear there was nary a sign of any meaningful weakness in the futures markets. Sure, currencies bounced around a bit with the Euro falling below $1.05, but that move has already reversed and then some with it moving above $1.075 in today's trading session.

Look, the precedent was set earlier this year where in the depths of despair at the February lows, when it looked as though the global economy was on the brink of recession, central banks stepped in with more monetary policy accommodation to stop the carnage. Then again following the surprise Brexit vote, the BOE announced an asset purchase program to stabilize markets, and going into the Italian referendum ECB President Mario Draghi suggested last week that the ECB would step in and provide liquidity to the market in the event it was needed.

At this point stock markets hooked on central bank incursions are responding in kind, given the conditional response that has been positively reinforced throughout 2016.

One quick thought on this referendum vote in Italy, which is being viewed through the prism of not so much an anti-EU vote as it is an anti-Euro currency vote. And while Italian voters took this vote as their Brexit opportunity, the path for Italy and the U.K. are very different. The U.K. has some arrows in its quiver that made stabilization in their capital markets much easier than is or will be the case for Italy. Namely, the U.K. has its own currency in the Pound which was devalued substantially following the Brexit vote and provided the economy with an additional stimulus almost instantaneously on a global purchasing power parity basis. Also, they have the luxury of having their own central bank. Italy has neither of these and they also have a bulls-eye on their back in regards to having one of the weakest banking systems in the world.

It's the Italian banking sector that should be monitored over the ensuing weeks and months as this segment of the global capital markets is one of several fault lines that everyone knows is there, but it's inconvenient to be bothered with at the moment.

Moving on, oil prices had their best weekly move on the year with WTI spiking 12% to almost $52. This came on the heels of OPEC being able to cobble together a production cut of 1.2 million barrels and expectation that Non-OPEC producers will cut 600k barrels. On the surface the deal looks good and allows OPEC to feel as though they still have some control (while fleeting) on the oil market, but don't get too excited just yet as there are a lot of loose ends to this deal that look very likely to go unfulfilled.

For the here and now, all this deal has done is push WTI back to the high end of the $40-$50 trading range it's traded in for much of the year and what we've learned this cycle is that most of the U.S. shale players have restructured their business to be profitable at $50/bbl. This foreshadows more rigs coming on line as was seen with the Baker Hughes rig count data showing 3 more rigs were added last week, which isn't a big jump, but when you compare the 477 oil rigs operating at the current time to the low of 316 rigs back in May – that's a 50% increase in less than six months. OPEC beware, you are no longer the swing producer you once were and at this price level more supply is likely to come online with U.S. producers happy to hedge future production in the $50-$55 price range.

The economic data over the last month has been nothing short of impressive, be it the Conference Board's Consumer Confidence survey spiking to its highest level of the cycle, PMI's across the globe (both manufacturing and non-manufacturing) pushing to or near 2016 highs, auto sales holding near cycle highs, and last Friday's employment report.

Now about that employment report, which showed the U.S. economy added +178k jobs in November and the unemployment rate fell to 4.6% (taking it to its lowest level since August 2007). There were no glaring holes in this jobs report other than pretty much all the good news was in the headline, with the U.S. economy still able to churn out +178k jobs this deep into the cycle. This report had late cycle fingerprints all over it:

1. The drop in the unemployment rate to 4.6% was primarily due to 226k people leaving the labor force after 195k left last month. Historically it hasn't been a good sign when people become disengaged from the economy to the extent they have over the last several months. A perfect example of this is that we now have a record 95.055 million people not in the labor force. Keep in mind we are talking about a labor force that tallies roughly 159 million people with 152 million of them employed. So that 95 million can be looked at two ways: A) ample slack remains in the labor force with the potential to put people back to work, or B) the mismatch between the skillset demanded by the current economy and the available job candidates is growing.

2. The household survey showed full-time job growth stagnated in November and has declined -99k over the last three months. Conversely, part-time employment has surged +638k since August and this has been one of the most concerning aspects of this economic cycle. The below chart shows

the number of full-time jobs reached 122.1 million at the peak of the '02 - '07 economic expansion. Fast forward to the present and the U.S. economy has only added 2 million net full-time jobs over the last nine years (a period where the U.S. population grew by 28 million).

3. Lastly, the cyclically sensitive areas of the labor market remain weak with factory payrolls declining -4k in November and the job losses in this area tally -30k over the last four months. Not only that, but the manufacturing workweek shrank -0.5% last month and this pours a bit of cold water over many of the upbeat post-election survey-based manufacturing indices such as the ISM.

The conference call that followed Dollar General's earnings report last week highlighted just how challenging the current environment is for the low-end consumers and throws some shade on the 'everything is awesome' psychology permeating the unabashed bullishness in stocks. Here is the response by DG CEO Todd Vasos when asked about his view around the health of the low end consumer:

> *"Interestingly, we talk to our consumers each and every quarter through panel data as well as we bring them in and talk to them in general and I can tell you as late as mid third quarter, they were telling us that their sentiment - feeling - is even more dire than it was in previous quarters in early 2016. What they're citing and continue to cite is the rising healthcare costs that they're facing. I don't believe any of our core customers realized what they were up against on those rising costs. And then rental costs continue and they call that out second on paying rent because most of our, again, core customers rent, don't own and those rents are going up across the nation at a pretty high rate.*
>
> *So we're hearing a lot of the same things we've heard over the last couple of quarters but what was interesting to us was that she was feeling worse off today, middle of the third quarter, than she was earlier in the year."*

There is no denying the momentum in a wide array of economic indicators since August (which looking back was a terrible month of data, but appears to be an outlier from the trend), but it will be interesting to see as we head into 2017 whether or not this momentum can be sustained in the face of a meaningful tightening in financial conditions, with interest rates up by more than 100 basis points on the 10-year Treasury since early July and the U.S. dollar recently challenging 14 year highs.

This takes me back to the Trump trade and the growing consensus view that his policies are going to spur a breakout in growth that jolts GDP above the 2% rate the U.S. economy has been tracking for the last year, and that animal spirits will continue to move the stock market even higher. So far, all investors seem to care about are the promises of tax cuts, deregulation, and infrastructure spending (President-elect Trump) while the uncertainties related to trade, tariffs and immigration policy (campaign Trump, which appealed to the rust belt and won him the election, but these policies on the whole are anti-growth…) have been forgotten.

I think every President-elect deserves the benefit of the doubt and Mr. Trump is no different. This election was one of the ugliest and most contentious in history which perhaps would have rendered any candidate unfavorable by the time they reached the finish line, irrespective of policy.

As with most things, time will be the ultimate arbitrator on whether we get campaign Trump or President-elect Trump, but ultimately investors will have to transition their analysis from hope and hypothetical to tangible/actionable policy.

If you look back through the recent history of Presidents, their reign and therefore their legacy is more defined by what transpired in the business cycle than any piece of legislation they pushed through. Say what you will about Ronald Reagan, but he perhaps had one of the best economic set-ups as any post-WWII President when he moved into the Oval office. The "Reagan Revolution" came on the heels of a miserable decade in the 70's where the U.S. economy was just coming to the end of a recession in 1980. This created an environment where interest rates were in the teens, tax rates where sky high, debt levels were extremely low, and P/E multiples were in the mid-single digits.

This didn't stop another recession from occurring in the first twelve months of Reagan's term with a -20% decline in the stock market, but make no mistake it was Paul Volker and the Federal Reserve cutting interest rates by -10% (from 1981 – 1983) that ignited one of the greatest bull markets in U.S. history. The recession ended and many of the excesses that were built up over the prior business cycle were finally extinguished. It's not any more complicated than that.

George W. Bush took the reins from Reagan in 1989 on the premise that he was going to extend the Reagan policies, but the problem was that the business cycle was deep into its seventh year of expansion and the Fed was hiking interest rates (the U.S. entered a recession in 1990).

When Bill Clinton was running for office in 1992 the impacts from the real estate recession and S&L crisis a couple years prior were wearing off and the business cycle was about to set sail on one of the most historical technological advancements in U.S. history. He had to do nothing more than allow it to happen, which he did by shifting to the center and watching a tripling in the S&P 500.

Then came George W. Bush, and who would have thought that a pro-business Republican from Texas would see a stock market crushed -35% over his term? It's not as though there was much he could do about it – he was inaugurated at the peak of the Dotcom bubble. Not only was this the most overvalued stock market in U.S. history, but the business cycle was in its eighth year of its expansion and the Fed was busy raising rates.

Hard to tell how history ultimately judges President Obama, but his timing for entering into office couldn't have been any better from the standpoint it would have been hard for it to be any worse. He was inaugurated in January 2009 during the depths of the Great Recession with the S&P 500 set to trough at 666 within a month and a half of him becoming President. It was the bottom of the worst recession since the Great Depression and the Fed had already cut interest rates to zero with the first of its QE policies ready to roll. The only surprise of the strong performance of the stock market during Obama's two-terms is perhaps the fact that the S&P 500 tripled on the back of the weakest post-WWII recovery in terms of economic growth.

President-elect Trump is set to start his term with a set-up much more common to Bush Sr. and Bush Jr. – an aging expansion, valuations at cycle highs, and the Fed raising interest rates. Maybe this time is different and one man with the supposed full backing of both the House and Senate can defy economic history and financial history. If you take President-elect Trump's campaign promises as a base case and then work off that (understandably working to the center on some of his extreme promises) you're still left with a world that is more uncertain today than it was two months ago.

So I urge investors to not abandon prudence, objective thinking, and investing discipline. Protectionism, isolationism, and anti-globalization policies worry me – not because they can't work, but because the last four decades have been a progressive global agenda in favor of them working. To think that doing an about face on this foundation will have no consequential impact during the transition period (if this is in fact the path that is chosen) is naïve, in my opinion.

My biggest concern is an interest in fighting yesterday's war. The most significant factor that has hollowed out U.S. manufacturing is technology. Plain and simple. And it's not just a U.S. phenomenon as manufacturing employment in China has declined by almost -2 million jobs since 2013. Talk about a weird twist of fate when the U.S. has gained +200k manufacturing jobs since 2013 – this isn't a statistic you heard about on the campaign trail. But it doesn't stop there – manufacturing employment across the globe has been on a steady decline over the last three decades, be it Germany, the U.K., South Korea, Brazil, and even Australia.

To think that the advancement in robotics and Artificial Intelligence is going to stop with the threat of tariffs and moving jobs overseas is foolish. What is also foolish is playing the blame game while pointing the finger at China and starting up a trade war with the second largest economy in the world.

Yet, the irony in this election is that President-elect Trump made promises to what has become his base constituency in the rust belt that we are just a few tariffs and a few watered down trade deals away from recreating those previously lost jobs. Moreover, if he doesn't deliver these jobs he risks being a one-term president and we all know that once you're in office, your job from day one is governing to stay in office.

The margin of safety and room for error is razor thin when you're talking about a stock market that according to a wide swath of valuation metrics is one of the top three most expensive stock markets in U.S. history. The following table from Goldman Sachs' research team aptly summarizes this data where the S&P 500 today on a median stock basis is in the 98th percentile:

Exhibit 32: S&P 500 aggregate and median P/E over time

as of November 28, 2016

Source: IBES, First Call, Goldman Sachs Global Investment Research

Exhibit 33: S&P 500 is expensive on most metrics

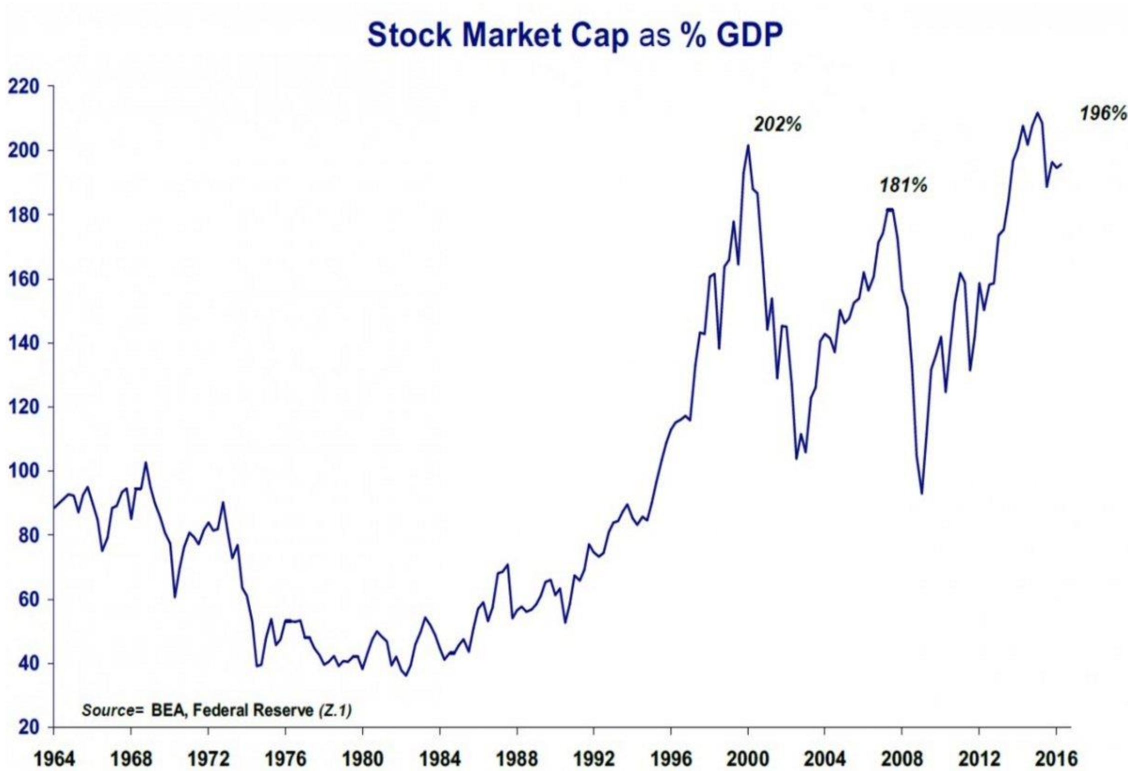
as of November 28, 2016

S&P 500 valuation summary

	Aggregate index		Median stock	
		Historical		Historical
Metric	Current	%ile	Current	%ile
P/E to growth (PEG)	1.5 x	96 %	1.9 x	100 %
EV / Sales	2.1 x	94	2.7 x	100
EV / EBITDA	11.3 x	88	11.5 x	99
Price / Book	2.9 x	73	3.2 x	98
Forward P/E	17.1 x	85	17.5 x	94
Free cash flow yield (FCF)	4.4 %	42	4.6 %	33
Cyclically adjusted P/E (CAPE)	23.4 x	82	NA	NA
Median		**85 %**		**98 %**

Source: Compustat, First Call, IBES, FactSet, Goldman Sachs Global Investment Research

For those that prefer a simpler, more visual take, the following chart is a favorite of Warren Buffet as it measures the value of the stock market as a % of GDP – which is suggesting the very same thing as the data above in the Goldman table:



One last thought as I'm wrapping things up and that pertains to diligence, prudence, and care. When I was working my way through the CFA curriculum (which I never completed, but it does have a meaningful impact on how I analyze and work through investment decisions) one of the core areas of study was their code of ethics. Within this code of ethics it states that,

> "Members and Candidates must exercise diligence, independence, and thoroughness in analyzing investments, making investment recommendations, and taking investment actions".

The reason I call attention to this statement is that it's easy to lose sight of this duty and responsibility in this profession when markets are racing to all-time highs – the reasons for it happening may not make sense, but just go with it because you can't fight it. However, those with a longer-term need and demand on their capital base cannot afford to sacrifice a future need that spans twenty or thirty years for the sugar rush of the next couple weeks or months.

Take the start of this century for example. It was the best of times in 2000 where the U.S. economy was hot to trot and few envisioned anything could go wrong. Then the Dotcom bubble popped in March 2000 and preceded to decline -49% until it bottomed in late 2002. It wasn't until July 2007 that the S&P 500 got back to its March 2000 high. Seven full years of trying to get back to even, to only have the S&P 500 peak once again in October 2007. This time the S&P 500 plunged -57% and it took until March 2013 for it to reclaim the level it first reached in March 2000.

What I'm getting at is that in the 192 months that span this century, the S&P 500 has been higher than the level it reached in March 2000 less than 25% of the time. Just as the tail end of 1999 / beginning of 2000 or the fall of 2007 didn't represent a great entry point to get all bulled up and load up on equities – today is no different. High valuations and animal spirits don't mean that the bull market ends tomorrow, but for those investors uninterested or unable to spend potentially a lengthy period of time getting back to even then I advocate you remain patient, prudent and disciplined. This isn't to suggest you stop playing or stop investing, but don't abandon the investing principles you know have proven to be prescient over long periods of time.

In the end, price and valuation matter, and it's my view that if a price of an asset cannot be justified based upon an adequate and reasonable basis and the investment is not supported by appropriate research, it should not be purchased. There is an abundance of investments in the current climate that fail this level of scrutiny.

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