September 26th, 2016

You don't have to play…

The 'buy everything rally' was back in full-force last week (at least for a couple days) following the Federal Reserve's decision last Wednesday to take a pass at making any changes to monetary policy at this time (more on the Fed below). As a result markets reacted in customary fashion with equities rising on the week led by the more cyclically oriented and higher beta segments (Russell 2000 +2.43%, Dow Transports +2.14%, S&P 500 +1.19%, Nasdaq +1.16% and the Dow Jones Industrial Average +0.75%). Emerging Market equities put in their best weekly gain (rallying nearly 4%) in three months furthering the year-to-date performance divergence between the MSCI Emerging Markets index (+16%) versus the MSCI All-World index (+4.4%).

Bond markets welcomed the latest dovish pivot in Fed policy with open arms as yields across the curve came down with the 10-year Treasury yield falling back to 1.60% from north of 1.72% early last week. German and Japanese 10-year yields moved back down into negative territory (-9 and -4 basis points, respectively) after temporarily flirting with positive yields.

Commodities, like most asset classes, remain ensnarled in a range with WTI oil prices toggling back and forth between $44 - $46 depending on the latest rumor from whatever OPEC official was last to speak. Gold is consolidating around the $1,340 level with investors embracing the potential flight-to-safety allure of the yellow metal in the event of global break down in perpetual central bank largesse.

So what about that Fed that appears to be so anxious to get a rate hike on the board, but just can't seem to get that darn economic data to corroborate their "case for an increase has strengthened" narrative? Yes, the Fed chose to take a pass at hiking interest rates last week which had to be a tough pill to swallow given their attempts to try and prepare the markets that a hike was possible leading up to the meeting. And you know what, it was the right move as almost every economic data report over the past month has come in below consensus expectations with many exhibiting a meaningful deceleration in activity.

The FOMC not only chose to take a pass at hiking rates but according to the updated 'dot plots' they took a rate hike off the table for both 2017 and 2018, which amounted to lowering the Fed Funds rate by 50 basis points by the end of 2018 to 1.875% from 2.375%. The terminal funds rate was trimmed again to 2.755% from 3.0% as they lowered their estimates for GDP growth and inflation while increasing their forecast for the unemployment rate.

Look, it's become commonplace to bash the Fed and poke fun at their dismal forecasting track record, but the fact of the matter is that they are backed into a very tight corner and doing the best they can in the aftermath of the most epic collapse in credit and asset values since the Great Depression. I find it humorous when I hear pundits advocate that a hike is necessary to build up the war chest to fight the next recession, or that it's only 25 basis points and the economy can handle it, so let's just get on with it. Have these people learned nothing from the debacle in 1937/38 when the U.S. was thrown back into a recession following the Great Depression as a result of a premature and ill-advised tightening in monetary policy?

Putting aside for a moment the fragility of the U.S. economic picture at the current time, investors need to be aware that the Fed does not (and shouldn't) operate in a vacuum. Almost every other major central bank on the planet is still easing policy or greasing the wheels to provide further monetary accommodation. That's why the cavalier calls that "it's only 25 basis points" sound so foolish to me given that's all the Fed did in December 2015 and that set off the worst start for the U.S. equity market in history, not to mention a sharp tightening in financial conditions and a stalling out of economic growth.

Back to the current state of the U.S. economy: we have employment growth decelerating and at its weakest year-over-year growth rate of this cycle, industrial production has been negative YoY for 12 consecutive months (has never happened before outside of a recession), and the trend in real PCE (personal consumption expenditures) growth is decelerating. Average annual GDP growth in 2016 is tracking about 1.5% (a considerable slowdown from the 2.6% pace in 2015) which is not only the weakest pace of this cycle, but also would be the third worst year in the last fifteen years. Just last week the Atlanta Fed lowered their Q3 GDP forecast to 2.9% (down from 3.8% in early August) and the New York Fed GDP model cut its estimate to 2.3% (both also lowered Q4 estimates into the low 1% range).

Last thing I want to highlight on this topic before moving on to the action at hand is the fact that it's been almost 4 ½ years since the Fed last saw its preferred measure of inflation reach its target. The U.S. economy as well as most of the rest of the world continues to suffer from secular deflationary forces (debt and demographics) which has fostered excess capacity in virtually every market. The solution to these problems is not higher interest rates, in my opinion, and if it is then investors best be prepared for a rough ride before reaching this destination.

Nevertheless, the Fed left the door open for a possible rate hike in December and as of now the markets are obliging this notion with Fed Funds Futures pricing in 50/50 odds.

However, there are almost twelve weeks until the December 14th meeting with a whole lot of event risk from now until then:

- U.S. election on November 8th, with the latest poll numbers showing Trump and Hillary in a very tight race as we head into Monday night's debate.
- Sometime in late November / early December they'll hold a constitutional vote in Italy with many people viewing this as a referendum on Italy's relationship with the EU.
- And, rumors are swirling that the U.K. is moving further down the path of invoking Article 50 which would set the ball in motion to separate from the EU (this is an unlikely event before year-end).

One quick thought as it relates to the U.S. election, and mind you I tread very delicately when wading through these waters, but my thought has more to do with math than the candidates or policies. While the polls have been tightening and recent momentum has definitely favored the Trump camp I would caution investors on putting too much capital behind the popular polls. The Presidential election is won through the Electoral College and on this front Mr. Trump has a much steeper hill to climb than Hillary. It takes 270 electoral college votes to procure the presidency and on this score the voting map skews 'blue' which makes the votes in the key toss up states such as Florida, Ohio, Colorado, Nevada, and New Mexico a necessity for Trump assuming the map falls similar to the last election where Romney only won 206 college votes.

Back to the capital markets where we learned last week that over the last twelve months through June net stock buybacks plus dividends paid by U.S. non-financial corporate businesses reached a record $1.24 trillion (breaking the previous record of $1.19 trillion at the end of December 2007). This was a 17.8% surge from June 2015, but that's where the bloom falls off the rose as this increase was accompanied by a -9.3% contraction in non-financial corporate profits from current production. Taking this disconnect a step further, in June 2015 the ratio of shareholder compensation (net buybacks plus dividends) to pre-tax operating profits stood at 79% compared to 103% in June 2016. This is the highest reading since Q3 2008 (113%) – a time when operating profits were in steep decline, and executives had little line of sight with regards to the severity of the contraction that was just around the corner – and before that you have to go back to June 2007 (104%) when this metric first pushed north of 100%.

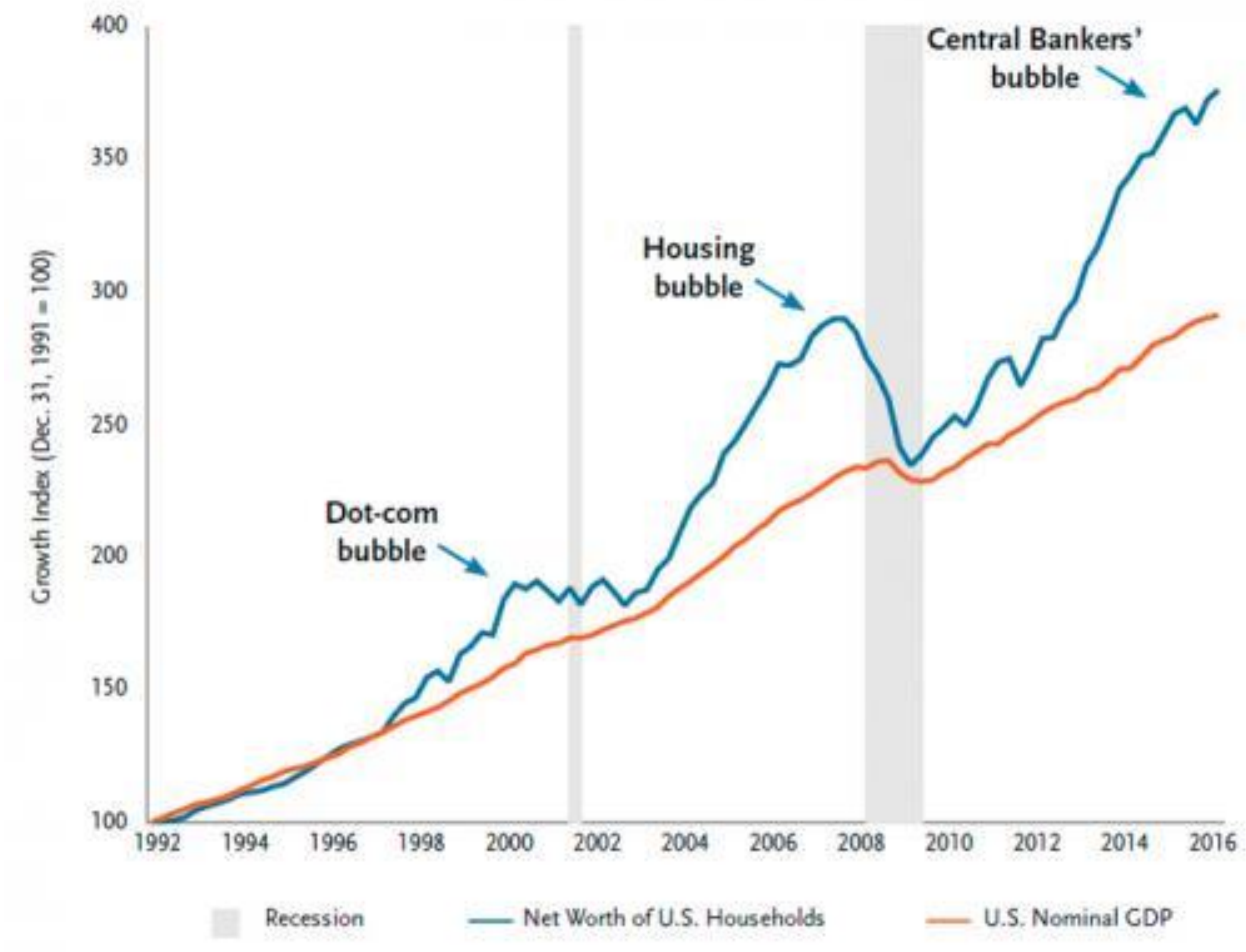
Not to sound any alarm bells (as of this moment we don't know if the June 2016 reading marks the top) but the last three times this metric peaked it was in close proximity to the end of these respective equity bull markets – Q4 2007, Q2 1999, and Q3 1989.

Now a resumption of profit growth could surely arrest this cautionary signal from flashing amber, but according to Factset it appears investors are going to have to wait at least one more quarter for earnings growth to flip back into positive territory. Earnings estimates for Q3 have moved back into negative territory for Q3 with Factset forecasting a -2.3% decline, which if it holds true would mark the sixth straight quarter of earnings declines. Though, on the plus side expectations are for revenue growth to come in positive (+2.6%) for the first time since the end of 2014.

It will be interesting to see how the final numbers come in when reporting season kicks off in mid-October as the economic backdrop has deteriorated throughout Q3, but corporate executives have been masters during this cycle at lowering the earnings bar just enough for them to beat when they report.

Now, while I stated earlier in this commentary that I can appreciate and somewhat empathize with the difficult position the Federal Reserve finds themselves in at this current juncture, I believe investors are also in as perplexing of a position. However, investors have an abundance of options when it comes to how they chose to navigate their capital through what is looking more and more like the twilight stage of this asset bubble.

Yes, I do now think we are in the throes of an asset bubble that transcends the three dominant asset classes that comprise a household's balance sheet: stocks, bonds, and real estate. In the U.S. each of these asset classes are at or near their all-time highs in terms of value and that's not up for debate. What can be debated is whether their respective values are validated by fundamentals and therefore the prevailing price levels can be sustained. I have my doubts, but I am also well aware of history which shows that expensive can get more expensive before it ultimately reengages with its intrinsic value. The below chart plots the trend in household net worth as a proxy for asset prices (stocks, bonds, and real estate) against GDP over the last two-and-a-half decades.



What you'll notice is that over this time period owners of assets (households) have experienced two periods which we now identify as bubbles (the tech bubble in 2000 and real-estate bubble in 2008). In each of these prior occasions it's easy to observe the divergence between asset prices (blue line) and fundamentals (GDP) and the eventual re-wedding of these two lines during the next economic downturn. I don't want to get too far afield with this topic as I don't want the simplicity of this observation to be obscured by complexity, but please don't mistake the simplification of this message as a lacking of foundation or analysis.

If excesses in technology in 2000 and excesses in real estate in 2007 (which propped up asset prices during those periods to varying degrees) were not sustainable then – why should we think that today's excesses are sustainable? After all, one of the key differences back then relative to today is that investors still had the luxury of choosing to (if they wanted to, which is easier said than done) cash in their chips in the stock market and move their capital into the bond market as it was still offering a mid-single digit interest rate yield (the 10-year Treasury yield was yielding north of 6.5% in January 2000 and north of 5.0% in June 2007). Investors don’t have this luxury today as interest rates globally have been pushed down to historical lows which has had the effect of forcing investors into risk assets and potentially accentuating the distortion in prices from value.

Let’s just isolate the present value proposition offered to investors by the equity market at the current time. I pulled the following valuation tables and data from a recent presentation put on by Meb Faber of Cambria Investment Management which highlights the historically rich valuations of U.S. stocks today.

This first table summarizes the three best 10 year return periods for U.S. stocks in history:

10 Year Ending	Nominal Return	Real Return	Start Dividend Yield	Start CAPE ratio	End CAPE ratio	CAPE Change per year
1948 - 1958	19.90%	17.76%	6.12%	10	19	6.25%
1988 - 1998	19.21%	15.61%	3.53%	15	39	10.20%
1981 - 1991	17.55%	13.12%	5.36%	8	18	8.94%

It's easy to marvel at the 17.55% - 19.90% range of nominal returns over these time periods, but what is equally as important to notice is the starting point for the Dividend Yield and CAPE ratio. The CAPE ratio (Cyclically Adjusted Price-to-Earnings ratio) takes into account the earnings stream for stocks over the preceding ten years rather than just using the trailing one year earnings or forward twelve month earnings (as is the case for the commonly used P/E reference). As you can see these high return eras started off of a very low valuation level and ended with high valuation readings.

The next table summarizes the three worst 10 year return periods for U.S. stocks in history:

10 Year Period	Nominal Return	Real Return	Start Dividend Yield	CAPE ratio Start	CAPE ratio End	CAPE Change per year
1964 - 1974	1.19%	-3.91%	2.98%	23	8	-9.60%
1928 - 1938	-0.90%	1.17%	4.50%	22	16	-2.97%
1998 - 2008	-1.38%	-3.82%	1.36%	39	15	-8.84%

This is the opposite set-up than what occurred to set off the best 10 year periods – lower starting dividend yield levels and higher starting CAPE valuation levels.

This last table averages the three best 10 year periods and the three worst 10 year periods while comparing them to the set-up today on similar metrics:

	Nominal Return	Real Return	Start Dividend Yield	CAPE ratio Start	CAPE ratio End	CAPE Change per year
AVERAGE 3 Best	18.89%	15.50%	5.00%	11	25	8.46%
AVERAGE 3 Worst	-0.36%	-2.18%	2.95%	28	13	-7.14%
NOW			2.00%	26	?	?

Which one does the current set-up more closely resemble?

For sure, valuation has always been a very poor timing metric to apply to shorter-term (tactical) investment decisions. But, for longer-term decisions, valuation is one of the best metrics to leverage when calibrating 5-10 year return expectations for equities. Now an investor may look at the worst 10 year return sequences and conclude that it just looks as though stocks were flat for ten years and that's an acceptable cost for investing in stocks. While that is an accurate observation it is extremely lacking of context.

In the 1964–1974 period investors had to weather the storm of three bear markets – a -22% draw down in the S&P 500 in 1966, a -36% draw down in '68, and -48% draw down in '73. In the 1928 – 1938 period you had to stomach an -86% peak-to-trough decline starting in September 1929 and another -60% plunge starting in March 1937. As for the 1998 -2008 period (most of you are all too familiar with this time period) where the S&P 500 experienced a -49% decline starting in March of 2000 and a -57% pummeling beginning in October 2007.

All I'm getting at is that the environment for investors today is extremely challenging with very few options that offer a favorable risk/reward trade-off. Sure, you can chose to play the game and already richly priced assets could very well get more richly priced. If this is the course an investor is willing to choose, just be aware that you are doing so at a time when asset prices are not only at or near all-time highs on an absolute basis, but they are also at or near all-time highs on a fundamental basis.

Or, you could choose not play the game. Nobody ever said you had to and, after all, the main objective for investing is to compound your wealth over time. The best way to do so is by not subjecting your capital to significant downside outcomes which is a conundrum for prudent investors at the momentum with today's capital market set-up exhibiting an increasing probability of such an occurrence.

It's not an easy decision and I'm not suggesting investors should sell everything and abandon ship, but get defensive, get hedged, and lock in some gains from a significant multi-year run in most asset classes – Yes I think that's prudent.

At times cash is an investment (it is a store of value) and even though it currently pays little to nothing, today is one of those times. I'm certainly not a big advocate of market timing on a short-term basis as it has proven to be a recipe for underperformance, but I also have been unable to come up with a fundamentally sound analysis for why this time is different than all the times in history that we've been at a similar juncture. What's more, is that we're in an era of central bank actions that we've never experienced before – I know, you could argue that variable for both the bullish camp and the bearish camp. I remain in the latter camp and think that the pervasive confidence investors have instilled in the actions of central banks is nearing its expiration date.

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