March 6th, 2017

Valuations are an important indicator for long-term returns…
Lost in the shuffle of President Trump's latest tweet tirade over the weekend was the fact that this bull market that began back in March of 2009 just reached its eight year anniversary. Depending on how one defines the criteria for a bull market the verdict on this one relative to history is up for debate, but at its core it nears the top of the list in both magnitude and duration.

The setup for investors today versus this time eight years ago could hardly be any further apart with sentiment indicators hitting bearish extremes back then while they touched cycle highs last week:

- The economy was knee deep in the worst economic contraction since the Great Depression versus a persistent (while sluggish) ongoing recovery today.
- Equity valuations were cheap with stocks having just endured a -57% peak to trough decline versus valuations today that rival some of the richest in stock market history.
- And monetary policy in December 2008 was just embarking on its Zero-Interest-Rate-Policy (ZIRP) experiment with an unknown (at the time) number of QE renditions yet to come versus a Federal Reserve at this time that is more adamant about normalizing interest rates than at any other time during this recovery.

One common thread between today and this time eight years ago is the need for investors to embrace, assess, and adapt to a change of leadership not only in person, but also in party as back then it was Obama riding the wave of a hope and change optimistic message versus President Trump's "Make America Great Again" rallying cry.

I don't think you'll find many complaints among equity investors if the performance of the stock market under President Trump can match that of his predecessor.

As for the stock market, it notched its sixth straight week of gains last week mostly on the heels of the jovial 300 point rally in the Dow Jones Industrial Average the day after President Trump's address to Congress. Your guess is as good as mine as to what prompted the large surge in stock prices as once again the promise for deregulation, tax cuts, and infrastructure spending was pronounced, but yet little in the way of details was provided as to what form they'll take and when these policy goodies may come.

Keep in mind that these campaign pledges are the same ones that everyone used to explain why the stock market rallied over +6% from the election through Inauguration Day. So, for the stock market to have rallied an additional +4% from the Inauguration through last week's address to Congress is a bit much and speaks to the level to which algorithmic trading is driving the momentum in markets at this juncture.

I'm sorry, but for the stock market to rally more than 1% on the widespread view that President Trump appeared presidential because he stuck to the script and read from a teleprompter – come on. To me that suggests more about how far we have lowered the bar than anything else. While the tone and delivery was a welcome change, within the actual speech were still undertones of protectionism and a token endorsement of the border-adjustment tax.

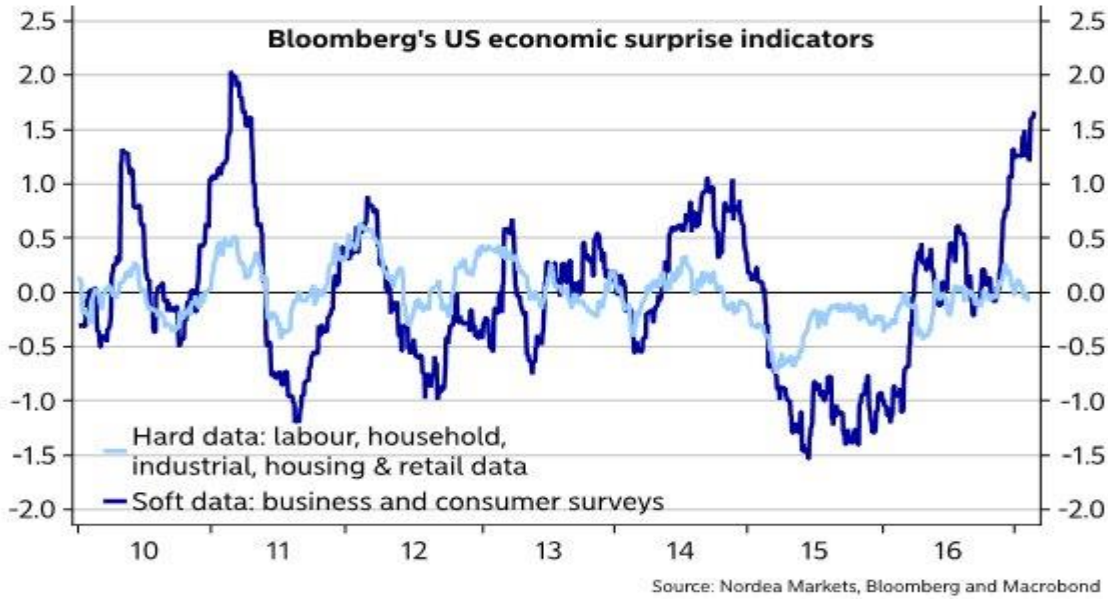
Nevertheless, it isn't really worthwhile to spill much more ink on this subject at the moment because in time we'll get some actual details that accompany the political agenda and from there investors will be better equipped to make some informed decisions on the capital markets. That isn't to say some rigor, research, and analysis on potential scenarios from what is known about the new administration's policy agenda won't be helpful, but meaningful portfolio action is another story all together.

One example is the potential for a border-adjustment tax which while providing incentives to U.S. firms to favor domestic versus foreign production and potentially improves our exports, it puts a lot of stress on the retail sector and ultimately (in my opinion) sets off a consumer recession before anything else happens. Keep in mind this is the same consumer that comprises 70% of the GDP picture that the U.S. economy so dearly needs to grow in order to support a suffocating level of outstanding debt and lofty equity valuation levels.

Several Fed members were out on the speaking circuit last week with Governor's Brainard, Powell, and Dudley striking a hawkish tone in their respective comments and signaling that a March rate hike is in order. This pushed Fed Fund Futures up to a roughly 90% probability of a March move and setup last Friday's speech by Chair Yellen to put the rubber stamp on the market's anticipation of a March hike – which she did. As a result the futures markets have moved to a 96% probability of a rate hike coming at the meeting on March 15th.

As I suggested last week, the next couple of months surely provide an interesting set up with the next two weeks jam packed as central bank meetings get under way in Europe on Wednesday, a BoJ and Fed meeting next week, and the debate on the debt ceiling coming back into the equation after a 15 month hiatus. Moreover, the next several months will provide either confirmation that the animal spirits that have ignited business, consumer, and investor optimism following the U.S. election will actually turn into tangible economic activity or show that it is nothing more than a huge head fake of dashed hopes. Don't overlook elections in the Netherlands and France where candidates touting the populist/nationalist agenda have better than a puncher's chance of emerging victorious.

One thing that continues to stand out like a sore thumb in the economic data is the divergence between the survey data and the actual "facts on the ground" data.



The hard data from last week all came in with a rather tepid and sluggish underbelly with auto sales declining -0.2% month-over-month, industrial production falling -0.2%, a -1.0% drop in construction spending, and real consumer spending sliding -0.3%. Why this is meaningful is that all of these components go into the GDP calculation and as a result you saw Q1 GDP estimates going under the knife last week with the Atlanta Fed cutting its estimate from 2.5% to 1.8%, and many Wall St. economists coming down to 1.5%.

The last time we witnessed such a large divide between perception and reality was back in 2010 and 2011 where in both cases the surveys caught down to the hard data – not the other way around.

Take last week's auto sales data for example, where J.D. Power estimates that incentives per vehicle amounted to $3,830 in February which represents a 10% increase over year ago levels and more than a -10% haircut to the list prices (for the eighth straight month). It's also worthy to point out that this is occurring with inventories at 9-year highs at over 70 day's supply and cars coming off lease are set to hit multi-year highs (suffice it to say that bloated inventory levels won't be helped by this). These are what you see in the late stages of a business cycle, not in the beginning or middle stages when there is still pent up demand coming out of the prior contraction.

This is not something that is being missed by the bond market where interest rates are increasing on the short-end of the curve in anticipation of Fed hikes, but the long-end of the yield curve has barely budged. As a result the 30-year/5-year Treasury yield curve has compressed to its tightest level (105 basis points) since last September (just prior to the pick-up in global economic data and prior to the U.S. elections). Recall that it is steepening yield curves that are pro-growth from a forecasting standpoint while flattening curves induced by Fed tightening cycles are precisely the opposite. This doesn't mean that the economy or markets are set-up for an imminent fall, but unless this trend reverses itself then investors should learn from what this was signaling back in 2000 and 2007 – well before the equity market caught on to what was underway.

Look I continue to be of the view that complacency and confidence are running too far afield from reality and this is occurring at a juncture with both geopolitical and economic uncertainty reaching heights we haven't seen in some time. The world to me today is more complex than at any point I can recall in this century when you consider the potential impacts of walking back the multi-decade push towards globalization.

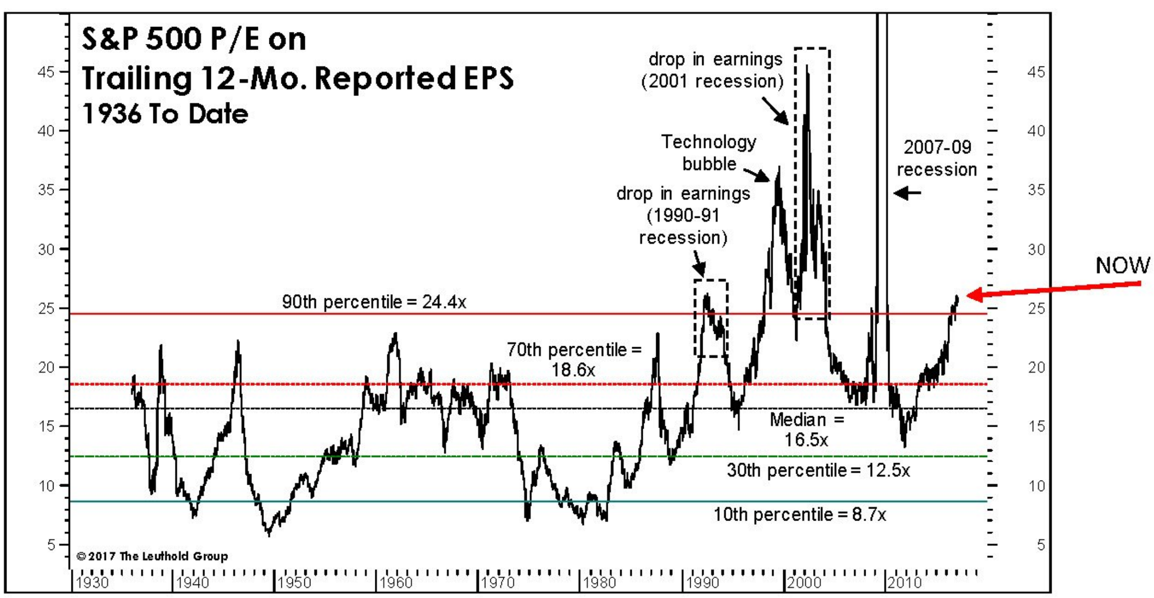
As if that potential tectonic shift wasn't enough, we have global central banks starting the process of removing the most unprecedented level of monetary policy accommodation in history where interest rates were held at zero for virtually eight years and with central bank balance sheets at levels never imagined in the pre-Global Financial Crisis era. After all, the Fed held interest rates at 1% from June 2003 to June 2004 before implementing seventeen 25 basis point hikes over the course of 2 years which led to the greatest extension of credit in the history of the U.S. economy – all of which culminated with the popping of the housing bubble.

Is it that unimaginable to think that there hasn't been a similar (possibly more severe) misallocation of capital in the later stages of this cycle? Rack a history book and you'll unearth that 10 of the last 13 Fed tightening cycles have ended with a recession – I don't think this will be any different. What you'll also uncover with history is that since 1900 we've never had a transition from a two-term President with a change of party leadership and not experienced an economic recession within 18 months of the new administration.

At this point the post-Trump honeymoon rally in the equity market is approaching record territory, sitting second to only Herbert Hoover and we all know how that ended. The fact of the matter is that you never know what you're going to get – Obama implemented a socialist agenda, but that didn't stop the stock market from tripling. George W. was highly touted as a pro-business guy, but he couldn't help getting run over by a stock market that declined -35% given it was bookended by the popping of the Tech Bubble and Credit Crisis.

Extrapolating today's market performance into the future and crediting it all to the election of Donald Trump is likely a mistake, just as it will be a mistake to put 100% of the fault on his lap if the stock market or economy falter. To my memory there's never been an economic cycle or bull market that hasn't ended and while we may not be in the 9th inning of this one we are likely beyond the 7th inning stretch.

One argument I continue to hear on bubblevision is that valuations are a terrible market timing metric, and depending on the context of this debate there is some validity, but it is very informative on what future returns investors could expect. Said another way, valuations don't tell you when you're going to fall, they are more helpful in telling you how much you fall when things go bad. Which is why long-term investors should adhere to some discipline and prudence when we see valuation levels like were experiencing today.



As indicated by the above chart from The Leuthold Group, outside of a recession (which causes a significant decline in earnings) and the tech bubble in ’99 -’00, in the 80 years since 1936 we haven’t seen a stock market trade at a more expensive trailing P/E than we are at today. With that being said investors should be favoring late-cycle themes in their portfolio positioning. This doesn’t mean moving all to cash – although raising some today to put back to work later seems prudent – but seeking out opportunities in a global market place where for the last five years it’s been U.S. stocks or nothing.

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