May 15th, 2017

Can investors afford to be wrong?

Over the last three weeks the U.S. equity markets are doing their best impersonation of what it would be like to watch paint dry or grass grow as the S&P 500 has traded within a 20 point range (high of 2,403 and low of 2,381) since April 25th. Just so you can see for yourself how unexciting the action has been at the index level for equity investors, the below table details the closing price of the S&P 500 over the last three weeks where the closing price levels are in an even narrower 15 point band.

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S&P 500 Daily Close

DATE	Price
05/12/17	2390.90
05/11/17	2394.44
05/10/17	2399.63
05/09/17	2396.92
05/08/17	2399.38
05/05/17	2399.29
05/04/17	2389.52
05/03/17	2388.13
05/02/17	2391.17
05/01/17	2388.33
04/28/17	2384.20
04/27/17	2388.77
04/26/17	2387.45
04/25/17	2388.61

This is somewhat disconnected from what is occurring within the index constituents as the number of stocks falling below their 200 day moving averages continue to increase and is a clear negative in terms of breadth and overall market health. Accentuating this point is the

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fact that since the S&P 500 first hit 2,400 on March 1st just five stocks (Apple, Google, Amazon, Facebook, and Netflix) have added roughly $260 billion in market cap while the remaining stocks in the index have lost a similar amount, channeling Rule #7 in famed market technician Bob Farrell's "10 Rules of Investing": Markets are strongest when they are broad and weakest when they narrow to a handful of blue-chip names.

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It’s a timely exercise to revisit all of Mr. Farrell’s rules and overlay them with some thoughts on the current environment:

1. **Markets tend to return to the mean over time.**
   Famed investor Jeremy Grantham of GMO says that “profit margins are probably the most mean-reverting series in finance, and if profit margins do not mean-revert, then something has gone badly wrong with capitalism. If high profits do not attract competition, there is something wrong with the system and it is not functioning properly”. There is no shortage of academic work supporting and validating this claim and it is an important relationship for investors to assess at the current time with profit margins hovering

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near not only their highs for this business cycle but also all-time highs.

I don’t care to get into the nuances and wonky financial math of profit margins in this missive as I think it would distract from what I feel is the more important point for investors to consider. Profit margins are a key ingredient that feed into corporate earnings and in what is the weakest economic expansion in the post-WWII era, where it has been challenging for businesses to move the needle in overall corporate revenues, their focus has shifted to other business management strategies to drive growth and profits, i.e. cost cutting, cost containment, capturing more market share, or competitive pricing for their good or service.

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If economic growth remains sluggish and the 2% average annual rate in real GDP growth that we've experienced during this expansion is the reality of what's to come, then investors should consider that we've likely seen the cycle high in profit margins. Margins are already coming under pressure from a fully employed labor force which is what the 4.4% unemployment rate is suggesting. What's more is the inflation data on the consumer level per last week's tepid core CPI reading of 1.9% in April (this reading was 2.3% in January, 2.2% in February, and 2.0% in March – see a pattern here?) suggests that price increases are not being and can't be passed along to the consumer.

This lack of pricing power makes sense with the industry capacity utilization rate at 76%, which is another way of saying we

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have 24% idle capacity relative to the capital stock, a level that is unheard of this deep into an economic expansion. Nevertheless, this just attests to the amount of excess slack in the system. Add to all of these undercurrents the speed at which technological innovation is moving today (be it robotics, artificial intelligence, 3D printing, drones…) and it only furthers the cost cutting pressures in the wake of this revolution.

So with an economy about to enter into the eighth year of this expansion businesses are at the point where they have to contend with an environment where profit margins start to come under pressure from a myriad of sources, but this portends slower corporate earnings growth and eventually lower equity market valuations.

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2. Excesses in one direction will lead to an opposite excess in the other direction. For me this one is all about the Fed and global central banks collectively. I just find it beyond hypocritical for central bankers to continue to comment on how strong the economy is or how they expect it to continue to strengthen in the future yet there is still over $200 billion per month in asset purchases being implemented via QE. In my view, a strong economy does not need the artificial support of additional asset purchases, let alone interest rate levels that remain near all-time lows.

For sure, we are now nearly a decade removed from the start of the Global Financial Crisis, but it is obvious that the scars remain. History suggests that this is customary where the workout period following a severe balance sheet recession

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is long and uneven. The best reference point for the U.S. is the Great Depression which some historians argue was a result of the excesses built up in the roaring 1920's (excesses that have a lot of parallels with today in regards to the build-up of debt and government encroachment on capitalism). 10-year Government Bond yields were just under 4% when the Great Depression started and didn't reclaim that level for good until the 1950's.

The excess that worries me most today is the debt load that has been piled onto the system at a juncture were the Fed has very little latitude in pushing interest rates any lower. You see, we are at the point now where we can't pull any more consumption forward through the allure of cheap financing – we've borrowed as much activity from the future as possible.

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Unfortunately, it gets me thinking that the U.S. financial system is much more like Japan than I was ever willing to entertain a short five years ago. This isn't to suggest that we are destined to follow in their footsteps (not that it would be a terrible outcome as that culture has one of the highest per capita living standards in the world and their infrastructure, manufacturing prowess, and technological capacity are top shelf), but it is harder to be as dismissive today than in the past when you consider where they were in 1990 relative to where they are today and where the U.S. was in 2000 compared to where we are today. There is more symmetry and parallels than any of us would like to see, the biggest one being the aging of the demographic profile and burdensome debt load.

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3. There are no new eras — excesses are never permanent.

I'm seeing a growing number of arguments that "this time is different" where central banks have the situation under control or that a pro-business administration is the panacea to what ails this economy, or that the business cycle has permanently been abolished and we are now in an era of persistent expansion.

For one, I fancy myself a student of history (of which there is still a lot for me to cover), but I don't know of any expansion in the history of the U.S. that has never ended. Business cycles are as natural as nature itself – there is a certain rhythm to both of them and like nature that rhythm can sometimes seem inhumane, barbaric, and painful when the downside of a

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business cycle occurs. However, as with nature it's the forest fire or the weeding out of the weak in a herd that allows for new growth in the circle of life.

History is also littered with examples of how we as humans thought we knew what was best for nature and tried to control it – have a look at what the National Forestry Service learned the hard way after believing it was their responsibility to stop forest fires. A similar fate awaits any individual or entity that thinks they have figured out the formula to control the business cycle. The most important variable in any model that measures the economy and capital markets is human nature. The problem with that is that human beings are at times irrational and as a result can't be modeled with accuracy.

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This is a lesson that we seem to have to be reminded of time and again – typically at the extremes of the business cycle, where at the height of a bull market investors are gleeful and exuberant that the good times will never end, or on the other end when we're in the depths of the recession and investors are in despair and disgust that there will never be another recovery.

4. Exponential rapidly rising or falling markets usually go further than you think, but they do not correct by going sideways.

This one is more difficult to contextualize on a broad market basis because it requires a time period for reference. If one were to evaluate the market from the end of 2014 when the S&P 500 was just below 2,100 and compare it to today at 2,400 you would be hard pressed to conclude this constitutes

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a rapidly rising market (that's about a 5.5% annualized return over that 2 ½ year period). Not bad for sure, but a far cry from an exponentially rapidly rising market, and nowhere in the vicinity of a failing market. As for the latter, you'd have to go back to the start of last year to find the last time investors experienced a more than 5% decline in the stock market that was actionable (I say actionable because the Brexit decline last June lasted all of about 72 hours and within a couple of weeks markets were back to their pre-vote levels, and it was less than 15 hours following the Trump victory that markets were above where they were prior to the vote).

So, I don't have much more to offer on this one other than the conditions that should cause one to consider this a positive or

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negative don't seem to be prevalent today. One place where a rational argument could be made would be the relationship between prices and fundamentals. On this front, I've been of the view that stock prices have separated themselves from fundamentals since the end of 2014. Even after the solid Q1 earnings season, Q3 2014 still represents the cycle peak for S&P 500 earnings whereby the more than 25% gain in the S&P 500 since that time has been all P/E expansion. As for the economy, Q1 2015 was the peak in terms of the rate of GDP growth on a year over year basis (as it was for employment growth and several other economic growth metrics).

Nevertheless, at some point fundamentals and valuations will matter, but today they don't and there is no telling when that time will be or at what price level we'll be at

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when they do. Keep in mind a realignment between prices and fundamentals could occur by the latter catching up to the former – this would be a welcome development to many – but it's hard (not impossible) to see this manifesting itself with what I'm seeing below the surface in the economy and credit markets today.

5. The public buys the most at the top and the least at the bottom.

Based upon the latest investor's intelligence readings where bulls outnumber bears by a 3:1 margin, this is high when compared to history but off the highs of the cycle reached back in late-2014 / early-2015. However, we are witnessing a meaningful surge into index funds this year on the part of retail investors at a time when equity ownership as a percentage of household net worth is

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near the all-time high it reached back in the Tech Bubble. The widespread use of ETF's to gain market exposure is to a degree rendering security selection somewhat obsolete as investor mentality has shifted in a manner that makes them price-insensitive buyers – bidding up bad companies with the good just because they're in an ETF that provides them with the market exposure they are seeking.

6. Fear and greed are stronger than long-term resolve.

Greed is definitely a more powerful emotion than fear at the current time with volatility readings in both the equity and fixed income markets trading at their lowest levels of this cycle and near some of the lowest readings in history. Moreover, the FOMO trade (Fear Of Missing Out) is in full bloom as investors quickly dismiss

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(most recently, blatantly ignoring…) any form of negative news, be it geopolitical risk, policy delays from this administration, a Fed determined to normalize interest rates, and a discernable weakening in economic data.

The below chart plots the S&P 500 (white line) against the Citigroup Economic Surprise Index (orange line) which measures whether incoming economic data is coming in above or below expectations. Historically there is a statistically significant positive correlation relationship between these data series with the Citigroup Economic Surprise Index tending to lead the stock market. This index recently peaked at +57.9 on March 15th following the hopes and expectations coming out of the election, yet at last read it has cratered to -29.5 (confirming that

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over 80% of the economic data readings over the last two months have come in below expectations), and the S&P 500 hasn't even blinked.

7. Markets are strongest when they are broad and weakest when they narrow to a handful of blue-chip names.

I touched on this above with only a handful of Large-Cap growth stocks carrying the load for the market. Further confirmation

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of this narrow breadth is visible when you see that the average stock is down almost -10% from its 52-week high (the median is down -7%), and the extent to which Transports (+0.26% year-to-date), Financials (+2.1% ytd), and Small Cap stocks (+1.9% ytd) are lagging the overall market.

8. **Bear markets have three stages — sharp down, reflexive rebound and a drawn-out fundamental downtrend**. We will revisit this when (if) the time comes – until then just take Bob's word for it.

9. **When all the experts and forecasts agree — something else is going to happen.** I could have picked one of several topics to elaborate on in this section where the

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consensus view has been far afield from what actually transpired since the narrative got recalibrated by Wall St. coming out of the election last fall (interest rates, inflation, economic growth). But I want to touch on the evolving view of Trumponomics and the increasing probability that it goes up in smoke – recall what the market's expectations were going into the election if Trump won and how quickly it changed following the election.

Keep in mind that any of the following remarks are not a dig at the President – yes, I do have my personal views about him and this administration, but I don't have the luxury of allowing those to cloud my objectivity when it comes to analyzing markets.

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The amount of ink spilled in this weekend's periodicals on Trump and everything going on that involves this administration was overwhelming – I simply could not get through it all. However, I did get through enough to determine that the bar for this administration to get anything done in terms of policy that will move the needle for the economy or markets is now set extremely high. Yes, there was a certain novelty about having an outsider, businessman, and different type of personality in the executive suite and this novelty brought with it a belief of hope, change, and progress. I get it, as an open-minded observer and evaluator, what was transpiring following the election and the spike we experienced across virtually every survey based economic metric (many of

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them surging higher after November, some even making cycle highs) was electric.

However, anyone paying attention has to also admit at this time that most, if not all, of that novelty has worn off – not so much for his devoted base, but surely for just about everyone else and in particular the independent voter. After all, it was these independent voters that pushed him over the top in the key battleground states that ended up getting him the Electoral College victory. All else aside – the fumble with healthcare, the constant badgering with the media, his off-the-cuff and unfiltered tweets, discord toward the Democratic party (which more than anything handicaps his ability to get even bipartisan policy initiatives through), the Comey firing, or the inability to get beyond the Russia rumor mill (although the media can take as

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much credit/blame for this issue) – it's the recent polling numbers that were released that should give anyone with high hopes for his agenda pause.

Per the latest Quinnipiac poll (and this is a widely-respected source) Trump's overall approval rating has slid to 36% while his disapproval rating is at 58%. What was a bigger surprise to me, and is troublesome to the Trumponomics agenda if these numbers don't reverse course, is that 54% of respondents want a Democratic House in the 2018 midterm elections (this compares to only 38% for the GOP) and this 16 point gap is the largest on record.

I interpret these results through two possible scenarios that then branch out from there. First one being, he has nowhere to go but up. Sure, it's easy to dismiss

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given the roughly four months of observation time we've had, but this is a President (for better or worse) that doesn't have a problem pulling a 180° and changing his mind. So, it's possible that this administration steps back, does a self-evaluation and starts working towards resetting public perception. That's not to say it will be easy or even likely, but as much as this nation and its constituents wanted what he was selling coming out of the election you cannot underestimate how quickly the current discontent could turn back into praise with some promises that turn into policy.

The other scenario, and the more dire one for markets, is that this entire pro-business / pro-growth agenda is derailed. Just look at the calendar – it's already the middle of May and it seems as though the Senate is

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going to take its time to recraft the heath care bill sent over from the House – so they mark it up as it's likely it wouldn't pass the House when it gets passed back… rinse wash repeat, then we're upon summer recess in August while we have another budget bill and the debt ceiling on the docket in September. Before you know it it's the end of the year and once we flip into 2018 all sights will be set on campaigning for the 2018 mid-terms.

Should there be little changes in the current poll numbers it is only going to get harder for an already fractured and divided GOP to get through any legislation (let alone legislation that the public disapproves of – like the recent version of the healthcare bill put out by the House). Couple the potential for little to nothing of substance coming from fiscal policy with tightening

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monetary policy and markets are potentially looking at a reality check.

10. **Bull markets are more fun than bear markets.**
This one speaks for itself, full stop. The only thing I'll add here is that investors should be focusing their attention outside of the United States in search of bull markets that likely have more left in the tank. Broadly speaking international markets have lagged behind the U.S. bull market this cycle, have much more appealing valuation levels (said plainly, they are cheaper), monetary policy acting as a tailwind with additional levers to pull, and superior earnings tailwinds. This year this approach is so far so good with the MSCI World Index (ex-U.S.) nearly doubling the performance of the S&P 500, the broad based Emerging Markets Index

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has outperformed the S&P 500 by almost threefold, and Frontier Markets (another market I like over the long-term) is up 2.5x the S&P 500.

One final thought in closing things up this week, and I don't want to leave it on a somber note nor do I want it to be construed as doom and gloom or me coming off as a fear monger, but while I consider hope as one of the greatest sources of strength and motivation any individual can believe in and buy into to get through various parts of the life – it is not a prudent investment strategy. Where I'm going with this is the capital markets today across almost the entire gambit of allocation choices (stocks, bonds, commodities, real estate, cash) are offering investors some of the lowest rates of returns in history for their respective risk characteristics. The following chart from Rob Arnott at Research Affiliates

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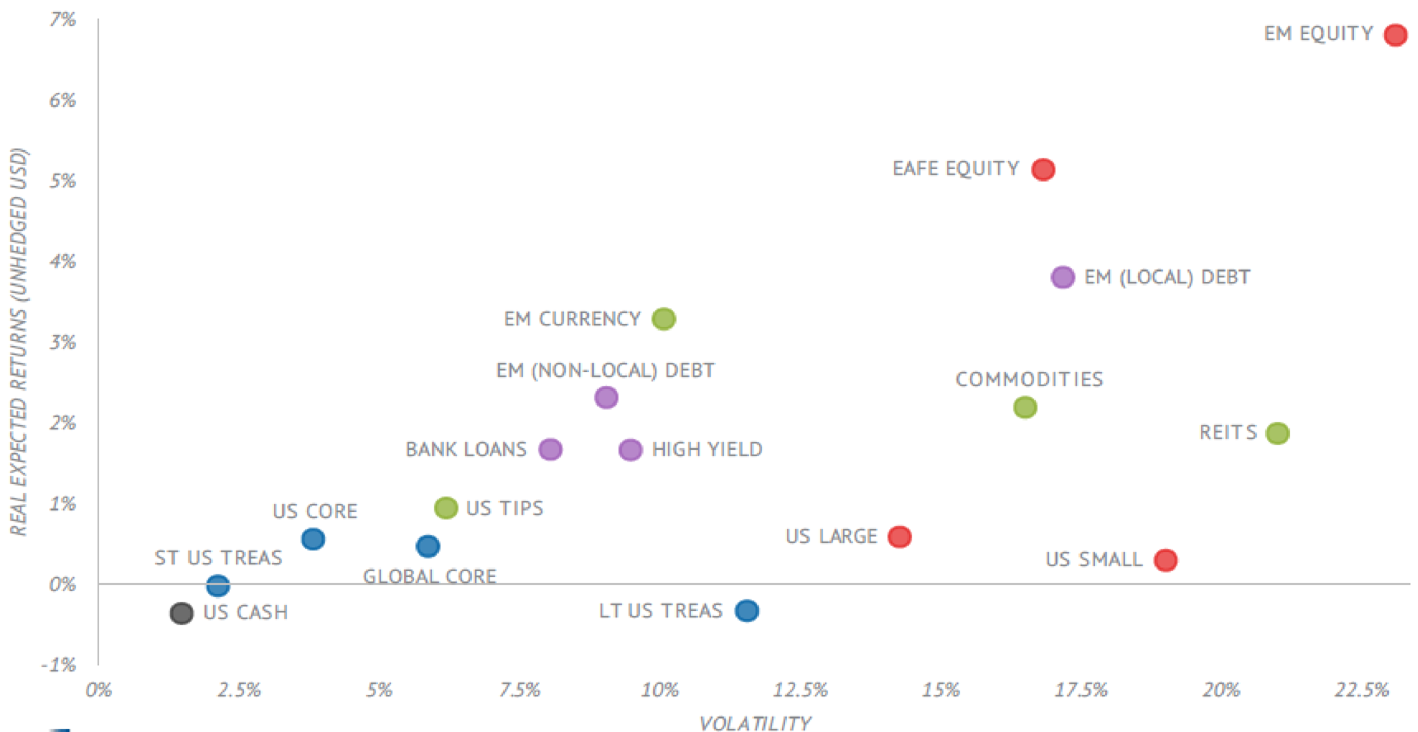
aptly captures this middling opportunity set for investors where international stocks and emerging markets are the only asset classes that stand out as offering investors a reasonable return, but those returns also come with an elevated level of risk.

GLOBAL ASSET CLASSES: 10-YEAR EXPECTED RETURNS

Note: All returns are geometric.



As of 04/30/2017. Source: These expected returns are calculated by Research Affiliates LLC using data provided by MSCI Inc., Bloomberg, and Barclays. Volatility is measured as standard deviation. These forecasts are forward-looking statements based upon the reasonable beliefs of RA and are not a guarantee of future performance. This content is not investment or tax advice or an offer, sale or any solicitation of any offer to buy any security, derivative or any other financial instrument. Any use of the above content is subject to and conditioned upon the user's agreement with all important disclosures, disclaimers and provisions found at www.researchaffiliates.com/en_us/about-us/legal.html. In the event the above content is provided or modified by a third-party, Research Affiliates LLC fully disclaims any responsibility or liability for such content. *©2017 Research Affiliates, LLC. All rights reserved.*

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You can see on the vertical scale, which is the real expected returns – most of the dots fall below the 3% return level for their expected 10-year returns. This is to be expected with where we are in this U.S. expansion and relative to valuations in the equity and fixed income markets.

Regarding the U.S. equity markets, I've had several conversations with some very sharp and wise clients over the last several weeks where they pose the question to me of "Why not just buy the stock market? Over time it has always gone up." Making the "it has always gone up" statement is highly dependent on the window of time one is using for measurement, and as of this moment the stock market has never been higher. However, I attempt to respectfully and professionally point out to them that this has not always been the case. Keep in mind that

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while the stock market today is at an all-time high, it is also one of the top three most expensively valued stock markets in history – only competing with the valuation levels that existed prior to the Great Depression in 1929 and the popping of the Tech Bubble in 2000.

Investors who made this claim in both of those years would live to regret that view for quite a long time. The Dow Jones Industrial Average peaked at 381 points in September of 1929 and at that time few believed that the stock market could go down, in fact famed economist Irving Fisher claimed that the stock market had reached "a permanently high plateau". By July of 1932 the Dow had declined to 41, losing more than 80% of its value and it would be two and a half decades (25 years) before the Dow would reclaim its pre-Great Depression level.

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Similarly, in 1999 the Dow was racing higher with calls that we were in a new era, perhaps punctuated by the publishing on October 1, 1999 of the book "Dow 36,000: The New Strategy for Profiting From the Coming Rise in the Stock Market". Little did anyone know at the time that the Dow would peak in December of 1999 at just over 16,700 and it would take almost a decade and a half (14 years to be precise) before the Dow would reclaim that level for good.

Keep in mind this is history and not a forecast, but rather observations. However, it does provide context and is an illustration of what can happen no matter how unlikely it seems. The point I'm trying to make is that some of us can afford to take the risk that it takes one or two decades for the stock market to recover from a dramatic decline – be it due to a longer time horizon, a greater capital base, or more

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modest needs. The most important question you have to ask yourself is can you afford it, and what you determine is all that matters.

**** Please note that Capital Market Musings & Commentary will taking a brief sabbatical next week, but will be back with a fresh missive to close out the month of May.**

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