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What do you do for an encore?

Even the most creative and optimistic of imaginations would have likely fallen short of scripting such a docile yet profitable backdrop for the equity markets in 2017. Here we are just a few weeks away from closing the books on the year, with most of the major global equity indices around the world sitting on gains at or above 20% for the year. The path to garnering these strong gains couldn't have been smoother with the maximum drawdown in the S&P 500 amounting to just over -3%, a feat investors have only experienced one other time in the history of the index (1995 – hat tip to Charlie Bilello for this stat). What's more is that the S&P 500 is on the cusp of a clean sweep for 2017, having yet to register a losing month on a total return basis. Yes folks, this is a year for the record books and as such investors need to remind themselves to not become overly complacent.

Given the unprecedented nature with which 2017 is ending, it leaves in its wake an inauspicious setup for investors to navigate going forward. This isn't to suggest that there is anything worrisome on the immediate horizon, but rather just the opposite in that the bar has risen to such an elevated level on many fronts that it will be difficult to exceed such lofty expectations.

Let's start on the economic front where the story for the second half of this year has been a relentless onslaught of data releases that have exceeded expectations. Last week's November retail sales report was the latest example, where the holiday shopping season appears to have gotten off to a strong start with retail sales jumping 0.8% month-over-month which increased the year-over-year rate to north of 5%. The internals of the report were as strong as the head-line suggests with the gains being very broad based, and there was an upward revision to October to boot. This report is just another in a string of strong economic data points over the last several quarters, and as a result we see the Atlanta Fed GDP tracker lifted its Q4 estimate to a 3.3% annual rate from 2.8%. Not to be outdone, the New York Fed's Nowcast is estimating Q4 GDP at 3.98%.

Should these estimates come to fruition (and judging by the strength of the data there is little reason to think they won't), then we're looking at a string of three consecutive quarters of +3% GDP growth – something that hasn't happened since 2005. Couple this with the growing likelihood that the GOP will pass their tax cut bill by the end of the year and you have plenty of ammunition to fuel the excitement that has found its way into a levitating stock market. Putting aside the debate on tax cuts (whether they will pay for themselves and how much economic growth they will create…), an important question investors have to consider is how much of this is already priced into equity prices?

After all, we're talking about an S&P 500 that is trading at a Shiller cyclically adjusted P/E multiple north of 32x, which has only been eclipsed in 1929 and 2000. Sure, should lower corporate tax rates funnel their way into the bottom line of corporate earnings then that multiple may be a point of two too high, but even then, we're still talking about a multiple around 30x (still in the same ballpark of where it was in 1929 and 2000). Consider that the S&P 500 started the year with a P/E multiple of 16.8x on expected 2017 earnings and now it's almost at 18.5x on 2018 earnings estimates. Even if (when) the tax plan goes through, investors are still looking at an equity market that is trading with a 17.5x multiple – a level that is still three points above its historical average.

I'm in the camp that thinks most, if not all, of the tax cut optimism is priced into equities at this point and the one market that may be feeling the same way is the bond market. It's interesting how dismissive the talking heads have become about the lack of any meaningful increase in the 10-year Treasury yield which ended last week at 2.35%. Here we are in the nirvana of economic growth environments, with a Federal Reserve that has hiked rates three times this year, and fiscal stimulus right around the corner – yet the yield on the 10-year Treasury bond is lower today than the 2.44% level it was at to start the year. What we are seeing in the fixed income market is a meaningful flattening of the yield curve with short-end rates increasing (the yield on the two-year T-Note now exceeds the dividend yield on the S&P 500) while the long end of the curve steadily falls.

This curve flattening is the bond market's way of saying that this hurricane assisted growth spurt won't last, inflationary pressures remain mild, and this nine-year old economic cycle is operating on borrowed time. Another message that the bond market is wise to is that we've seen this movie before, with the Fed now moving ahead with rate normalization into a fragile and low-quality economic expansion. Ultimately what happens is the Fed continues to hike rates until something breaks and forces them to stop. Don't think it's possible? Rack a history book as this was the case with the housing and credit crisis in 2008, before that it was the Tech Bubble popping in 2000, Long-term Capital Management in 1998, the Tequila Crisis in '94, and the S&L Crisis in 1990. All of these events had the same thing in common – a tightening in financial conditions and reigning in of liquidity by a central bank that has no way of knowing how much is too much.

While I fully acknowledge that the economy at the current time is as solid as it's been since late 2014 / early 2015, I also remain of the view that the energy and artificial support it took to get us here will not be repeated going forward (this year was also assisted by three significant natural disasters which spurred activity that otherwise wouldn't have happened). For starters, we have a U.S. economy that is now more indebted than it's ever been and the entity that controls the price to be paid on this debt (interest rates) motivated to increase that price. Let me remind you that the U.S. economy has added $14 trillion in debt since Q4 2007 compared to an increase of $4.8 trillion in GDP over this same time period. This has increased the debt-to-GDP ratio to 250% for the non-financial sector from 225% back in 2007. This debt-load has not been a problem to this point because the cash-flow to service these liabilities hasn't been interrupted.

However, one of the levers households can pull on to service this outstanding debt load is tapping into built up savings, but the wiggle room on this front is getting pretty thin. The savings rate reached 11% at its peak this cycle, but that has since been pared down to just 3%. This is a common theme you see as business cycles age with the current setup mirroring what happened in the 2001-2007 cycle, where the savings rate fell from a 6.3% high to a low of 1.9% in November 2007. Same story going back to the cycle in the 1990's where the savings rate fell from 9.9% to 3.5% just as the business cycle was coming to an end. You see what I'm getting at here, where high savings rates are classic early cycle indicators and indicative of plenty of pent-up-demand once confidence is restored that it's safe to go out and spend. Whereas low savings rates in the 3% arena are an indication that the cupboards are pretty bare as all of the pent-up-demand is used up, and this has historically been a reliable confirmation that we are in the later stages of an expansion.

It’s funny how loud the ‘this time is different’ chorus grows as we move through a business cycle, and while all cycles have their own unique characteristics, they ultimately all end up at a similar point. That is to say, they all end, and this one will be no different. The irony is that after the last cycle, which was exacerbated by over-indebtedness, you would have thought we would learn our lesson, but as it turns out it looks like we’re repeating similar mistakes. In the 2001-‘07 cycle, non-financial debt expanded by $13 trillion which helped create $4 trillion in incremental GDP gains. The cherry on top this time is that we’re about to pass a tax cut where the estimates suggest it will add an additional $1.4 trillion to the deficit over 10 years.

To this I say, thanks for trying guys, but wrong policy at the wrong time. Bush implemented tax cuts back in ‘04 and Obama enacted fiscal stimulus in '09 with one of the key differences between those measures and today being that in both instances we were very early on in the economic recovery. However, just to show how smart markets are, in both cases what we got was rampant asset price inflation which is perhaps what risk assets have been front-running all-year long.

In his recent market commentary, Gluskin Sheff Chief Economist and Strategist David Rosenberg brought to my attention two articles that I found to be thought provoking enough to pass along. The first from The Economist, '*Can the Trump Boom Last?'* is worth a read irrespective of one's political view point as the following point is worthy of deeper reflection for forward looking investors:

"All expansions eventually come to an end. Even if America does not inflict a recession on itself – through ill-judged trade politics, say – a global shock could do the job. When that time comes, America's policymakers will end up regretting how government revenues were squandered on a badly designed tax cut. The deficits that result will make it politically harder for Congress to agree on a fiscal stimulus to combat the next downturn. Interest rates will in all likelihood peak at much lower levels than in the past, limiting the scope for big cuts to fight a recession."

The other is a NYT op-ed column in last Thursday's issue written by Desmond Lachman, *"Are We in Another Bubble?"*, where he ends with the following:

> *"It's unclear, however whether the world's largest economy can take the lead this time. The Trump administration's budget busting tax cuts risk overheating markets even further and limiting the government's ability to respond when the bubbles pop. This heightens the risk that when the bubbles burst, we'll be forced to rely yet again on artificially low interest rates, which will set us up yet again for another boom-bust cycle."*

So here we are, where the economy is humming along and the stock market is merry, but it begs the question of "What do we have for an encore?" The carrot that was tax cuts which has been hung over the markets all year long is now all but done. Global central banks are going to start reigning in the liquidity punchbowl in a material way after a calendar year (2017) that ended up experiencing the highest level of global central bank asset purchases in history (yeah, let that sink in and don’t underestimate its significance in the way risk assets performed this year). After a year (2017, once again) that saw China inject the largest amount of new credit creation in its history, they have pivoted to deleveraging mode and as such the world’s second largest economy likely won’t be able to pick up the slack next year.

This isn’t to suggest that an end is nigh, but rather that to maintain momentum in either the global economy or the capital markets, we’re going to have to see some other catalysts come to the fore to keep it going. Otherwise, reconsider the simplest definition of what growth is, and that is: doing what you did last year, plus some. That is a pretty high bar, and that bar has sucked in investors who collectively are holding their second highest exposure to stocks as a percentage of their net worth, of all-time (only bested by the months leading up to the peak of the Tech Bubble). And this exposure coincides with valuation levels that are only bested by that infamous 1999 – 2000 period.

The only words of wisdom I have looking ahead is to not take anything for granted, don't assume that what is will remain so, and don't abandon risk management strategies that – while seeming to be nothing but a drag on portfolio outcomes – will inevitably remind you of why you use them.

** Capital Market Musings & Commentary will be taking next week off in observance of the upcoming holidays. We would like to take this opportunity to wish you and your families a very happy Holiday Season and a healthy and prosperous New Year. We greatly appreciate your continued readership and look forward to returning with a fresh missive to ring in 2018. **

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