Observations and Outlook

October 6, 2017

Selected Index Returns 3rd Quarter/ Year to Date

Dow Jones Industrials 5.58%/ 15.45% S&P 500 4.48%/14.24% MSCI Europe 6.45%/22.79%

Small Cap (Russell 2000) 5.67%/10.94% Emerging Mkts 7.89%/27.78% High Yld Bonds 1.7%/6.22%

US Aggregate Bond .85%/3.14% US Treasury 20+Yr .58%/6.26% DJ/UBS Commodity 2.52%/-2.87%

Q3 of 2017 marked the 18th positive return month for the major stock indices out of the past 19. We are also seeing a record length of time without a 5% decline. This has only occurred 4 times since 1929, the last in 1995. Year to date, everything is up. Bonds are up, stock markets around the word are all up, bonds of all characteristics are up, along with gold. Gold actually has been outpacing the Dow for most of the year. While European and emerging market stock indices retain their YTD leadership, US small caps came roaring back to life, nearly doubling their YTD return during the third quarter.

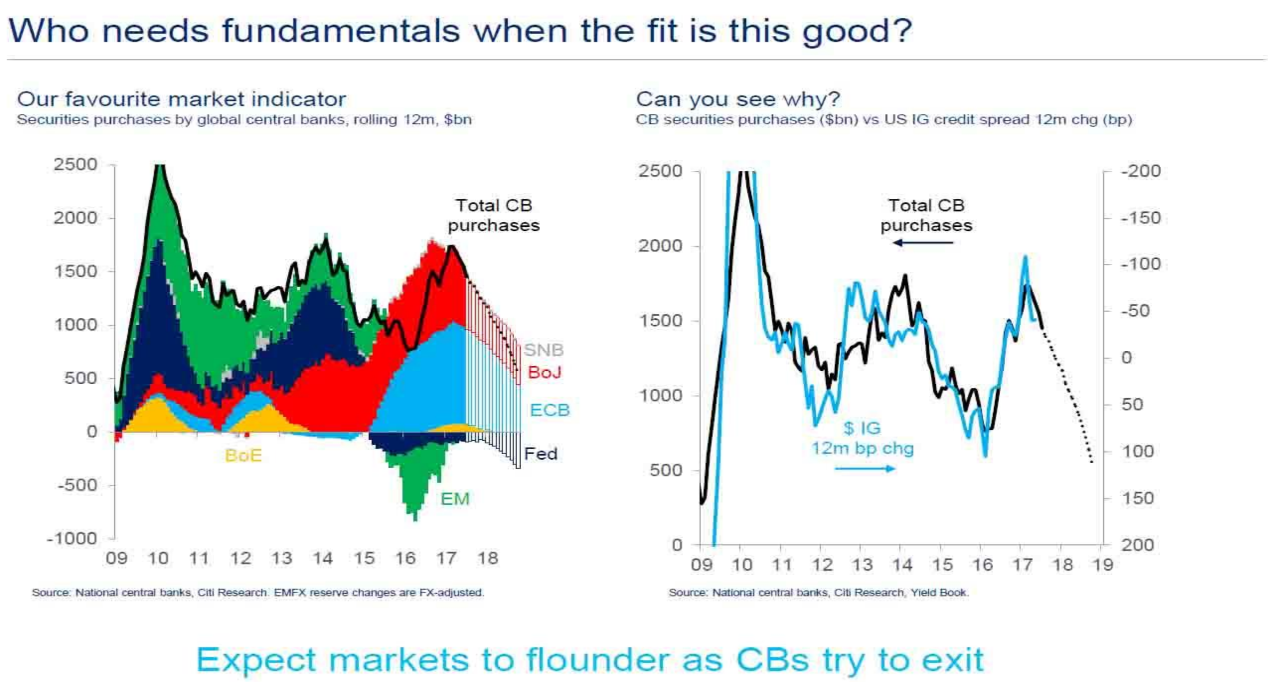
The recent run in equity prices (and September's near-term peak and decline in gold and bond prices) can be described as Trump Trade-lite. Immediately after the election, stocks raced up, bond prices fell dramatically, gold fell resuming its decline from the summer, and the US Dollar resumed its rise that had begun in the summer 2016. Each of these trends, except for stocks, stopped and reversed direction early in 2017 and continued until September. Bond and gold prices rose, oil stocks reversed and made new lows below October 2016 levels. The US Dollar fell throughout the year, giving strength to assets denominated in other currencies (like European and emerging market stocks). The jolt post-election was due (as is the common rationalization) to the expected impact on the economy and corporate profits from Trump's planned policy initiatives: repeal of Affordable Care Act ("Obamacare"), infrastructure spending and tax reform. We are now in the thralls of that trade's second iteration, despite failure to enact any reforms thus far. As of this writing, tax reform is still in the 'proposal' stage. Congress must first pass the 2018 Budget, then ***begin*** discussing tax reform. Some change to the tax code will likely occur but analysts are almost uniformly agreed that tax reform as proposed will not pass in its current form. It is likely that until it is clear what kind of tax reform will pass, that equity markets will stay elevated on the hope that lower taxes will (somehow) create jobs to spur spending to enhance corporate earnings, and that corporations getting tax relief to repatriate profits will use those funds to invest in their businesses, which is also assumed to be a job-creating act.

At the end of the day, decoding the root of short term market moves is not as vital as understanding the likely determinant of the ***excess*** gains from equities. I say excess because in 2009 earnings were very low and there was concern as to the survival of the global financial system. As the global central banks intervened, and survival was guaranteed, prices came back and the capital markets began to function again, allowing the economy to operate more normally once more. So, while stocks were undervalued at one point, displaying valuations below historic averages, today equities are valued (based on Price to Earnings, Price to Cash Flow, Price to GDP, Price to Sales) higher than 99% of any other time in history. US equity markets went from briefly undervalued, straight through average/fairly valued (commensurate with the increase in earnings) to now exceptionally overvalued. I believe that Quantitative Easing (QE) has a lot to do with this and the process of 'balance sheet normalization' will have an impact on equity markets.

From QE to QT

During the crisis, central banks lowered interest rates dramatically *during* the stock market crash. The Fed Funds Rate went from 5.25% July 2007 to 3.0% March 2008 (when Bear Stearns failed, most people remember Lehman, which failed in September). That summer Freddie Mac and Fannie Mae failed and the FFR was lowered to 2% and then 1% in September and finally 0% was the official rate in December 2008. All the while financial asset prices kept falling and the economy was hemorrhaging. Soon after hitting 0% as the cost of money to the banking system, the Federal Reserve started Quantitative Easing, where the Federal Reserve would buy mortgage backed securities (as well as other tax-payer insured instruments) to provide 'liquidity' to the markets. The stated goal was to increase the prices of assets (stocks, real estate, bonds) so that the "wealth effect" would spur people to spend money rather than save it. Given the anemic pace of economic expansion, the primary effect QE has had has been to push up stock prices well beyond normal valuations.

While the US has ceased QE, raised interest rates off the 0% mark, and laid out a plan to shrink its balance sheet (taking liquidity away from the market); the European and Japanese central banks continue to buy assets. The Europeans buy corporate bonds and the Japanese buy everything including equities. The ECB has expressed a desire to cease its purchases (stopping new liquidity into the market) starting in 2018, but have not committed to a schedule. The chart below combines all the central bank's asset purchases and projections into 2019 (left side). Notice how the EM (emerging markets withdrew liquidity late 2015 to 2017—emerging market stock indices (EEM) fell 39% from Sept 2014 through Jan 2016). The chart shows the Fed's net reductions in liquidity and the Swiss, Japanese and Europeans declining levels of new liquidity to the marketplace. Given that adding liquidity boosted asset prices, as additional liquidity slows and possibly reverses, it is not unreasonable to assume markets will become much more volatile as we approach that time. We will likely see the effects of Quantitative Tightening (QT) beginning in, and throughout 2018. One way to counteract this, would be for private investors to save/invest rather than spend this difference (approx. $1.2 trillion), but a reduction in consumer spending would bring its own problems.



In the near-term markets can stay aloft, swinging from earnings hopes to tax cut hopes to the usual 'growth around the corner'. In the slightly longer run, extreme valuations do not persist.

Adam Waszkowski, CFA
awaszkowski@namcoa.com
239.410.6555