WEIGHING THE EVIDENCE

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Unless you've recently returned from a very long vacation to someplace so remote that news doesn't reach it, you're probably aware that the capital markets are behaving far differently in 2018, than they were in the prior year.

A quick look at the chart below shows that both the S&P 500 Index (domestic stocks), and the E.A.F.E. (Europe, Australia, Far East) Index (foreign "developed" countries' stocks), have been fluctuating wildly throughout the first sixty-four trading days (thru April 17th) of 2018. The Barclays Aggregate Bond Index (domestic bonds) has been in a gradual, though no less costly decline for the entire year-to-date.

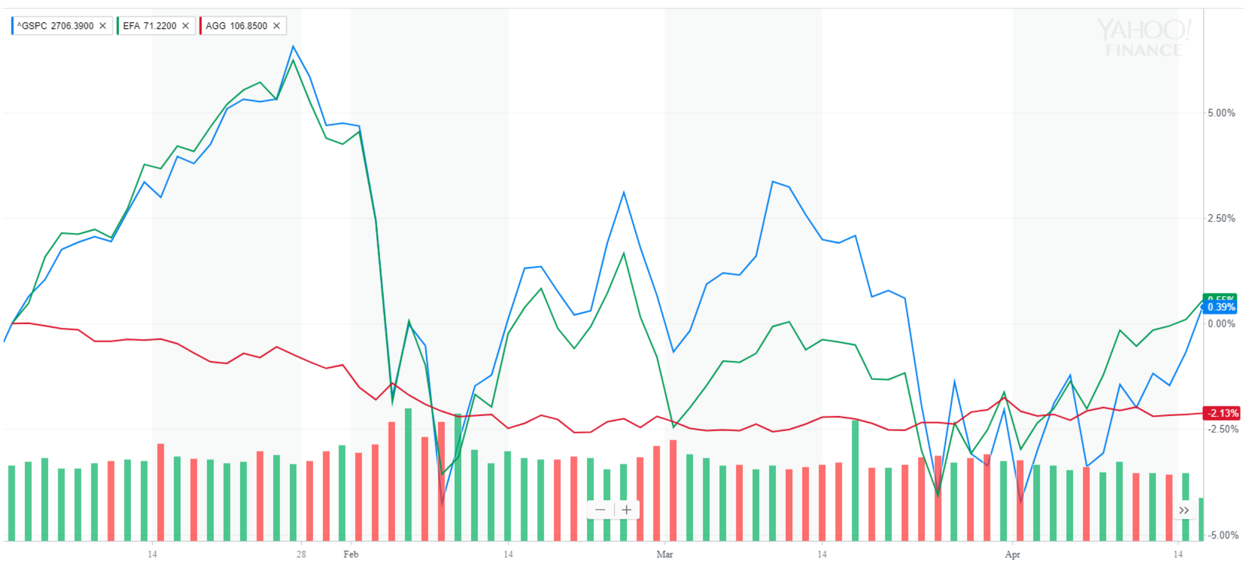

Chart Source: Yahoo Finance

The S&P 500 Index reached its all-time closing high of $2872.87 on January 26th. Investors up to that date had been lulled into an incredible level of complacency, as January marked the *fifteenth consecutive month* of positive returns for the domestic stock market, dating back to November 2016, the longest consecutive streak of monthly gains in recorded history.

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February delivered an unexpected jolt to previously sanguine investors, as the S&P 500 Index shed 291.87 points (-10.16%) over the following eight trading days, the first "correction" (defined as a market decline of 10% or greater) since January 2016.

Volatility is back, and in a big way. In the 56 trading days between the market's peak and April 17th, the S&P 500 Index closed _down_ (-1%) or more on 13 trading days, with an average daily decline of (-1.97%), and it closed _up_ +1% or more on 9 trading days, with an average daily gain of +1.59%. That said, for all the up and down volatility that we've seen this year, the S&P 500 Index is sitting just +0.39% above where it started the year. The E.A.F.E. Index is up just +0.55%, and the Barclays Aggregate Bond Index is down (-2.13%) year-to-date. Clearly, market participants cannot make up their minds as to the near-term direction of the global equity markets, and until there is a consensus, its likely we'll continue to see those markets fluctuate up and down in a "sideways", or directionless pattern.

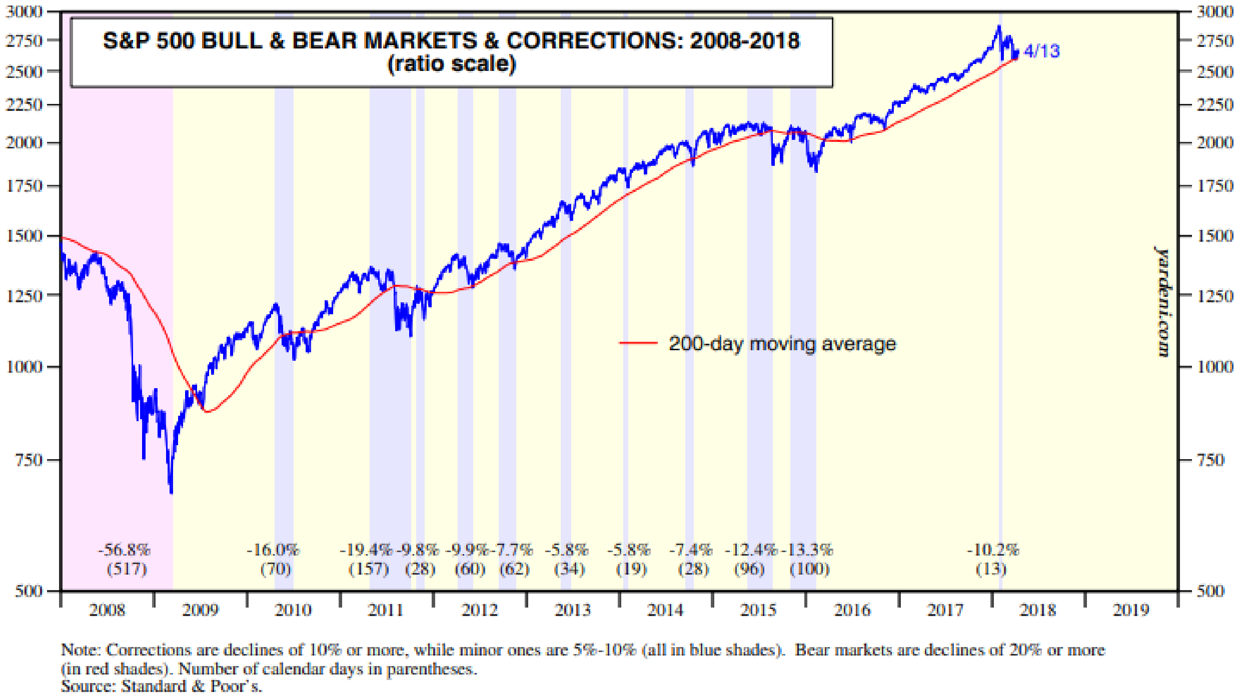


Chart Source: Yardeni Research Market Briefing: S&P 500 Bull & Bear Markets & Corrections; April 13th, 2018

As the chart above reveals, stock market corrections of (-10%) or more occur relatively frequently, with five such declines taking place since the end of the 2007-2009 crash, and two additional ones coming within a tick or two from being added to that total. Despite the recent spike in market volatility, we remain in the *second longest* bull market in U.S history without a "*bear market correction*", defined as a decline of (-20%) or more, dating all the way back to March 2009, some 110 months ago. For those of you who are keeping score, barring a (-20%) decline in stock prices in the coming five months, we will eclipse the *longest* bull market in U.S history (10/11/1990 – 03/24/2000) in September of this year (Source: FactSet).

Retail investors and market professionals alike are desperately trying to read the tea leaves this market is leaving behind, but truth be told, trying to predict the near-term direction of a market like this, is, in my humble opinion, an exercise in futility. The truth is, the global stock markets have made very little sense from a fundamental perspective for the past several years. In my experience, when markets stray too far from "reasonable" fundamental valuations, a bear market correction becomes inevitable. But as we've all learned over the last eighteen years, through two consecutive "boom – to - bust" market cycles, markets can remain irrationally overvalued from a fundamental perspective for *years* at a time, before "rationality" (aka reasonable fundamental valuations) returns. The last three years' market advance has been quite reminiscent (to me) of the years 1997 – 1999, inclusive. On December 5th, 1996, with the S&P 500 Index trading at 19.13 times its collective 2016 "As Reported Earnings (1), then Federal Reserve Chairman Alan Greenspan was quoted as suggesting that "*irrational* (investor) *exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions, as they have in Japan over the past decade."* Chairman Greenspan would eventually be proven correct in his "market call", but way off on its timing, as the markets would continue to climb more than +97% from the date of his speech, until the "Tech Wreck" that began more than three years later in March of 2000 devastated investors' portfolios. Every bit of the market's advance that followed Greenspan's speech was given back by the time the massive bear market that followed ended in October 2002 (2).

As wealth managers entrusted with the management and allocation of our clients' portfolios, we don't have the luxury of *not* forming opinions on the near-term direction of the markets in which we deploy capital, even when there seems to be no particular (observable) market direction. In times like these, I like to create *lists*, compiling what I call are the "*Pros*", and "*Cons*" of the current investing environs, in hopes of determining which direction has the greater "*weight of the evidence*" behind it. Let's start with the "Pros":

Pros

1) **Corporate earnings are rising at their fastest rate since March 2011.** In calendar year 2017, the S&P 500 Index' "As Reported Earnings" (per Index share) rose +16.21%, year-over year (3). Analysts' "consensus estimates" are that 2018 will see "As Reported Earnings" rise another +33% in 2018, primarily a result of the "Tax Cuts and Jobs Act" Congress passed into law in December of last year. Even if those analysts' future estimates are wildly overinflated, as they typically are, U.S. corporations are growing their reported earnings at a pace not seen in many years. In fact, assuming earnings estimates for S&P 500 Index constituent companies' for Q1 2018 are in fact, realized, it will be the first time in several years that year-over-year "Operating Earnings" (+18.18%) and "As Reported Earnings" (+16.57%) have *exceeded the growth in the Index' price* (+11.77%) When earnings grow faster than prices, P/E Ratios shrink, and that is a good thing, especially at current levels. More on that in the "Cons" list to come.

2) **The U.S. economy, as measured by Gross Domestic Product ("GDP") is growing at its highest percentile rate since Q1 2015.** Following a Q4's GDP growth rate of +2.9%, and a year-over-year GDP growth rate of +2.3%, consensus estimates by the Federal Reserve and others are that we may see the first yearly increase in GDP "north" of +3% since the four calendar quarters ended March of 2015, when we averaged +3.75% GDP growth (4). A more rapidly expanding economy is a tremendous tailwind to corporate earnings, and typically, to their stock prices as well.

3) **It's not just the U.S. that is seeing economic expansion. The entire world is experiencing the first "synchronized global expansion" since 2010.** According to the World Bank, "Real" (inflation-adjusted) GDP Growth for the U.S. in 2018 is expected to reach +2.9%. In Europe, they expect +2.1%, in Japan, +1.47%, in China, up +6.9%, and in the Emerging Markets, they are forecasting GDP growth of +4.5% (5). Not since 2010, have all regions of the world been united in economic expansion. And according to Janney Investment Strategy Group, *all but one* of the sixteen bear market corrections that have occurred since 1929 were accompanied by an economic

contraction (6). While many economists believe the U.S. is in the later stages of the current economic recovery, now more than ten years in length, *few are predicting a recession before 2019*.

4) **Unemployment is at cyclical lows.** At 4.1%, the U.S. labor force is close to fully employed. In October 2009, Unemployment reached 10%, and has been falling steadily since.

Seasonally Adjusted Unemployment Rate

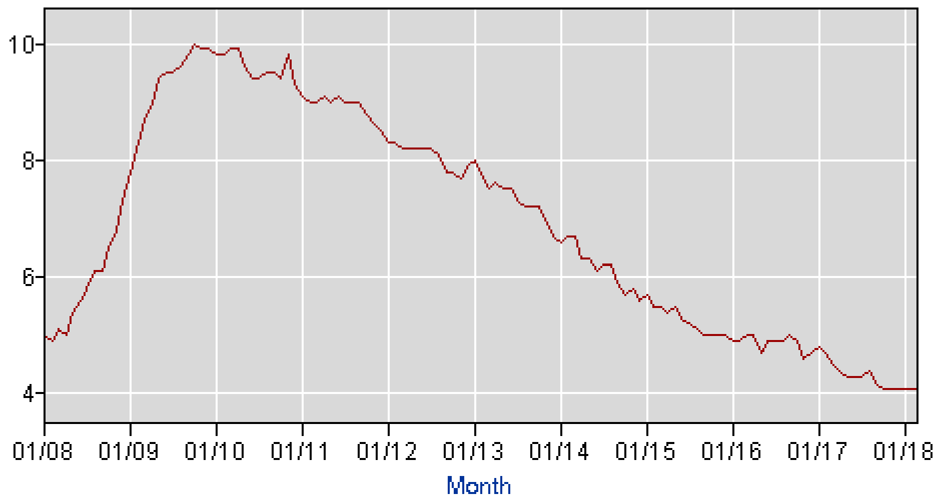


Chart Source: https://data.bls/pdq/SurveyOutputServlet

Since President Trump was elected, the country has added 3,052,000 jobs to the labor force. Labor Force Participation has gone from 62.7% to 62.9%, so we've been able to increase the percentage of the labor force while adding to the job market. (7)

5) **Interest Rates are still low.** With the help of the Federal Reserve, interest rates have been kept artificially low for a long time. On Tuesday, July 5th, 2016, the benchmark Ten-Year Treasury Bond yield fell to an all-time historic low of 1.37%. It has risen to 2.83% as of April 17th, 2018, but as the chart below reveals, these higher rates remain well below historical averages.

10 Year Treasury Rate 1870 - Present

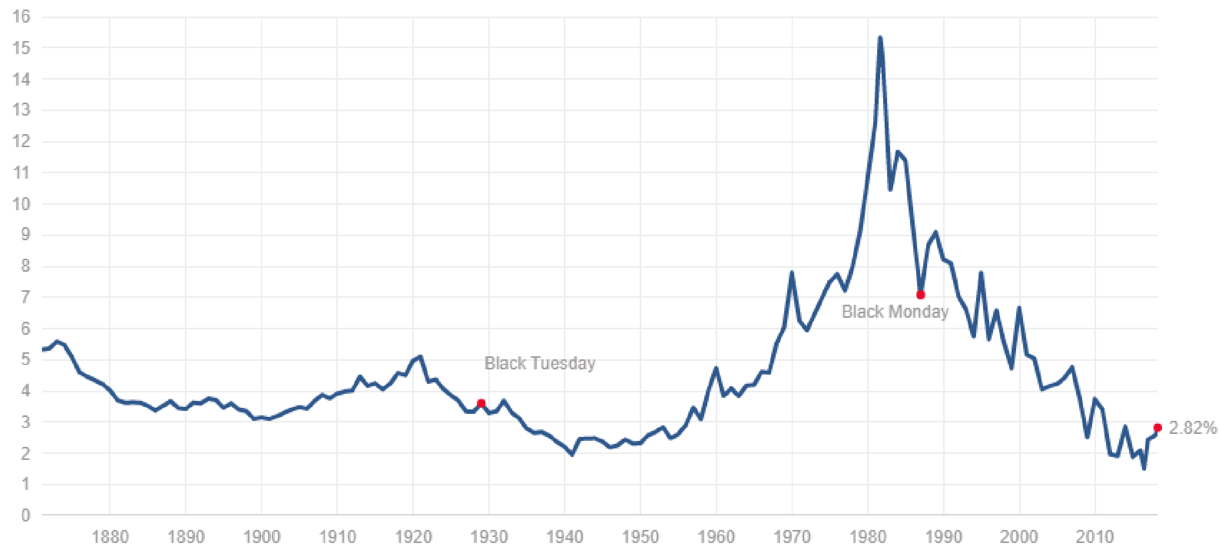


Chart Source: www.multpl.com/10-year-treasury-rate/table/by -year

Low interest rates support higher stock prices and higher P/E multiples, since bonds look far less attractive as competition for investors' capital. At current price levels, stocks (as represented by the S&P 500 Index) deliver an earnings yield of a bit more than 4% on invested capital (8), and until or unless bond interest rates approach and/or exceed stock price profit "yields", stock investors will likely keep their assets in stocks.

6) **Investor Sentiment is becoming more pessimistic.** The American Association of Individual Investors ("AAII") weekly Investor Sentiment Survey is conducted with 170,000 individual investors. These investors are asked one question each week: Over the next six months, are you "Bullish", "Bearish", or "Neutral" about the direction of the stock market? For the week ended April 11, 2018, 42.8% of survey respondents indicated they were "Bearish", while 31.2% said they were "Neutral". Only 26.1% of respondents said they were "Bullish". *Why is "Bearish" Sentiment a positive for stocks, making our "Pro" list?* Because an analysis of the survey's readings back to the survey's origin in 1987 reveals that both extraordinarily high levels of pessimism, and/or extraordinarily low levels of optimism have been shown to be "contrarian

indicators". Interestingly, and counterintuitively, six-month returns following high levels of pessimism have been *better* than following high levels of optimism. In fact, the more pessimistic, the better the returns. A "Bearish" reading of 42.8% is higher than the historical average of 30.6, and a "Bullish" reading of 26.1% is well below the historical average of 38.8%. While the indicator is not a perfect contrarian indicator, there is an impressive amount of data to suggest that when "Bearish" sentiment is high, as it is today, the market is more likely to rise, than to fall (9).

7) **Stock Buy-Backs Will Hit Record Highs in 2018.** As many investors know, many corporations have used large portions of their profits in the repurchase of their own shares, instead of investing in capital and equipment, or increasing their dividends. This is becoming a way for company CFO's and CEO's to shrink the number of outstanding shares in the market, and in so doing, increasing their "per share earnings" by spreading them out over fewer shares. It's a bit of "financial engineering" of one's earnings numbers, but it has become quite popular in Corporate Boardrooms. Last year (2017) $525 Billion was reinvested into repurchasing shares, and according to Mark Kolakowski of Investopedia, 2018 is set to see a whopping $800 Billion, a 55% increase in share repurchase programs (10). That's $800 Billion in increased demand for those companies' shares than the market demand itself would provide, and that added demand will help prices rise.

That's an impressive list of "Pros", suggesting that despite the length of the current expansion, the stock market has further to run. It's not all rosy however. The list of "Cons" is equally impressive.

<u>Cons</u>

1) **Stock Valuations are near cyclical highs, and well above historical averages.** As many readers of these Reports know, I pay close attention to fundamental valuation measures, like Price/Earnings ("P/E") Ratios, Price/Book ("P/B") Ratios, Price/Sales ("PS") Ratios, etc. These Ratios have been calculated for decades. A chart of the P/E Ratio of the S&P 500 Index from 1870 to present, is below:

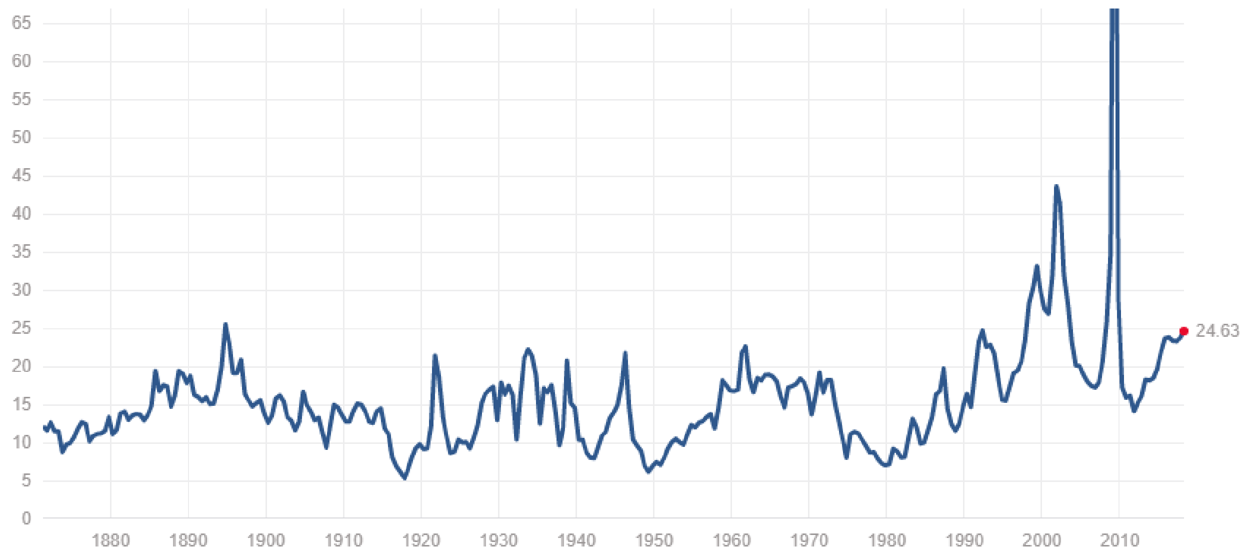


Chart Source: http://www.multpl.com/

The current P/E Ratio of the S&P 500 Index is 24.63, meaning an investor in that Index would pay $24.63 for every $1 in earnings those companies collectively generated over the prior four quarters. The Index' average (Mean) P/E over its history is 15.70, and the Median P/E is just 14.69 (11). At the current P/E level, we are 55%, and 66% above the Mean and Median readings, respectively. As the chart above shows, the Index' P/E has been this high just four times since 1870, and on each of those occasions, the markets declined precipitously in the months and years that followed, bringing the Ratio back to "equilibrium", or fair valuation. Intuitively, we know Prices and Earnings should be highly correlated to one another, with Earnings being the *driver* of Prices. While I listed accelerating Earnings on our "Pro" list, as they have finally started growing as fast, or faster, than Prices, the Price we pay for stocks (and their Earnings) today reminds me very much of the prices homes were selling at in early 2006…

2) **The Federal Reserve Bank ("The Fed") is no longer a tailwind to the markets, but a headwind.** The Fed uses monetary policy to stimulate the economy, or to slow it down from overheating. Its primary tool has been the setting of the Federal Funds Rate, the overnight rate of interest that banks pay to borrow from the Fed. It's also referred to as the "Base Rate", to which all credit and duration risks are added to determine interest rates for loans, government and corporate bonds, etc. When the Fed wishes

to stimulate growth, it *lowers* the Fed Funds Rate, and when it wishes to slow the economy's rate of growth (to avoid rising inflation, typically), it will *raise* the Fed Funds Rate. As the chart below shows, in May 2004, as the economy was heating up, the Fed took the Fed Funds Rate from 1%, up to 5.25% by August of 2006. When the Housing and Credit Crisis of 2007 hit, the Fed aggressively dropped the Fed Funds Rate to near 0%, and kept it there for eight straight years, before starting to raise it to its current 1.69% (12).

Fed Funds Rate 1954 - Present

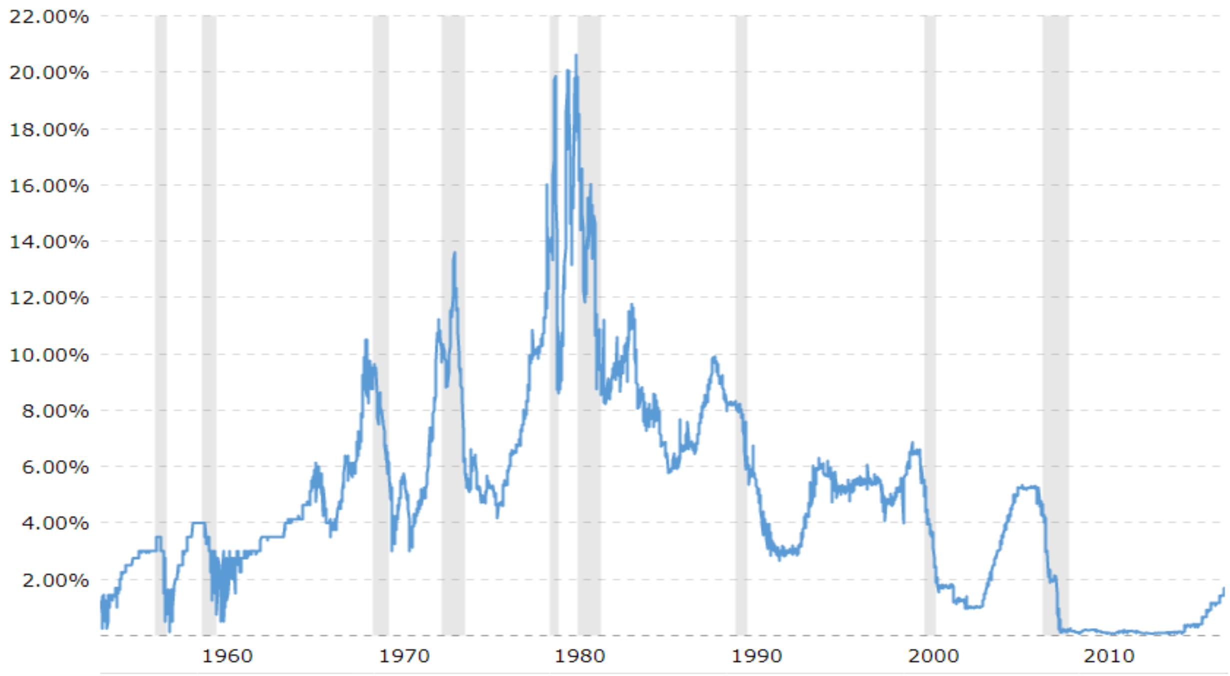


Chart Source: http://www.macrotrends.net/2015/fed-funds-rate-historical-chart

In addition to keeping rates historically low, the Fed began to buy U.S Treasury Bonds, and Mortgaged-Backed and Asset-Backed securities, literally printing cash to make the purchases. This strategy, called "Quantitative Easing" ("QE") was applied over a six-year period in four different programs. The purpose of applying QE was to provide demand, albeit *artificial* demand, to a market that needed more demand for those securities than organically existed, to keep prices afloat. The equity markets loved QE, and showed their approval with every printed dollar's purchase. The

Federal Reserve's Balance Sheet, which consisted of these investment securities grew to $4.4 Trillion. A graph of the Fed's Balance Sheet (red line) overlaid with the S&P 500 Index levels (blue line) reveals how "dependent" the stock market became on the infusion of artificial demand. Whenever the QE programs that had been announced and implemented were ended, the market reacted very negatively, with sharp declines. The Fed, desperate to keep the declines from accelerating, would see the declines, and react by announcing a new QE program.

Fed Balance Sheet Vs. S&P 500 Index 2008 to Present

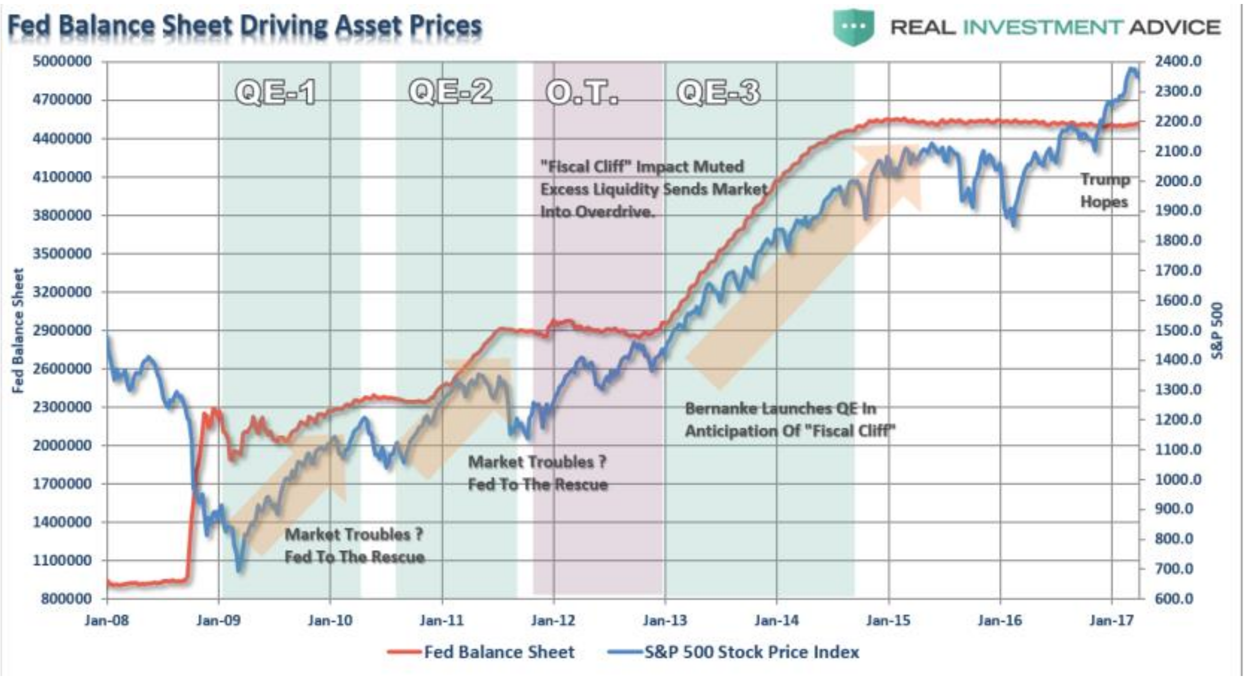


Chart Source: http://realinvestmentadvice.com/

In October of this past year, the Fed announced its intention to allow $10 Billion of Treasury and Asset-Backed Security holdings to "mature", without reinvesting the payoffs into new securities, as it had for the prior eight years. They intend to increase that "runoff" to $50 Billion a month over the next twelve months. It intends to continue this until their Balance Sheet holdings are reduced to $2.3 Trillion, a goal projected to be reached sometime over the next four years.

There is an old expression amongst stock traders: "*Don't fight the Fed*". What that means is when the Fed is "accommodative" in its monetary policy, lowering the Fed Funds Rate and adding to its Balance Sheet with printed money, as it did from 2009 – 2017, investors should ride the wave to higher stock prices. When they are "removing accommodation", i.e. raising the Fed Funds Rate and decreasing its Balance Sheet, as it is now, watch out. The Fed has provided an incredible "tailwind" to the markets the last eight years, a wind that became a *headwind* to the stock market as of last October.

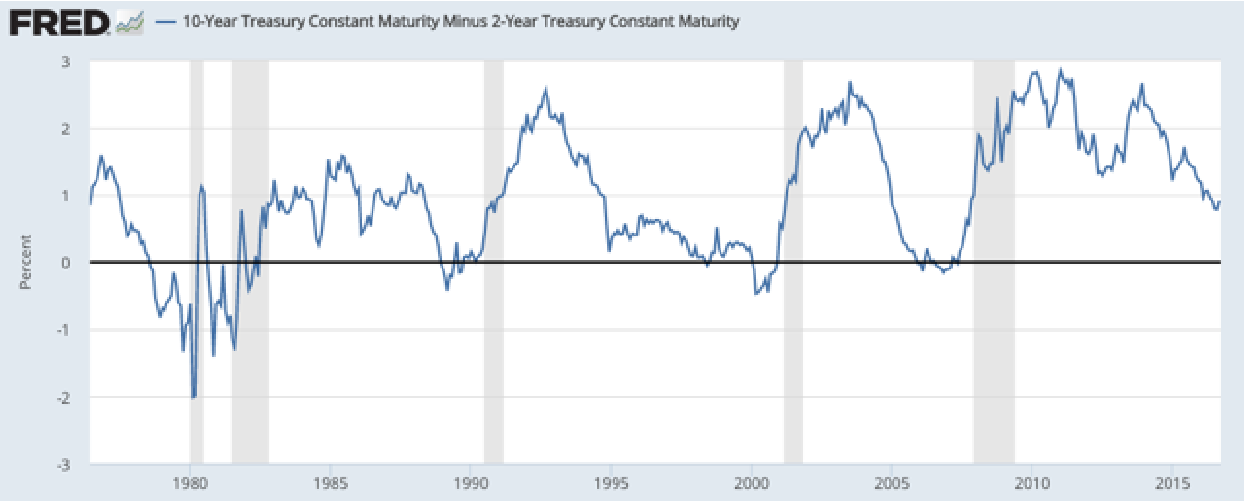
3) **Government, Corporate, *and* Consume Debt Levels are at, or very near, to all-time highs.** As I type this, the U.S. Treasury has over $21 Trillion in outstanding debt (13), up from $9 Trillion at the beginning of President Obama's first term, and $4.3 Trillion at the beginning of the George W. Bush Administration. Federal Debt, as a percentage of the country's GDP has risen to 105%. When Obama was sworn in, the Treasury's debt was just 77% of GDP, and when Bush assumed office, it was only 55% of GDP (14). Economist suggest that when a country's Debt-to-GDP Ratio exceeds 100%, rising interest rates and the "carrying costs" of servicing that debt at higher rates can crowd out other critical spending needs. The trajectory of this nation's debt load is alarming. American non-financial Corporations have increased their Debt as a Percentage of GDP as well, now at a record high of 73%. It was as low as 39% of GDP as recently as 2011. And Households have joined in as well. At its height in 2008, U.S. Households had personal and mortgage debt totaling 98% of the country's GDP. It has moderated as a percentage of the country's GDP to 79% (currently $13.15 Billion) in the ten years since, but the total debt *in nominal dollar terms* is at its all-time high.

   In moderation, debt can be helpful. But debt at these levels, can be stifling. With interest rates still near historic lows, the debt service *seems* manageable, but just a 1% or 2% increase to interest rates would add $500 Billion to $1 Trillion a year in just Government, Corporate, and Household debt carrying costs. In an economy that produces $19.75 Trillion in annual GDP, an additional $500 Billion to $1 Trillion taken from productive use, and redirected toward debt servicing, would have a recessionary impact on the economy.

4) **The Yield Curve is Flattening.** In a normal interest rate environment, investors in longer-dated bonds would be compensated for that "duration risk" (i.e. the risk that rates would rise substantially during the holding period, decreasing the value of lower-yielding bonds) with *higher* interest rates. An oft-cited measure of the health of the interest rate environment is the difference in yield an investor in 10-Year Treasury Bonds would receive, as opposed to the yield an investor in 2-Year Treasury Bonds would receive.

Historically, the "spread" (excess interest) investors get for buying the longer-dated bond is between 0% and 2.50%. Anywhere in the middle of that range would be considered "normal". As I type this on April 17th, 2018, it is just 0.41%, and trending downward (15). Why is a flattening yield curve bad, you ask? Without getting too deeply into the reasons why, historically, whenever the yield curve "inverts", where longer-dated bonds pay less than shorter-dated bonds, a recession occurs in the near-term. Look at the chart below:

10-Year/2-Year Yield Spreads 1975 – Present w/Recessions



The shaded bars along the time line of this chart indicate periods of economic recession in the U.S., five of which have occurred since 1975. All five recessions were immediately preceded by an inverted yield curve, as indicated by the "spread line" declining below the 0% Interest Line. "Flat" to "Inverted" Yield Curves are signs of economic trouble ahead.

5) **Inflation is starting to rise.** Through March of this year, the Consumer Price Index ("CPI"), the "official" measure of the U.S. Inflation Rate is +2.4% (16), the highest monthly reading since March of 2017. Employment Costs, or Wages, are a large percentage of CPI, and are now +2.6% higher than a year ago (17), the fastest pace since late in 2008. Inflation of +2.4% or Wage Growth of +2.6% aren't overly concerning, but the trend is. With the country operating at "Full Employment" levels, the pressure to increase wages, which have been relatively stagnant for years, will increase. Higher Wages squeezes Corporate Profits, and that in turn, hurts stock prices. If Inflation reaches +3% or greater, I believe we will see a direct impact on stock prices.

6) **Geopolitical Risks are Rising.** The list of potential problems that could lead to military intervention or all-out war is scary. We are rattling sabers (or worse, in armed conflagrations) with Russia, North Korea, Syria, Iran, and we may add China to the list in the South China Sea. We are aggressively economically sanctioning several countries and outright rescinding previously agreed-to Trade Pacts and Nuclear Proliferation Deals. The world has become a very dangerous place in recent years, and Russia, China, North Korea, and Iran are all provocatively "testing" this country's resolve, while simultaneously forcing dramatic increases in our defense spending. The budget for U.S Military defense spending in Fiscal Year 2018 is $700 Billion dollars, the highest annual budget for Military spending on record. According to the Peter G. Peterson Foundation, in 2014, the last year for which the numbers were calculated, the U.S. spent $610 Billion on Military Defense, which was more than the next seven countries' highest Military budgets, *combined*.

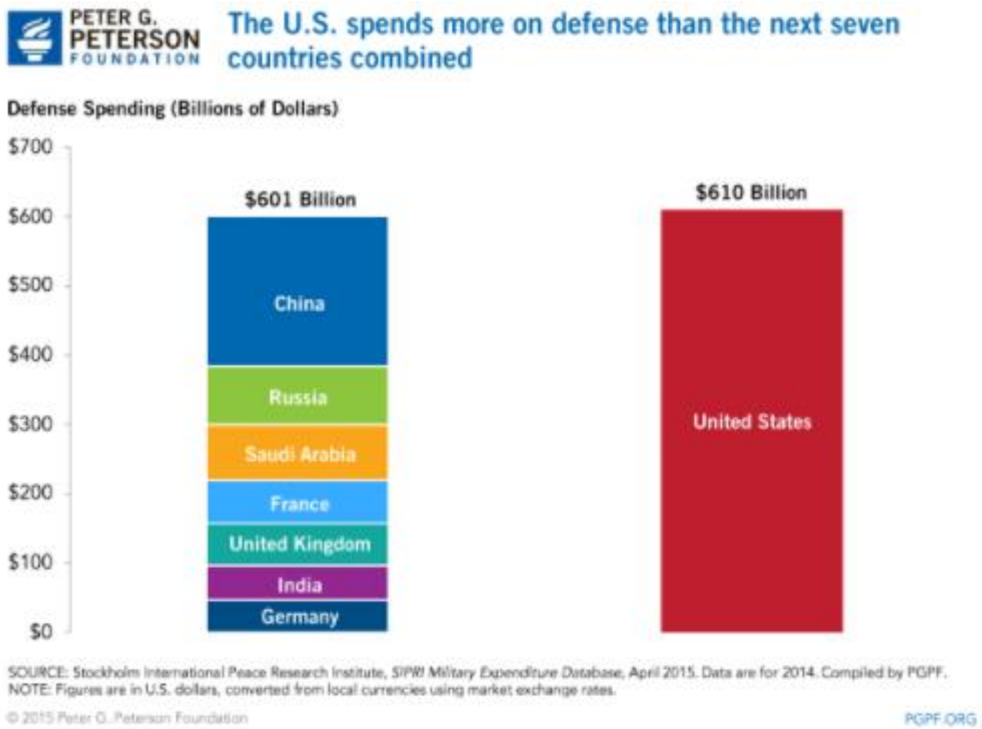


Chart Source: PolitiFact

Our Military force is spread around the world, where our presence either keeps the peace, or actively engages hostile forces in theaters all over the globe. Our enemies are rarely inactive in their efforts to sew discord and thwart our efforts to export democracy and freedom. Armed conflicts with Iran and other Middle Eastern countries would be very challenging. Armed conflicts with nuclear powers would be frightening. Capital markets *hate* armed conflicts. Avoiding war on the Korean Peninsula, along the Ukrainian Border, in Iran, or along the West Bank across from Syria, or in the South China Sea will keep the markets from crashing, but the first time we fire on a Russian or Chinese ship, look out below.

7) **Political Polarization.** Perhaps it's just recency bias, or the fact that there are hundreds of news outlets reporting "news", or their "versions" of the news, but I don't recall a time in my adult life when we had more political polarization in this country. Whether you are left-leaning or right-leaning, we tend to listen only to those news outlets or cable channels who share our perspective. Both sides are entrenched in their efforts, not just to trying to advocate for, and promote their respective agendas, but

seemingly just as importantly, to stopping their political opposites from moving their agendas forward. Observations of bipartisanship in Washington is as rare as a "supermoon". The inability of our elected leaders to work together to do the peoples' business effectively is a problem. The capital markets need to be able to plan their business' activities knowing that the government agencies that manage the country's business are working efficiently. What is happening in Washington today is anything but efficient, and the capital markets are showing their distaste for the overpoliticization of the government we all pay for. If Washington can't get their act together, and soon, the capital markets will express their displeasure as capital is removed from them.

So, let's review our lists:

Pros	Cons
1) Corporate earnings are rising fast.	1) Stock valuations extremely high
2) U.S. GDP is accelerating.	2) The Federal Reserve is a headwind.
3) Global "synchronized" expansion.	3) Govt. Corp. Household Debt are high.
4) Unemployment is at cyclical lows.	4) Yield Curve is "flattening".
5) Interest rates are still cyclically low.	5) Inflation is starting to rise.
6) Investor Sentiment is weakening	6) Geopolitical Risks are rising.
7) $800 Billion in Stock Buybacks in 2018	7) Political Polarization

As I review the list, it's clear than many of the "Pros" are strong reasons to hope for a continuation of the stock markets expansion. The earnings acceleration is particularly positive, as is the increase in economic expansion, not just in the U.S. but globally as well. Market crashes rarely occur when corporate earnings growth exceeds corporate price appreciation, or when the work force is, well, at work.

Conversely, the "Cons" aren't insignificant challenges. Valuations stretched well beyond average levels, a Federal Reserve intent on removing accommodation, and a country awash in debt are all "landmines" that could derail our progress. Throw in rising inflation and wage growth that could pinch corporate profits, not to mention the possibility of any number of shooting wars, and dysfunction in the body politic, and now you can really start to lose some sleep. I know I have!

In market environments that have conflicting data like this, a relatively "directionless" market, using a "*weight of the evidence*" approach to positioning assets is critical. Our investment approach remains tactical and defensive. We have equity and debt exposures, but only through the use of money managers and funds that will attempt to get out of the way of the inevitable market crash that ends all market cycles, whenever it may occur. And make no mistake. Trees don't grow to the sky, and markets don't rise forever. Though today's investors may have forgotten about market crashes, they *do* occur, and typically when you *least* expect them to. Chairman Greenspan's observations about "*irrational exuberance*" may have been early, but they were nonetheless proven right, and to the detriment of investors who were guilty of allowing their exuberance to blind them to trends and patterns of excess, and of the hubris that comes with believing that "*this time is different*". It's not. It never is. Rationality, and fundamental valuations are like the force of gravity. They can be overcome…for a time. As the late, great, fundamental investor, Benjamin Graham is credited as saying many years ago, "*In the short run, the market is a voting machine but in the long run, it is a weighing machine.*" It's time for investors to weigh the evidence, both "Pro" and "Con", and decide for themselves.

As always, we welcome your comments and questions.

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(1) Federal Reserve Chairman Alan Greenspan, speaking to The American Enterprise Institute; December 5th, 1996.
(2) Source: marketwatch.com
(3) Source: Standard & Poor's Earnings and Estimates Report
(4) Source: Bureau of Economic Analysis; U.S. Department of Commerce
(5) World Bank - *Global Economic Prospects*; published January 2018
(6) Janney Investments: *Recessions and Bear Markets – When and Why*; published September 11th, 2017
(7) Bureau of Labor Statistics – Labor Force Statistics from the Current Population Survey; April 16th, 2018
(8) https://us/spindices.com/indices/equity/sp-500
(9) http://www.aaii.com/journal/article3/is-the-aaii-sentiment-survey-a-contrarian-indicator?viewall=true
(10) https://www.investopedia.com/news/record-stock-buybacks-will-fire-bull-market/
(11) http://www.multpl.com/
(12) http://www.macrotrends.net/2015/fed-funds-rate-historical-chart
(13) http://www.usdebtclock.org/
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