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JULY & AUGUST 2018 INVESTMENT COMMENTARY

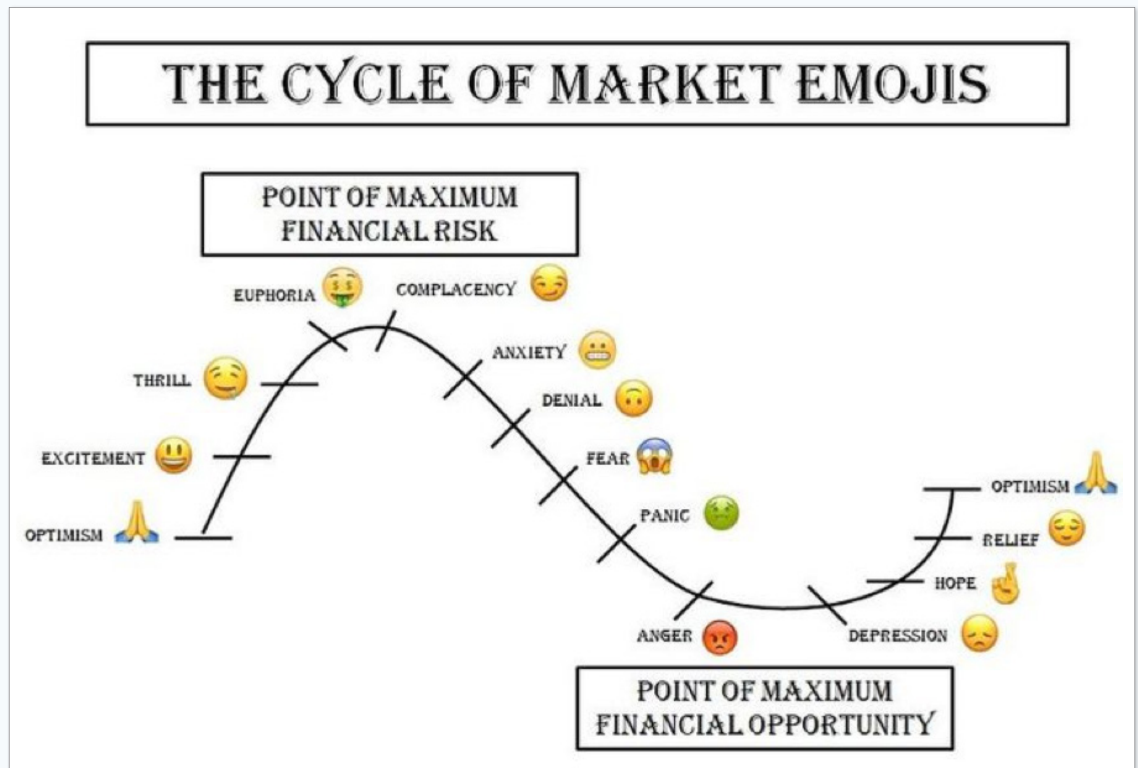
WHERE ARE WE IN THE MARKET CYLCE? WE ONLY KNOW WHERE WE ARE NOT!

Because of the unprecedented nature of the 2008 financial crisis being the United State's first severe "balance sheet recession," the years that followed that crisis, including the present do not fit neatly into the "normal" post-recession blueprint. Therefore, there has been great disagreement among economists, policy-makers, and market strategists over where in the cycle we have been at any point in time since 2009.

Having a sense of where we are in the economic and market cycle is very important in determining how to invest capital for the future. This is because valuations of securities are much less meaningful without the context of where the economy is within a normal seven to ten-year cycle and what that means for interest rates and economic activity going forward. It is challenging to be precise regarding where we are in a cycle even under more normal circumstances.

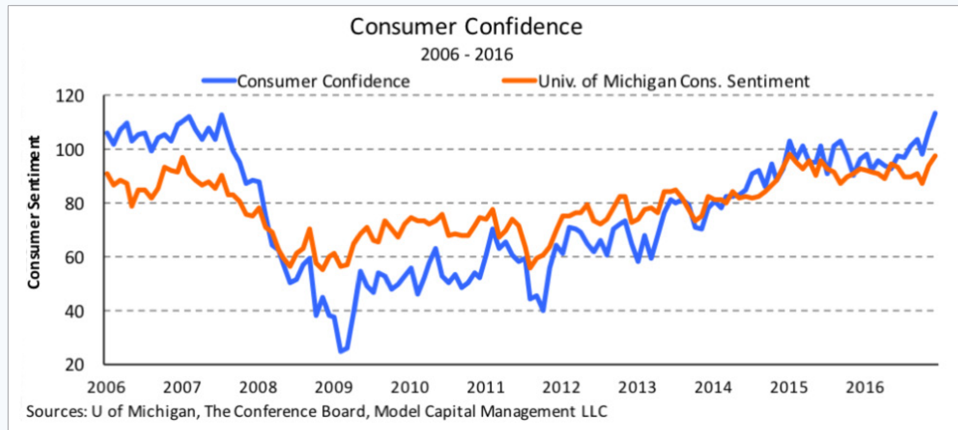
Thus, following a type of recession that most individuals are not familiar with and fiscal and monetary policy response that is unprecedented in size and scope, tracking progress along the market cycle, which has as much to do with psychology as it does finance or economics has become imminently more difficult, but no less important.

I came across the following illustration of a market cycle produced by Sungarden Investment Research that I thought was elegant in its simplicity:



Sungarden Investment Research 2018

What we do know is that early 2009 represented "Panic". If we look at an illustration of consumer confidence and overall sentiment shown below compiled by Model Capital Management LLC, we can clearly see that sentiment and confidence bottomed out between the end of 2008 and early 2009. We then can see a snap back as panic is replaced by "anger" and "depression" between mid-2009 and early 2013 when we can see a very modest improvement in sentiment and confidence readings along with some fleeting periods of improvement followed by a period of falling readings. Essentially, confidence readings did not sustain levels above 60, where it sat just prior to the September 2008 through February 2009 period when confidence readings dropped over 35 points, until early 2013.



From 2013 through early 2015 the readings of confidence and sentiment rose steadily to levels not seen since early 2008 prior to the bankruptcy of Bear Stearns in March 2008. One could make that case that the 2013-2015 period encompassed "Hope," "Belief," and "Optimism." The confidence indicators did not break out to new higher levels until late 2016 when it appears that confidence levels and sentiment levels entered the "excitement" phase. Given the strong stock market performance in 2017 followed by a sharp market correction followed by relatively flat performance over the first half of 2018, one could argue that we have entered "Complacency" with signs that "Anxiety" is around the corner. The other view would be that the "Thrill" and "Euphoria" stage still lies ahead.

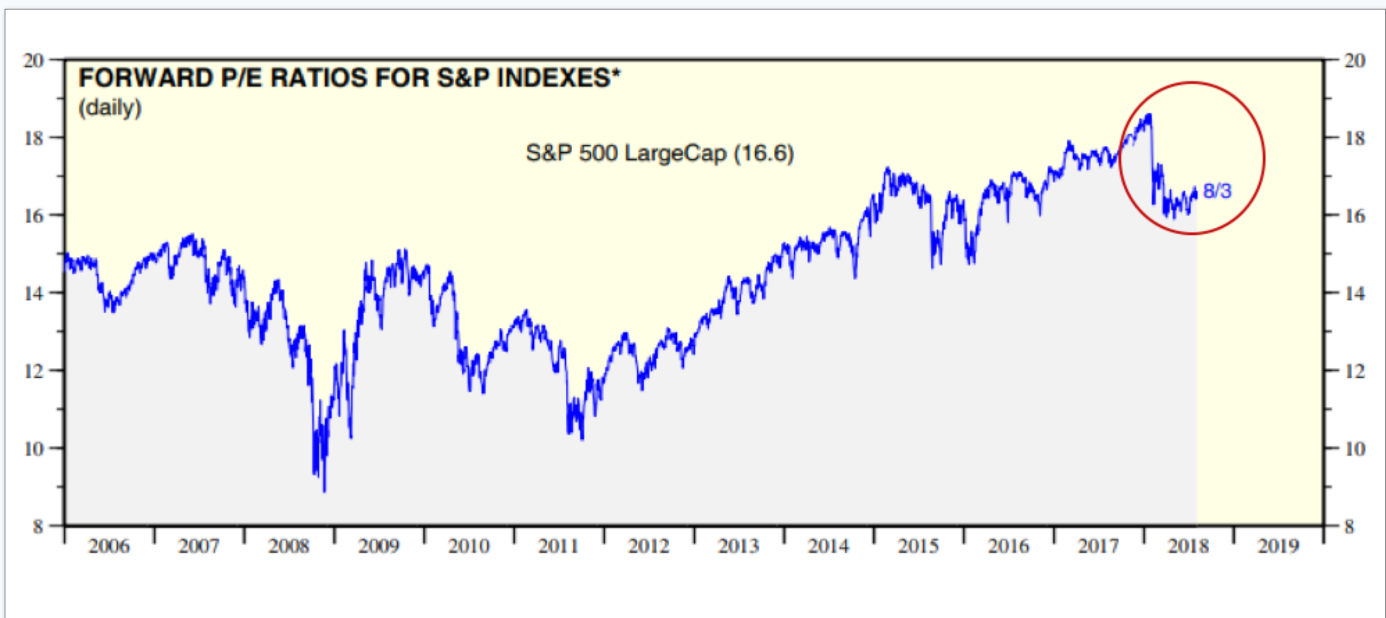
The remainder of 2018 will be very informative regarding whether we are still on the ascending side of the cycle or the descending side. The following chart using the University of Michigan Consumer Sentiment Survey shows the sentiment readings since the beginning of 2017.

Based upon the chart on the previous page, it appears that sentiment peaked out during the fourth quarter of 2017 and the first quarter of 2018. This reading can be quite volatile and that is why I say the second half of 2018 will be very informative in trying to determine where we are in the market cycle.

This uncertainty is why I indicated in May that I would be using the upcoming twelve months to lower equity allocations below a client's baseline target from levels that had risen 5-10% above the baseline.

There is a lot of noise that all investors have to process on a weekly and monthly basis. That information can appear contradictory in the short-term. For example, 2018 has seen a continuation of strong employment growth and Gross Domestic Product (GDP), while inflation rates have been on the rise, interest rates are sitting at multi-year highs, and the yield curve, an important recession indicator, is flattening. Also, worrisome are signs that the housing market is buckling under the pressure of lack of inventory, short labor supply, raw material cost pressures, and higher mortgage rates.

One thing that has improved since the beginning of this year are equity valuations. Strong corporate earnings, bolstered by the large corporate tax cut that became effective in January 2018, have lowered the average P/E valuation of the S&P 500 due to the market index rising much less than average earnings growth since the beginning of 2018. See the sharp drop in the P/E ratio at the beginning of 2018 below in a chart published on August 3rd by Yardini Research, Inc.:



There is some solace in a lower market P/E ratio. However, the chart above illustrates that today's forward P/E ratio is lower, but not low relative to levels seen over the last 12 years. We also have to be careful about drawing any broad conclusions about the appeal of a 16X P/E versus an 18X P/E ratio when inflation expectations are rising, and the 10-Year Treasury Note yield is 0.50% higher today than it was at the beginning of the year. JP Morgan CEO Jamie Diamond stated on August 6th that he believes that the 10-Year Treasury yield should be at 4% today and could reach 5% before this cycle is over. It is important to remember that valuation metrics like the P/E ratio are inversely correlated to inflation and interest rate expectations.

I hope that this commentary drives home the message that the market environment that we find ourselves is extremely challenging to define or measure. Investors always have had to navigate through unpredictable times. What makes the current environment different than past times is not unpredictability, but instead today we are dealing with the following factors which have not been present in the last 35 years or ever:

- The end of the 35-Year bull market in bonds.
- The existence of Quantitative Easing and the need to reverse this unprecedented monetary policy tool.
- A very substantial $1 trillion-plus fiscal stimulus (Tax Cut Bill) at a time of full employment.
- The introduction of trade and supply chain uncertainty as a result of high stakes tariff gamesmanship and contentious negotiations related to various multilateral trade agreements, including NAFTA.
- The crisis of climate change is in plain sight, and there is now a blatant disregard of this developing catastrophe by the world's second largest emitter of carbon emissions (U.S). This unprecedented climate catastrophe is already having major adverse economic impact, let alone the human cost.
- A rise of nationalism is occurring both in the U.S., in Great Britain, and Europe that we have not seen since before WWII. This rise of nationalism raises a worrisome combination of potential social, political and economic adverse consequences.
- Technological disruption by Artificial Intelligence (AI), Blockchain, and robotics are on the cusp of changing the way millions of people live and work.
- Generational culture is important to understand in order to build an investment strategy. The largest demographic bulge in the U.S. is no longer the Baby Boomers, but instead, it is the Millennial generation. Those in the Baby Boomer generation cannot make the mistake of assuming that the Millennials will manage their education, families, household formation, and retail consumption which mirrors the Baby Boomer's past.
- Lastly elections have consequences. The 2016 Presidential election has resulted in many policy U-Turns introducing uncertainty and a massive corporate tax cut that gave a temporary shot in the arm to corporate earnings and by extension the 2017 U.S. equity markets. An expectation or realization that the ballot box will reverse the fortunes of the current majority party would most certainly have meaningful market consequences by signally more policy U-Turns in the near future.

I sum all of the above up as a heightened level of uncertainty unlike any time that any investor alive today has navigated. That may sound like hyperbole. However, I believe that there is currently an unprecedented number of known unknowns.

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