

More to Go?

But Walking on Broken Glass

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Street performers are fascinating and the acts that come to mind are the striking theatrics of walking barefoot across a dense bed of broken glass, bare feet crunching and pressing against sharp edges and points. Painful to watch yet doable if properly prepared. The bed of glass is usually thick and only slightly settled so that the larger pieces of glass on top can move and shift when pressed while the smaller slivers have settled to the bottom. The performer walks slowly taking care to move or reweight the portion of the foot that feels any sharp points, and often the glass comes from a wine bottle or other item having smooth curves and fewer angles. It's a delicate process at best, and clearly remains risky. It is an image which captures our feelings about investing in these coming months.

This commentary is a slight update from our previous notes. We will quickly highlight some of our earlier comments and freshen those thoughts for the next few months. The titling of "more to go, but walking on glass" certainly applies to our thoughts on stocks, so we start there.

US Stocks

In our January 15 "Alamo" commentary we proposed that if stocks could essentially hold a line in the sand at those levels just under 16,000 on the DJIA, then a meaningful rebound could develop and we'd be patient with quality stock holdings despite our longer-term concerns. The March 22 comments in "Vertigo" suggested the upside was limited with the DJIA at 17,582 and the potential opportunity was not what it was in mid-January. Since then, the market has seesawed between 17,000 and 18,500 but the trend has remained up, or at least a strong sideways, with the DJIA closing today at 18,168.

But we think the path from here through the first quarter of 2017 will feel like walking on glass, with a nod to several factors. Figures coming from FactSet news releases this week have the trailing P/E ratio now just under 20x on the S&P500, as the forward looking P/E ratio is just under 17x -- a figure at the highs of the last dozen plus years. We can discuss similar figures on other valuation metrics. Corporate debt levels have exploded, the relationships between cash and debt on corporate balance sheets have deteriorated, both growing fragile situations which are symptomatic of central bank policies and low interest rates. Debt service remains satisfactory so long as the cost of capital does not rise. In our bond market discussion, we note that the costs of debt (and equity) capital may rise even independent of central bank action because of the impact on financial risks. There would be some limit to that divergence, but ultimately the costs of capital are determined by capital market investors reflecting upon risk relative to return.

Earnings announcements for the 3rd quarter will begin in a couple weeks, and flat-to-down overall earnings are likely for the 5th or 6th consecutive quarter. We've had a poor view of the US economy and this "recession" in

S&P 500 earnings over the last couple years has mirrored that – but low interest rates, a low cost of capital, has supported corporate stock prices. This weak earnings and revenue picture is something we have discussed in past meetings, it really first started to surface at the end of 2014 or early 2015. So earnings per share for the market has been declining in calendar 2015 and 2016, much certainly due to the declines in the oil & gas industries as well as a drop in the size of stock buybacks. Today however, there are signs that corporate earnings and revenues may improve towards year-end. Third quarter GDP may come in just above 2%, not great, but possibly the best report since the first half of 2015. US GDP growth figures earlier this year approached miniscule levels almost as low as European GDP growth figures. However with some minor rebound, even a hint of some interruption in the string of poor earnings reports could support some further uptrend this year.

Also, investor sentiment seems dull or discouraged, not lively, and we would look for more enthusiasm once the trend has run its course. Clues will be provided by things like large IPO activity and bullish new era headlines. IPO activity as an example has been near the lows of this decade according to some public releases from FactSet today. For now, uneasiness about the November elections is no doubt partially responsible for the heavy mood. We expect the White House to be occupied by a generally unappealing and untrustworthy character with a questionable and uncomfortable past record – and a last name that begins with either a T or a C, probably a C. More importantly, the US Senate likely rests on the incumbent races of Republicans Kelly Ayotte in New Hampshire, Pat Toomey in Pennsylvania, and Richard Burr in North Carolina, as well as Democrat Evan Bayh challenging in Indiana. The market will wrestle to anticipate the outcome over the course of October and resolution may be interpreted in a positive way, all while the fundamental factors supporting this uptrend in stock prices are very fragile.

Some of the timing devices we monitor suggest inflection points in mid-October, then around Thanksgiving, and then in early April, with the bulk of 2017 in a downtrend. The only problem with those comments is that they involve the future! Also note that most of the meaningful rallies we've had in recent years were directly preceded by sharp drops. That pattern has been so consistent, that one is tempted to say we might need a quick scare, a sharp drop, to establish a pattern that might then develop into another rally to new highs. That wouldn't surprise me over the next two or three weeks. This setup seems quite likely to us...the only problem with that comment is that it involves projecting an image of the past into the future. So we will continue to judge the circumstances daily, and with skepticism.

In any event, despite our longer term concerns about the fragile underpinnings of this bull market, the majority of the factors we analyze do not provide sufficient evidence to suggest that the uptrend is over. There is evidence to suggest however, that a major trend change is approaching so quickly, that one feels like this market is walking on broken glass.

International Equity

For a number of years now, the US stock market has provided overall returns superior to the European markets such as Germany, France, Italy, UK and so on. Demographics, debt, regulation and other structural issues are a poor backdrop for European business activity, and we continue to believe the Eurozone currency experiments are very fragile. This has been our stance and we've not yet changed our tune on that in terms of relative performance.

Going back a few years, we'd really expected Italy to surface as the dominant threat to the European Union. We did not expect a Great Britain "Brexit" to be the first referendum against the EU (Great Britain has never been part of the Eurozone currency), but we don't think those Brexit negotiations are going to go well. We've tended to look at Italy as the weakest link with the strongest populist trend of the larger economies there, and the Five Star Movement is now probably the most popular party in Italy, including Ms. Virginia Raggi the new nonprofessional politician mayor of Rome. Her supporters feel that the typical politicians in Italy are crooks. If this sounds familiar, these are real social trends. An Italian referendum is scheduled for vote on December 4th...so expect growing media focus on Italy and the euro in coming weeks. We also noted a couple years ago the growing Northern Front party of Ms. Marine Le Pen in France, a populist movement pushing for France to exit the EU. These trends echo the populist movements of Bernie Sanders and Donald Trump in the US. Europe is going to have its hands full for some time.

The Eurozone has not had a GDP growth rate over 1% in 10 or 15 years. We have sometimes invested in a few select multinational European firms, but Europe has economic problems that are not being solved by the colossal efforts of the European Central Bank. Deflationary forces from debt, regulation and demographics are tough. Europe is ahead of the United States on that timeline, though more recently the GDP growth rates of Europe and the US are converging just as some of the political trends are. Unfortunately. Globally there has been a recognition that monetary policies are insufficient to resurrect global growth, and that politicians do not know what to do to fix it. Perhaps we do know how to fix it, but reforms take time – too much time and pain to then get reelected. Publicly traded companies are sometimes criticized for being focused on short-term quarterly earnings... take a look at the fiscal policies of politicians around the world.

The same underperformance relative to the US market has been true in China and parts of Asia, although we've had a much more positive view of certain Asian markets for the long-term. We could see India, Taiwan, emerging markets tech companies, Hong Kong and some other Pacific Rim spots providing investment opportunities.

Oil

There remains an excitement and strong focus on oil among traders, but in fact the excitement was in the first quarter and the market has become more boring since then. Our stance has not changed meaningfully from the opinions expressed at the beginning of the year. We commented in mid-January that crude oil should rebound into the mid-40s from the upper 20s at that time, and then in late March suggested that prices would likely drop again upon reaching our target in the \$40s. On that point we've been wrong, oil prices have remained pegged to the mid-40s range pretty consistently and are priced at \$48 on the front month future as this is written.

Interestingly, the rise in oil prices this year, and any further rise, could help the Federal Reserve justify some increase in short-term interest rates. The desire to see inflation in the range of 2% is mentioned as a partial reason for delaying further rate increases, and to the extent oil prices can contribute to some inflation, it might encourage the Fed to act. If so, they better hurry, we don't yet think that oil prices are in a long-lasting sustained uptrend. Not yet.

Oil has had a nice rebound this year from \$26 in January. There is likely a bit more to go, but the oil market faces some fairly significant resistance in the low to mid 50s. The bullish enthusiasm for crude oil this week is palpable and well-discussed, but we have a difficult time establishing upside targets. We think oil remains vulnerable back to the low \$40s or, just as likely, further sideways consolidation into the winter. There is still a lot of broken glass to be repaired in the supply/demand balance in the oil industry, and some of the measured change in oil prices (priced in dollars) is simply the result of changes in the US Dollar. In other words, the denominator has had some influence on the numerator. It is often helpful to view commodity prices in different currencies to understand the fundamental supply/demand influence. A rise in the value of the dollar will not be helpful to the oil bulls, which leads these comments to currencies and gold.

Gold and Currencies

Our lonely bullish views on gold (more than a couple quarters too early as it turned out) had been well-discussed, but it has been a strong market this year and we are no longer lonely. In late March we proposed that gold could retrace from about \$1300 back down under \$1200, but then still rally further over coming months. That more or less happened as gold became a choppy market and in late May did drop down to kiss the support levels at \$1200 before now moving on higher.

Our bullish case rested on very low interest rates globally, unstable currency exchange rates, growing distrust towards central bank monetary experiments, and a washed out negative sentiment towards gold. A very nice rally unfolded this year but the factors supporting gold have become more fragile in terms of the US Dollar. We expect Italy to again torment European unity, populism continues to rise in France, and Germany increasingly diverges from the other powers. We think there is room for the US Dollar to strengthen, for the Euro to become weaker, for interest rates to move somewhat higher, and for gold to find these conditions challenging. The case for gold is being interrupted, so we are out of gold for now. There may be more to go in gold, there is a clear scenario for that, but that trade could require a more complicated (possibly fragile) structure, perhaps against a

denomination other than the US market. That market may also become more volatile in our analysis, perhaps to a degree that is less appropriate for some investors. We feel more comfortable having now stepped away from that factor bet.

Bonds

As we noted a few months ago, one of the issues the financial markets must resolve is that the cost of capital (economic risk and return) is diverging from the cost of money (central bank/government planning). In 2011 we referred to this environment of aggressive monetary policy as a science project. Eventually the guinea pigs and the monkeys watch the scientists and get nervous about the experiment. There is an element of this which seems to be growing in the bond market of late.

Global debt loads are at all-time highs while global interest rates have been at all-time lows, with strong demand for the higher risk and fragile segments of the debt markets. This is not a new development. The underpinnings of low interest rates and a low cost of capital have been the foundation of the capital markets for a number of years now, but this balance does not seem as secure.

In terms of market action and structure, the debt markets act like interest rates want to go up. The Federal Reserve acts that way as well to our eyes. This could show itself in a steepening of global yield curves, and we think this is a trend which could develop further in time. Having said that, it is not our sense that a particularly dramatic increase in interest rates is imminent.

For many years the general consensus had been that aggressive monetary policies would lead to higher inflation and interest rates. We were not part of that consensus for a long time, but are moving in that direction in terms of long-term interest rates. It is tricky to think in terms of there being limits to the growth of aggregate credit, but we are devoting a lot of time to this topic and our conclusions are uncomfortable. Some of the existing trends may still have more to go, but increasingly navigating these markets may feel like walking through scattered shards of glass.

It's been a somewhat tricky or thorny process this year already. We understand, and this is from a thing on CNBC we read in the last week or so, but we understand that just 1 out of 6 large-cap mutual funds are outperforming broad market benchmarks such as the S&P 500 this year. I don't know if that's accurate, but we do feel pretty fortunate to have had a strong start this year in most of the stock portfolios.

We have also worked to be careful and deliberate with asset allocation decisions in portfolios. Our thoughts here now include some important "event risks" related to both domestic and international political elections and finance problems. Increased cash levels may be important to portfolios as we navigate this outlook. It's the equivalent of wearing shoes while you walk across the broken glass. It might not be as thrilling or as entertaining, but it's comfortable.

-Brian