

Hiatus

So, who has the baton?

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Brian W. Rahlf's, CFA

In the mid-1990s I met with a potential client of the private bank that employed me at the time. It was in fact our third meeting – at his golf club in the Texas Hill Country. Our conversations had gone very well, he seemed pleased with our track record and the proper arrangements for asset management. The client, who has since passed away and should not be identifiable by this story, was a very successful corporate executive and business owner in a couple of different “rough and tumble” industries. He had what some would call the “book smarts” certainly, but he was loaded with “street smarts.” We sat down for lunch in a private room in the club and began with some easy conversation. As a waiter came to the table to prepare and then serve from a large salad bowl, the client suddenly barked out “Waiter! You’re bruising the salad!” and proceeded to stand up and demonstrate in a truly gruff manner exactly how this poor belittled waiter should be performing the task. It was a rude and boorish display. But it was an eye-opening experience to say the least and it left an impression I apparently will never forget. It was not until later I realized or suspected that the display was not actually aimed at the waiter.

I was the intended audience. And I’m rather certain the waiter was forever befuddled about the whole event! The client had conveyed he had certain expectations and standards, and he would in no way be shy about assuring that his standards would be met, even to the point of making himself look offensive in the process. He’d waded through a lot of mud holes in his career and a few more weren’t going to bother him much. Be assured that he had no need to capture my attention in that way, and I think it was absolutely the wrong thing to do, but also be assured that he did indeed communicate quite effectively, and he accomplished it without brandishing the baton directly at me.

Either that, or he was really picky about his lettuce.

It’s been over 300 days since our last written commentary and, while we did update our thinking with postings to the website “whiteboard” on March 22 and May 21, we have not felt much urge to update our comments until now. We have not been on a hiatus, but rather the “More to Go” title of the previous commentary remained descriptive enough of our attitude towards the market.

Today, we think some inflection points in the major markets may be developing.

Equities

To this day, it has surprised us that a recession was technically avoided in the last half of 2015 and first half of 2016, per the composite U.S. GDP statistic. However, even the official statistics show flat and declining GDP in the subsectors of manufacturing, transportation, warehousing, utilities, mining and energy in that period – no small list. We'd discussed aggregate earnings per share also declining for several quarters during that 2015 timeframe, and stocks were essentially flat from late 2014 through early 2016.

While corporate earnings per share increased steadily as companies bought back stock and reduced the number of shares (again excluding that 2015 timeframe), U.S. corporate profits (total, not per share) have not meaningfully advanced in the last 5 or 6 years. It was a rough stretch of stagnation.



For the moment, that stagnation is over. This year – both aggregate corporate profits and earnings per share are aligned to rise, and this is part of the story providing support to equity prices. This is important, and it was suggested as an important ingredient in anticipating we had “more to go” in our last October commentary. We don't disagree with those who point to P/E multiple expansion as the backbone of a rising stock market in recent years (and being an alarm bell at current valuation multiples). Stocks are highly valued, but corporate earnings per share has the baton right now. Another factor, another part of the story, is competing for the baton as well:

Politics

Markets rallied very strongly after the November elections provided a single political party with a rare, though razor thin, control of the federal government. For years we've noted that monetary policy was the only instrument available as fiscal policy moves seemed impossible. After the election, legislative progress seemed feasible again (just as many had concluded that monetary policy had lost its effectiveness) and optimism was ignited. One might say that a baton was passed from Janet Yellen to Mitch McConnell on November 8, 2016. That optimism culminated with the well-received State of the Union speech at the end of February, and has become less assured since then. Still, this environment along with earnings improvements, increased business confidence, and regulatory reforms certainly fit well enough with the “more to go” thesis from our last commentary.

Where do we stand now? In our March 22 whiteboard posting we anticipated some initial difficulties in passing tax reform, but felt there was low-hanging legislative fruit that would provide some additional fuel and optimism for this stock market rally. Instead, Congress' inability to take the baton and pass any substantive legislation is concerning. It's concerning enough on the surface, but we'd also recognize that the proposed legislative bills thus far lack, to our eyes, a depth of judgment or comprehensive well-reasoned policies. It's not just the headline facade of insufficient votes at the front of the house, we have questions about the quality of the proposed legislation from the back of the house. One might counter that the substance could be worked out in a joint Congressional conference committee, but thus far there is little evidence to hang that hat on.

These perspectives present a near-term question of how effectively the baton can be passed from monetary policy to fiscal policy. It's not at all clear that the executive and legislative branches of government are truly held by the same party, just as it was not clear that the respective Republican and Democrat political parties were

sufficiently united or respected during the election process. The House is now on a hiatus for over 5 weeks, the Senate will not start their summer recess until August 11, and then both will end their hiatus on September 5th. This leaves a Congress and White House in flustered disarray, a President upsetting many, or toying with us if his intended audience is sometimes cloaked, and the befuddled media seemingly embarrassing themselves (and us on the world stage). Maybe everyone should take a little hiatus. Unlike some of that group, we think the stock market has both “book smarts” and “street smarts” – though possibly even investors could be a bit humbled in being ahead of themselves under these circumstances. So, we see plenty of opportunity for the market to take a hiatus as well over the next couple of months, or to be vulnerable to even minor developments during this August-September vacuum.

Having said that, in suggesting there is a window here during which the market can fall back to rethink this year's trends, we are not trying to call “the top” here. Valuation levels are elevated and you know that we have great concerns longer term, but the current direction of earnings growth remains an important backdrop and the bar has now been set low for the politicians. Some legislative wins later in the year, some disciplined improvement in White House function, along with some improvement in communication tone would also improve the ambiance for tax reform, fiscal policy, and equity values. Rightly or wrongly, the President now has certain audiences sufficiently on notice and on edge, so perhaps that tone changes a bit. Some of the supporting actors may even start to figure it out.

With international equities, we continue to like certain Asian markets, Taiwan, India, and emerging markets longer term, and even some of the European countries at least for a limited time. These selections will continue to periodically appear in certain portfolios depending on our overall risk posture.

Interest Rates

The following chart of the 10-year Treasury Bond is from the March 22 whiteboard, with prices updated since that time, and rather awkwardly cut and pasted into the previous projected shaded zone...



The concept of an upward/sideways consolidation has seemed reasonably valid, and may continue to be so. We do anticipate higher rates but the timeframe appears to be lengthening or slowing. Frankly, low costs of

capital, low interest rates, are so embedded into the infrastructure of investment values and economic activity in this generation, that both suppliers and users of capital understand the risks of any material long-term change in the yield curve. Still, the yield curve may be headed for a change, as we work on the implications of the Federal Reserve unwinding the several trillion dollars of purchased securities on its balance sheet.

The accumulated financial securities held by the Fed are about \$4.5 trillion (purchased to reduce borrowing costs for all, including the Federal Government, and prop up the economy). As the Fed no longer reinvests, someone new will have to, a process that seems likely to increase interest rates. This process might typically lead to recession and so the process will begin very slowly, and one would suppose likely halted at any sign of major problem, though no love lost between the Fed and the current administration. For now, we would envision less than a \$1.5 trillion reduction over the next 14 quarters (steering to Trump's term), and most principally in the mortgage securities.

Another factor contributing to our thoughts comes from some disagreement expressed by former Fed Chair Ben Bernanke in a Brookings Institution paper he wrote several months ago. Bernanke essentially argues that the process of unwinding the large holdings of financial securities should be postponed until short-term interest rates have moved sufficiently higher. In our opinion that point has not yet been reached, but Janet Yellen is clearly more eager to begin this process and wants to hand off the baton to fiscal policy if someone will take it. It's a risk, and likely justifies opportunistic cash balances in the fixed income side of a portfolio.

Commodities

For many investors, the principal commodity sector of interest is oil and gas. The following oil price chart is from the March 22 whiteboard displaying our projected shaded zone, and then with the subsequent price update again cut and pasted into the image...



Our concept of an almost triangular progression of somewhat lower lows with a low-50s ceiling on prices has played out fairly well. We still generally like that picture although our conviction is not quite as high now.

Globally, oil has been oversupplied for some time. Some of the excess inventory has been worked off recently, enough to say that oil has moved from being very oversupplied to simply oversupplied, but either way supply remains sufficient. The efforts of OPEC, problems in Venezuela, seasonal inventory draws, the highest monthly US demand in June in 10 years, and some weakness in the value of the dollar – if these factors can't get oil prices into the mid-50s, how inherently weak is this market?

A solid argument can be made that the baton in the oil market has been passed from OPEC to U.S. producers. Prices could move higher if OPEC wants the baton back bad enough, but we generally continue to view oil as having more downside than upside in coming months. Indeed, should the value of the dollar rebound in the next couple months, oil could conceivably move to a new low for the year. If that's unlikely during this seasonal demand period, in the interim, we may update our thinking with further posts to the whiteboard section of the website. It would be nice to pick up a stock like Schlumberger in some portfolios, if it dropped to a new low just as an example. Again, we will be keeping one eye on the foreign exchange markets in this regard.

Elsewhere in the commodity sector, the price of copper spiked sharply higher when Trump was elected, and the rally has continued to this day. Copper prices have historically been a strong and predictive indicator of economic activity. We track some commodities to profit from future moves, and we track some commodities to help identify what is happening and where we are in a cycle. Copper is currently in the latter category, and for now it remains pointed up. Our conviction level would not justify an investment in that direction however.

Gold has been mildly supported by some weakness in the dollar this year, but nothing more. We have not been focused on gold now for almost a year, but we have developed a market profile for gold which could encourage a move up above \$1400 in coming months. So, we think the hiatus in gold may soon be changing. We may attempt to accumulate on weakness, but only if we can buy it right. Perhaps some rebound in the dollar will provide us with an opportunity to sneak back into that market in appropriate portfolios.

In summary, we think stocks have become vulnerable to a near-term retracement of significance but for now will resist the temptation to proclaim an end to the bull market (though that could easily unfold in the next several months). We sense a possible opportunity in gold, and we'd be uncomfortable expecting any major strength in crude oil or natural gas right now. Interest rates seem likely to rise but that market is a bit more difficult as Janet Yellen may not want the baton and Mitch McConnell may not be able to run with it. The concept of passing the baton is important here as well in that, to the extent interest rates and the costs of capital are positioned to move somewhat higher, the wind is no longer at the back of the stock market in terms of expanding valuation multiples and the baton is fully passed to earnings growth (the Main Street vs Wall Street commentaries we first discussed some years ago). We do think that any significant rise in interest rates is more likely to involve a significant steepening of the yield curve with longer dated securities most vulnerable. Stocks would also suffer.

Politically, socially, we do think there are some folks who would benefit by sittin' on the dock of the bay watchin' the tide roll away. Let's hope that hiatus changes the tone. At this juncture, we also think the markets may be subject to certain attitude adjustments.

-Brian