Market Analysis August 2017

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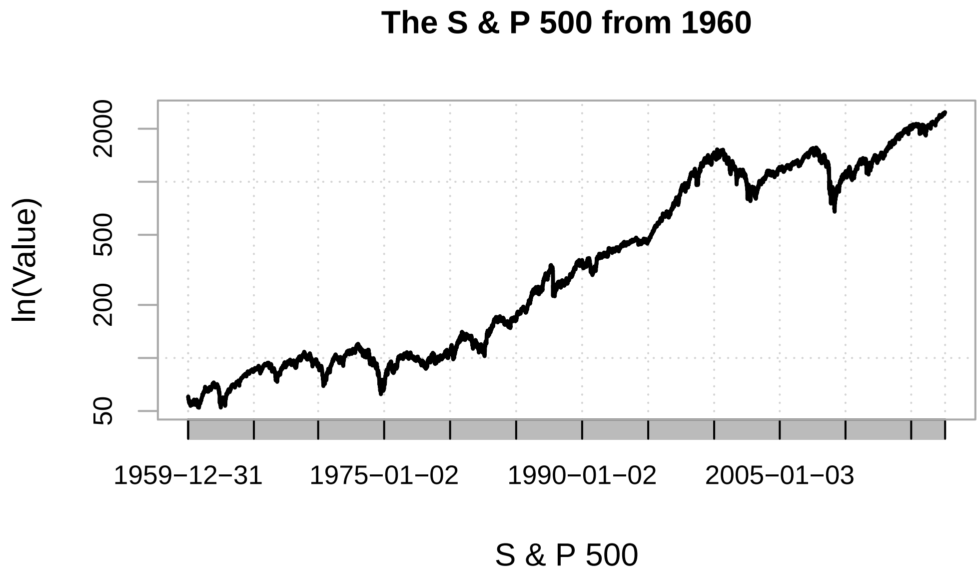
Where did Price Discovery Go?

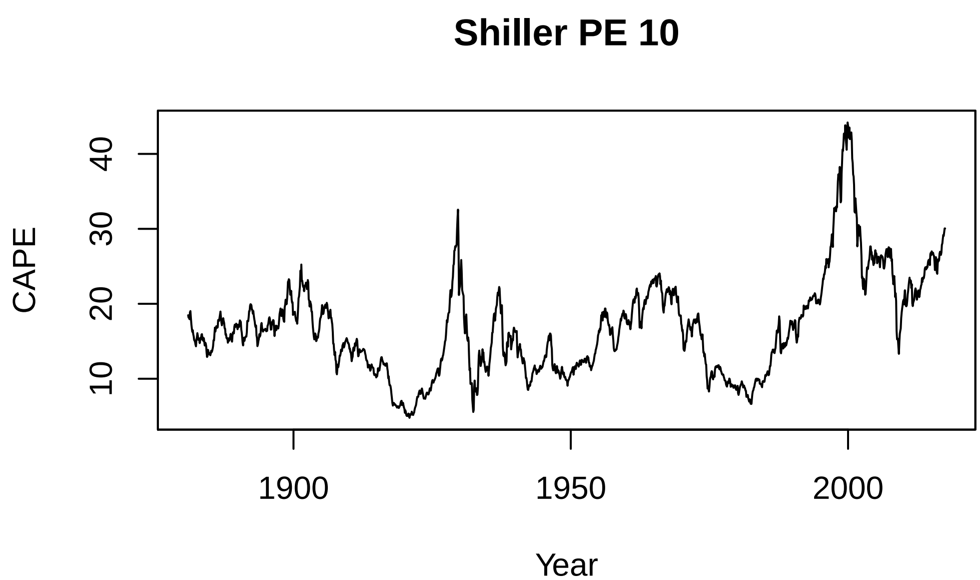
Equities

As many of you know, we have been reluctant to be overweight equities with valuations being high in our view. We took this view sometime ago with an even more cautious stance at the beginning of the year. The cyclical nature of markets will eventually prove you right if you hold on to a view long enough. Gold bugs believed gold would rise to very lofty heights as it approached $800 in the 80s. They were eventually right 30 years later. In recent months, it has been difficult to be underweight U.S. stocks as they have been up almost 20% since the election. Our shift to being more conservative is expected to last 1 to 3 years. I wish I could provide you exact timing of valuation compression but predicting markets is a precarious venture. My suspicion is we won't be 30 years early as the gold bugs were.

What is the cost of being early? It is lower relative returns and a portfolio built for volatility. I will discuss specifics related to returns and portfolio construction in a soon to follow paper. Since bottoming in March of 2009, the S&P 500 is up over 271%. Earnings peaked in September of 2014 at $114.00 per share but likely to be eclipsed with this most recent second quarter at something close to $116.00. In 2014, three year forward earnings were forecasted to be $154.00 by June 2017. Earnings have fallen short by almost $40.00 per share from that forecast and that means virtually all the price movement since 2014 has been valuation expansion.

A lot has been mentioned about the FAANGs lately (Facebook, Apple, Amazon, Netflix and Google). They represent 12% of the S&P at $3.2 trillion with an average price earnings ratio (PE) of 96. What about the rest of the S&P? A cap weighted S&P stands at 22 time earnings and an equal weighted at 22 times as well. This is the third most expensive only trailing 1929 and the 1997-2000 period. The Shiller Cyclically Adjusted PE is the third highest ever at over 30. (Called here the PE10).





Earnings per share is forecasted at $136.00 in one year and $162.00 three years from now. Engineering the PE10 using those earning assumptions, inflation at 2.5% and the 10-year treasury rising to 3.8% puts the PE10 at 22 if the S&P stays flat. To maintain the same 30 PE10 ratio it would go to 3,500. It is possible but things need to line up close to perfect with respect to earnings per share growth and profit margins. Either way valuations would remain elevated for an unusually long time.

What about forward returns for stock? We use several factors but I'll highlight two of them here. First, the Shiller PE10 that I provided a graph for earlier and second the Unemployment Index.

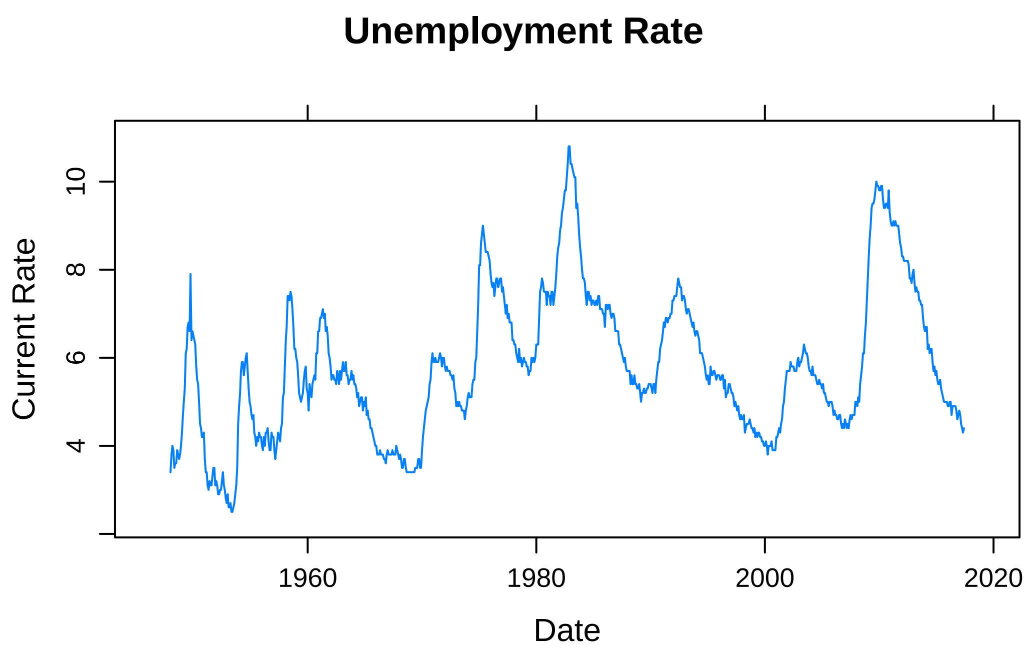


Table 1: Average annual 3 year Forward Returns at Various Levels of PE 10

Shiller.PE.10	Average	Lower	Upper
10 to 13.5	12.07%	9.94%	14.22%
13.5 to 15.5	9.10%	6.80%	11.41%
15.5 to 18	7.19%	4.89%	9.60%
18 to 20	6.28%	2.45%	10.15%
20 to 21.5	2.41%	-0.93%	5.93%
21.5 to 23.5	3.05%	0.68%	5.38%
23.5 to 25	6.25%	2.97%	9.57%
25 to 30	5.43%	0.50%	10.36%
30 and greater	1.56%	-3.45%	6.78%

Table 2: Avearge annual 3 year Forward Returns at Various Levels of Unemployment

Unemployment	Average	Lower	Upper
2.00% to 3.80%	4.12%	-1.90%	10.16%
3.80% to 4.25%	-2.22%	-7.38%	2.92%
4.25% to 4.80%	-0.50%	-9.75%	8.91%
4.80% to 5.25%	1.08%	-7.70%	10.27%
5.25% to 5.50%	8.84%	1.58%	15.80%
5.50% to 5.75%	12.32%	7.24%	17.53%
5.75% to 6.00%	11.05%	6.37%	15.72%
6.00% to 6.80%	8.28%	3.37%	13.01%
6.80% to 7.40%	7.74%	3.05%	12.52%
7.40% to 8.00%	2.91%	-3.11%	8.90%
8.00% and greater	14.17%	9.60%	18.65%

The current PE10 is above 30 and unemployment is 4.4%. By averaging the two returns at that their respective levels, expected returns compounded over the next three years are at less than 1%. The range is between -6.60% and 7.85% averaging the two factors. Taking a few quantitative liberties this suggest that there is a 95% chance returns will be less than 7.85% annually over the next 3 years. A 50% chance of less than 0.

Risk

The volatility index (or sometimes referred to as the "fear index") has reached all-time lows over the last month. The VIX index, a measure of implied volatility on one month options on the S&P 500, stands at about 10. It has averaged about 20 over the long run. The issue is that by definition volatility can't go to zero but can and has gone to 80. You have a very large, non-linear loss profile and by proxy variance move as volatility goes from 10 to 80.

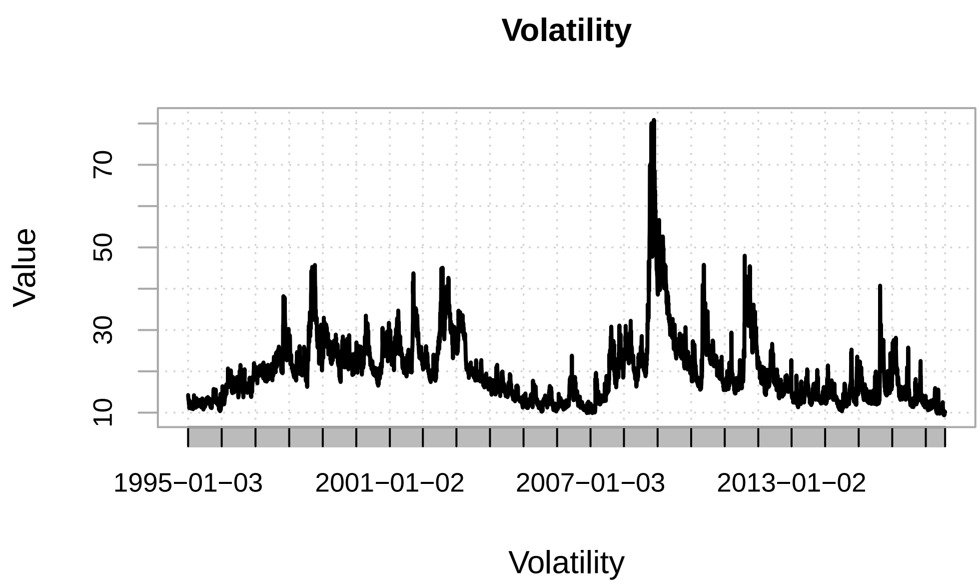


Figure 1: The VIX Index since 1995.

Fixed Income

The world's monetarily medicated bond market possesses its own set of issues. In the asset allocation process over the last 35 years, government and investment grade bonds have not only provided a source of returns but a protection against equity volatility. What seasoned bond investors could't imagine 50 years ago is that long-governments would go from about 5% to 15% and then to 0% interest by 2016. I recall in the mid-80s a discussion related to this question. The moderator asked people in the room "how many think you will see 6% long-governments again?" Almost no one raised their hand. What clairvoyant saw $13 trillion of European and Japanese sovereign debt priced to yield less than zero by the summer of 2016? On the other side of that, what investor would purchase such a bond?

Regardless of the direction of rates from here, there is very little opportunity to add to your return profile. In fact, a gradual sustained rise in rates is problematic for bond portfolios.

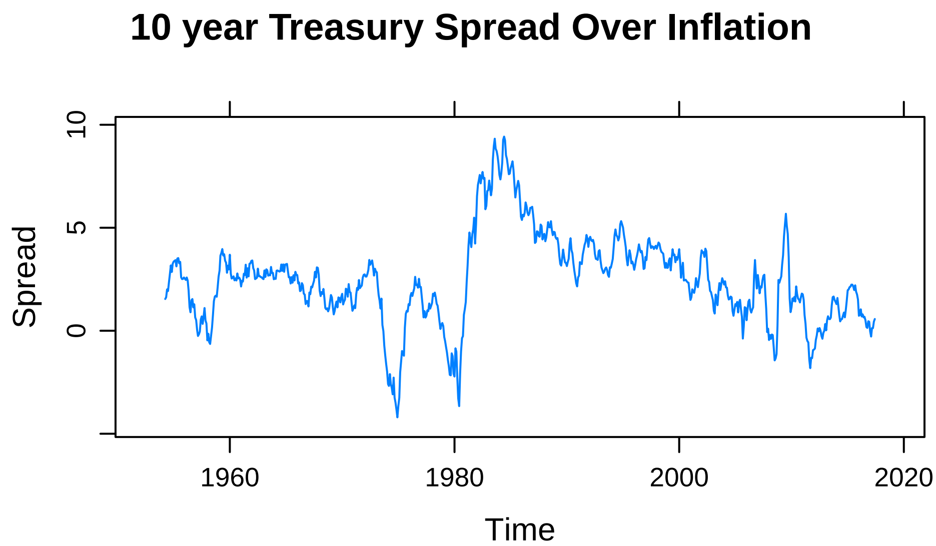


Figure 2: The average real rate is about 2.5% and has averaged about 0.25% over the last 12 months.

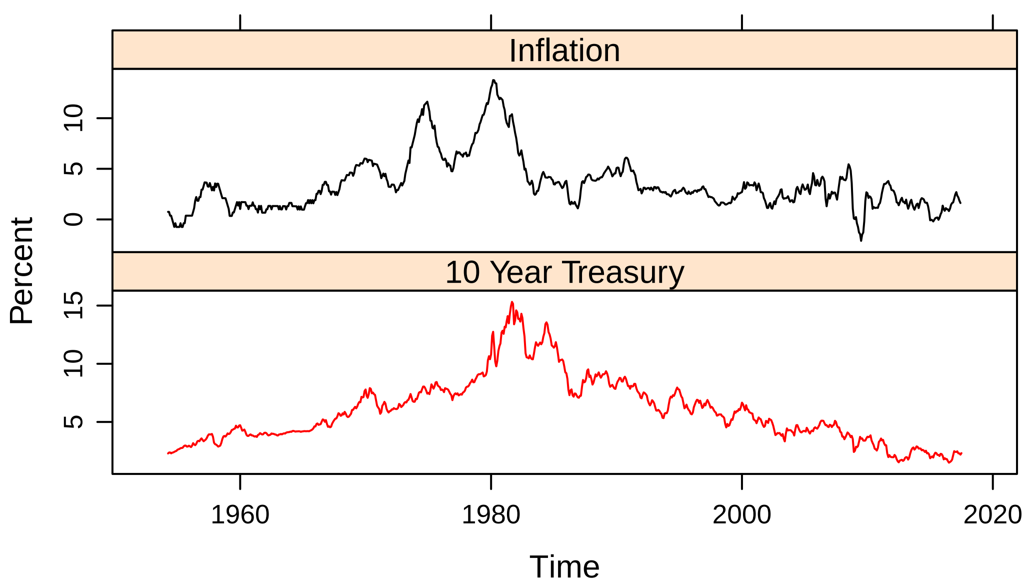


Figure 3: The 10 year Treasury and Inflation

High Yield

What about high yield? This is where you get a real feeling about investor sentiment. High yield is anything considered less than investment grade debt. This is where investors go hunting for higher returns. The current spread is 3.59% over the 5 year treasury bond with nominal yields at 5.59%. Adjusted for default and recovery rates, the risk adjusted spread is around 0.93%.

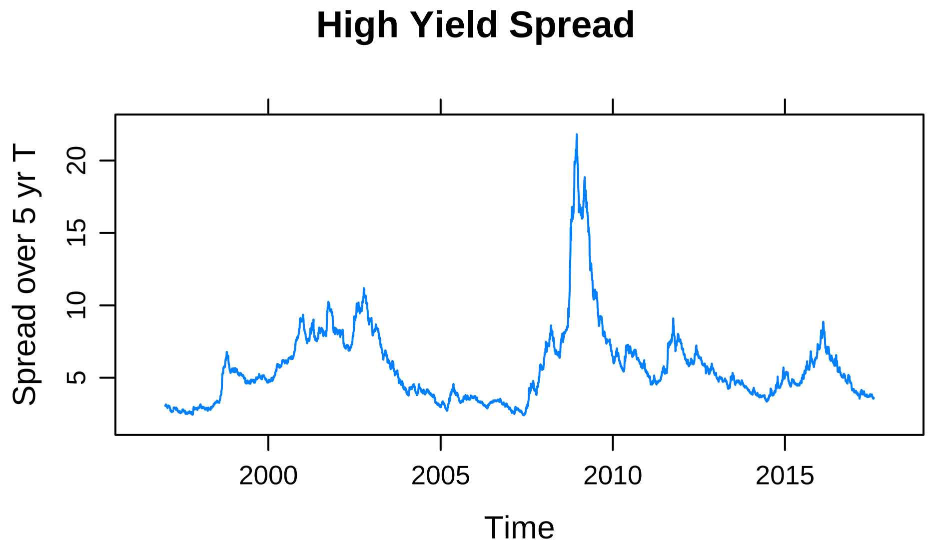


Figure 4: The average spread is 5.75% with the minimum at 2.41%. The current spread is 3.59%

Conclusion

Price discovery is looking at values, drilling down a bit and asking some questions. Interest rates are low and cash returns very little. Patience is a virtue but investors seem to have little at market tops. The fear of missing out so to speak. In "The Big Short", Dr. Burry had to endure a 20% draw down over two years before mortgage backed securities began to reprice. I am not comparing the financial crisis to the current investment environment just the patience needed when fundamentals are stretched.

You won't get many arguments about valuations being high or that there is a lot of cash chasing higher returns. That is what has driven up valuations across both public and private markets. The issue is are you willing to accept lower returns in the short run to benefit in the long run. Piling on risk to get a 10 year Netflix bond at under 4% (I love House of Cards just not their valuation or negative cash flow) or being overweight stocks at some of the highest valuations on record doesn't make sense.

We will discuss in detail risk/return and the implications of our policy as well as portfolio construction in a soon to be written paper.

Disclosure

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