# PARAPROSDOKIANS

It doesn't seem that you can have a conversation about the market without it becoming immediately dominated by a discussion on President Trump.

I must admit I like many of his policies. If effected, they could do wonders for the economy and the stock market, and I'll get to that momentarily.

However, his deportment as the leader of the world's most powerful country does leave something to be desired. But, out of respect for his office, I thought I might raise the bar and take the lead from one of the world's truly great leaders, Winston Churchill. He was always good at a little misdirection when talking about someone else and used paraprosdokians to make his point. These are figures of speech in which the latter part of a sentence or phrase is surprising or unexpected in a way that causes the reader or listener to reframe or reinterpret the first part. As I said, Winston Churchill loved them and I thought I might recount a few that he might use today.

One I can directly attribute to Sir Winston:

- "You can always count on America to do the right thing – after they've tried everything else" - Churchill
- Since light travels faster than sound, some people appear bright until you hear them speak
- If I agreed with you, we'd both be wrong
- We never really grow up – we only learn how to act in public
- I didn't say it was your fault, I said I was blaming you.
- To be sure of hitting the target – shoot first and call whatever you hit the target.
- Do not argue with an idiot. He will drag you down to his level and beat you with experience.
- "A fool and his money are soon elected" – Will Rogers

<u>Where are we in the cycle</u>?

OK, enough on Trump for now, let's talk about the market. For perspective, I think you have to consider where we are in both the economic and stock market cycles. Right up front, I'll confess these aren't good market timing factors. However, if you find yourself in a crowded theater, it always makes sense to know where the exits are before you enjoy the rest of the show.

From a 50,000 foot level, it looks like we're late in the cycle. While, I think it will carry on for a little longer, we should consider a few things:

- The economic recovery is eight years old. That's the 3rd longest since 1928 and is only shorter than the dot com era of the 90's and the fabulous 60's which ranged 120 and 106 months, respectively. That compares to an average of 58.4 months. But then again the Australian economy just celebrated the longest expansion in history at 25½ years;

- The stock market's advance is the second longest on record at over 100 months compared to the average of 33 months and the longest at 150 months;

- Valuations are high. The S&P 500 is up 163% since the bottom in 2009 while the U.S. GDP has only advanced 33%. The divergence was pushed by a 123% increase in the Federal Reserve assets during that period;

- Profit margins are at a peak and unemployment is at a cyclical low;

- Cash reserves held by investors relative to the value of the market is low. In fact, margin debt has risen to nearly $540 billion which is nearly double the levels seen at the market peak in 2000;

- And finally, the Federal Reserve is reversing its accommodative monetary policy with its fourth interest rate increase. This "normalization" will soon include the shrinking of its balance sheet from over $4 trillion to about half of that amount. Currently, the Fed holds 24% of the treasuries held by the public and it's causing a flattening of the yield curve which is another late stage symptom. Raising interest rates affects the price of money but shrinking the balance sheets impacts liquidity which I find the most disturbing.

A current trend that I also find troubling is the indexation of passive investment strategies that continue to gain in popularity. It reminds me of 1999 when "value" managers lost assets in favour of the "growth" i.e. dot com managers. It further depressed cheap stocks while it extended the overvalued tech sector. Similarly, we see money moving from active advisors to passive ones and from underperforming ETFs to those that are doing well. And what's the common denominator of the winners? FAANG – Facebook, Amazon, Apple, Netflix and Google.

In a recently published article in Barron's Magazine, it was noted that there are 6,000 indices today, up from less than 1,000 ten years ago. There are now more indices than stocks while the Wilshire 5000 has declined to 3,599 Issues.

In the first 5 months of this year, investors have directed $338 billion to passive funds and ETFs on top of last year's record $506 billion. However ETFs and "passive" investment strategies are taking on a more active flavour with a "smart beta" approach and factor tilts. Last year, 4 of the 5 most heavily traded securities were ETFs. The Vanguard Group, a major passive fund manufacturer now owns 5% or more of 491 of the S&P 500 companies.

Trusting to diversification and broadly-based products is a little reminiscent of the triple "A" rated packages of junk mortgages that were mathematically condoned as safe during the financial crises. Not only do index funds assure that you will capture 100% of the strategies' upside but they also guarantee you'll capture 100% of the downside.

Because the indices are structured around market capitalization, there is no valuation judgment. They are merely momentum machines rather than valuation machines and execute a perverse logic of buying more of what has gone up the most and what's more expensive.

Today, ETFs are being used to buy market exposure to either a sector or the general market. The methodology is based on asset class allocations or algorithms of correlated factors, not the traditional principles of good management and fair valuation.

Perversely, the premise that index funds are broadly diversified to provide liquidity and lower volatility may not be accurate as these funds own similar stocks and have reduced those company's outstanding float. If and when they all decide to sell, there won't be any support at the individual stock level. Is the underlying liquidity issue relevant? Well consider this. In 2016, the dollar value of trading in the 100 largest ETFs reached $13 trillion which is about the same as the trading in the 100 biggest stocks. However, the market cap of those ETFs was only $1.6 trillion compared to $12.8 trillion market cap for the individual stocks. Mathematically, it means you have a turnover rate of about 120% for the stocks but nearly 880% for the ETFs.

Active portfolios that are differentiated from those built on passive strategies will probably be spared from a self-liquidating death spiral. As was the case in the dot-com boom in 1999, the concentration created by following the crowd creates value in those companies that are overlooked. Buying cheap, good companies will pay off as the momentum strategies push individual market caps to levels that are too big to be sustained without even greater amounts of money. This tide eventually turns. Which might help explain why in the 21 market corrections since 1987, active managers outperformed passive strategies 76% of the time.

However, we are missing one late cycle symptom and that is excess. There is no apparent bubble, with the exception of a handful of stocks, and the economy isn't overheating. Furthermore, investors don't share an abundance of optimism. There's no euphoria or "all clear signs" for future expectations that you usually see at a top.

Current market

Bottom line, I think the bull market will continue until you get either a recession or a much tighter monetary policy. For sure, the Federal Reserve is moving away from accommodation but with negative real interest rates and only plans for reducing their holding of treasuries and mortgages, monetary policy is a long way from being tight.

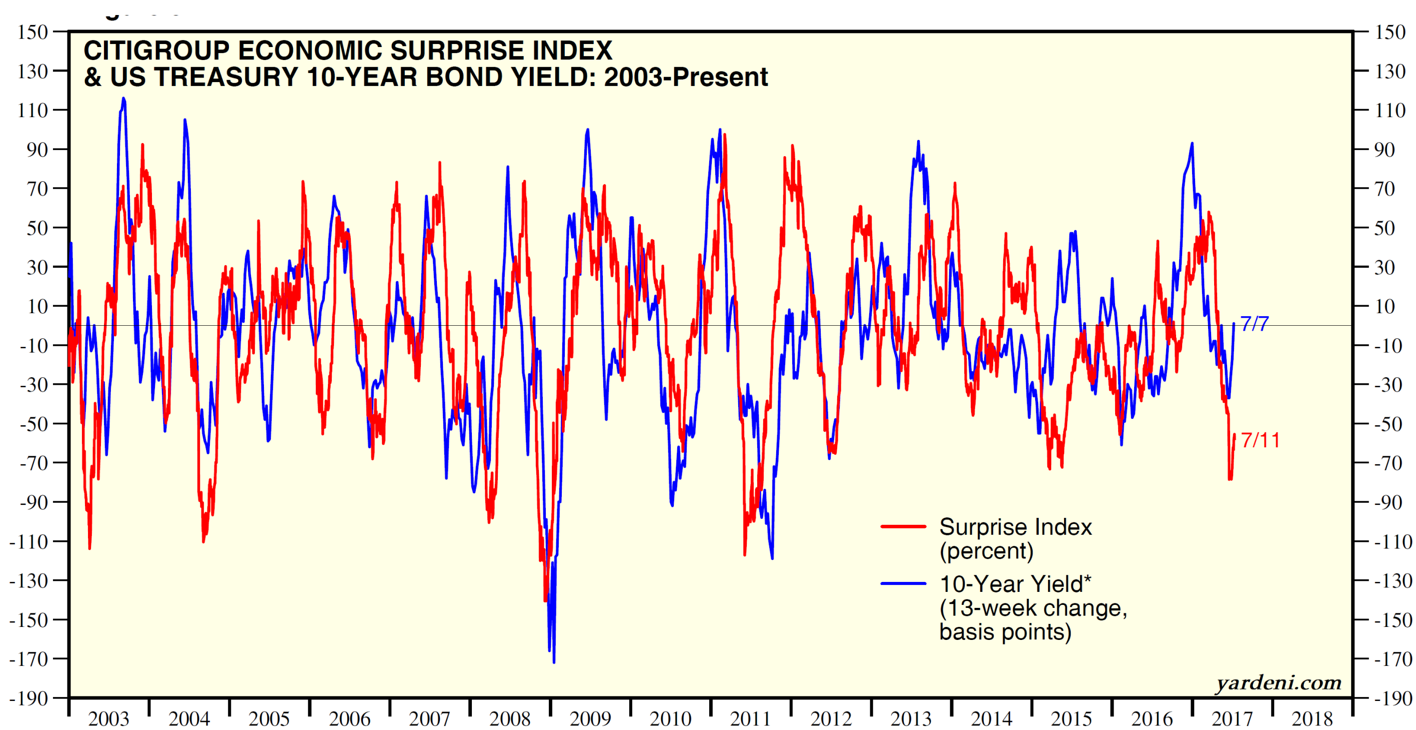
However, I wouldn't rule out a market correction. I'm a big believer in reversion to the mean. If something goes too far or for too long in one direction, it eventually changes direction.

The last 5% correction for the S&P 500 was the past Brexit panic about a year ago. The 247 days since that pullback is the longest in over 20 years. We also saw extremely low volatility in the second quarter, as the S&P endured only one daily drop of more than 1% (May 17$^{th}$) and only one day of a positive 1% (April 24$^{th}$). But, volatility is also cyclical and an increase would likely be associated with a decline.

However, the complexion of any further advance in the market is likely dependent on President Trump. If he is successful with his agenda, I think the more economically sensitive and value oriented stocks will do well. If he isn't, then I believe that a growth orientation will work better. Right now the jury is out.

So, let me explain. The economy was already improving before Mr. Trump got elected and that's crucial to the market's continued advance. However, his proposed policies added a great deal of expectation to those growth projections. Consumer confidence, small business confidence, and CEO/CFO confidence surveys all shot through the roof after Trump's victory. Yet, the hard actual economic results have not supported those soft indicators until recently, when both the leading and coincident economic indicators went to new record highs and the market followed suit.

In my opinion, the best two indicators to watch are the Citigroup Economic Surprise Index (CESI) and the 10-year Treasury bond yields. They've pretty well told the story of this market.




* Average for the week ending Friday.
Source: Federal Reserve Board and Citigroup.

We started 2016 with expectations for economic improvement and higher interest rates, which were mostly undermined by a continued weakness in oil.

The ten-year Treasury yield dropped from 2.30% on December 16, 2015 to a record low of 1.37% by July 8th of last year. In addition, the yield curve spreads narrowed from 215 bps to 97 bps which caused a collapse in the banking stocks, a leading component of the value sector. One can also see that the CESI Index was weak through the first half of 2016 but turned higher at mid-year and then surged after Trump's election. Ten-year Treasury yields also continued higher through the last half of 2016 and value stocks, especially banks shares, led the market.

Since the July 2016 lows, the 10-year Treasury yields have risen from 1.37% to 2.62% in March of this year. During that period, while the CESI increased from – 25.4 to a peak of 57.3 and closely coincided with a stock market peak.

Since then, the CESI has plunged to -76.4 and the 10-year treasury yields declined to 2.21% as did the yield curve spread from 196 bps to a low of 98bps.

Banking shares and "value" have also underperformed. In fact, "growth" outperformed "value" as the top 200 growth stocks in the Russell Index outperformed "value" by 1048 bps, the second-biggest spread on record after 2009. However, history suggests a reversal of fortunes in the second half which many have started with the June correction in the technology sector.

Nonetheless, the first half of this year is a little reminiscent of 2015 when the price of oil declined, economic statistics were weak, the yield curve flattened and the FANG stocks surged.

Right now, Trump's agenda has stalled. There has been no progress on the budget or the debt ceiling. Infrastructure spending has been pushed off until next year. Healthcare is still being debated in Congress and there is still no solid proposal for tax reform, the most important piece of legislation for earnings and the stock market.

Conclusion

Deregulation, consumer and business confidence and more employment will keep the economy growing. But for value and economically sensitive stocks to regain their leadership, it will require some success on the Trump agenda.

Since the start of the year, the market cap of the FAANG stocks is up 41.4% while the market cap of the S&P 500 is up 14.3%. Consequently the FAANGs have accounted for 27.8% of the increase in the S&P500 and collectively, ex-Apple, trade at 42.8x forward earnings. That's a steep premium to pay for "growth scarcity", especially if the rest of the market can benefit from a stronger economy.

On balance, the conditions for a continuing bull market remain in place. The economy is growing, all be it slowly, but then again, this doesn't lead to excesses nor a reason for the Federal Reserve to adopt a tighter monetary policy.

Although we are well along in both the economic and market cycles, they generally don't die from old age and should continue to support earnings growth.

However, none of this would rule out a market correction as our greatest concern is valuation. A pullback of 5% to 10% would at least get us closer to fair value while a Trump tax cut could in fact make the market look cheap.

So, you can say what you like about President Trump, but if you own equities you've got to be rooting for him to succeed. And as Churchill said, "let's hope that you can count on America to do the right thing."

GRC/amh

July 4, 2017

Credits: Ned Davis Research
Barron's Magazine
Yardeni Research
Grant's Interest Rate Observer