HOPE FOR ROTATION

We've said repeatedly that we believe the current bull market will continue until there is either a recession or a restrictive monetary policy.

So far, that position has been accurate as the S&P 500 recently hit a new all-time high and the length of this bull market, according to some, has become the longest on record, beating the previous bull market that took place between October 11, 1990 and March 24, 2000. However, there are those who say the market decline in the 3rd quarter of 1990 was actually a correction. If they are right, then the bull market of the 1990's actually started on December 4, 1987. That extended bull market lasted 4494 days compared to about 3500 for our current run. That might lend some comfort to those trying to handicap how far we are into this cycle. Furthermore, the current economic expansion supports the market as it will become the longest expansion on record in July, 2019.

So, you might reasonably ask, what's bugging this market? The bears have a long list of issues. Starting with the thought that the market's in a bubble driven by:

1. Too much Central Bank liquidity
2. Too much debt
3. Too many corporate buy backs
4. Tax inflated earnings
5. Overvaluation
6. Falling foreign markets
7. Upcoming elections.

And the list goes on. But in my estimation, we still come back to the two things that I think will end this bull market, either a recession or tight monetary policy. And this causes us to focus on tariffs and the Federal Reserve.

So, let me talk a little about each of these.

Tariffs

Tariffs are restrictions to trade; they are a tax and they cause inflation.

Trump is using tariffs in a divide and conquer strategy primarily focused on Europe, NAFTA and China. And so far, his strategy seems to be working. The negotiations with Europe have been put on hold as the EU Chief trade negotiator, Cecilia Malmstrom said that Brussels was willing to scrap tariffs on all industrial products including cars – if the US does the same.

We all know what has happened with NAFTA as the US has made a bilateral deal with the Mexicans leaving us with a limited ability to negotiate. Once settled and with Europe off the table, it leaves the Chinese as the last target with little support from the rest of the world as they will not want to inflame just concluded negotiations.

To further the US cause here, President Trump recently initiated a 10% tariff on an additional $200 billion worth of Chinese imports and threatened duties on a further $267 billon of imports if China retaliates.

These duties started on September 24th and the rate will increase to 25% at the end of the year.

To retaliate, the Chinese have now imposed duties on about $110 billon of US goods which is most of what China imports.

Of course, analysts are working overtime to quantify the impact of these tariffs. According to J.P. Morgan, a 25% tariff on $250 billion in goods will cut the US GDP by 15 bps (0.15%) and boost inflation by 2%.

For China, their growth will decline by 70 bps (0.70%).

More importantly, earnings are affected. Under the current tariff measures, the S&P 500 earnings will be cut by about $5. share and that figure could rise to $8 - $10 if tariffs are expanded to $500 billion in goods.

Furthermore, such actions have caused the US dollar to appreciate. We estimate every 2% rise in the dollar's value cuts S&P earnings by a further $1.50 per share.

Now, I wouldn't ascribe too much creditability to the accuracy of the estimates but directionally you can see why a trade war won't be good for either the economy or earnings.

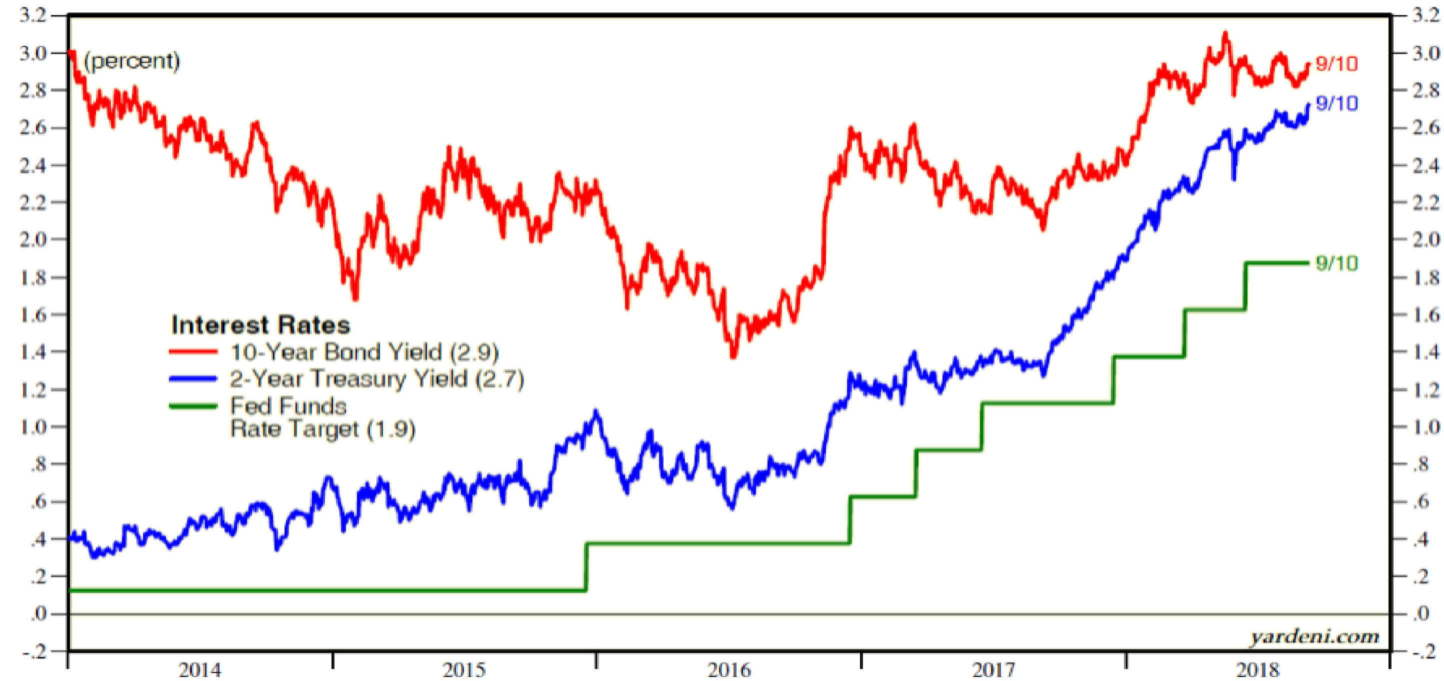
Is it enough to tip the economy into recession? I doubt it, but it will certainly cause GDP growth to head in the wrong direction. Remember, we're talking about tariffs on possibly $500 billion in goods on a $19 trillion economy.

Federal Reserves

So far, they've raised interest rates 7 times to 1.75% and the market is anticipating an additional 2 more rate hikes this year which would take us to 2.25%, with possibly 2 to 3 hikes in 2019.

Historically, higher interest rates are not good for the market. Initially, they limit the market's valuation or price earnings ratio and they often foretell a slowdown in the economy. Today, economists aren't sure how much tightening the economy can take because of the extraordinary amount of debt outstanding. So, the worry is that the Fed could overshoot and take rates too high. Nonetheless, Fed Chairman Powell seems intent on further rate increases as he references the "Neutral Rate" as his target. This is the level of interest rates where monetary policy neither boosts nor slows the economy but keeps it moving forward on an even keel. Powell said that he believes the neutral rate is in the range of 2.25% to 3.5% and that suggests that he sees at least another two or more rate increases.

US Treasury 10-Year & 2-Year Yields & FED Funds Rate



Source: Federal Reserve Board, Yardeni

In this chart you can see the Fed funds rate increases and the impact on 2- and 10-year yields. Those are respectively the Blue and Red lines.

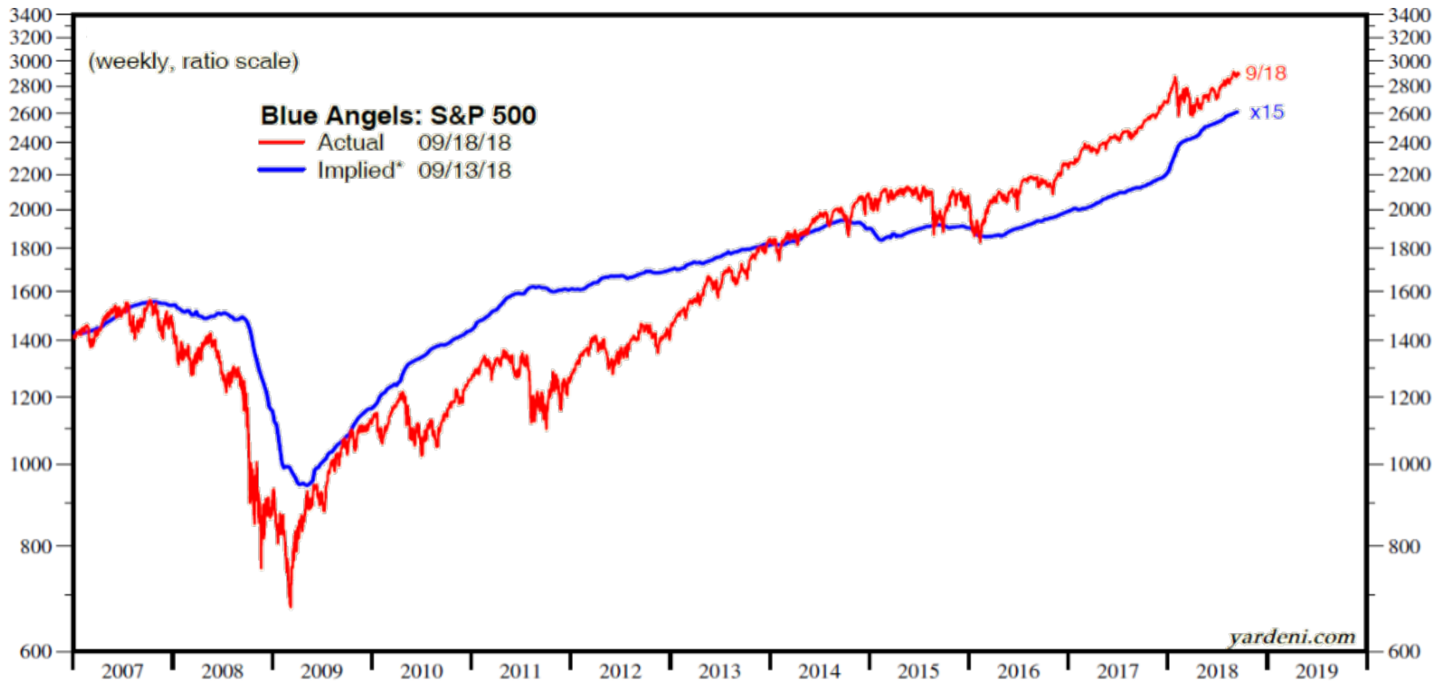
Today, the 10-year Treasury yield is about 3.20%. If the spread to the Fed Funds rate is maintained, further increases will push the 10-year yield to 3.75%. Furthermore, the real or inflation adjusted yield for the 10-year treasury has been 2.3% since 1962. With CPI at 2.8%, it would mean the 10-year treasury could yield 5.1%. Interestingly, that is the number J.P. Morgan CEO, Jamie Dimon, recently suggested as a realistic expectation and markets should be prepared for this.

Trouble is, I don't think the market is ready for rates that high. Current market valuations and economic growth expectations don't incorporate such aggressive forecasts. This is why we think the Fed Policy is one of the most critical issues.

Current Market

So where does this leave us?

S&P 500 Forward Earnings and Valuation



* Implied price index calculated using forward earnings times forward P/Es. Weekly data start January 2007.

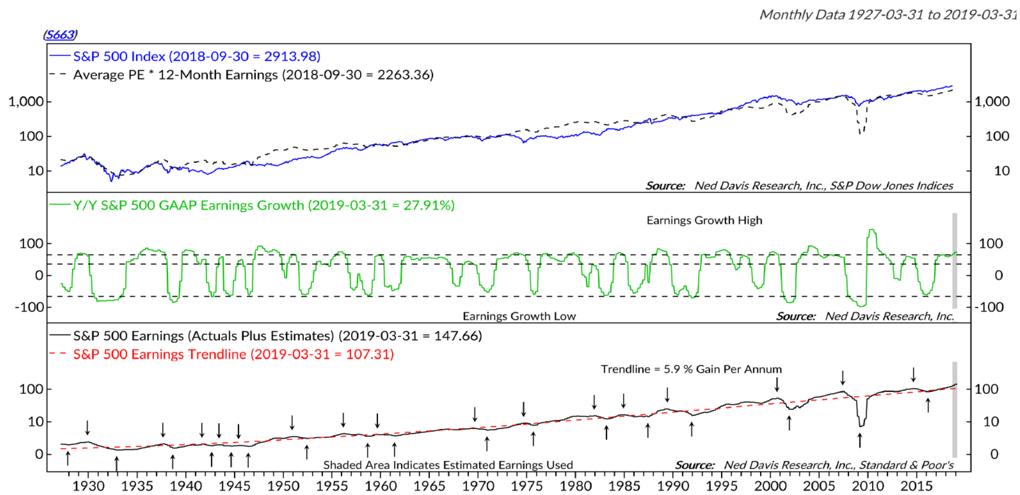
Source: Standard & Poor's and Thomson Reuters I/B/E/S

If you look at this chart, it suggests that the US market is trading at almost 17x forward earnings compared to an historic 15x. Canada is cheaper at around 14x. So, the US is a little on the expensive side but not wildly overvalued.

Furthermore, consensus calls for 2019, S&P 500 earnings of $178.68. So, the market's valuation could improve a little by the end of the year.

Nonetheless, this valuation, late in an economic cycle, with earnings growth slowing relative to this year's tax induced jump and increasing interest rates, doesn't suggest a great deal of upside. A multiple of 17x next year's earnings only gets the S&P to 3000. To get to a 15% upside you need over 19x next year's consensus earnings estimate.

S&P 500 Index vs. GAAP Earnings Growth



Date	4Q EPS (3rd Clip)	Y/Y % Change (2nd Clip)
03/31/2018 (A)	$115.44	15.1
06/30/2018 (E)	$122.48	17.7
09/30/2018 (E)	$130.83	22.2
12/31/2018 (E)	$142.74	29.9
03/31/2019 (E)	$147.66	27.9

Average P/E at Earnings Peaks (Down Arrows) = 13.06
Average P/E at Earnings Troughs (Up Arrows) = 24.85
Based on Earnings Reversals of 10%

S&P 500 Index Performance
Full History: 1927-03-31 to 2018-09-30

Y/Y Earnings Growth (Latest Actual):	% Gain/ Annum	% of Time
Above 20	2.64	22.97
Between 5 and 20	7.10	31.13
Between -20 and 5	12.08	37.71
-20 and Below	-13.58	8.20

Buy/Hold = 6.01% Gain/Annum

Source: Ned Davis Research Inc.

For perspective, the market has historically only been willing to pay a little over 13x for peak earnings.

If Trump wins the trade war, you might get some kind of melt up. But you can see it takes some optimistic assumptions to project any kind of major upside for the averages.

However, I wouldn't extrapolate this into avoiding equities. I think there is an alternative and it will be reflected by a change in the market's complexion.

To date, the market averages have been driven by a handful of companies.

Amazon	24 Points
Apple	15 Points
Netflix	9 Points
Facebook	5 Points
	53 Points
Microsoft	15 Points
	68 Points

This is very apparent when you review the performance of some of the FAANG stocks, (Facebook, Amazon, Apple, Netflix and Google). Through June 30th the S&P 500 was up approximately 78 points.

As you can see, four of the FAANG stocks accounted for almost 70% of the advance. If you focus on only Microsoft and Amazon, they account for 50% of this year's gain.

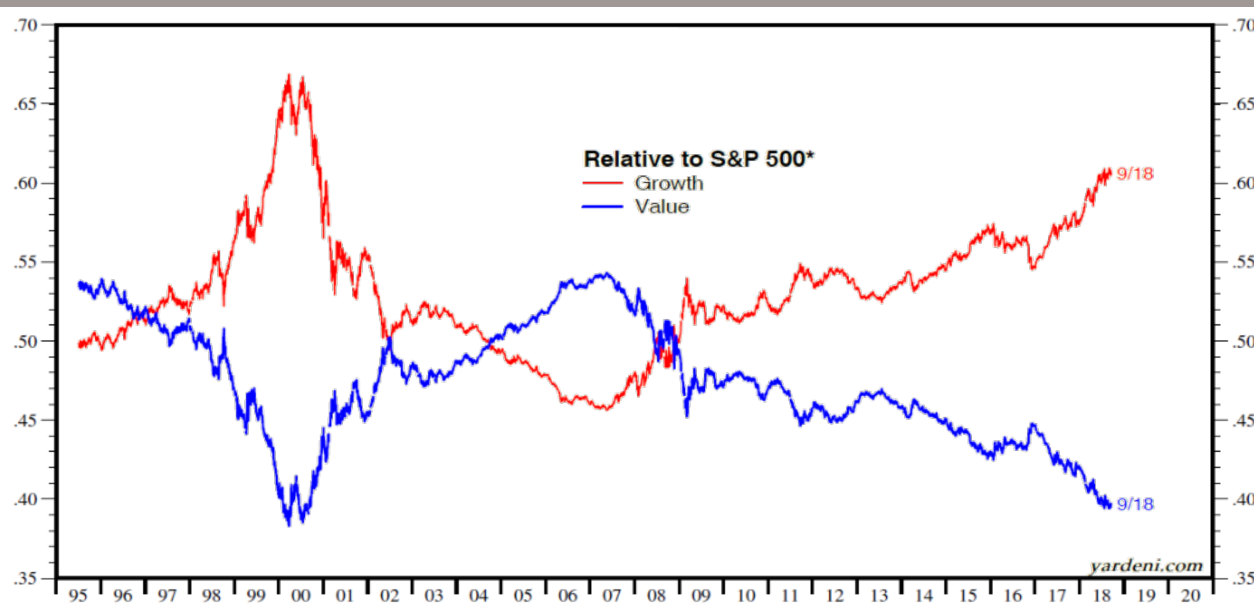
This lack of breadth is not good. If it doesn't expand, the market is likely to top out. If the market breadth does broaden, it is quite possible that money comes out of the FANG and technology stocks and gets reinvested elsewhere. This could leave us with a very healthy rotation in the market making it possible to earn reasonable rates of return while the averages mark time.

In fact, this seems to be happening as inflows to passive investment vehicles which own many of the overvalued stocks are starting to reverse. If this money flows elsewhere, it could be a significant opportunity. Just consider that passive strategies tend to buy market capitalization – i.e. the biggest – not the cheapest. As an example, Amazon and Netflix, both huge companies, each trade at nearly 100x earnings. Furthermore, the market capitalization of the 5 biggest companies in the S&P 500 equals the market cap of the smallest 282 companies in the S&P 500.

Think about that. With the proceeds of the 5 biggest you could buy more than half of the S&P 500.

What could trigger this change? Well, first there is valuation.

S&P 500 Growth vs. Value



* Rising (falling) line indicates that the index is outperforming (underperforming) the S&P 500.
Source: Standard & Poor's and Haver Analytics.

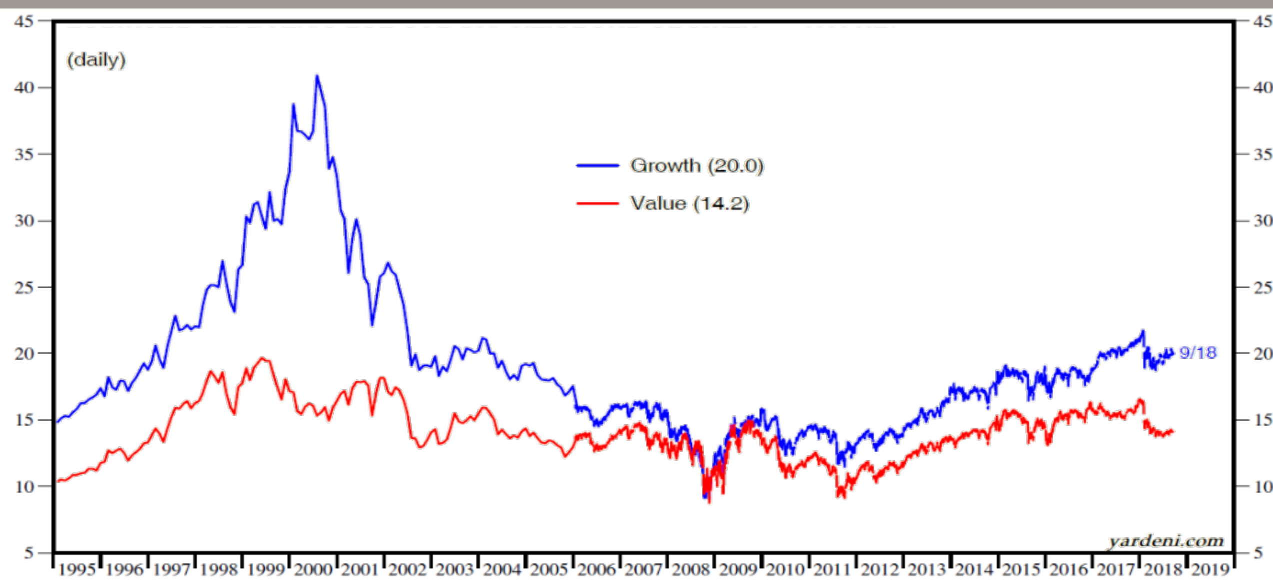
As, you can see in the above chart, the spread between the S&P 500 Value Index and its Growth counterpart is close to historic extremes.

Relative Price Index

Source: Standard & Poor's Corporation and Haver Analytics.

The bottom chart indicates that Growth has now outperformed Value for 10 of the past 11 years, one of the longest stretches on record.

Forward P/E Ratios



* Price divided by 12-month (52-week) forward consensus expected operating earnings per share. Monthly data through December 2005, daily thereafter.
Source: Thomson Reuters I/B/E/S.

This has resulted in a valuation gap where growth stocks are trading at over 20x earnings compared to about 14x for value stocks.

Forward P/E Ratios

* Price divided by 12-month (52-week) forward consensus expected operating earnings per share. Monthly data through December 2005, weekly thereafter.
Source: Thomson Reuters I/B/E/S.

This last chart suggests that the only time we've seen a wider gap was in the 2000 tech bubble.

Another reason the preference for growth could change is the threat to technology companies from government regulations and taxes plus the possible impact from tariffs.

We think it is unlikely that the regulations will be able to resist passing laws to restrict or break-up some of the largest companies for anti-trust reasons. Furthermore, they represent an opportunity to raise tax revenue. Just consider that Facebook, Twitter and Google have all been asked to appear before congressional committees. And the European union has imposed taxes and penalties on both Apple and Google.

Such challenges could go beyond just preferences and hurt some of the tech sector's growth prospects. Profit margins in this sector have expanded from 11.7% at the recession low to currently 23%. That's considerably higher than the pre-recession high of 13.9%. So, further profit margin expansion is unlikely to contribute to the industry's growth rate and in fact could hurt it.

So, some rotation and broadening of the market are probably the only alternatives that won't see things ending badly but one that we think is highly likely if Trump and tariffs don't derail the economy nor does Fed Chairman Powell go one interest rise too far.

GRC/amh
October 4, 2018