JANUARY 2018

OBSERVATIONS ON AN ELDERLY BULL MARKET

The US stock market has moved through several phases since 2009 that have allowed it to reach record levels (**chart #1**). Early on, the sharp decline to near zero interest rates from Federal Reserve policy was a first phase that set in motion corporate debt refinancing and liquidity being restored to markets. It also provided cheap cash for investors and speculators to leverage bets in financial assets. In this first stage there was less investment in so called Main Street or from corporate expansion, but rather the money went to Wall Street. Financial assets absorbed the new liquidity. Much of the market's phases have subsequently coincided with the pace of monetary policy known as quantitative easing (QE). **Chart #2** notes the growth in assets at the Federal Reserve as their bond purchases fostered low rates and a rising stock market. Since this liquidity failed to enter the real economy, deflationary worries continued about the slow pace of the economic recovery. Each succeeding year of QE failed to spark GDP growth much above 2%. The real economy seemed stuck. Stocks for the most part ignored the slow economy and made good progress from 2011 to 2014 in almost direct correlation with Fed asset purchases (QE). Stocks offering higher dividend yields than bond yields were purchased as bond proxies, drawing bond money into the stock market.

The monetary dependent phase of the stock market was challenged when, in 2014, the Fed hinted at slowing its QE. A swift reaction from the bond market followed that overflowed into stock prices. Stocks saw a decline of about -5%. I think this marks the end of the Fed supplied monetary phase's primary support to stocks. Markets began to discount a path to interest rate normalization. I don't want to over-simplify what moved the market. I believe, however, the *Fed supported, liquidity driven phase* crested and shifted to a phase of *price-to-earnings expansion* that brought higher stock prices. In this phase investors paid higher prices for essentially the same earnings, as our real economy was not yet in gear generating much growth. To be fair, profit margins were historically high from the cost benefits of globalization moving labor costs off shore. Financial engineering also propped up stock prices through stock buy-backs as companies reported per share earnings would rise given fewer shares outstanding.

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Chart #1

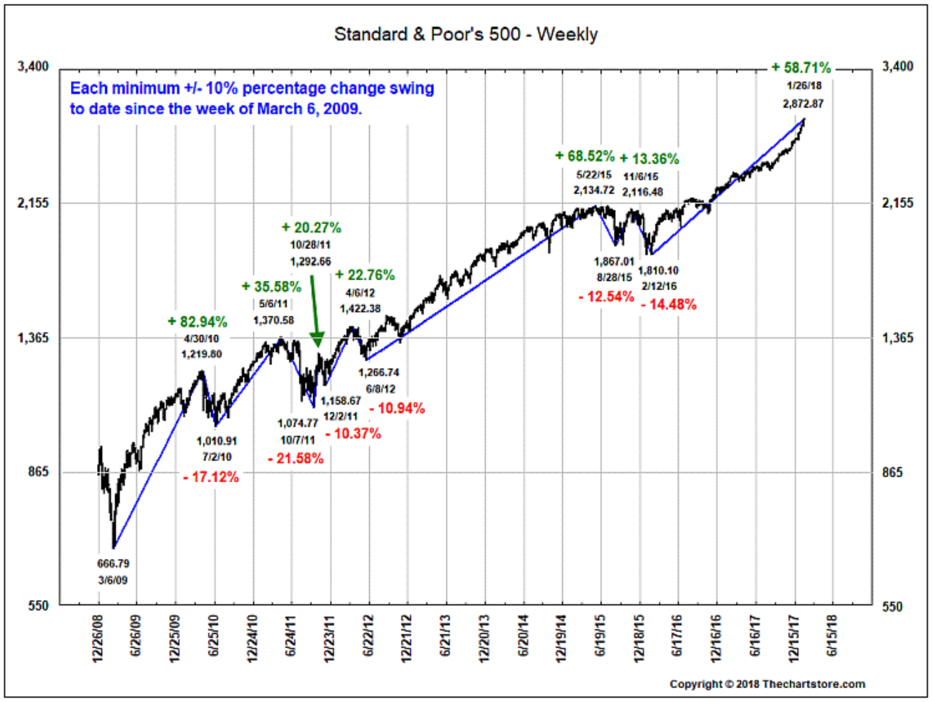
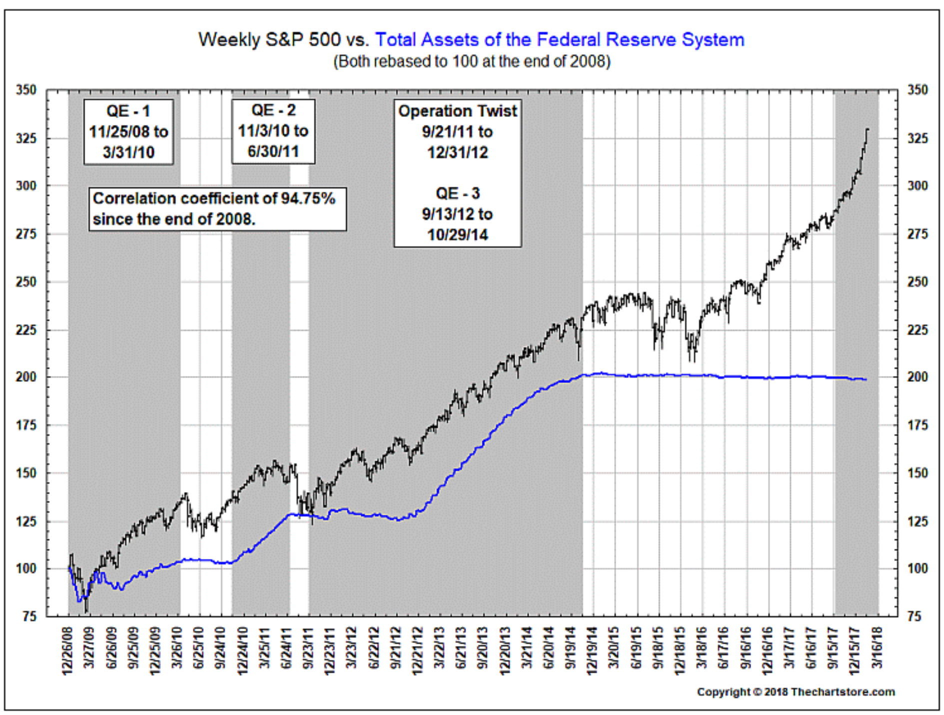


Chart #2



Our current phase or position has evolved from the *P/E expansion phase* to where there is now fundamental economic support for the domestic economy. This is taking place in a positive global context some are calling a synchronous global expansion. This news has even reached the New York Times, an economic skeptic. The financial crisis that went 'round the world in 2008-2009 has finally been patched up and growth is resuming.

2017 stock prices in the US cheered better than expected earnings growth and animal spirits have crowded the market with momentum bulls and those who fear missing out. What phase is this? This is the phase that relies on real economic progress, better jobs lifting more people out of part-time gigs to make a living, more investment from business and more trade. Monetary policy is not the source of new business investment and expansion decisions. The calculus from business comes from confidence of future growth. Monetary policy may still be influencing mergers and acquisitions as companies move to do their deals ahead of further rate hikes.

It would be reasonable to think we should question the duration of this business cycle since, by historical measures, nine years is a long time. I would propose our cycle really only started when we ended the dependency of the market to the Fed liquidity phase. By that measure, perhaps we are only in year three or four. Much will depend on the rest of the world (ROW) and, of course, China in particular. Trump is involved in the current regime of the market if not explicitly from policy than indirectly from reaction to policy proposals. Wall Street and the big banks seem to be pleased with his proposals of less regulation and tax cuts. We as investors, however, should not want financial safeguards dismantled that could expose us to systematic risks. Simply put, in the current phase, higher future stock prices will need earnings growth to keep pace with any Fed withdrawal of policy support. A tipping point would be reached that could hurt stocks if that is not achieved.

The current valuation of the US stock market is its biggest vulnerability to the tipping point. How much good news is discounted or extrapolated in share prices already? Most everyone that normally owns stocks is at a full allocation, households and institutions alike. Only strong earnings growth makes all the metrics look better. The market must keep its balance on the tight rope where a Fed mistake on rates or a disappointment in earnings might cause a fall. At the moment, the crowd is happy to watch the spectacle taking comfort from the Fed's slow pace safety net. It would be naive not to expect a market wobble, but the danger of recession, which is the real danger to stocks, registers low on the probability scale. Watch bond yields to measure the cross winds on the tight rope. Financial stocks being anti-correlated to bonds may be a stabilizer to a portfolio if interest rates surprise on the upside.

Avoided values are best buys,

J.T. Underwood
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