**Market Commentary - August 2016** View this email in your browser

For a while now, we have opined that the bull market was likely in the latter innings. Now it looks like it may be in extra innings. This, however, doesn't mean a bear market is lurking just around the corner (especially given the lack of investor optimism and high cash levels–both bullish signs). A market with rich valuations can work itself out in two very different ways. First, a correction or bear market may be needed to correct the market's excesses. Or, time may be necessary for earnings to "catch up" with stock prices (a time correction). In this case, stocks may be in "pause" mode and trade sideways for a while. If market fundamentals stay positive (for example, continued GDP growth, job gains, no Fed surprises, earnings growth resuming) we think the "pause" alternative, not a bear market, will be the market's likely path.

# Equity Valuations Still Matter


The bull market advance in stocks has slowed but continues its upward trend. This has been one of the most hated rallies in recent history because so many gave up on the market (quit) and never returned. Further, mutual fund investors, as net sellers over the past few years (indicating they no longer believe much upside remains) have been frustrated by the market's recent move to new highs. Clearly, market timing has served these investors poorly.

P/E is projected to be 18x estimated earnings with 2017 at 16x (assuming 13% earnings growth in 2017). When compared to the long term P/E average of 14.3x prices now appear rich. Remember that only six months ago the 2016 P/E forecast was about 16x. In the intervening time frame prices have moved higher (by 6%) while earnings have declined.

Are valuations high enough to topple the bull market? Valuations alone rarely spark bear markets but when stocks are fully priced or priced to perfection, an exogenous event combined with rich valuations can take the market down–and quickly.

Equity valuations still matter. There is a limit to how high valuations can go. From current levels, the chance of significant P/E expansion is minimal (especially considering the high worldwide debt levels and slowing GDP described below). There is an old saying that the market frustrates as many investors as it can. Currently, many reluctant investors are feeling the pain (frustration) of being left behind so the path of least resistance in the short term is probably upward. Nevertheless, vigilant investors know that discipline and the avoidance of behavioral miscues can be a real challenge–as it is today.

Should utility and telecom stocks, currently growing earnings at about 3% annually, trade at 20x forward earnings as they do today? Probably not. Those sectors may remain rich for some time if investors continue to feel the need to chase yield. However, over time, stock valuations need to be supported by earnings growth. Actual 2017 earnings growth of 13% (as currently forecast) would be a great start but it may take more than that for the market advance to continue. At some point earnings will have to catch up with share prices.

# The Global Bond Market – A Dangerous Place

Recent financial shocks have caused surprisingly little damage to the global markets. An upsurge in worldwide terrorist activity, the historic British vote to leave the EU, the Turkish military coup attempt and China's managed currency devaluation could have caused significant damage to risk assets–yet they didn't. By risk assets we are referring to stocks, commodities, junk bonds and emerging market corporate and sovereign debt. And while U.S. Treasury debt initially benefitted from Brexit (10 year Treasuries rallied nearly 40 basis points to 1.35%), investors have remained remarkably calm. It's as if events that in the past caused the markets to swoon no longer matter.

But as we saw this past January, markets are not shock-proof and investor composure has its limits. Central bank policies, while boosting financial assets in the short-run, may be creating dangerous long-term imbalances (such as negative interest rates abroad). It could be argued that investors are now returning to risk assets just as bond rates are reaching historic lows and stock valuations have become full. Higher risk asset allocations have been embraced by investors struggling to find yield and return.

There is a high probability that this yield chasing will end poorly for unwary retail investors. Worldwide debt levels are dangerously high at about 300% of collective GDP while growth among developed countries has been halved in the new century. Further, the corporate credit cycle appears to have entered a more fragile stage after the collapse of the commodity super-cycle. We believe that high-net-worth investors should avoid higher risk holdings including domestic high yield bonds, leveraged loans, non-public REITs as well as emerging market sovereign and corporate debt.

By dismissing the importance of recent shocks, market participants may be underestimating the severity of these events. We believe recent events are linked and reflect growing imbalances resulting from central bankers' and politicians' actions. Resurgent nationalism, beggar-thy-neighbor currency policies, frustration at slow economic growth and the rising class struggle are all the result of these events, not the cause of them.

We are convinced that the recovery and repair phases of this credit cycle will be elongated, taking several years longer than in the past. Many of the low quality bonds described above could suffer significant losses, languishing for years. Therefore, we now are purchasing bonds of the highest quality, including U.S. Treasuries.