Market Commentary - August 2017

CLEARVIEW
WEALTH SOLUTIONS

Second quarter earnings update: With about 60% of companies reporting so far, earnings have risen 11% year-over-year after a 15% gain in the first quarter (the first consecutive quarters of double-digit profit growth in six years). The strong growth can be attributed to higher U.S. wages, improved consumer confidence, and a weaker U.S. dollar. Revenue growth for the second quarter is projected at 5% (the highest in five years). More on earnings below.

The Most Hated Bull Market in History

This bull market (now eight+ years old) is often cited as the most hated bull market in history. Why? Because so many investors are underinvested in equities or not invested at all. The stock market wreck in 2007-2009 saw prices fall 55% from peak to trough. This was on the heels of another bear market in 2000-2003. By 2009 many investors had given up on stocks for good (after suffering two severe bear markets in a decade), only to miss out on the S&P 500's 350+% gain since then. We are still in a bull market hitting new highs almost daily it seems. Can equity markets keep advancing?

For stock indices to go higher, including the S&P 500, either the P/E multiple must expand further, or earnings must drive prices higher. There is no other way. What are the chances of either happening?

Let's take a look at P/E multiples first. Here is a table of the market today compared to previous key dates: the peak in 2000 and the trough in 2009.

	MARCH 2000 PEAK	MARCH 2009 TROUGH	AUGUST 2017 TODAY
S&P 500 Stock Index	1553	666	2470
P/E Ratio [1]	24	9	17.8
Index Earnings	$65	$74	$140

1 Next 12 months.

The table shows the market's P/E ratio has nearly doubled from the 2009 low and is now the highest since 2000. **How much higher can P/Es go? Not much in our view. It's highly unlikely they will approach the 2000 high.** That was a once in a generation feeding frenzy when sales and earnings didn't seem to matter. It was about eyeballs, clicks, and the 'new economy' with its new rules. We saw how that played out with the subsequent bust in 2000, and negative stock returns for the next decade.

Earnings, however, could propel this market even higher. Estimates for 2017 company profit gains sit at 10% with 11% forecast for 2018. Add corporate tax reform legislation and infrastructure spending, and these forecasts could go higher still. If earnings come through this year and next, this hated bull market probably has more room to run. If not, then we might be approaching the last days of this aged bull.

Final thoughts:

- Our continued concerns about the market at these levels is twofold: first, P/E ratios are high (see above table) with little room for expansion, and second, we are having a very difficult time finding attractive stocks using our time-tested, disciplined criteria.
- Many investors, including professionals, are investing based on projected relative returns. Investors should be assessing offerings in terms of absolute returns and absolute risk. You can't eat or spend relative returns.
- Even though we are living in a lower return, higher risk investment world, we would rather make money for our clients in the next couple of years than see a bear market that creates bargains. Investors like bargains, but no one is eager to endure the pain of the price declines that create them.
- Clearview will continue to apply the same investment process (discipline) that has served our clients well over the last 35 years.

The Bond Market Reacts to Fed Policy Change

Over the past few weeks the Federal Reserve, European Central Bank, People's Bank of China, Bank of Japan and Bank of Canada have all signaled a more restrictive policy stance going forward (the beginning of the end of quantitative easing and zero interest rates). These new policies are designed to unwind the massive accommodation that followed the 2008 housing collapse.

The stock market's response thus far has been muted. However, the bond market is telling a different story. The yield curve (10-Year Treasury Notes minus 3-Month Bills) has flattened from over 2% in early January to 1.2% at month's-end. Essentially short rates have risen (about 60 basis points) in anticipation of additional rate hikes while the 10- year Treasury yield has fallen 20 basis points. Those 80 basis points represent a loss of nearly half the overall spread. Flat or inverted (negative) yield curves often signal the end of a financial cycle and could lead to recession.

Strangely enough, from a dollar standpoint, Fed posturing toward more restrictive monetary policy has been more than offset by the perception of weak economic data. Further, a resurgence of the weak economic data/ slow growth narrative has translated into a falling dollar on expectations of fewer rate hikes etc. (as we discussed last month). The dollar index in off 10% this year! However, expectations may change if Janet Yellen's determination to raise rates remains unchecked and (or) economic data strengthens. Clearly, the Fed now wants to normalize rates and unwind past QE bond purchases while the economy allows.

Conversely, we believe significant additional rate hikes are unlikely over the next few years. Global debt levels (municipal, corporate and household) are among the highest ever at 325% of GDP (according to the Institute of International Finance). Further, developed market work force populations are highly likely to decline for the next 15 years (according to the OECD) and productivity shows few signs of improving after having flat-lined at depressed levels throughout this recovery. U.S. growth and coincident inflation have clearly suffered from each of these factors. Bear in mind that GDP growth relies on consumer spending, a growing work force and rising productivity. **While assets valuations have recovered from the 2008 housing crisis, economic and wage growth have lagged and this may limit the Fed's more restrictive policy designs and thus rate hikes.**