Market Commentary - November 2017

CLEARVIEW
WEALTH SOLUTIONS

Q3 Earnings Update: Coming into earnings season, estimates for third quarter growth were reduced from 6% to 2% primarily due to the hurricanes. With over half of S&P 500 company reports now released, actual earnings growth is 4.7%. Estimates remain the same for all of 2017 (+10%) and 2018 (+11%). Source: FactSet.

What Other Money Managers Think

What other money managers think about the markets is important for us to know. What they think tells us a great deal about how they're investing. After all, it is the consensus thinking of investors that is discounted or effectively priced into the stock market. In other words, their sentiment and expectations about the future are reflected in individual stock prices and the market as a whole.

Barron's magazine publishes a semi-annual poll that includes both large and small money managers (140 in total in their latest tally) and asks them key market related questions. Here are the latest poll results:

What is your Investment Outlook through the end of 2018 …?

	% of poll respondents	Approximate change expected from today through 2018
Bullish	61%	+5%
Neutral	27%	
Bearish	12%	-16%

Interestingly, the number of bulls is up 10% since 6 months ago. Just 4% of respondents characterize the market as 'undervalued'.

Our analysis: 61% is already a relatively high reading but that means another 39% could turn bullish pushing stock prices higher. Remarkably, the average bull is looking for only a 5% gain in the next 12 months. So are managers really that bullish?

Will Congress enact legislation on …?

Tax reform	87% yes, according to the poll
Healthcare reform	33%
Immigration reform	57%
Entitlement reform	11%
Wall Street deregulation	39%

Our analysis: We were **very surprised** to see the high percentage of managers who expect some kind of tax reform. Does this mean stock prices already reflect the benefits of tax reform, including lower tax rates, higher corporate profits, and an investment spending boost? If so, further upside to stock prices may be limited. And if tax reform doesn't pass, or its final form disappoints investors, there may be significant downside (a correction of at least 10%) because of expectations that appear already baked into the cake.

What are the biggest threats to stocks in next 12 months …?

Geopolitical crisis	29% of poll takers
Earnings disappointments	2%
Economic slowdown/recession	11%
Excessive valuation	9%

Our analysis: The first and last points concern us the most. A confrontation with North Korea would likely send stocks sharply lower in the short run but investors would quickly assign probabilities as to how our economy would be impacted. This scary possibility could actually end up being a buying opportunity. And as our readers know we are extremely concerned about valuations which have only been higher (by many measures) in 1929 and 2000.

When will the next recession arrive …?

2018	13% of managers polled
2019	41%
2020 or later	46%

Our analysis: Recessions are often the tipping point for bear markets so getting this one right is crucial. Right now we see no signs of recession on the horizon. But the view is cloudy because of possible Fed policy mistakes ahead (such as raising rates too quickly or unwinding QE too rapidly). Bear in mind that QE was a first ever experiment in ultra-accommodative monetary policy and the impact and timing of its' unwind is not yet known.

Conclusion: Most money managers are bullish, expect tax reform, and don't see a near term recession. These expectations go a long way toward explaining why stocks keep hitting all-time highs. And this optimism is clearly reflected in share price valuations. **Optimism, however, has not yet turned into euphoria (the last stage of a typical bull market) but if or when it does, that will likely signal that the end of one of the longest bull markets of all time is at hand.**

An Argument for Conservative Bond Management

Extraordinarily high debt levels among many corporations could be setting the fixed income market up for a fall–especially if interest rates were to rise significantly in a short timeframe. According to Longview Economics (a research consultant) 12% of all listed US companies (apart from financials, ETFs and investment trusts) are "zombie companies." Zombie companies are characterized as those having insufficient company earnings (EBIT) to cover their debt interest payments over the prior three years.

While not yet an apocalypse, we are dealing with the highest percentage of zombies in 17 years and rising interest rates could further cause further damage. Other developed countries are dealing with similar corporate debt problems, aging work populations, and skimpy economic growth yet many are expected to begin raising interest rates shortly as well. A sign of the growing threat may be reflected in the two-year Treasury note which recently touched a nine-year high of nearly 1.60% as a result of the Fed's recent tightening.

The search for extra income has compelled investors to chase yield further and further down the bond credit quality ladder. This demand has tightened high yield credit spreads (lowering the yield spread compared to like maturity Treasury notes) to the least rewarding ever. By that we mean high yield bond issues now provide the lowest amount of compensation for the risks taken on record and yet remain very popular. These bonds suffer from poor liquidity in the best of times. **We believe that nine years into the rally is not the time to be chasing yield and that those who accept this added credit and default risk will eventually get burned.**

Over the past few years we have moved to an ultra-low risk fixed income approach in client portfolios. We have accomplished this by investing only in short and intermediate maturity bonds and ETFs. These high credit quality, shorter maturity investments offer less yield but have limited downside potential from rising rates. And if corporate credit spreads were to widen significantly (normalize) as we believe they will, these fixed income investments should see price appreciation.

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