U.S. Markets at Midyear

Market Viewpoint: July 27, 2018

The U.S. capital markets had a challenging time in the first half of 2018. By the end of June, equities, including dividends, returned just 2.6%. Bond yields went up and prices went down, leaving total returns negative year-to-date. Only cash provided an improved total return, thanks to the Fed's rate hikes.

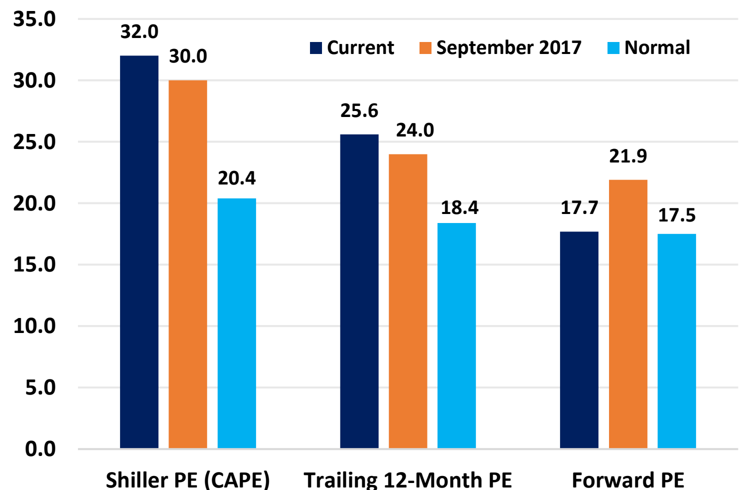
The brouhaha about trade wars has been cited by experts as the cause of the market's 2018 rise in volatility. However, share prices were vulnerable even as they rallied early in the year for other reasons. In "The Gathering Storm", published in September, 2017, MRP cited a laundry list of concerns about the equity bull market's sustainability. While earnings and estimates are up substantially since then, valuations remain very high by most measures.

Total Return by Asset Class

	2018 H1	2017	Past 10 Years
Stocks	2.6%	21.6%	13.5%
Bonds	-2.2%	2.8%	2.0%
Cash	0.8%	1.4%	0.3%

Valuations Still Extended

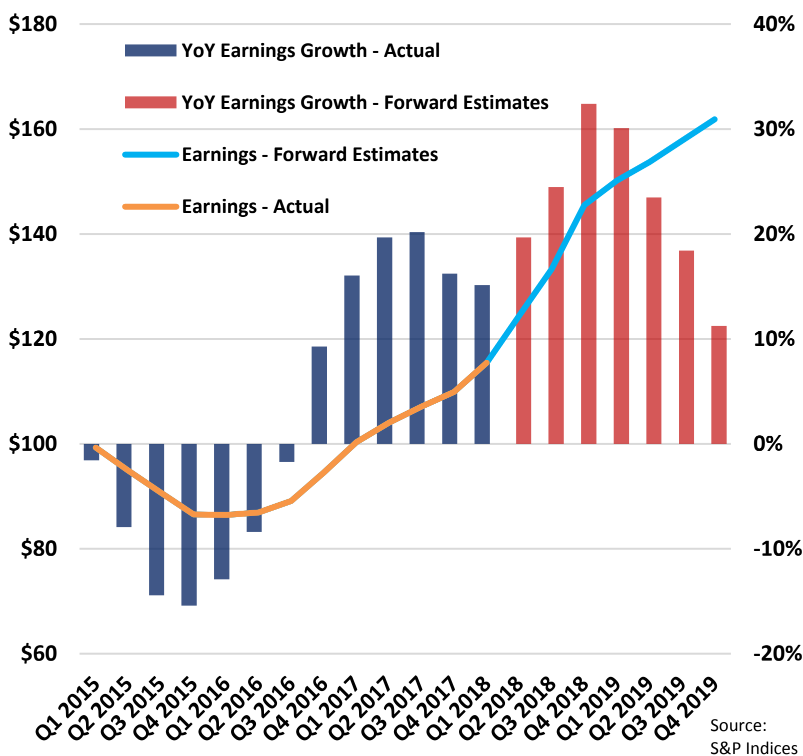
The most widely followed valuation statistic is the P/E of the S&P 500. But analysts point to different P/E numbers depending on what E is used as the denominator. Most commonly followed are the trailing P/E, wherein E equals the sum of earnings for the past four quarters, the forward PE which measures the sum of the EPS projections for the next four quarters, and the Cyclically Adjusted P/E (CAPE) which utilizes the average of 10 years of earnings, adjusted for inflation.



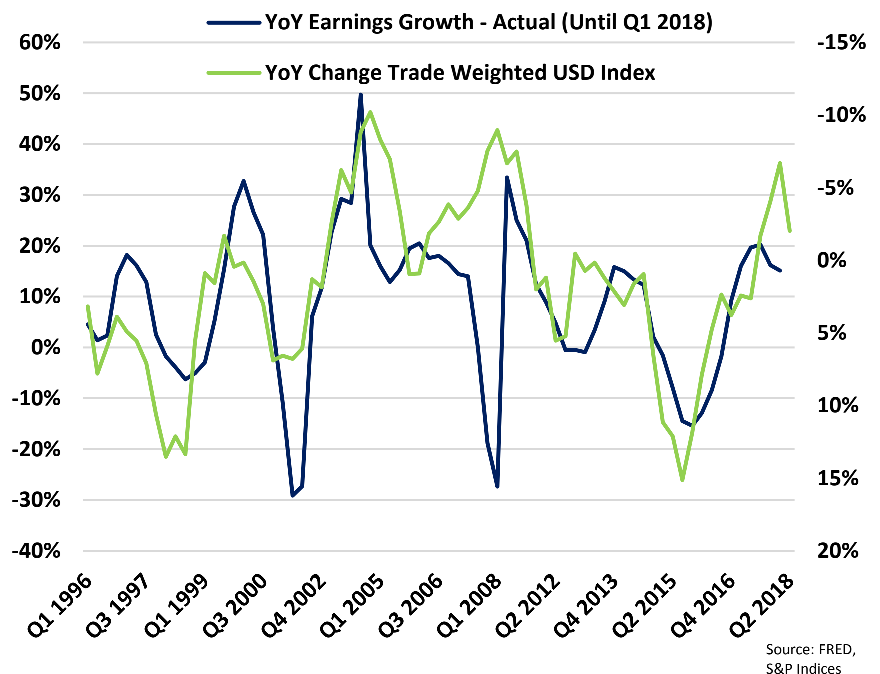
Joseph J. McAlinden, CFA, is the founder of McAlinden Research Partners (MRP) and its parent company, Catalpa Capital Advisors. He has over 50 years of investment experience. Mr. McAlinden founded Catalpa Capital in March 2007 after leaving Morgan Stanley Investment Management where he had spent 12 years, serving first as chief investment officer and later as chief global strategist. During his 10-year tenure as chief investment officer, he was responsible for directing MSIM's daily investment activities and oversaw more than $400 billion in assets. As chief global strategist, he developed and articulated the firm's investment policy and outlook. Prior to Morgan Stanley, Mr. McAlinden held positions as chief investment officer at Dillon Read and as President & CEO of Argus Research.

The trailing 12-month P/E ratio has a historic average of approximately 16.4. With outliers removed, the normalized mean is 18.4, almost exactly the same as the median of 18.5. We calculate a trailing P/E ratio of about 25.6 around mid-year, exceeding the mean and median by almost 40%, up from 30% nine months ago.

Notably, the forward P/E is barely elevated, due to high levels of optimism about future earnings. Based on consensus EPS estimates of $153.58 for the 12 months ending in the 2nd quarter of 2019, we calculate a forward P/E of just 17.7 versus a long-term average of 17.5, with outliers accounted for. So, by this measure valuations remain elevated – but just barely. Of course, that assumes that analysts' estimates of a strong fourth quarter gain in earnings materializes, an assumption that seems overly optimistic. The consensus among analysts is that earnings will have grown 20% for the 12 months that just ended, and will continue to grow before peaking in the final quarter of this year. The long-term average rate of YoY growth in earnings is 16.3%, but when outliers are accounted for, that average shrinks to only 8.5%. This means that in the final quarter of this year, earnings growth is expected to be nearly quadruple the historic mean, soaring to 32%.



Today's record earnings are the result of a strong economy and the impact of historic tax cuts being compared with year ago numbers when a tax cut was only a glimmer in Trump's eyes and the economy had not yet begun to accelerate from its long malaise. In addition, a weak dollar vs the prior year has boosted comparisons as a result of the currency translation effect. But going forward, comparisons will be more difficult as the base effect begins to include these strong 2018 numbers and a recent reversal of the dollar's trend will soon be subtracting rather than adding to earnings growth.



If the dollar continues to strengthen, currency conversions in markets where US products are sold will depress reported earnings. Bank of America Merrill Lynch estimates that a sustained 10% appreciation in the dollar against the euro results in a 3-4% reduction in the S&P 500's EPS. In the second quarter of 2018, the dollar gained more than 5% against major trading partners' currencies. Netflix, which does not hedge its revenue with derivatives, said on its earnings call that foreign exchange rates pushed expectations on the 2018 operating margin to near the lower end of its target range. Facebook also noted on its latest earnings call that currency fluctuations will hurt the stock for the second half of the year, after helping it for the last several quarters. Meanwhile, Trump's Trade War and the Fed's tightening are supporting the dollar's strength.

All else being equal, given that the year-on year decline in the dollar already turned positive during the last week of June, earnings growth estimates will go down, causing the forward PE to go up.

The Cyclically Adjusted P/E ratio (CAPE), also known as the Shiller PE ratio, is currently around 32, nearly double the long-term average of 16.9. After removing outliers, the CAPE's normalized mean is equivalent to 20.4, further reflecting that the market is over-bought. The average CAPE ratio on the eve of the five worst downturns of the past century - 1929, 1937, 1973, 2000 and 2007 - was 29 and the median was 27.

Another valuation ratio worth looking at is the total market cap to Gross Domestic Product. A ratio between 75% and 90% is typically considered to represent a fair valued market. As of June 28, 2018, the ratio is over 142%.

Looking around the globe, it is US equities that are especially overvalued. Recently, the Bank of America Merrill Lynch monthly fund manager survey, which polls investors managing $541bn of assets, showed in June that equity investors had returned to being overweight US equities for the first time in 15 months. This is in spite of US stocks being the most richly valued of all developed markets. At the same time the respondents said they were most overweight global technology shares, while simultaneously believing that being long large US and Asian technology shares was the "most crowded", and therefore dangerous, trade at the moment."

Bullish Sentiment

Optimism may begin to run out soon. According to the American Association of Individual Investors (AAII), the proportion of bullish investors has decreased to 34.7% (38.5% is the historical average as of the week ending July 18). On the other hand, the bearish group has also decreased recently to only 24.9% (30.5% is the historical average). From the week prior, the neutral category swelled 12.6 percentage points to a total of 40%, well above the historical average of 31.0%. The broad shift reflects a lack of direction due to ongoing drama in Washington over trade, as well as the fact that the S&P may already be in the midst of a correction, having peaked on January 26th.

Outflows have been growing stronger as well. The week to June 20th also saw the largest weekly US stock outflows since March. The move out of international equity funds was a bit more notable. The $1.29 billion in outflows was the highest since mid-November 2016.

Portfolio Leverage

Margin Debt for all FINRA regulated firms reached almost $669 billion in May, up nearly 15% YoY, and equivalent to 3.35% of GDP. In the aforementioned June survey, Bank of America found that a record net 34% of equity investors say companies are over-leveraged, more than in the throes of the 2008-09 crisis. However, with defaults still low, credit investors are chasing yield and gravitating to short-duration corporate bonds - including some of the riskiest junk debt. Bonds in the CCC ratings category and below have returned 4.3% this year, according to Bank of America index data, while the debt of investment-grade companies posted a 3.3% loss

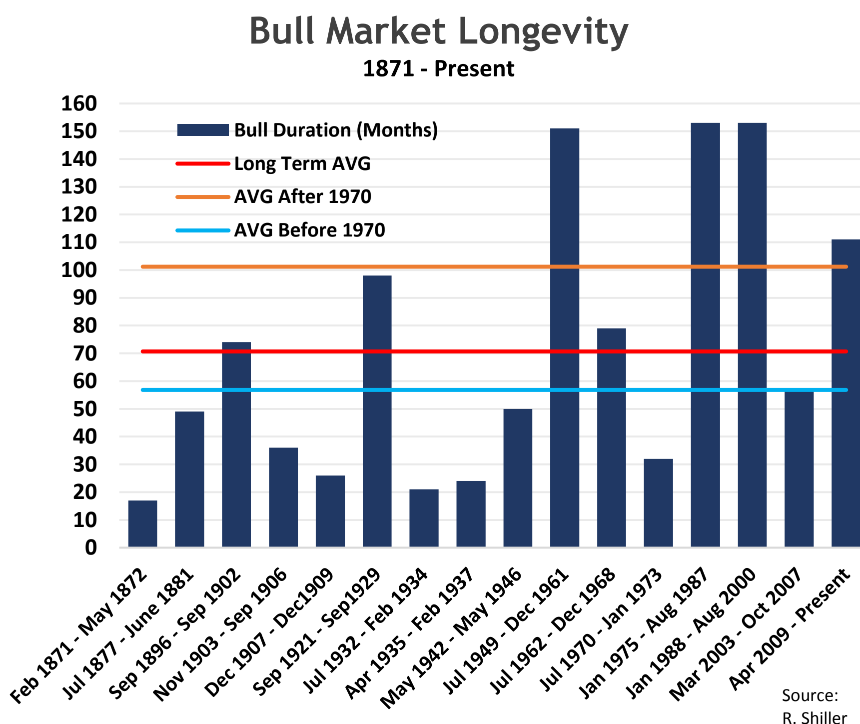
Outstanding leveraged loans and high-yield debt are at $1 trillion and $1.1 trillion respectively, nearly double the amount outstanding in 2007, while credit to U.S. nonfinancial corporations stands

at $14.26 trillion; on an absolute basis, this is 34% higher than it was in 2008, while relative to GDP this represents an all-time high of 73.5% versus a peak of 72.5% in 2008.

It is worth noting, however, that banks are much better positioned to withstand a 2007-type financial meltdown. The debt-to-equity ratio of the financials index has dropped to 159% as of the first quarter from 563% at the end of 2007. The debt-to-assets ratio has fallen to 19% from 43% over the same period.

Ageing Bull

Assuming this bull market is alive and well, its stamina against the historical record of the economy has been impressive. The average complete stock market cycle lasts about 69 months with the average period of expansion lasting 58 months and the average period of contraction about 11 months. This current bull, the fourth longest in history, has now avoided bearish territory for 111 months. It is the 12th bull market since the end of World War II, and the other 11 market expansions have ranged in duration from a little over a year to 153 months.



It is noteworthy, however, that like human life expectancy, bull markets have been lasting longer. Prior to the mid-70s, they lasted, on average, only 42 months. Subsequently, the average has expanded to 73 months. But the current bull run is already 1/3 longer than that updated average. It is possible, however, that the post-crisis bull market is over – having already reached a final peak in late-January.

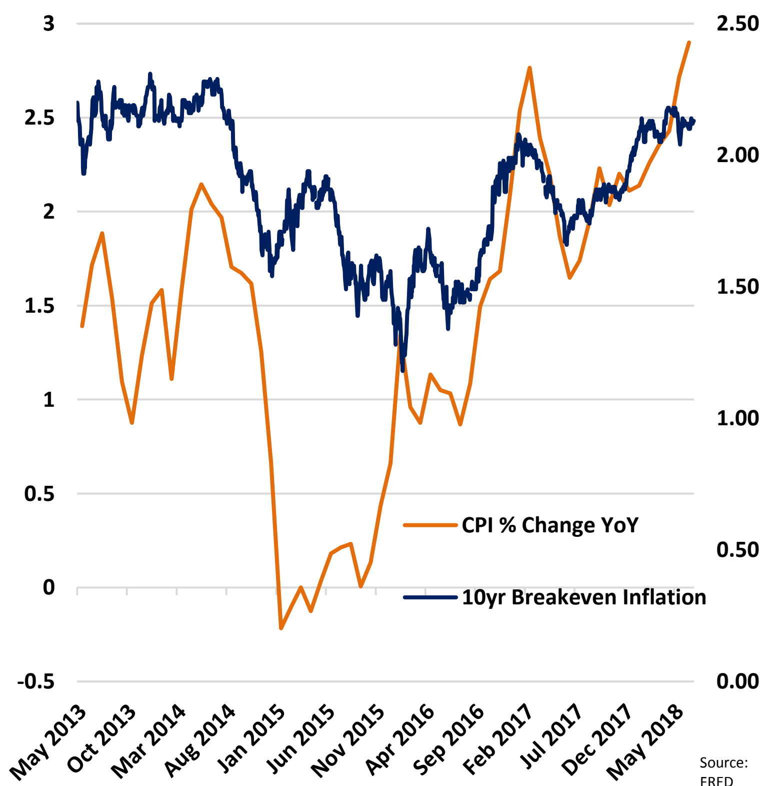
Inflation

In May, MRP addressed rising inflationary pressure that could have a ripple effect across the broader equity and bond markets. Some surveys of inflation expectations have been inching higher; some

have not. In June the University of Michigan inflation expectation survey climbed to 2.9%, up from a 12-month low of 2.4% in October 2017. The NY Fed's Survey of Consumer Expectations for May showed little change in 1-year and 3-year inflation expectations, which remain at about 3.0% each, and those figures are up 15% each YoY. However, the Fed's survey of Primary Dealers showed no sign of acceleration in expectations, with 37% of those surveyed anticipating inflation between 2.0% and 2.5% between March 2018 and February 2023, while 13% said they expected inflation above 2.5%. The survey has shown a median expectation of 2.2% in from the beginning of 2018, down from 2.3% this time last year.

Nevertheless, in June, actual inflation did indeed tick up as the CPI rose by 2.9% YoY for the first time since February 2016. Also, in May, the Fed's preferred measure of inflation, the Core PCE deflator, finally reached the central bank's 2% target. June data will be released around the end of July. These figures are both far cries from below-zero readings in 2015. The 3-percentage point cumulative rise will strongly influence the Fed's tightening of monetary policy in the coming months.

Further potential disruption lurks in the escalating trade war. Producer prices are ramping up in the US as the PPI experienced the largest jump in 6.5 years, accelerating 3.4% YoY for the month of June. China's PPI simultaneously accelerated to a six-month high in June, increasing by a stronger-than-expected 4.7% YoY. Rising wholesale and other selling prices at businesses indicate that inflation pressures in the production pipeline are firming amid rising demand and tariffs on steel and other goods. Higher materials prices are also pushing up transportation costs of goods, with general long-distance freight trucking costs advancing 9.4% in June from a year earlier, the largest increase in a decade. For U.S. consumers, prices rose to the highest yearly



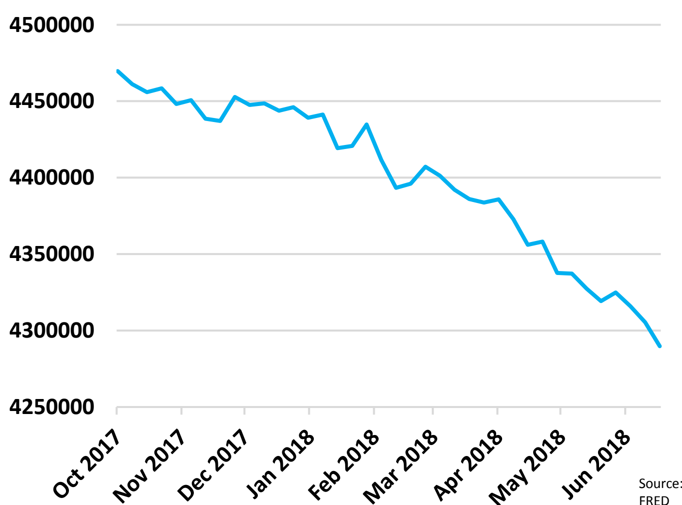
rate since 2012, reflecting an economy that's running hotter than any time since the Great Recession. The case for higher inflation looks even stronger, especially as the second quarter's GDP results showed a 4.1% annualized rate of growth, the strongest since the third quarter of 2014, stronger oil and commodity prices persist, and consumer spending keeps rising due to new tax cuts.

Bonds

This inflationary pressure comes in the midst of the US Federal Reserve's tightening cycle – raising short-term rates while also shrinking its balance sheet. When rates go higher, they not only increase the cost of borrowing and diminish companies' future earnings, but also boost the discount rate that determines the present value of future earnings streams. The central bank has raised the benchmark Federal funds rate twice in 2018, and is now targeting at least two more hikes before the end of the year. For the last few months, the 10-year treasury yield has been hovering between 2.8% and 3.1%. Although this benchmark has lately struggled for direction, it has come a long way from yields as low as 2.3% In October 2017, and 1.4% in July 2016.

New high-powered money created out of thin air was the primary force holding down yields from their natural level for a long time. The current plans by the Fed to continue shrinking its balance sheet, albeit gradually, has marked a major turning point.

Traders have grown used to the central bank continually capitulating and resetting its trajectory for interest rate normalization. But, the Powell-led Fed has already reduced its balance sheet by $180 billion since mid-October and raised the median projection for fed funds in 2019 by a quarter point, provoking complaints from the administration. Powell is still backed by a new rotation of non-Governor FOMC voters. The recently released minutes have shown growing concern about inflation. Some members expressed "concern that a prolonged period in which the economy operated beyond potential could give rise to heightened inflationary pressures or to financial imbalances that could lead eventually to a significant economic downturn."



We think Powell will be very different from Yellen if inflation continues heating up. In the meantime, the overwhelming majority of officials at the central bank believe they should continue to raise interest rates on a regular basis. Nevertheless, due to current tensions between the U.S. and its trading partners, the Fed did marginally decrease its real GDP growth estimates beyond the first half of 2018, given a higher assumed path for the exchange value of the dollar.

Other growth estimates were driven higher by upside surprises in Europe and Asia, as well as tax reform and deregulation in the United States. Stronger global growth is boosting rates. Surging commodity and crude oil prices also played a factor, but could take a hit following new US tariffs on foreign steel and aluminum. Despite the trade war drama, the IMF's most recent projections still see global GDP growing at 3.9% in 2018. The World Bank estimates international growth will remain robust, advancing 3.1% this year, the strongest rate since 2011.

Looking Forward

While it is always possible that the current tariff one-upmanship could spiral into a full-blown trade war that disrupts global GDP, as the expert cacophony relentlessly suggests, MRP continues to doubt that is in the cards. We have described the early stages of this unfolding saga as a kabuki dance. Perhaps, at this point it has turned into something more… but not a lot more. Some cuts and bruises, but no mortal wounds.

We maintain the view that, it is not the trade war issue that threatens the aging bull market. Rather, it is mostly the issues cited above, particularly the rise in both short and long-term interest rates, as well as the prospect of even higher rates down the road at a time when valuations are quite high. These forces are likely to continue to pressure both equity and bond prices in the second half of the year.

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McAlinden Research Partners | 60 E 42nd Street, Suite 2223 | New York, NY 10165 | Tel: 212.231.8701 | For inquires contact nelly@mcalindenresearch.com