Fourth Quarter 2018 Investment Outlook

It's Always Something

"It just goes to show you, it's always something. If it's not one thing, it's another. "

Roseanne Roseannadanna – Consumer Affairs Reporter - Saturday Night Live

"The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs."

Warren Buffett – Berkshire Hathaway

"If one looks at price momentum – it is positive for U.S. stocks and negative for Europe and emerging markets across all relevant look back windows. This has never happened before."

Marko Kolanovic– J.P. Morgan

The best comedy skits are those that have a component of truth behind them. If it doesn't touch upon the truth, it's not as funny. The Roseanne Roseannadanna character played by Gilda Radner on Saturday Night Live was funny not only because of the her look and personality but because Roseanne always went off on multiple tangents talking about things that have nothing to do with the topic she was supposed to reporting on. In going off topic, she would discuss things in real life that were true but that no one else would consider talking about in front of others. However, it was no problem for Roseanne Roseannadanna. In one SNL Weekend Update skit, Roseanne was reporting on National Smokeout Week and by the end of her report she was describing being naked in a sauna with Dr. Joyce Brothers who had a sweat ball dangling off her nose that was grossing her out so bad she wanted to flick it off for her. How many times have you been with someone who had something in his or her hair, teeth, or nose and you wanted to say something but just couldn't bring yourself to do it? It's the area between proper decorum and public embarrassment where comedy ideas can be found.

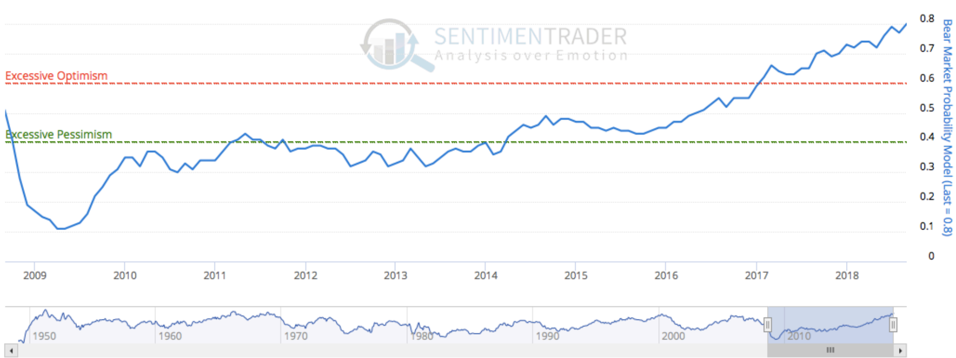
Investing is often the opposite of comedy. Sometimes the truth in investing is very sobering and not funny at all. In fact, in times of strong financial market returns, when others start to boast about their latest hot stock or how well their investment portfolios are doing, it's the Rosanne Roseannadanna investment types that investors should be paying attention to the most. Names like Jeff Gundlach, Howard Marks, and Ken Griffin come to mind today. The ones willing to tell you to your face that you have a sweat ball dangling from your nose. This is particularly true in today's investment environment. The longer financial markets experience unusually low volatility and fewer market corrections such that excesses build up, the more likely something bigger is coming down the pike later on. As Roseanne was famous for saying, it's always something. Today, there seem to be more somethings to consider.

The key to long-term financial success (aside from being a prolific saver) is to know when to place a greater emphasis on risk management rather than return generation. When investment returns have been above long-term averages and trends become overextended compared to historical norms, the wisdom of Warren Buffet and the notion of prudence should become more important to your investing mentality. Everyone loves (to tell) a great investment success story but avoiding outsized losses is really the more critical component to long-term investment success. Don't laugh. It's the truth.

In this quarter's Investment Outlook we touch upon some truths that are not very amusing and which point to an increasingly difficult forward outlook for financial assets and U.S. stock returns in particular. These truths include:

1) Investor sentiment is overly bullish
2) U.S. stock valuations are at historically high levels
3) Easy and cheap debt has been a big factor behind rising U.S. stocks the past decade
4) Forward 10-year return expectations for global stocks are low single digits at best
5) Non-U.S. stocks offer the better house in a bad neighborhood
6) Globally, growth stocks are way overextended relative to value stocks

Let's start with investor optimism using two charts from SentimentTrader. Sentiment indicators are short-term and contrarian in nature. As markets move continually higher and experience fewer corrections or low volatility, investors increasingly throw caution to the wind and begin to extrapolate recent positive experience as sustainable and invest more cash in riskier assets. When bad news hits in waves, the opposite is true and investors sell risk assets, often at the bottom. As the first chart below shows, investor optimism is now excessively positive. It's not a stretch to say that this recent optimism really started to gain traction when Trump was elected and has accelerated since he successfully pushed through broad tax reform. The second chart below shows how stock option traders are currently positioned. It's another sentiment indicator showing that traders are aggressively positioned for a bullish outcome in stocks and to an extreme degree.



You may recall the gloom and doom of early 2009 when the Global Financial Crisis was in full swing and 401k and IRA balances plummeted. Investor pessimism hit extreme lows as shown on the far left side of the top chart on page 2. In retrospect, it would have been a great time to step into the fray and invest more cash in stocks because for the 10 years ending 9/30/18, U.S. stocks as measured by the S&P 500 Index generated a 12.0% annualized return profile, well above the long-term historical average of 9.8% going back to the 1920s.

If you were able to earn above average returns for the ensuing 10 years starting in 2009 when the investment environment felt as bad as it possibly could get, what do you suppose is the most likely return outcome over the next ten years with investor sentiment today at extremely optimistic levels? Returns for the next 10 years most likely will be far less than the past 10 years. Also, consider the fact that the past 10 years was a decade when central banks instituted extreme policies for keeping interest rates low and used unprecedented policy actions like Quantitative Easing (QE) to keep global liquidity spigots fully open. The past 10 years of stock returns had tremendous liquidity tailwinds behind them. Of the major central banks, the U.S. Federal Reserve has started to reverse the process of easy money by raising short-term interest rates and reversing QE. The European Central Bank has announced it will follow along by year-end although at a more moderate pace of reversal than the Fed. Since stock returns the past decade benefited tremendously from aggressive central bank monetary policy actions, what do you suppose might happen to stock returns when those policy tailwinds turn into policy headwinds?

Let's next move on to the U.S. stock valuations picture. There are many different valuation measures used by investors to determine where the current valuation levels of stocks are compared to history. The two being shown hereafter are the 12-month forward Price Earnings (PE) multiple and Price to Book (PB) ratio. The first chart on the next page plots the 12-month forward PE multiple of the S&P 500 Index (red line) starting in 2007 to today and plots its progression over a rolling 5 year average (center blue). The chart also shows one (dashed grey lines) and two (solid grey lines) standard deviation bands around the rolling 5-year return average to both the upside and downside. Two standard deviation events are rare and mean that the current observation is very far above or below its time series average. Let's again go back to early 2009 on the left side of the top chart on page 4. The chart shows that the forward PE multiple was dipping below the negative two standard deviation band, meaning that stocks were very cheap. In fact, at just under a 10X forward PE multiple, stocks were also cheap in the context of the entire U.S. stock market history. Fast forward to today and the far right side of the chart shows that the 12-month forward PE multiple is running near its positive two standard deviation band, or at the extreme high end of forward PE valuations over the time period shown on the chart. Not surprisingly, the S&P 500 Index current 12-month forward PE multiple of 17X is also at the top end of its long-term trading history as well.

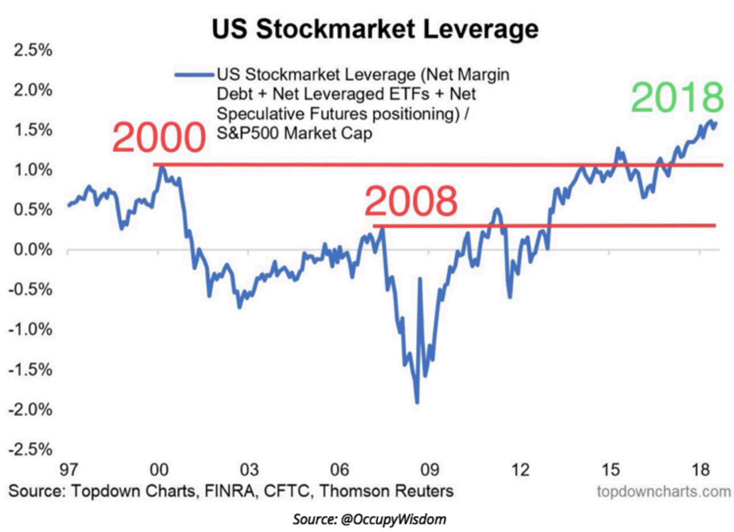
Source: Jefferies Research, IBES, Factset

The next chart below plots the PB ratio of the S&P 500 Index from 2007 to today and indicates that the PB ratio is now exceeding the two standard deviation upper band of the past 5-year rolling average. Again, one can see that in early 2009 this valuation measure dipped below its negative two standard deviation band and indicated a rare cheapness that was confirmed by the forward PE multiple chart above. Today, the exact opposite is true with both forward PE and PB valuation measures at or above the extreme valuation range band.

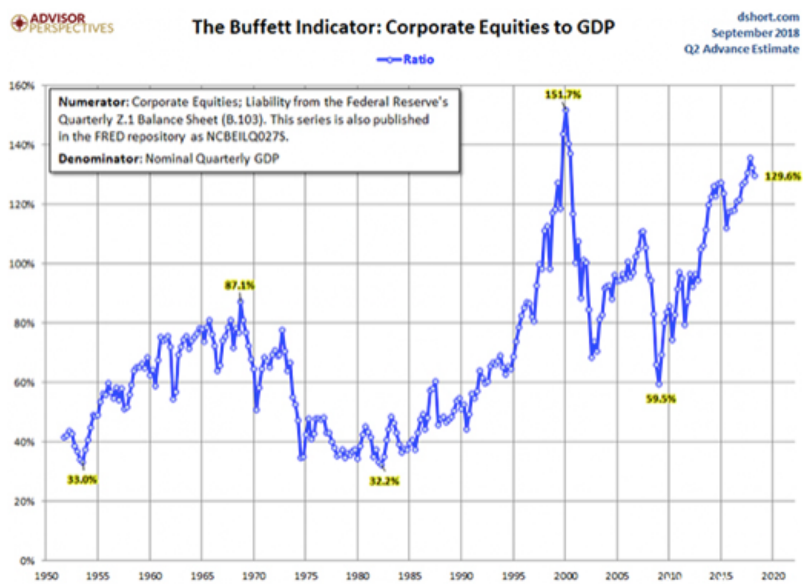
Source: Jefferies Research, IBES, Factset

Let's next look at another key factor behind the decade long rise in stocks. As investor optimism grows, they become more willing to take on margin debt to chase returns, especially if the cost of borrowing is low. The Fed's unprecedented low interest rate policy it maintained for 9+ years created cheap debt and incentivized investors to increase their margin balances in order to invest more money in stocks. The next chart below shows how margin debt (blue area) has exploded higher over the past decade with the Dow Jones Index (yellow) following this explosive growth of margin debt higher from the 2009 market low.

The next chart is another way to look at the impact of excessive leverage in financial markets. It combines the margin debt shown in the chart above plus net leveraged ETF assets plus net speculative futures assets divided by the S&P 500 Index market cap. Total stock market leverage has never been higher going back to 1997 and now exceeds the tech bubble level of 2000. Both of these charts indicate the U.S. stock market advance since the 2009 market bottom has been heavily supported by aggressive Fed monetary policy and cheap debt. This excess liquidity has found its way into financial assets resulting in excessive valuations and many extreme stock market relationships. Keep in mind that as the Fed continues to raise short-term rates, the cheap margin debt spigot is slowly getting turned off as the cost of borrowing increases.

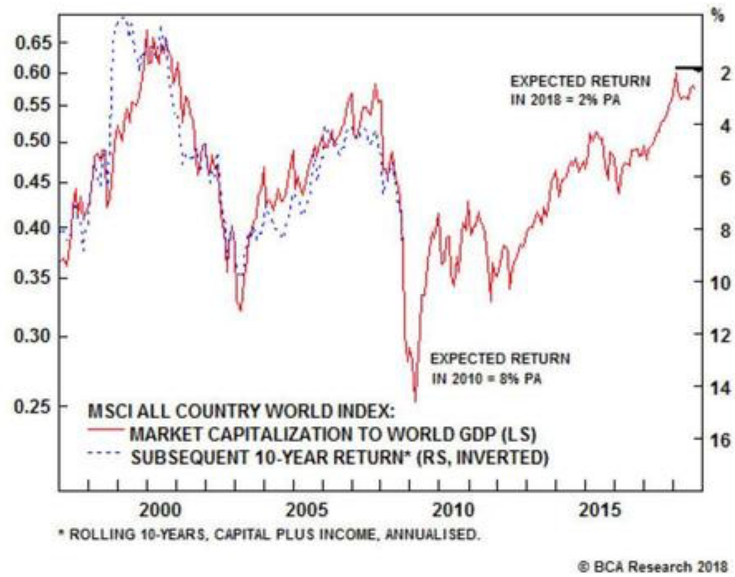


Let's next review forward stock return expectations. The next chart shows another valuation measure that has been referred to as the Warren Buffet Indicator. It plots the ratio of the stock market capitalization of U.S. stocks to nominal U.S. GDP. In other words, the market value of stocks relative to size of the economy. The chart indicates that today's stock market is not quite as overpriced as the 2000 tech bubble but it is at the 2nd highest valuation profile going back to the 1950s or nearly 70 years. It's worth noting that the cumulative return decline from the 2000 peak to 2002 market low was -37%.

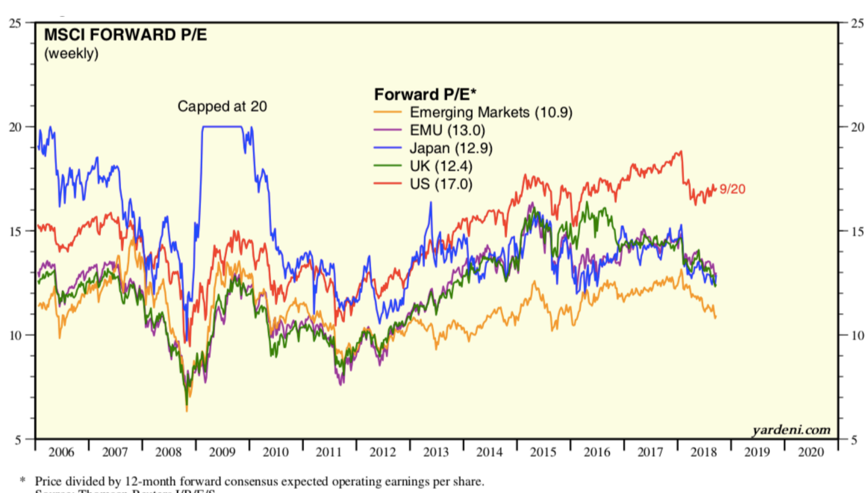


Source: Advisor Perspectives

The next chart a the top of page 7 is a global version of the Warren Buffet Indicator. Instead of just the U.S., it plots the ratio of the market capitalization of all global stocks to global GDP profile on the red line. The dashed blue line captures the subsequent actual 10-year return experience of stocks (inverted right side scale). Note how tightly correlated the two time series are to each other, which indicates that over long periods of time this market cap / GDP indicator has been a reliable guidepost for future stock returns. Again, we are going to focus on two time periods to compare the extremes. First, in early, 2009, after global stock markets had collapsed during 2008 and into early 2009 (so did global GDP), the global market cap to GDP ratio hit extreme lows. At the market low in early 2009, the forward 10-year annualized return expectation ended up being 14%. Recall from page 2 that the actual 10-year annualized return of the S&P 500 Index at 9/30/18 was 12% so pretty close to what this indicator forecast returns would be back in early 2009. As stock markets have rallied strongly over the past decade but GDP growth has not grown as fast (thank you central banks), the market cap to GDP ratio has rocketed higher and is hitting levels last seen at the peak of the tech bubble of 2000. Similar to the 2000 tech bubble peak, the forward 10-year return expectations has now dropped to low single-digit levels as stock valuations have risen dramatically. At today's market cap to GDP ratio profile, global stocks would be expected to return closer to low single digit annualized returns for the next 10 years as opposed to the 12% annualized return of the past 10 years. Unfortunately, many of the Baby Boomer generation hit their retirement age window over the next decade. The smart ones that recognize the high probability of low future returns from financial assets will adjust their savings or retirement contributions upward as a result.



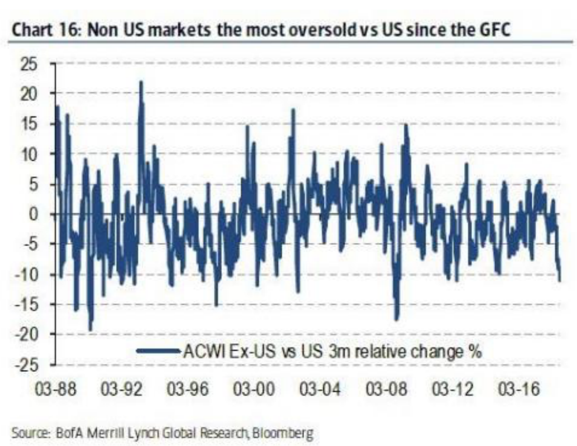
Let's next discuss where the better return opportunities reside at present in stocks to increase ones chances of winning in a low return world. While the chart above indicates that forward 10-year global stock returns should be quite meager compared to historical averages, the valuation profile of U.S. stocks is much higher than for international and emerging stocks. Refer back to the two charts on page 4 for a current snapshot of U.S. stock valuations. The next chart below compares the forward 12-month PE ratio for major investment regions going back to 2006. The red line is U.S. stocks and shows the forward PE at near 17X. In contrast, every other non-U.S. investment region, especially after the wide return spreads of 2018, trades a much lower forward PE profile. It is true that U.S. stocks typically have a higher forward PE profile than non-U.S. stocks. However, the spread today is at the widest level of the past 18 years. The valuation profiles for developed international market regions EMU/Japan/UK (13X) are not quite as cheap as EM (11X), but certainly well below U.S. stock valuations (17X). It's important to note that the large drop in the U.S. line starting at the end of 2017 is mostly due to the effect of U.S. corporate tax reform, which caused 2018 earnings estimates to rise materially and thus lowered the PE multiple as the earnings denominator surged higher.



The valuation premium of U.S. stocks compared to the rest of the world has become wider as 2018 has unfolded. Two big factors behind this growing disparity has been the combination of U.S. corporate tax reform in the U.S. and the trade wars initiated by the Trump administration. In the case of the corporate tax reform, U.S. corporate tax rates were lowered materially for U.S. corporations to bring them more inline with global peers. Of course, lower tax rates raises the earnings of companies because less taxes means more profits are available to distribute to shareholders. 2018 earnings estimates moved approximately 10% higher this year after corporate tax reform passed in late 2017. As it relates to trade wars, global stock investors have decided to seek a safe haven in U.S. stocks as global uncertainty has risen. The U.S. dollar has also moved higher, which has added to weakness for both developed international and emerging stocks. The next chart shows that when trade rhetoric started to escalate in mid-May, U.S. stock returns decoupled from non-U.S. stocks. Normally, the return correlation between U.S. stocks and non-U.S. stocks is usually high, as reflected in the left to middle portions of the chart below. Clearly, the relationship changed dramatically starting in mid-May.

Source: DoubleLine

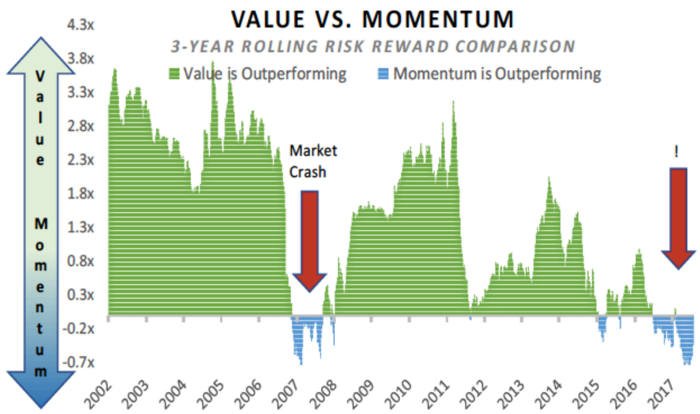
The next chart shows that non-U.S. stock markets are the most oversold relative to U.S. stocks since 2008 during the Global Financial Crisis. The chart below goes back 30 years to 1988 and shows that this level of relative underperformance of non-U.S. stocks to U.S. stocks is hitting a level where it typically peaked and reversed in the past.



Lastly, let's look at the investment setup globally between growth and value stocks. Growth stocks have been on a massive outperformance run compared to value stocks. Growth stocks (and the S&P 500 Index) are heavily weighted towards tech stocks. Social media or web centric companies like Facebook, Apple, Amazon, Netflix, and Google have been the strongest growers over the past decade and increasingly dominate broad stock market returns. The next chart shows a running 10-year annualized return comparison of the MSCI Growth Index versus the MSCI Value Index going back 30 years. Once again, this chart shows the long-term average (grey middle line) and then plots +/- two standard deviation bands over time. The last time growth stocks were this extended relative to value stocks was during the tech bubble of 2000.

Refer back to the investor sentiment chart at the top of page 2. Care to guess where investor sentiment is the most wildly optimistic within U.S. stocks about the sources of future returns?

Another way to track this large return disparity is by plotting momentum and value factor performance relative to each other. Price momentum is a factor most commonly associated with growth stocks. The next chart on page 10 plots these factors on a rolling 3-year risk reward comparison basis going back nearly two decades. Note there are very few times momentum gets to an extreme relative level like it is today. The last time the relationship became as extreme was in the window just before the 2008 Global Financial Crisis hit and stock markets plummeted. Often during periods when uncertainty increases, or expectations of growth slow, investors start to herd into growth stocks, which they expect to hold up better if their expectation of slowing growth comes to fruition. However, as often happens, investors often end up willing to pay too dear a price in terms of hiding out in stocks they expect will hold up better as they sell or avoid value stocks. The highly concentrated market returns of 2018 are another indicator of the narrowness of stock market returns. The S&P 500 Index may look like the best investment product to participate in U.S. stock market returns, but it is also increasingly risky as those investment returns are being generated by a fewer number of the largest tech stocks in the index. It's worth noting that value usually has a more sustained period of return outperformance once it comes back into favor.



Source: Artemis Capital

Summary

A hint of truth in comedy is what makes it funny but truth in investing is usually not funny at all. The truth is that U.S. stocks have had a decade long run of excellent returns that are above the long-term average. After experiencing a long period of above average returns, prudent investors should now place a greater priority on limiting losses over full participation in gains. Excesses have built up, most notably in the U.S. stock market, but bonds also offer their own set of challenges as bond yields move higher and credit spreads sit near historical lows. Balanced portfolios face a challenging return outlook ahead for the next decade as both stock and bond returns most likely will be well below historical averages. That's not very funny, but it is the truth. Just ask Roseanne Roseannadanna.

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IMPORTANT DISCLAIMER: