Verity Asset Management

Commentary

July 31, 2017

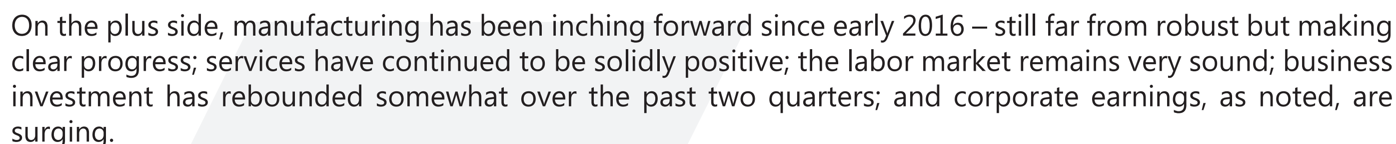
Through 2nd Quarter and into 3rd, the equity market has continued to move higher, with strong support from corporate earnings. To some, valuations are a material concern, but despite its gains, the overall behavior of the market can hardly be called "exuberant". It has been more than 3 months since the S&P 500 rose by more than 1% in a single day, the longest such stretch in over 10 years. And in a recent investor sentiment survey, there were actually fewer bulls than normal (and also fewer bears) – an unusually high 41% of investors were in "neutral".

Discussion of valuation data can be a bit confusing to many investors, because valuations are calculated in a wide variety of ways, yielding sometimes conflicting results. By nearly all measures, though, valuations are currently high – and by some measures, very high. At the same time, corporate earnings are expanding again after a string of negative quarters that ended in 2nd Quarter 2016, and earnings for the first half of 2017 have been particularly strong. So long as interest rates remain low and corporate earnings strong, there may be reasonable justification for higher valuations, but there is not a lot of margin for error. Investors are demonstrating this - companies who miss their earnings forecasts are being severely punished, and even some who beat their forecasts are being punished when elements of their results or future outlook fail to please a very demanding market.

This concern with valuations is often accompanied by expressions of nervousness over the length of both the bull market and the overall economic expansion since the financial crisis in 2008-2009. While attentiveness to valuations is legitimate, concerns about the length of the bull market are significantly less so:

- It could be argued that we experienced a virtual bear market from mid-2015 to early 2016 that was obscured on the surface by the outperformance of a handful of very large companies. Such an interpretation would mean the post-crisis bull market ended two years ago, and a new one has now begun.
- Regardless, the age of a bull market or an economic expansion is little more than an interesting anecdote - it is not material to market direction. Bull markets and economic expansions do not end as a result of old age – they end due to some combination of market, economic, and/or monetary conditions. If one needs an explanation for the unusual length of this expansion, it could be that a combination of debt deflation, demographics, and central bank policy may have slowed the rate of economic expansion and in the process extended its duration by preventing the kind of "overheating" that would typically lead to its demise. Similarly, the caution demonstrated throughout this bull market by most investors – both laypersons and professionals - may have prevented precisely the type of "irrational exuberance" which leads to a market bust. In other words, the fact that so many have not been "sold" on this market for so long may be one of its sustaining factors.

Throughout the first half of 2017, the economy has been solid but subdued, with no sign of the acceleration that was envisioned coming into the year. After a disappointing first quarter, economic data for 2nd Quarter started optimistically but then trended downward almost the entire quarter. The end result, a 2.6% annualized rate of growth, was positive compared to most quarterly growth rates of recent years, but it fell significantly short of the surge expected following the first quarter weakness.



On the plus side, manufacturing has been inching forward since early 2016 – still far from robust but making clear progress; services have continued to be solidly positive; the labor market remains very sound; business investment has rebounded somewhat over the past two quarters; and corporate earnings, as noted, are surging.

But wage increases remain anemic; the housing market has flattened out in recent months after a long upward progression; vehicle sales have declined four of the past five months; and retail sales in general are a big disappointment, showing essentially no growth over the past quarter.

The wild card could be interest rates. After almost everyone missed the two biggest and most obvious market bubbles of a generation leading up to 2000 and 2008, it has become popular to see bubbles around every corner. Most such interpretations are questionable at best, but the bond market is a different issue. Rates have been held artificially low by the Federal Reserve and other central banks for an extended period. They may or may not react sharply at some point – sound opinions differ – but a sharp move of significant magnitude would be very disruptive to both bonds and stocks, as higher rates would undermine a key element in the rationale for high equity valuations.

Starting this fall, the Fed currently plans to begin letting bonds in its massive portfolio roll off as they mature, rather than repurchasing new ones to replace them. This will remove a tremendous source of demand from the bond market, potentially putting upward pressure on rates. It will be the Fed's intent for this to happen gradually, but things don't always go as planned. This is something we will be watching closely.

There are of course plenty of other things that could trigger a sharp increase in market volatility, with clear potential in place for a selloff of significant magnitude. With computer-driven algorithms dictating an increasing percentage of trading, and with more and more people herding into index funds, downside moves could easily turn dramatic. But absent a change in economic conditions, corporate profitability, and/or rates, it seems unlikely based on current data that a selloff in the near term will turn into a sustained decline of greater magnitude. For the present, the secular bull market remains firmly in place.

This analysis does not intend to make light of the broader risks. As we have maintained for years, we live since the financial crisis in an uncharted macroeconomic environment burdened by enormous debt and unsustainable entitlement spending, among other things – and that's just on the domestic side.

But markets in most periods move on through all kinds of circumstances, and our role is to structure portfolios to respond specifically to markets, not the overarching conditions. In the near term, we have identified specific triggers which could cause this market to move materially in either direction. Investors should remain positioned within the level of risk consistent with their temperament and financial circumstances – no more and no less. An appropriate measure of caution is not always satisfying, but it is warranted.

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This material contains forward looking statements; there is no guarantee these outcomes will be achieved. All investing involves risk of loss, and there is no guarantee that strategies which may have been successful in the past will be similarly successful in the future.

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