SFA
Santa Fe Advisors

May 9, 2017

Interesting Times

It is widely believed that the saying "May you live in interesting times" is the English translation of a traditional Chinese curse. The idea is that little of particular note tends to happen during times of peace and prosperity, whereas "interesting" times are marked by uncertainty, turmoil and upheaval. The latter, while perhaps interesting in a historical sense, are the opposite of what most non-historians would wish to live through.

While it's too soon to get much of a historical perspective on 2017, there is no question that the situation in the US is quite a bit more "interesting" than it has been, at least in the sense that we are witnessing significant political upheaval and contentiousness. The 2016 election was a clear repudiation of the political establishment and "business as usual" in favor of someone who promised to go to Washington and shake things up. Regardless of your political views and whether you think that the current situation is a curse or a blessing, we seem destined for a considerable amount of change.

As everyone knows, since the 2016 election there has been a sharp rally in US equity markets. In January, when we reduced the magnitude of our underweight position in stocks, we commented that we could no longer justify the very conservative positioning we had held, because of the possibility of meaningful tax and regulatory changes that, if enacted, could result in materially higher corporate earnings.

As the 2016 year-end rally extends into 2017, metrics such as price-earnings (P/E) ratios have risen to very high levels relative to historical averages, suggesting that the market is "pricing in" a high degree of confidence that these positive developments will actually occur.

Writing in the New York Times on March 31, Robert Shiller discussed the cyclically adjusted price earnings ratio, a longer-term measurement of equity valuations that he developed. Mr. Shiller wrote that the current CAPE ratio is higher than at any time except for 1929 or a few months in 2000…neither of which were exactly great times to go into equities. More topically, my partner David Marion has pointed out that the current trailing P/E ratio for the S&P 500 is now 21.6, which is considerably higher than long-term averages. Does this level of valuations mean that the stock market is now particularly risky? Well, perhaps. A lot depends, as noted, on how fast earnings increase.

With any new Federal administration, there is always uncertainty about the extent to which it can implement its agenda, and the timing thereof. Because the President and his senior appointees had virtually no government experience or track record, there has been more than usual uncertainty about how successful the administration will be in implementing its priorities.

It would have been reasonable to assume that with Republicans holding the Presidency and majorities in both the House and Senate, the passage of tax and regulatory reforms would be highly likely. However, as the protracted attempt to repeal the ACA has demonstrated, passing major transformative legislation can be extremely complicated, particularly in the current partisan environment. No change in the tax code is without its winners and losers, especially if (to placate deficit hawks) any tax cut must be accompanied by an offsetting tax increase or spending cut. Losers in any fiscal change can naturally be expected to fight vigorously to maintain the status quo. As the ACA struggle has shown, the Republicans can't afford to lose too

many members of their caucus before they lose their ability to pass bills, absent any (unlikely) support from across the aisle.

If meaningful policy changes are implemented, or earnings growth appears from other sources, then current stock valuations may not be so high after all. If the "E" in the P/E ratio increases sufficiently, it will catch up to the "P", even in the absence of a price correction: as of this writing US large company earnings are on track to meet the consensus forecast for an earnings increases of over 16% in the first quarter of 2017, compared to the first quarter of 2016.

If earnings do not continue to grow at the current rate, however, or if the magnitude and/or timing of a corporate tax cut appears disappointing compared to what the stock market has priced in, then there may well be a pullback in equities to bring valuations more closely in line with historical averages. A reversion to the 20 year average P/E ratio of 19.6x would bring the S&P 500 down close to 10%. A reversion to the long term average of 15.6x would involve a correction of over 25%, which would be quite unsettling to many investors, even though such intra-year corrections have occurred 5 times in the past 36 years. We are not suggesting that the latter is in the cards, but it is certainly well within the realm of possibility -- and indeed, we regard a smaller pullback (of 10% or more) this year as quite likely at some point. This would hardly be an anomaly: the average intra-year pullback in US stocks over the last several decades has been roughly 14%.

For the reasons discussed, we are continuing to maintain an underweight to stocks of roughly 10-15% below our normal exposure (for example, our moderate risk portfolios, which have a midpoint target of 50% in equities, are currently at 43%). We are maintaining an above-average position in other risk assets such as high yield securities and real estate, which partially offsets this underweight and keeps our overall "risk budget" fairly close to our strategic "neutral" midpoint.

As always, please contact your relationship manager, or any member of the SFA team, should you have any questions or if we may be of assistance in any way.

David Kantor
Partner and CIO
(505)501-6203
dkantor@santafeadvisorsllc.com

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