January 18, 2018

How Bull Markets Die

In addition to being a legendary investor, the late Sir John Templeton was also the source of many nuggets of wisdom on markets. Among his most famous observations was the following quote:

"Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria."

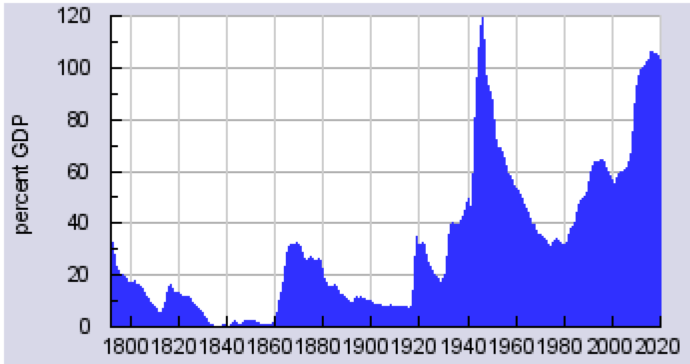
The current bull market in US stocks, the second longest in history, approaches its ninth anniversary on 3/6/2018, supported by the tailwinds of a widespread surge in global growth and increases in company earnings growth. Large US stocks posted a 21.8% return in 2017, slightly lagging the aggregate global stock market, which returned 24.6%. Other "risky" asset sectors such as REITS and high yield bonds posted strong single digit returns, rewarding investors for taking risk yet again. As a result of the powerful, multi-year rally, most major asset classes are trading in the top decile of typical historical valuation metrics, creating the conundrum that we find ourselves faced with: how much portfolio risk should we take in an environment of accelerating economic strength, but also expensive (and therefore more risky) investment options?

As we wrestle with that question, it makes sense to ask where in Sir John's time series we find ourselves. It seems that we have exited the skepticism phase and have spent time in the optimism phase; we are paying close attention for signs of the investor euphoria that often accompanies a market top.

Tax Cuts, the Economy, Debt, and the Fed

When one sifts through the noise and partisan hyperbole surrounding the recently passed Tax Cuts and Jobs Act of 2017 (TCJA), from an investment perspective the essence is really two-fold. On the positive side, significantly lower corporate tax rates will add to company earnings, encourage business investment, and make the US a more attractive destination for capital. These positives will be quite supportive to the US economy, and provide a powerful tailwind for a continuation of the bull market in stocks. On the negative side, the economic stimulation provided by the cuts is unlikely to spur immediate growth sufficient to "pay for" revenue lost due to the cuts; as a result US budget deficits and national debt are likely to expand. While the expansion of US government debt associated with TCJA is unlikely to be extreme on an absolute basis (reasonable estimates are in the 5-10% of GDP range over a decade), this potential expansion would come at a time when US government debt (over 105% of GDP) is close to its all-time high, and at an all-time high excluding the World War II period.

Graph 1 – Gross US Federal Debt



Source: usgovernmentspending.com

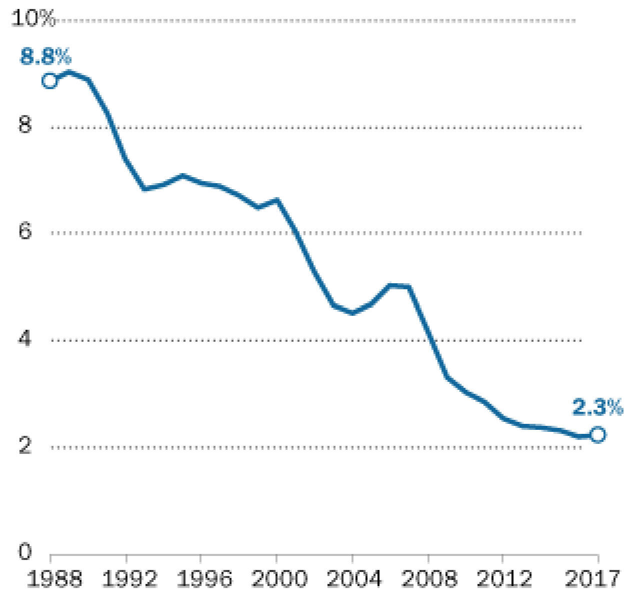
Why is this important? In this brief note, we will not attempt to outline all of the implications and risks of excessive debt in general, but will simply focus on the potential consequences of a large national debt burden at a time when the Federal Reserve is beginning to raise interest rates as it unwinds the easy money policies of the last decade.

In response to the 2008 financial crises, the Fed (along with other major central banks) aggressively provided emergency liquidity to financial markets, in what is widely viewed as a successful attempt to restore confidence and prevent a systemic financial collapse. In addition to providing cheap liquidity (largely in the form of low short-term interest rates), the Fed also took the unprecedented step of manipulating long-term interest rates, driving them to all-time lows in a (less clearly successful) attempt to spur economic growth. The aggressiveness of these policies had several implications, not all of which are completely clear. One effect was to make safer bond investments unattractive, due to low yields. As a result, money went into investments offering the potential for higher returns, supporting the stock market rally and, according to some, fueling a bubble. Another effect was to lower the cost to the US government of financing its ever growing debt, making ever accumulating deficits seem relatively painless, and kicking resolution of the debt issue down the road.

Now that the Fed is reducing its monetary stimulus by allowing interest rates to rise, the cost of servicing the US debt is going to rise as well. Graph 2 shows that the average financing cost of US government debt has fallen to 2.3%, an all-time low.

At such low interest rates, financing even the high current level of US debt has not been particularly painful. However, rising interest rates will increase that cost. With a debt burden greater than the size of the entire US economy (and growing), a rapid rise in interest rates could quickly cause debt financing costs to outpace the growth of the US economy. This could quickly lead to a deterioration in investor confidence, and a vicious cycle of ever higher financing costs and debt. The result could be an extended period of economic stagnation, large market declines, or both (as heavily indebted Japan has experienced in recent decades).

Graph 2 - Average Interest Rate on US Government Public Debt



Source: Treasury Direct

So the Fed has the difficult challenge of reducing monetary stimulus by raising rates, without stoking inflation by moving too slowly, or choking growth by moving too quickly. Just as there is no precedent for the scale of the monetary easing of the last ten years, there is also no precedent for the management of this exit.

Investing is Risky Business

The US debt burden and the Fed's dilemma are among the constant reminders we have that the investment business is one of taking and managing risks. As Mark Twain's character Pudd'nhead Wilson astutely observed:

"October is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August, and February."

Nevertheless, the US stock market has historically provided positive returns in about 75% of years, making it generally a losing proposition to exit the market entirely, regardless of the concerns and risks dujour. That is why we advise clients to adopt an investment risk profile suited to their needs and long-term objectives, and then to stick with it throughout market cycles.

In the short run, we think it's probable that economic momentum and positive investor sentiment will support a continuation of the stock market rally, though returns will likely be lower (with volatility higher) than in recent quarters. Most likely the debt reckoning discussed here will occur in future years. However, our concerns about valuations argue for a bit of caution, and inform our current portfolio positioning which is a very slight risk underweight relative to our neutral strategic targets.

Thank you for your trust, and best wishes for a happy and prosperous 2018 from the SFA team!

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