July 11, 2017

Climbing the Wall of Worry, Eight Years Later

Synchronized Growth in Global Economies and Markets

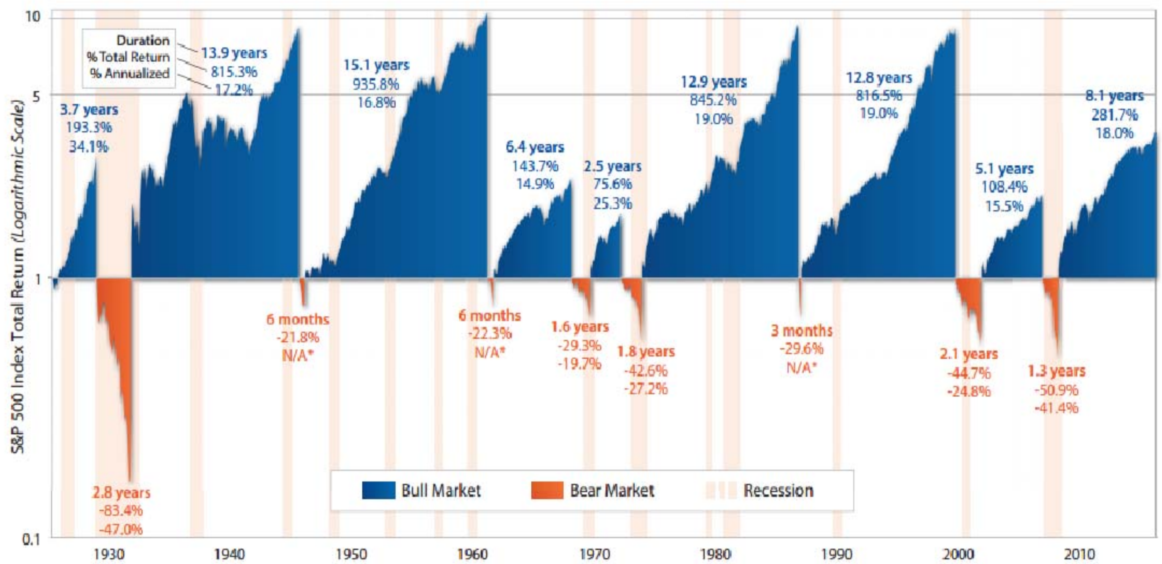
The first half of 2017 was an extremely favorable one for investors, with most major stock markets producing strong returns. During this period 26 out of the 30 largest global stock markets posted gains, a result which has occurred only four times in the previous 20 years, most recently in 2009. Global stocks in aggregate posted an 11.8% return: large US company stocks returned 9.3%, international developed market stocks returned 14.2%, and emerging market equities led the way with an 18.5% return. Fixed income investors also enjoyed positive returns: high yield bonds returned 4.9% as defaults remained low, and US investment grade bonds (measured by the Barclays US Aggregate Index) returned 2.3%. Despite an increase in gold prices, most commodity indices declined, led by a supply-driven drop in oil prices.

The latest leg of the 8+ year stock bull market began immediately after the US Presidential election, and rode a wave of euphoria based on the expectation of policy changes including significant US corporate tax cuts, an easier business regulatory environment, and significant infrastructure spending. However, this euphoria appears to have abated somewhat, since the administration has not yet been able to deliver on these campaign pledges. As we wrote in our last commentary “Interesting Times”, once markets have rallied after pricing in favorable expectations, it becomes increasingly risky that these expectations might not be met, and that a market reversal may then occur. While markets have been patient with the implementation of the Trump administration’s economic agenda, a significant tax cut is still ultimately expected, and disappointment on this front remains a major risk factor for stocks.

While expectations of pro-growth US policy changes have faded as drivers of recent market gains, it has become increasingly apparent that the global economy is enjoying a synchronized (albeit modest) pickup in growth in most major regions. The long recovery in Europe seems to be slowly gaining momentum, and the Eurozone (like the US) appears to be moving toward a 2+% real growth rate. While such a growth rate may sound unimpressive, it is a level the Eurozone has only been able to achieve for one quarter since the 2008/2009 financial crisis. Additionally, the Japanese economy is slowly picking up, Chinese growth has stabilized, and Brazil appears to be pulling out of recession. Overall, the global economy is on the verge of four straight quarters of 3+% growth, a trend which last occurred in 2010. With positive economic growth, corporate earnings in most major international markets have strongly rebounded, following the turn which began last year in the US.

As we have often discussed, prices in most major asset classes are quite high relative to historical measures. Among the many examples are the US stock market (S&P 500), which currently trades at about 30% above its long-term average price/earnings ratio, and high quality sovereign bonds (approximately $11 trillion of global bonds have negative yields!). While the SFA team believes that increasingly expensive markets involve greater risk, we also need to be aware that there is historical precedent for bull markets to last much longer than the current one. It can be very costly to exit a bull market too soon: the average S&P 500 return in the last

24 months of all bull markets going back to the Great Depression is 58%. The chart below of US stock bull markets (defined as a 20% correction) going back to the 1920s shows four such rallies longer than the current one.



Historical Performance of the S&P 500 Index throughout Bull and Bear Markets from 1926- March 2017. Bull Markets represents from the lowest close reached after the market has fallen by 20% or more, to the next market high. Bear Markets represents when the index closes at least 20% down from previous high close, though the lowest close reached after it has fallen 20% or more.

Source: First Trust Advisors L.P., Morning Star as of: 3/31/17

Is Good News Bad Again?

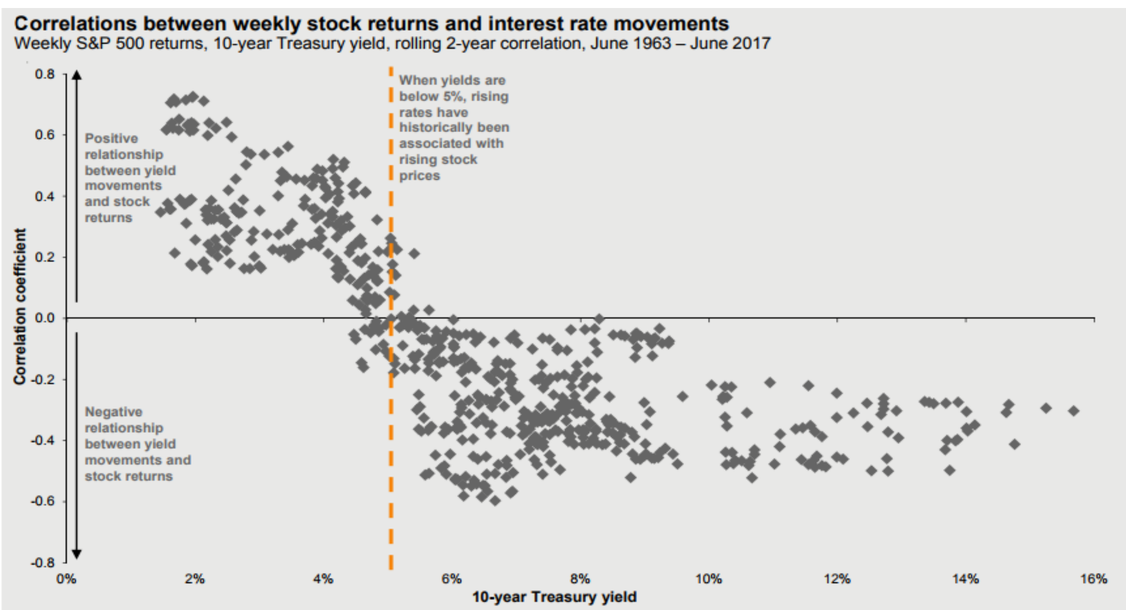
The 2008/2009 financial crisis evoked a very aggressive response from global central banks, which acted swiftly to flood financial markets with liquidity in an attempt to first save the financial system from collapse, and then to spur economic growth. Fueled by this cheap money, stock and bond markets recorded large price gains. In the years that followed, market attention focused on global central bank actions as never before, and perversely caused investors to perceive good economic news as bad news for markets: often when a good piece of economic news was released, stock markets would drop on the fear that the “monetary stimulus” to which markets had become addicted would be decreased as a result. As the US economy improved more rapidly than other major economies, the US Federal Reserve became the first major central back to begin paring back the scale of its easy monetary policy. When the Fed first announced its intentions to “taper” policy in 2013, the US stock market fell over 4% in three days. Nevertheless, as the market digested the news, normalcy returned and the stock market rally continued, as the reality of an improving economy took precedence over the prospect of tighter monetary policy. The same phenomenon occurred in late 2015, when the Fed first increased the short-term Fed Funds interest rate: the US stock market initially fell, only to resume its rally a few weeks later.

July 11, 2017

An interesting parallel occurred during the last week of June, when UK, European, and Canadian central bank heads all spoke with confidence about their respective economies, and hinted that continued economic strength might soon allow for a modest tightening of monetary policy. In response, all three stock markets declined, amid investors concerns of the higher interest rates associated with tighter policy.

While higher interest rates do constitute a headwind for company earnings and financial asset values (particularly high quality bonds), interest rate increases *from a low starting point* actually tend to be associated with strengthening economies and good stock market performance. Until excessive borrowing costs begin curtailing economic activity, rising interest rates are likely to be a good thing. Central bankers are not going to recklessly raise rates so soon after the financial crisis, and rising rates are likely to mean a return to healthy economies. The sooner they rise, the better.

Below is a chart showing the relationship between the 10 year US Treasury bond yield and S&P 500 returns, which shows a positive correlation until interest rates reach 5%, well above today's rate of about 2 ¼%.



Source: FactSet, Standard & Poor's, FRB, J.P. Morgan Asset Management.
Returns are based on price index only and do not include dividends. Markers represent monthly 2-year correlations only.
Guide to the Markets – U.S. Data are as of June 30, 2017.

Our Current Positioning

We have often noted that markets tend to climb a proverbial "Wall of Worry", which basically means that the more investors are bearish and afraid, the more likely it is that the market will continue to rise. Market contrarians have long noted that excessively widespread bullishness is a negative indicator, and extreme bearishness is a positive one. This concept makes some sense from a behavioral perspective: excessive bullishness may indicate a dangerous lack of caution, while excessive bearishness may indicate an irrational unwillingness to see opportunity. Certainly, the historic bull market of the last 8+ years has occurred with no shortage of fear and negative headlines.

We ignore headlines and invest based on valuations and intermediate term trends that we think are likely to continue. Currently, we recognize the favorable economic and earnings trends discussed. Against that, high valuations give us a measure of caution – at some point there will be a stock market correction, and eventually a significant one. As a result, we continue to maintain a slightly underweight overall portfolio risk position (we have a significant underweight to high quality bond risk, to minimize exposure to rising interest rates). Should the equity market rally continue, our clients will participate. But we have held back a bit of dry powder as a measure of caution, and to utilize for opportunities when we see an inevitable market correction.

Thank you for your trust, and please don't hesitate to contact a SFA team member with any questions.

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Disclosures