



QUARTERLY COMMENTARY

January 2017

The year 2016 was a year like few others. In the hours immediately following the closing of the polls in November, major stock indexes were trading below 2015 year-end levels. As sentiment turned on a dime from fear of a Trump presidency to celebration of the prospect for new business-friendly policies, stock prices surged over the ensuing five weeks. Interestingly, bond prices experienced exactly the opposite reaction, plummeting over the five weeks following the election. The money investors made in stocks was erased by the money lost in bonds.

Just a few months earlier, investors were faced with the greatest dichotomy in the history of financial markets. Interest rates were hitting record lows while U.S. stocks were just below record highs. As I wrote in our October Quarterly Commentary, bonds were pricing in Armageddon, while stockholders were pushing prices of the majority of stocks to unprecedented levels of overvaluation. As I write today, those extremes have only slightly moderated.

Third Longest Equity Rally

While bond prices, especially of longer maturity bonds, have been pummeled over the past two quarters, U.S. stocks continue to trade near all-time highs. We are, in fact, experiencing the third longest stock market rally in U.S. history, now more than seven years and ten months long. There is a commonly-voiced bullish argument that bull markets don't die of old age. That is probably true, but a close reading of history demonstrates that as bull markets lengthen, more and more people buy into the bullish rationale being voiced by analysts and commentators. After all, as those analysts convincingly argue, market prices are proving their theses. And bearish cautions are backhanded away as the bleating of worrywarts who have been wrong for years. This explains why so many investors buy near market highs, the point at which the bullish case has been most persuasively demonstrated. Extended market rallies provide ample time for the accumulation of excesses that ultimately are the most proximate causes of major market tops.

It is instructive to examine the outcomes of the only U.S. market rallies that have outlasted the current one. The longest spanned almost the entire decade of the 1990s, covering the nine years and five months preceding the market peak in early 2000. A painful 50% decline marked the onset of the new century, followed by an explosive rally and another destructive decline, leaving prices 57% below their early 2000 highs in early 2009. The only other U.S. equity rally to exceed the length of the current advance lasted just a few weeks longer, topped in 1929, ushered in the Great Depression and bottomed in 1932 with stock prices down 89% from their peak less than three years earlier. In other words, we have no example of a rally lasting this long that did not immediately precede a severely damaging, long lasting price decline. The decline that bottomed in 2009 brought stock prices back to 1996's levels, erasing 13 years of price progress. The 1929 crash that bottomed in 1932 wiped out an even longer 18 years of price history. Precedent does not dictate the future, but only the foolish would ignore a century or more of history. There may be reasons that are not obvious that limit market rallies to a shorter duration than we are currently experiencing.

Tom Feeney provides frequent economic and investment commentary on our blog at www.missiontrust.com/blog.

Excesses Have Grown

As I expressed earlier, when rallies lengthen, excesses that ultimately lead to market tops escalate. Let me examine where we are today in terms of conditions that have commonly marked the end of stock market advances.

As a valuation-based firm, we always examine how much investors are willing to pay for corporate earnings, dividends, book value, sales and cash flow. An aggregate of the most commonly employed valuation measures shows the overall equity market today at the second most overvalued level in U.S. history, trailing only the extreme overvaluation that characterized the dot.com mania at the turn of the century. That bubble ended very badly. Valuation measures of the median U.S. common stock are at their most extreme ever. In other words, we're paying more for the median stock relative to its underlying fundamentals than ever before.

Are there good reasons to expect that prospects for economic growth and corporate profits are similarly better than they have ever been before? While conditions can always change, both domestic and international economic growth rates have been significantly subpar for years despite the greatest amount of monetary stimulus ever. Corporate profits have also been stagnant for several years despite that aggressive stimulus. With problematic demographics and very weak productivity growth, it is unlikely that we are at the dawn of a new age of economic and corporate profit growth.

For centuries, in our country and throughout the world, excessive debt – personal, corporate or governmental – has contributed mightily to the severity of economic and securities market declines. Over the past few years, debt growth around the world has been unprecedented. In the United States, combined debt levels are barely off their all-time highs relative to the size of our economy. But for bankruptcies and foreclosures, which eliminated much debt, we would be at all-time highs. The world's second largest economy, China, is increasingly being seen as a ticking debt time bomb, with its debt levels exploding upward in recent years. Major world central banks, especially Japan, the European Central Bank and England, have been flooding their economies with newly printed money, offset by an equivalent amount of debt, as though their economies were collapsing. What do they see that they're not revealing? World debt has just reached its highest level ever at 325% of GDP. It is distressing to realize that excessive debt has been an integral ingredient in virtually every major stock market decline in modern history.

Bullish analysts and commentators like to point to the historically low levels of today's interest rates as justification for hopes for an extension of the current, lengthy stock market advance. I believe it to be an open question as to whether one can look at current interest rates as we have looked at rates over past decades. Never before have rates been as directly suppressed by central bankers worldwide as in recent years. But rates, at least in this country, have begun to rise, and the Federal Reserve and most analysts expect them to rise sequentially over the next few years. Fed rate tightening actions have typically put significant pressure on stock prices, especially when valuations are high.

Rising interest rates, of course, are also destructive to bondholders, as prices decline when rates rise. That risk is especially relevant now, because the average bond today is at its longest duration ever, i.e., at its greatest sensitivity ever to rising rates. The quest for yield has led investors to buy longer maturity bonds in an era of historically low rates.

Weak Long-Term Equity Prospects

John Hussman and Nobel Prize winner Robert Shiller have each done intensive historical analyses of stock market performance from various levels of equity valuation. So extreme are today's levels that their studies show the expected annualized equity return over the next 10 to 12 years to be in very low single digits. Hussman's work dictates that a 50-60% decline in that time period would be a normal expectation. We believe that the most prudent investment policy in such an environment is to take steps necessary to prevent major declines in portfolio value in order to have plentiful buying power available when prices revert to historical means or below.

Conflicting Bullish and Bearish Conditions

While valuations, debt levels, the longevity of the current rally and rising interest rates all strongly suggest caution, most stock market technical conditions remain at least moderately bullish. While momentum has slowed, far more stocks are still advancing than declining, and supply and demand figures remain bullishly configured. Over many decades, growth in supply typically precedes major market tops by several months. A dangerous buildup of supply is not yet obvious.

We find ourselves in a very confusing environment. Notwithstanding more minor advances and declines, the technical conditions that normally precede a major decline do not yet appear to be in place. On the other hand, fundamental conditions that presage very severe market declines are very much in evidence. Even those who agree with that evaluation of the evidence may be tempted to try to squeeze a bit more out of this rally. And that approach could succeed. It is important to recognize, however, that adding to stock holdings at current levels will prove profitable only if prices never again dip below today's level or if prices go higher and sales are strategically timed before a later decline.

Normal outcomes could also be dramatically altered by an economic, military or political shock. In an environment of polarized political feelings in this country and around the world, the risk of such a surprise is hardly inconsequential. Investors need to evaluate carefully their individual ability to assume such risks.

Thomas J. Feeney
Managing Director
Chief Investment Officer