MISSION®
MANAGEMENT & TRUST CO.

QUARTERLY COMMENTARY
April 2017

The first quarter marked a continuation of the behavior characteristic of the stock market and economy for the better part of the past several years. Stock prices sustained their post-election rally through the end of February, rising over 7% in the year's first two months, then giving back a bit more than 2½ % to mid-April. At the same time, the economy has grown, but at an extremely sluggish pace.

Newspaper headlines and investment firm research trumpet the good news of increasing employment statistics and growing wages. More houses are being built and sold at increasingly higher prices. And economic growth is widespread, not restricted just to the United States. There is, however, a "but…" associated with each of these apparent positives.

Employment rolls are growing, and unemployment statistics are shrinking, but largely because millions of former workers have opted out of the labor force, many discouraged about job prospects. Wages are rising, but at a far slower pace than in prior economic recoveries. More houses are being built and sold, but the numbers are far below levels of a decade and more ago. These statistics look good only in comparison with the extremely depressed numbers that resulted from the Financial Crisis. And the global economy is growing, but at a rate only marginally above stall speed.

Add to these qualifiers slowing vehicle sales, sluggish consumer spending, stalling bank loan growth, declining individual and corporate tax receipts at the state level, and bond yields reflecting significant economic uncertainty, and there is good reason to question a bullish economic outlook. The Atlanta Federal Reserve Bank, which has issued the most accurate forecasts in recent quarters, has dropped its most recent forecast for GDP growth to just 0.5%, a barely perceptible rise.

According to Evercore ISI, improving stock and housing prices since the Financial Crisis have raised household net worth relative to disposable income to an all-time high in this country. Logically, more wealth in the pockets of potential investors and consumers should bode well for tomorrow's stock market and economy. Ironically, in the 70 years of this study, the only two prior instances that approached today's wealth level marked the stock market and economic peaks following the dot.com and housing bubbles. Those peaks preceded serious recessions and declines that cut stock prices by more than half.

Since the election, consumer, executive and investor surveys have displayed remarkably strong levels of optimism. Such surveys are called "soft data." Unfortunately, "hard data" (real economic results) have been coming in surprisingly weak. In fact, in recent years, there has never been a disparity this great between hard and soft data. It brings to mind Warren Buffett's famous line that in the short run the market is a voting machine, but in the long run, a weighing machine. Bullish attitudes have "voted" stock prices higher, but "weighing" fundamental conditions could result in far lower prices.

Because corporate earnings were so depressed in the first quarter of 2016, largely because of oil price weakness, analysts expect to see a significant --possibly double digit-- jump in this year's first quarter results. Earnings per share (EPS), however, have become increasingly deceptive over the past several years. Since 2009, corporate EPS are up 221%, the sharpest post-recession rise in history. Corporate revenues, however, have increased by just 28% in the same period. *The Wall Street Journal* accused corporations of "…clever exploitations of accounting standards that manage earnings to misrepresent economic performance." Share buybacks, which have become commonplace in recent years, increase EPS without companies increasing overall corporate profit. Total corporate earnings, not EPS, through the fourth quarter of 2016 were at 2011 levels despite the S&P 500 having advanced by 87%. The only thing that has soared has been the price-to-earnings (PE) multiple. Over many decades, periods of PE multiple expansion have been followed cyclically by multiple contraction. The current cycle of year-over-year multiple expansion has lasted 57 months, the longest on record. The two prior longest cycles ended in 1987 and 2000 with two of the U.S.'s most devastating stock market crashes. Excesses are inevitably followed by reversion to the mean.

As I have explained repeatedly in recent quarters, despite minimal economic progress, stock prices have been boosted mightily by the historic levels of monetary stimulus provided by the Federal Reserve and other major world central banks. That stimulus has extended well beyond traditional interest rate and money creation measures. As early as 2014, *Financial Times* reported that central banks, especially the People's Bank of China, had bought more than $1 trillion in equities. In more recent years, the Bank of Japan has committed so many assets to equities that it has come to dominate that country's exchange-traded-fund market. I have long maintained that our Fed, either directly or, more likely, indirectly, has been supporting U.S. stock prices at strategic moments.

This historic stimulus, which continues at an aggressive pace in Europe and Japan, has created unprecedented levels of debt worldwide. For more than the past century, the major countries of the world have experienced GDP growth at far faster rates when national debt has been low rather than when high. This paradox places a major hurdle in front of the world economy as it struggles to grow in an era of unprecedented debt burdens.

Let us revisit the "bet" which I have discussed in each of our last two Quarterly Commentaries. It is a fact that stock prices have always ultimately reverted to their fundamental means. At valuation levels far out of synch with underlying fundamentals, today's portfolio values are at substantial risk should that reversion happen quickly. That outcome is the safe bet, at least in the long run. On the other hand, the central banks of the world are on an eight-year run in which they have been able to overcome weak fundamentals with an avalanche of new money and other market-supportive stimulus. It is not unreasonable to bet that central banks will remain both willing and able to keep market prices aloft. Unless the current instance permanently flies in the face of historic reality, however, profiting from equity purchases from current levels will demand that markets continue to rise before suffering substantial losses, and investors will have to make a timely sell decision before prices eventually decline to align with underlying fundamentals.

Let me introduce a few more conflicting items for your consideration. All but very short-term technical conditions continue to look reasonably bullish. Supply /demand and advance/decline figures still offer the probability of further equity price advances over the intermediate term. And while the Fed has begun to "normalize" its monetary policy in very gradual steps, it is unlikely to abandon its support of investment markets should other factors begin to put meaningful downward pressure on prices. On the other hand, the thirteen Fed rate hike cycles since World War II have led to ten recessions, a 77% rate. And, without making a political statement, every new Republican administration since Ulysses S. Grant's (14 in all) has been in recession within two years of its inauguration. Interestingly, most experienced significant market advances from election day into the administration's early months, as is currently the case. Complicating matters even further, both U.S. and Russian warships are steaming into contentious waters. Obviously there exist a great many highly unpredictable crosscurrents.

I'll refer once again to the wisdom of Warren, listing two more of Buffet's famous aphorisms: "Most people get invested in stocks when everyone else is. The time to get invested is when no one else is. You can't buy what is popular and do well." And: "Be fearful when others are greedy and greedy only when others are fearful."

Such advice gets difficult to follow when abnormal conditions persist for years. It is important to remember that inevitable reversions to fundamental means can take back many years of profits. Most recently, the 2007-09 decline took stock prices back to 1996 levels, eliminating 13 years of gains. It's critical for all investors in pursuit of profits to evaluate carefully their individual financial and psychological ability to withstand risk and losses, especially if markets should go through extended periods of weakness.

Please let us know if we can provide additional information about your portfolio or our investment thinking.

Thomas J. Feeney
Managing Director
Chief Investment Officer