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“trees don’t grow to the sky”

“By The Way”

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The S&P 500 Index continues to act in a positive manner, and we see no compelling reason to change that outlook at this point in time. While there are legitimate concerns being expressed by many pundits, the actions of the market do not suggest anything more than a buyable correction/consolidation for the foreseeable future. Valuation measures are not cheap, but are not so extended as to be alarming. And it is heartening to see that the E in the S&P 500 P/E ratio is showing good growth after almost a three-year stagnation. Global economies continue to grow and provide support for higher stock markets. One of our favourite leading indicators, the Purchasing Managers Index (PMI) is indicating economic expansion around the world. In some countries, notably the U.S., the PMI appears to be peaking, but a look at history shows that on average it has taken approximately 2 ½ years from such a peak to the start of a recession. Some strategists point to the FED raising rates as a major negative for stocks, but again history tells us that markets continue to rise along with rates until the tipping point when the Fed goes too far and those higher rates stifle economic growth. Still, no one rings a bell to tell us the market has topped, and after almost 10 years of a rising market, we are likely closer to the end than the beginning of this bull. There are many examples of being right but being early, and yours truly can cite many such instances from personal mistakes. Charles Merrill (the founder of Merrill Lynch) famously warned his clients in 1928 of the overvaluation of stocks, and was proven correct in 1929, but the market rose almost 50% between his letter and the eventual top. The point is, no one knows where the peak will be, but we do know trees don’t grow to the sky, and that the day is out there somewhere, and we should prepare ourselves before it occurs.

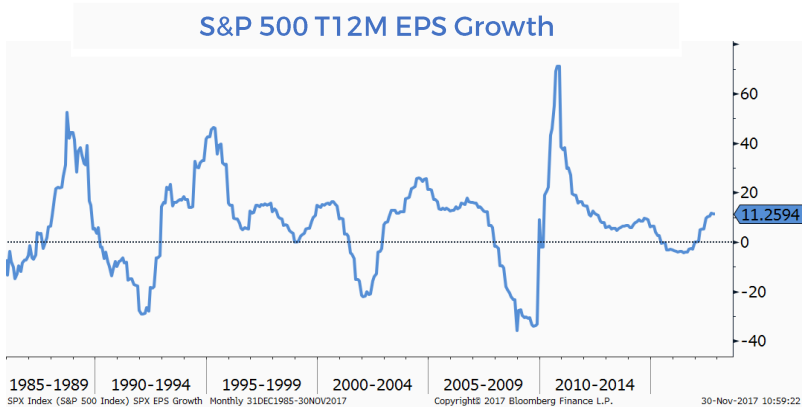
Given all of the above and the approaching new year, I thought it would give me the opportunity to express some thoughts on longer term and larger issues which may not be specific to financial markets, but will still have a potentially significant impact. To be up front, I will admit to certain biases; first I believe in cycles, that what goes around comes around and that the pendulum usually swings too far in each direction. And secondly, that these are nowhere near normal times in financial markets and geopolitics, and that socially and economically we have to return to a more normal place. This will not happen without disruptions.

Let’s start with bonds versus stocks. Since the financial crisis of 2008, bond funds have experienced inflows of \$1.5 trillion while equity funds are flat. Obviously, bonds are the current favourite of the two asset classes, but remembering my belief in cycles, I see that swinging back toward equities. I have never been an expert on interest rates or fixed income securities, but I am amazed by much of what is

happening in the bond market. The European high yield bond index trades at a yield almost equivalent to U.S. Treasuries. Is there no risk premium for perceived safety anymore? As an example, Veolia, a French environmental company with a rating of BBB, recently issued a €500 three-year bond to yield negative -0.026%, and it was four times oversubscribed. Here is another one, people are calling 2017 “the year of the dictator bond”. In September, Tajikistan raised \$500 million in 10 year bonds at 7.125%; initially it was offered at 8% but after orders reached \$4 billion, the rate was lowered. This is a country with annual GDP per capita of just \$804, and a banking system that had to be bailed out in 2016, and is said by Moody’s to remain under “severe stress”. This quest for yield without what I see as proper due diligence has me recalling the subprime mortgage crisis, and I fear a similar ending. It is my opinion that when global economies hit the eventual slowdown stocks will fall, but parts of the bond market will suffer a much worse fate.

One more thing that causes me to lose sleep is the continuing rise in wealth inequality and the hollowing out of the middle class. If we only look at the last 10 years since before the financial crisis, studies show median wealth for lower-income families has decreased by 40%; is 33% lower for middle income families; but is 10% higher for upper income families. In part, it is the result of central bank easing that has caused financial markets to rise significantly, and we know lower-income people don’t own many stocks or bonds. I could go on citing statistics, but I think we all know this is a real problem that leads to anger, dislocations, and political change. I don’t know how this dilemma will be resolved, but the rise in populism has been one result. Examples such as Brexit, protests in Catalonia, the rise in strength of ultra right-wing parties, and even the election of Donald Trump, point to the disruptions that can occur when people get mad and feel powerless.

I don’t like being a “Debbie Downer”, but I’m a worrier at heart, and want to be prepared for negative outcomes. In the meantime, stock markets continue to make new highs.



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