—New Albany—
Investment Management

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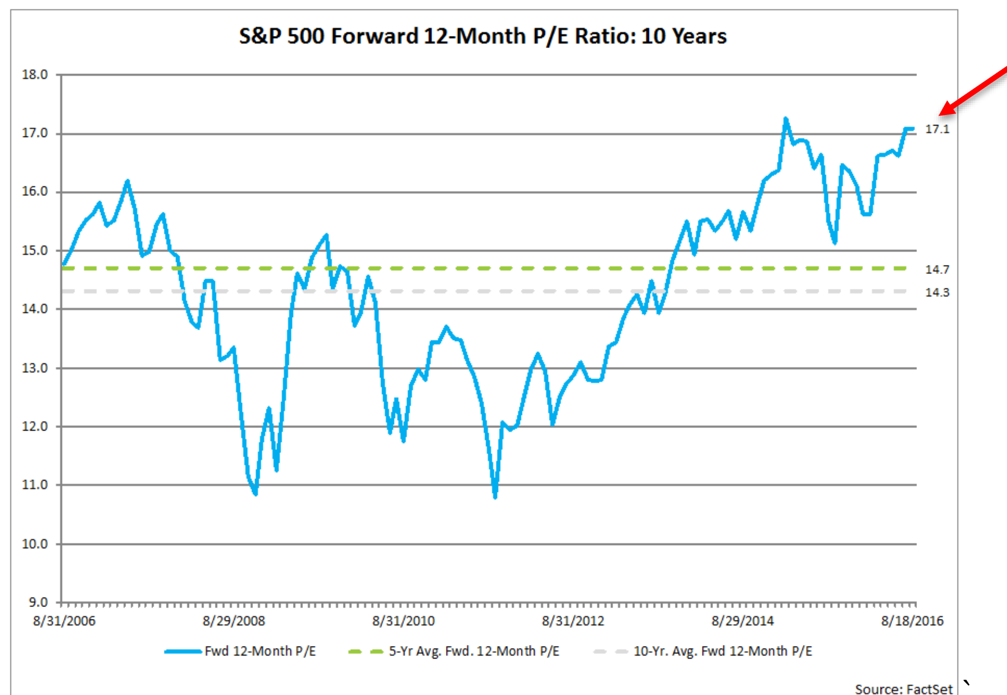
Market Insight: Markets Keep Rising. Should You be Concerned?
Three Sleeping Giants

Street Chatter: As the markets continue to make new highs, there is a lot of talk that a severe correction is just around the corner. Many continue to look for reasons why the bull market is nearing an end, with the biggest being prices have gone too far, too fast. The chart below shows a rising S&P 500 P/E ratio, indicating prices are rising faster than earnings. The current P/E ratio is 17.1 and is well above the 5yr and 10yr average.



Should you be concerned? Is the market forming a bubble that will pop soon? If so, is your risk position too high? How would you feel if the market drops 10%? Perhaps your antenna is pulsing right now-indicating some level of unease. These are all legitimate questions to ask and should not be dismissed.

It is human nature to look back at how far the markets have come, but in truth, the past really has very little to do with where the market will go in the future because by definition, stock prices are primarily driven by expectation of future earnings. So, before trying to answer the questions above, perhaps the first question to ask is: are the current expectations of future events realistic?

New Engine for Growth, Three Sleeping Giants. Though a number of factors affect expectations, long term trends are mostly driven by underlying economic fundamentals. Without true organic growth, it is difficult for the markets to sustain any positive bias. Today, the fundamentals continue to look solid, however, the current expansion has been missing three key elements that if come to pass, would give a new engine of growth for our economy such that GDP would finally break above the 2% level. **The kicker to growth could be the awakening of three sleeping economic giants: Increasing CAPEX; Rebounding Productivity; and Tax Reform.** I call them sleeping giants because, because long ago these economic boosters were key drivers for growth, but have been in a deep slumber since 2008. The impact of these giants on interest rates and stock prices could be HUGE!

Giant #1: CAPEX. Earnings Growth begets Economic Growth: It was another strong earnings quarter, with 3Qtr17 earnings estimated to have risen by 9.5% from the prior year. If this holds, it will represent the fifth straight quarter of positive earnings growth since the recovery from when the oil collapse began. Historically, earnings growth tends to lead capital expenditures (capex) by four quarters. As earnings accumulate, business must decide whether to payout earnings, payoff debt, buy back stock, or reinvest into their business (CAPEX). The first three options provide only a short term benefit. However, CAPEX is for long term growth. **The decision to make capital expenditures is an indication of business confidence and a leading indicator for future growth and earnings**. Currently, CAPEX remains subdued; however, future plans look quite promising.

The chart below shows existing CAPEX expenditures (blue line) and future capital spending plans (green line). Notice how far above the green line is from the blue line, indicating **companies have big plans to spend next year. This could be a positive kicker to GDP growth in 2018.**

Future capex plans surging

Source: FactSet. Fixed investment as of June 30, 2017. Future Capital Spending Diffusion Index (as of September 30, 2017) is part of the Federal Reserve Bank (FRB) of Philadelphia's Manufacturing Business Outlook Survey and represents % of respondents indicating an increase minus those indicating a decrease in future capital expenditures over the next 6 months for reporting regional manufacturing firms.

Giant #2: Rebounding Productivity: A leading Indicator for future growth. Productivity is a measure of output (goods and services) produced per hourly cost. The chart below shows the downward trend in productivity since 2007 and is one of main reasons economic growth has been unable to rise above the +2% growth level during this recovery.

Recently, however, productivity has begun to rise, setting the stage for potential new leg up in growth. Research analyst Jim Paulson from *The Leuthold Group* explains: "A pop in productivity would finally replace those 2-ish% real GDP numbers with regular 3% handles, forcing many to recalibrate economic growth and earnings estimates. It would come at just the right moment in a recovery where wage and price pressures are intensifying. It could allow the renormalization of bond yields to be stretched over a more measured pace."

The chart below compares productivity (blue line) to business's ability to spend (green line). With tight labor conditions and strong balance sheets, companies are ready to deploy their capital and boost productivity. According to Paulson, a **pop in productivity "this late in an expansion could reset the recovery clock, acting like a fountain of youth for the economy and perhaps sustain this bull market for much longer than most believe possible**."

Productivity Set to "Pop"

Source: The Leuthold Group, as of June 30, 2017. Four-quarter moving average. *Business spending ratio = corporate cash flow divided by capital spending, all as a ratio of unemployment ratio.

Giant #3: Tax Reform: The last major tax reform was in the 1980's during the Reagan administration. The new tax bill proposes $1.5 trillion in tax cuts, of which $1 trillion is targeted for businesses, and the remainder for individuals. Though many news stories are focusing on changes to personal income tax structure, what will **truly matter for the economy is the proposed change in the corporate income tax rate from 35% to 20%.** This change is huge as it will lead to a major increase in capital spending and it will boost earnings. Currently, the US has fourth highest corporate tax rate in the world, which has had two major impacts on growth: US corporations have been at a competitive disadvantage because their cost of goods are higher; and those companies that can, have kept their earnings overseas, investing abroad instead of domestically. The consequences are seen in low productivity and capex, and ultimately realized in lower earnings. **According to the Council of Economic advisors, the reduction in the corporate tax rate is expected to lift GDP from its current 2% level to 3% in the near future, and could get to 5% over the next 3-5yrs.** Although there is a loose relationship between GDP and stock prices, **lowering corporate tax rates will indeed boost profitability which will help raise productivity and real wages**. This is good for the economy and stocks.

Back to the 90's: If these sleeping giants do awaken, the impact will be a big support for a higher level of long term growth, and similar to what we saw in the 1990's. As the burden of heavy regulation and taxes are lifted, and the Fed's ultra-accommodating policy is unwound**, the natural market forces of the economy will be free to do what it does best in the USA- innovate!** If GDP gets back to 3-5%, AND inflation stays subdued (important!) stocks could see double digit returns. At the same time, interest rates would be significantly higher- 10yr treasury rates could rise from 2.3% today back to +4.5-5%.

So what to do now? Sit tight. With global growth gaining momentum, inflation subdued, and earnings improving, the environment for stocks is still positive and thus the investment strategy for accounts remains at the top end of target levels. However keep in mind, the markets are always looking ahead, and sometimes they can get way ahead (overpriced). This means they could either correct lower or consolidate in a large range until the fundamentals catch up.

Litmus Test: Assessing risk and economic conditions is an ongoing process. It is both prudent and healthy to ask questions because at the end of the day, it is your hard earned savings that is at risk. A good way to measure your risk tolerance is to consider what impact a 10% drop in the market would have on your portfolio. For example, if 50% of your portfolio was in stock, and the market dropped 10%, the total value of your portfolio could decline by 4-6% (depending on the assets allocation structure). How does this sit with you? Keep in mind, short term dips should not disrupt your long term financial plan as long as it is based on sounds assumptions and realistic goals.

These are my thoughts on the current market environment and investment strategy. As always, please contact me with any questions or concerns.

Kind Regards,

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