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While the World Swirls with Worry, Markets Grind Higher

The geopolitical news is nothing short of deplorable and good reason for caution when it comes to investing. At the same time, economies around the globe continue to struggle: the Eurozone is faltering, China's growth is still slowing, and Japan is barely growing. Daily, the global headlines are awash with shocking news, and yet the US markets (both stocks and bonds) continue to grind higher, seemingly unfazed by the potentially far reaching consequences of the current events. What is propelling the US markets? Are valuations too high? Is it too late to buy? Is the market vulnerable for a brutal fall? Investors are continually reassessing their answers but in the end, they are lured into the market pushing prices in some sectors to new highs.

Below is a look at the fundamentals driving the market today, valuation, and an assessment of the current risk of investing.

Two locomotives pulling for the market are Growth and Confidence.
Growth**:** The US economy is finally on solid footing and gaining momentum. The labor market is steadily improving to its best level since 2007; capacity utilization is near 80% which is a sign companies are finally beginning to deploy their cash stash; and the housing market continues to be resilient in the face of rising mortgage rates. Furthermore, the fact that the Fed is finally withdrawing its QE policy and contemplating raising rates, is evidence that even the Fed is confident the recovery can stick.

Confidence: US markets are a 'safe haven' for global investors. As the world swirls with worry about intensifying international conflicts and doubt about the fate of certain economies, the improving growth picture in the US is both a comfort and beacon for investors. Money always flows where confidence is high, and right now the US looks to be the best bet. In the past, global uncertainty has caused money to flow to Gold for safety and oil because of scarcity. This time however, the price change for both Gold and Crude Oil, though positive for the year, has been rather subdued which shows investors are believing the US growth story is real.

Does Valuation Matter? It all depends on who's talking and from what vantage point. Every week there are a half a dozen articles discussing market valuation. Some are arguing the market is expensive and bound to fall, while other are saying the market is cheap, with much more room to move up. So which is correct? Both and Neither. What? Yes, the market is expensive by some metrics and cheap by other metrics, but this is not what causes a market to move up or down. In its simplest form, today's valuation reflects the present value of *expected future earnings*. The key word here is 'expected'. Prices fall (or rise) when expectations about future and earnings fall (rise), not because of a certain price level. In other words, expectations and change in expectations drive the direction of the market, not price level. Thus, **instead of wondering if the market is cheap or expensive, it is better to consider the risk of entry at today's valuation.**

What is the current risk of investing? One way to view market risk is to consider where we are in the credit/economic cycle. According to Citi analyst Rob Buckland, every economic cycle has four phases:

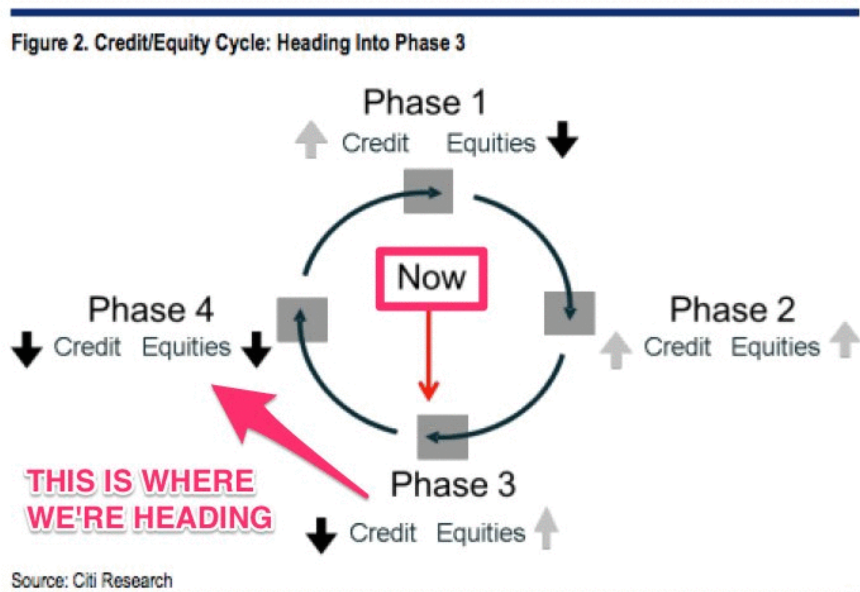
Phase 1: This begins at the end of a recession, when interest rates have fallen, money is cheap, but stocks are still battered.

Phase 2: A bull market sets in during phase 2, when stocks start to rise as easy credit lubricates the economy.

Phase 3: This is the tricky part. Stocks are still flying high, but credits spreads are widening as investors become increasingly unwilling to finance further risk. Corporate CEOs have now experienced a lengthy period of gains and become risk-happy. Central banks are talking about raising interest rates. Bubbles can form in Phase 3, Buckland says, as the high-flying stock market ignores the early warning signs of the deteriorating credit market. Hello, tech startup IPOs!

Phase 4: Stocks react to the lack of available credit by collapsing, and we see the kinds of things you get in a recession: "This is the classic bear market, when equity and credit prices fall together. It is usually associated with collapsing profits and worsening balance sheets," Buckland says.

Here is Buckland's Credit/Economic Cycle diagram:



According to Buckland**, the economy is just entering into Phase 3 which means equity prices will likely keep rising, but valuations become stretched, irrational bubbles form, making for a riskier investment environment**.

How long and how high can Phase 3 can last? It depends on how quickly asset bubbles form (P/E rise) and credit becomes scarce. I will leave you with two thoughts to consider: the Fed is controlling credit expansion and is in no hurry to pull the plug; the current bull market is the longest uninterrupted bull market in 85 years, 64 months old to be exact however, it is not the biggest bull market ever in terms of appreciation, (the late 90's tech bubble still holds that title.)

Investment Strategy: Price action is expected to be firm but choppy into the Fall as investors wrestle with the consequences of global conflict offset by a strengthening US economy. Portfolios are fully invested however risk has been further diversified across asset classes. High yield exposure has been reduced and allocated into investment grade short term bonds.

Please contact me with any questions or concerns.

Kind Regards,
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