Nov 23-17

IS THIS SHORT TERM GAIN-MIDTERM PAIN?

Good Afternoon To All

I think over the short term Equity markets will climb higher into the first half of 2018 but then I fear the risk vs reward relationship becomes even more slanted towards RISK.

Euphoria and momentum (e.g. Passive ETFs) has returned to the markets and that is pushing markets to extreme valuations. From my review the galloping Herd is huge and includes retail investors, fund managers, newsletter writers and Hedge Funds. The two most glaring examples of this ubiquitous euphoria over the last week, was the record sale price of a Da Vinci art piece and the insanely frothy levels of Bitcoin where we now have 130 Hedge Funds focused on cryptocurrencies (most set up in the last 4-6 months)! This is so Deja Vu 1999 and 2007 for me!

In the short term these very late cycle "investing wiring flaws" (euphoria, complacency, risk blindness, zero volatility and greed) will continue to push markets higher as the Herd Momentum is one very powerful force, but my guess is by mid-year 2018 this will all reverse…lord knows we are due for at least a 15% correction as the last one was waaaay back in 2011!!

Additionally, November 2017 starts the Second year for President Trump and my hunch is that it will NOT be anything like last year. History tells us that it is in Year 1 & 2 of the 4 year Presidential Cycle when almost 90% of bear markets occur (M Nickles, S Harding)….odds are high that history will repeat in 2018!

But there are a lot of moving parts that can influence the markets (e.g. a Trump Tax Reform) so let's briefly review some of the market positives, then the negatives and decide on how to best deal with this.

MARKET POSITIVES

#1 The Synchronized global recovery

-this is real and we are seeing global service and manufacturing PMI's supporting this…the risk here is the surge in commodities that often occur at the tail end of a recovery just before the recession forcing inflation and rates higher…

#2 Liquidity

-remains positive on a global basis as the ECB will not reduce its QE until Jan 2018…but then global QE will be in decline for the first time in 10 years!!! That is a big risk for markets in 2018 but will take a few months to sink in (bond markets will price it first then equities)

#3 No Recession

-is expected in the next 6 months and that is why we are “gently” buying back in some accounts…several Leading Indicators remain positive and the global manufacturing-service surveys (ISM-PMI) are reflecting continued growth and the equity markets like this

-this ”no recession call” and the synchronized global recovery gives me some confidence in equity exposure over the short term BUT NOT in the midterm (see below)

#4 The HERD

-is close to or all in which allows for great equity market momentum…this bullish herd mentality covers newsletter writers, retail investors, fund managers etc. and it now spreads faster than an airborne virus thanks to the internet...have a look at the bitcoin or FAANG chart as an example

-The Investors Intelligence (of newsletter writers’) poll reveals that bulls are at a 30 yr. high at 63.5% and the bears are only at 14.4%--this 50 point spread is the widest in 30 yrs.!!

-The Conference Board Consumer Confidence came in at 125 last month—the highest since Dec 2000

-Univ of Michigan Consumer Confidence are at giddy levels or the highest reading since 2004…yes higher than 2007!!

-Household Equities as a % of total Financial Assets are now at 35.7% vs 33.9% in 2007! That equates to the herd being all in!

The movement of any Herd is a powerful force, but it is also a double edged sword as once all are in markets typically reverse and so the contrarian view on this extreme euphoria and complacency will become very bearish at some point, and on comparing the above numbers to prior turning points we are very, very close here….

#5 Trump Tax Reform

-has decent odds of passing in the next 6 months (at least 50% odds in my books) (despite the massive deficit associated with it which is a tragedy for future generations) –if it does, even any version, then markets will climb higher into mid 2018 is my guess

-in 1986 markets rallied 10% after Corp taxes were cut fyi so would expect a similar boost??

#6 Earnings and Revenue

-we just completed the 3rd quarter and the E/R were good making that the 4th quarter of recovery from the terrible earnings recession back in 2015-16 when we had 4 consecutive contracting quarters . The E beat was 72% and the more important R beat (as it is less manipulated) was 67%.

-One could argue that the stellar market rally over the last year was more about E/R recovery than a "Trump Rally'??

-But the question is can this continue into 2018? The synchronized global recovery bodes well for this BUT there are several hurdles such as falling margins, wage increases(?), higher interest rates and the US dollar is no longer weakening.

-The bond market (see later) disagrees with the equity markets euphoria as you will read later

#7 Mid Term US Elections

-only here under "positive" as it sets a clock for the GOP to get the Tax deal done at all costs before Nov 2018!

MARKET NEGATIVES

#1 Valuations Frothy

-you are sick of me ranting about this (CAPE, P/S, Buffett Indicator etc.) but returns from these rich levels will be VERY weak folks!!!!! So do we need this risk this late in the cycle?

#2 Liquidity

-is now in reverse with the US Fed raising rates and QT, ECB reversing QE in Jan 2018, BofE 2018?, China's Central Bank now in tightening mode?....remember--do not fight the FED....

#3 Late Cycle

-everything points to this being the last inning or OT for this 9 year cycle (second longest ever) so it's logical to take chips off the table now rather than the panic selling that occurs AFTER the fact

#4 BUBBLES Everywhere is LATE CYCLE!

-The recent Da Vinci master piece selling for $450mil vs the expected $100 mil!!

-or how about the Paul Newman Rolex auctioning for $17.8 mill vs the expected $1mill!!!

-Or the Bitcoin Bubble or the FAANG bubble or the Housing Bubble or the ETF Passive investing…they are everywhere and tells me it's very late cycle….

-now seeing the ICE offering future contracts trading on FAANG and Bitcoin….that to me is the final nail in the coffin when we see leverage bets on a bubble

- now everyone (at hockey) is asking me about Bitcoin and FAANG stocks!!

-worth noting that over the last 3 years 30% of the S&P 500 return has been from just 5 stocks---FAANG!!

-or how about during the dotcom mania when there were 29 stocks on the S&P 500 that traded above 10x sales/revenue….today….there are 28!!! That should scare even the bulls.

#5 Bond Market Signal

-the Yield Curve (2/10s) is at the same level as Nov 2007…NOBODY was predicting a recession in 2007 yet we had it a year later and stocks went nowhere for the next 12 months, and then they plunged later in 2008…so the bond YC told you that risk vs reward in Nov 07 **was very tilted towards RISK and that is the same today**

-the flattening YC tells me Equities got it wrong about the future economic growth and inflation and if the FED raises rates 2-3 more times than we have an inverted YC…I fully expect this in 2018 or the odds are very high and enough to put me on DEFENSE and WAD PROTECTION!!

-currently the 2-10 yr. spread is 60 bp and 2-30 yr. is less than 100 bp—that is the lowest in over a decade!!

-Google search on “flattening yield curve” has soared in the last month as the Herd gets educated—once we hit 50bp on the 2/10 my flashing goes from yellow to RED folks!! Stay tuned.

(PS last week the Junk Bond market sold off which is often an early precursor to an equity sell off so I will be watching this)

(PS when the YC does invert (or even gets in the 20-40bp range) that is typically the peak in the equity markets even through the recession takes another year to hit BUT equities are forward looking and start dropping BEFORE the recession hits BUT the point is that most of the gains have been had at that point (inversion) and we are 1-2 rate hikes away…..

#6 Tax Reform

-a no go would be bad for stocks I think (and the GOP and Trump)…that is why I think he will pull it off….and will use all options available to him???)

#7 Evidence That The Herd is All In

-Merrill Lynch Client Allocation to bonds is 23% (vs 26% in 2007) and allocation to cash is a low 10% (vs 11% in 2007)

-the VIX Fear Gauge remains at record lows revealing extreme complacency about risk

-every month in the last 12 months have been positive on the S&P 500—last time we saw that was 1935—90yrs ago!!!

-we have only seen a 2.8% market pull back in the last year (vs avg of -14%)---this is the smallest 12 month draw down since 1914!!

-it's been 1465 days since we saw a 15% correction—that's 2011 folks or 7 yrs.!!!! Only seen this twice before 1957 and 1998…so we are due—hey?

-the BAML survey of global fund managers revealed that cash levels are now at a 4 year low…very contrarian sell indicator when professional managers cash is this low…

#8 Seasonality-Four Year Presidential Cycle

-a Bespoke review revealed that when we see a 20% return in the first year after a new president that the second year is negative 70% of the time and the avg decline is -9%

-also Year 1 & 2 are historically very weak Presidential Cycle Years (vs 3 & 4 strong)…but maybe less Presidential Cycle influence now as they all stimulate all the time (thanks Brooke Thackray)

#9 DEBT BUBBLE

- this is at all levels—student loans, autos, Corporations, Junk bonds, Gov

-US Corp debt to GDP is now at 45%--last time it was this high was 2000 and 2008….just before…

-the total US debt level is now at 250% of the GDP vs 228% in 2007 (when we had a debt bubble!!!)

-China is at 270% of GDP!!!

-and now the GOP wants to add to the deficit by allowing more tax breaks ….when will we ever see a SURPLUS????

-Especially as the entitlement costs are soaring as 10,000 boomers retire every day and collect gov cheques????

-increasing deficits/debt at a time of rising rates and this late in the cycle is a big problem for me…the math just scares me

#9 Income Inequality

-the proposed Tax Reform does not help this from my read and this is one major structural headwind for the US and many G7 countries going forward

-making matters worse--the US consumer savings rate is now at a very low rate of 3.1%—the last time it was this low was Dec 2000….

-when will we see the expected wage growth that everyone is calling for—it is stuck at 2.4% yoy vs the normal 4% at this point in the cycle?? This perplexes the FED and could lead to a major Policy Error if they "anticipate" wage inflation in 2018 and raise rates?

#10 The Demographic Bulge

—David Foot has said that demographics accounts for 2/3 of everything and that means more entitlement spending for the US (and most G7 countries) BUT THIS AT A TIME that their deficit is growing and income inequality is soaring???

-the math does not compute??

CONCLUSION

Although markets may climb higher in the short term I remain convinced that RISK far outweighs REWARD in this very late and rich cycle and my plan is to stick to our strategy of Defense and some Offense!

I feel my primary goal right now is to focus on WAD protection over WAD growth. I am convinced that our patience will be rewarded because we are so late in the cycle and markets are so richly valued!

Now is NOT the time for excessive risk taking such as the galloping HERD is aggressively doing! The valuations are simply too high to allow for decent returns in 3-5 years!!

My assessment is that we could see SHORT TERM market gain over the next 2-6 months thanks to the greedy Herd BUT then very high odds of significant Mid Term PAIN!? (but of course this is 100% guess work as predicting the short term market direction is impossible BUT it is also a very educated guess based on similar situations in history)

Supporting this cautious and bearish viewpoint is renowned Money manager David Swenson (runs the Yale Pension Fund which has the best long term record) in a recent interview where he commented:

“When you compare the fundamental risks that we see all around the globe with the lack of volatility in our security markets, its profoundly troubling and makes me wonder if we’re not setting ourselves up for an 87 or 98 or 2008”!!! (Yikes-Terry)

“prior to the downturn in 2008 we were probably about 30% in uncorrelated assets”……..”and we are currently targeting about 32.5%”.

Terry’s read on this is that he had 30% “cash and cash substitute” in 2008 and today they are 32% and that is a massive amount for a pension plan paying out regular cash!! So you have to pay attention to guys like Swenson folks and suggest a YouTube of the interview!

Yes, of course I cringe when I see markets climb higher (and me in defense mode) but then I ask myself why really smart and wise guys like Buffett ($100 B in cash), Seth Klarman (42% cash) and brilliant David Swenson (who is more defense now than 2008) are willing to hold cash getting them nothing and then the penny drops—they are all waiting for the FAT PITCH!!

Of course they do NOT know when this will happen but they have weighed the risks vs rewards and tilted heavily towards patience---that is what we are doing!!

I am however flexible and tactical as you all know and will continue to monitor the major points covered in this newsletter especially on Tax Reform and the synchronized global recovery…these could both make me “a little” less defensive later in 2018??? We will cross that bridge later BUT for now its defense!

Terry

ATTACHMENTS

#1 The White Hot Cdn Real Estate….bubble spotting…

#2 Art Bubbles

#3 Every decade has 1-2 recessions—but not this one so far…

#4 A Positive First Year for markets after new President means very negative second year according to history (2018)

#5 Yield Curve--flattening

#6 Reasons to be Cautious—D Rosenberg

#7 Optimism next 6 months when 2017 so good in USA markets—Bespoke

#8 Bad Breadth not a good sign

#9 Investors Playing with fire on Valuations—TC here—agree 100%!!

#10- Nouriel Roubini--pessimistic

#11 The Felder Report –when stocks trade 10x sales!!!!!!!

#12 Seasonality may lift markets next 6 months…

#13 Stock market History –longest streak ever!!! EVER…so that should make one suspect….

#14 Ken Rogoff—Crypto Fools Gold

#15 The Economist---The Bull Market in Everything!!!!......

#16 RBC Report is very bullish and optimistic fyi…BUT I am not as you know