Neuro Approach
INVESTMENT NEWSLETTER

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2017- The Risk of Over-time Play!

Ok, so I am still mourning the loss of our Canadian Junior hockey team to the US team in the recent over-time then shootout gold medal game! But it is also a great analogy for where I see the markets heading in 2017. My opinion is that we are no longer simply in the late 3rd period (or late innings for the baseball fans) but are now well into OVER-TIME (OT) with this very protracted bull market and rich valuations. The unknown for investors is how long the OT will last and how to best position your portfolio as the sudden death loss could be very painful for reasons covered below. There are of course many optimists who believe that massive changes are afoot with the new President and that this bull market has been reinvigorated with no signs of end in sight. Let's review the pessimistic "limited" OT –sudden death scenario and the more optimistic "protracted" OT scenario, and then summarized a most likely outcome for 2017.

PESSIMIST - Over-Time & Sudden Death

#1 This Bull Is Long in the Tooth

The average business cycle since WW2 has lasted 40 months and this one is now at 92 months. The S&P 500 bull market that began March 2009 now exceeds the 1990-98 bull in duration (1998 is when first 20% decline occurred) making it the second longest bull ever (soon to be 8 years) as it closes in on its March birthday. Some will argue that the 1990 bull was longer extending all the way to 2000 (i.e. 9 year + 5 months) but either way you measure, this is one very, very long bull market. If it continues to March 15-2017 it will surpass the longest bull ever of 1921-1929 (i.e. 8 years + days). It is also worth noting that it's been 1979 days since the last 20% US market correction and since 1928 the average is 635 days.

My point here is not to lose sight of the fact that we are already in very rare waters re this bull duration, and to keep this in mind if we see a further surge in 2017 (that is my hunch) as these prolonged bulls always **end very poorly**. It is often that final surge (e.g. think 1929, 1999, and 2007) that drags the last investors into the markets only to realize that they just bought at the top again.

#2 Valuations Are Excessive

By almost all measures todays valuations are the **second most expensive** ever e.g. Shiller CAPE ratio, Price/Sales ratio, Tobin Q ratio, Buffett Indicator re Market Cap: GDP and the median P/E level. The "counter optimist" argument on this is that we are in a very low interest rate and low inflation environment allowing for higher valuations. There is some truth to this, but I will remind readers that both of these variables are now on the move upwards.

I will make two observations about valuations. Firstly, when they are this rich investors are typically happy (and eventually euphoric) as they have experienced significant gains in their equity portfolios and their "behavioral herd brain" easily finds ways to justify these rich levels. This in turn allows them to balance the brain conflict of why they are "buying high" or why they remain fully invested. In 1999 it was the false belief (but accepted by the majority) that dot.com companies would change the world and in 2007 it was the false belief that housing prices "would never go down". My suspicion is that the new President will increasingly be viewed as the "game changer" in 2017 and this will allow investors to justify why it "is safe" to continue buying higher which will create the herd positive feedback loop and push the markets higher (at least in the short term).

Secondly, repeated research reveals that when you are buying this high your future returns from these levels will be very poor! This is a mathematical fact in cyclical markets. The most important determinant of future returns is the price you pay! The logical goal is to buy at 10x trailing earnings and not the current 20x. Unfortunately, my guess is that the herd greed will once again win out over logic for the next 4-6 months and markets will run higher setting us up for a potential big decline later in 2017?

Supporting this thinking is the timely article about Jeremy Grantham and GMO in last week's WSJ. They reported that GMO has seen a 35% decline in AUM (assets under management) over the last two years as this value-macro investors refuses to buy high. Mr. Grantham is one of the most knowledgeable and seasoned investors who has lived through this herd behavior at least twice before in 1999 and 2007. He is one of the best macro investors and an expert on equity market bubbles. The steadfast clients who remained with GMO in 1999 and 2007 were significantly rewarded for staying the course after both crashes. This to me is a classic Tortoise vs Hare scenario ready to repeat! I suspect that his remaining clients will again be rewarded at some point over the next 6-18 months.

#3 The Consumer Health & Jobs

Because the US economy is 70% fueled by the consumer it is important to keep your finger on the pulse of the financial health of the consumer. Although the headline data tells us that we are at "full employment" with a 4.7% unemployment rate I still have many concerns about the US consumer. The broader U6 under-employment number remains high at 9.2% and in all prior recoveries this dropped to the 7% range. This is a limitation on overall aggregate consumer spending. We also know that there are 95.1 million Americans outside the labor force and not working-earning. This is another drag on consumer spending. Additionally we know that there are 23 million in the 25-54 age group that are not in the labor force, which are the peak earning and housing buying years. There has never been a US recovery without a healthy housing recovery. At the same time we have a record number of seniors working so as to support-supplement their retirement, and in the process they are taking jobs from the younger workers (and these folks are not big spenders).

This weakness in jobs is reflected by the continued weak retail sales. December core retail sales saw no growth when we exclude the volatile auto and gas sales. December restaurant sales (i.e. the very discretionary money) declined 0.8% and this was the largest decline in 12 months.

The other major hindrance for the US consumer has been weak wage growth. Although the December jobs report was encouraging in that the average hourly earnings grew 2.9% (Nov was 2.5%) the work week shrunk from 34.4 to 34.3 hours. Prudent investors know that it is far more important to focus on the change in **average hourly earnings** and the **work week length** than the headline number. The aggregate change

affecting the existing 150 million employed workers (i.e. massive aggregate spending difference) is far more important than the much smaller 156,000 new jobs created (i.e. where aggregate spending difference is small). The head wind for the consumer is that in real terms (after inflation) the yoy rate of growth in weekly incomes has now declined to a skinny 0.5% from 1.7% one year ago and from 2.5% two years ago when both of these measures are considered (L Fuller).

The other problem with jobs is that the quality of job creation has been poor (low paying and part-time) and that most of the tepid wage increase has gone to the small supervisory positions.

The bottom line is that despite the headline job numbers looking good there are several problems beneath the surface that have resulted in significant Income Inequality for the very large middle class. This remains a major headwind for President Trump in 2017 and the economy! He needs to find a way to bring back high paying jobs to unskilled workers and that will be a challenge.

#4 The Trump Risk

The biggest global risk with the Trump "election platform' is the potential for increasing protectionism and trade wars. Trump has stated that he will label China a currency manipulator and slap huge tariffs on their imports. He is also threatening car importers in recent days. This would be bad news for the already weak global economy and trade. Global trade growth has been running at only 50% of its usual growth over the last few years (3% vs 6%) and it was especially low last year at 1.7% (Gary Shilling). This was reflected in the very weak global real GDP of only 2.3% in 2016 which was the weakest since 2008 (World Bank)!

Additionally, markets have already priced in great Trump execution success on fiscal spending, broad tax cuts and deregulation. But the worry is that newly elected Presidents always over promise and under deliver—and Trump may be the worst on excessive promises! We do not know how much of this will materialize (or when) but for now the markets appear priced for a perfect execution on all promises and no downside price for his "shooting from the hip" tweets!

#5 Other Pessimistic Factors

-the headwind of massive global and **US debt** has been covered many times in this newsletter. Excess debt is simply a drag on growth and is a major reason why this expansion has been the weakest ever! Mr. Trump will almost definitely run large deficits so we can expect more debt as he is "the king of debt". How this rising debt level plays out with his conservative Congress and at a time of rising rates will be interesting to watch or how the debt loaded Emerging markets will work through this?

-I am a big fan of how **demographics** influence the economy and spending and I see soaring elder boomer numbers (US persons over the age 65 soar from 40 mill in 2010 to 72 mill by 2030!!) as a significant head wind on spending. Additionally, I see further spending problems for the "poor" millennials as interest rates and mortgage rates rise in 2017.

-under "normal conditions" I would not be worried about 2-3 **Fed rate hikes** 8-9 years into a healthy expansion BUT this expansion is like no other in many ways re global debt, demographic issues and the perverse "bond bubble" so I am worried (or at least uncertain) as to how this will play out in 2017? I know that 10 out of the last 13 recessions were associated/caused by Fed rate hikes and I also know that 9 of the last 10 recessions occurred under the GOP (Grand Old Party) watch!

-the **rising US dollar** is a substantial risk in 2017 (now at a 14 year high). Over 40% of S&P 500 revenues come from outside the US and with the

US the only major country raising interest rates I see a high US dollar as a head wind for multinational offshore corporate profits and US exports (where most of the jobs have been lost and Mr. Trump promises to replace…). Additionally, a strong dollar will attract global funds seeking higher returns adding more froth to the US equity markets in 2017

-**Europe** is also a risk in 2017 and has been covered before re the leveraged EU banks and increasing right wing politicians in Italy and France.

-**Housing** will also be at risk as interest and mortgage rates rise in 2017. Mortgage refinancing and applications have plunged over the last two months. Virtually all prior US recoveries required a strong housing recovery and so this is a worry.

-**Income inequality** remains a major problem in the US and most industrialized countries e.g. in the US the top 0.1% hold the same wealth as the bottom 90%!!

OPTIMIST - Extended Periods & No Sudden Death

#1 No Recession in 2017

One of the main reasons to be fully invested in 2017 is that the "estimated" risk of a recession is low by the majority of strategists, money managers and economists. The indicators that they look at such as the Yield Curve, manufacturing data, unemployment job claims, Leading Economic Indicators etc. are all flashing green for 2017. This background information plus the surprise win by Mr. Trump has invigorated the animal spirits for investors and money has now flowed back into equity markets over the last 2 months, especially the more cyclical stocks (e.g. energy, commodities, financials, and materials).

Two cautionary observations are worth mentioning here. Although we can see 20-25% market declines in non-recessionary times these usually fully reverse over 6-8 months and therefore offer excellent "buy low" opportunities. Secondly, investors need to keep in mind that market declines associated with recessions, especially after such a prolonged bull and current rich valuations, typically decline 40-50% and remain depressed for prolonged periods. We see recessions every 4-5 years on average and the last one was 2008 (i.e. 8 years ago…). The optimist sees very low odds of this scenario in 2017 especially if President Trump is able to execute…the pessimist will tell you that our success rate at predicting recessions is very poor!

#2 The Earnings Revival

The profit recession appears to have ended in the last quarter. After nearly three years of near zero growth in corporate US earnings, last quarter rose on a yoy basis 3.1% for the first time since the first quarter of 2015! Expectations are for the 4th quarter to grow 3.2% (reporting starts today) and then a whopping 11.5% in 2017 (Bloomberg). These estimates **do not** include any benefits from the new Trump administration and so the optimist believe that growth could be even higher with reduced corporate taxation and deregulation. This in turn would bring down expensive P/E ratios and allow markets to climb higher into 2017. The risk of course is if earnings do not materialize because of the multiple head winds such as the high US dollar, decreasing margins, rising wages or declining share buy-back volume. Consequently, I will be following the next three weeks of reporting very carefully as well as the CEO's outlook for 2017.

#3 The Trumpforia Factors

There are several promised economic/market friendly changes coming in 2017 from the new Trump administration. He has promised broad tax reductions for corporations and individuals, massive fiscal spending on infrastructure and deregulation especially for small business. So what is not to like about that if you are a CEO or an

investor? Markets love these potential changes and have soared over the last two months over the anticipated earnings and GDP growth.

What is potentially compelling for the bulls is that this Trump trio of promised changes typically ONLY occurs during **recessionary times** and then markets soar over expected future growth. So will we see the same economic-market benefit this time around? The answer has to be yes (at least in the short term) based on these expectations and if Trump actually executes on 50% of what he promises then 2017 could be a banner year for stocks.

But I have to keep asking myself why this is occurring now, 8 years into "this recovery" with an unemployment rate of 4.7% and interest rates near zero?? There has got to be an inflationary risk with this type of aggressiveness during non-recessionary times I would think? Will the Fed be forced to raise rates more aggressively in 2017? Or will we see the dreaded Stagflation environment of weak growth and rising inflation?

Of course I also realize that many of these proposals will undoubtedly get watered down over the next 6 months and that it will take 6-12 months for many to get a pass in Congress, but right now the potential for a large economic surge is being sensed by the forward looking markets. The question is whether it has staying power?

<u>#4 Invigorated Animal Spirits (AS)</u>

I see AS as the big potential positives for markets over the next 6 months. The level of AS is moving towards euphoria on many accounts! History tells us that this type of mass enthusiasm is very infectious and my sense is that it will raise markets to even higher levels over the next 6 months. For example, the NFIB Small Business Optimism survey reported this week and jumped the **MOST in 36 years** (7.4 points to 105.8), and is now at the highest level since Dec 2004! The percentage of small business owners who expect "a better economy" going forward rose from 12% to 50%!! These increases and levels are typically seen coming out of a recession and not 8 years into a "recovery"….so that is a lot of optimism-euphoria. We see the same ubiquitous increase in optimism-euphoria in all recent surveys from the Individual Investor surveys to Financial News Letter Writers to Investment Advisor surveys.

Supporting this change in outlook towards optimism we have seen massive outflows from bonds and into Equity US funds and ETFs in November and December. It is important to remember that since 2007 US Equity <u>outflows</u> amount to 2.1$ Trillion and US Bond <u>inflows</u> amount to 2.4$ Trillion with the majority of this happening in the last three years (ICI). So this "Big New Rotation" of money out of bonds and into equities has room to run further if animal spirits remain invigorated in 2017.

Of course this is a double edged sword as when all participants become optimistic and euphoric this leads to excessive valuations and is invariably followed by a decline in markets. My sense is that this reversal could happen later in 2017 (or early 2018) and the exact timing will depend upon #1 how earnings perform and #2 how Trump performs. But for now animal spirits alone should lift US equity markets well into 2017 as long as loose lips does not sink any ships along the way…

<u>#5 The Consumer & Jobs</u>

The most recent December employment numbers revealed a 2.9% yoy increase is US wages (vs 2.5% in November). This was the fastest wage increase since 2009 which has been one of the three missing ingredients in this lackluster 8 year recovery (the other two are animal spirits and CEO Cap Ex spending). The optimist knows that if we see continued 3% ish wage growth the consumer will spend more in 2017 and this will be a support for the markets.

#5 Other Optimistic factors

-it is hard to ignore my three favorite investors (Ray Dalio, Prem Watsa and Stan Drukenmiller) who have all turned more bullish with the Trump win (but I also know that GMO has not and top strategist Francois Trahan turned bearish recently…)

CONCLUSION

The majority of evidence indicates that equity markets are in extended "over-time" play. I think it is foolish not to acknowledge the risks associated with rising rates during the second longest bull market ever and when valuations are this rich! Now we need to factor in that President Trump brings along significant optimism and euphoria to this "old party" which will very likely extend both the duration and richness (in the short term)! Additionally, on several fronts we remain in very uncharted waters with massive global debt levels, global experimental QEs remaining in place (exception being the US), record low-negative interest rates, a G7 elder boom that we have never seen before, and now add the unpredictable President Trump personality into this mix! That is uncertainty folks and is a reason to be aware that many OT games end in sudden death!

The absolute worst case scenario for this type of prolonged and rich market would be to encounter an unforeseen recession in 2017. Although the majority are NOT predicting a recession in 2017 I will remind readers that history tells us the odds of a recession in the next 1-2 years are very high! US Recessions most often occur in the first half of the four year Presidential Cycle (about 90% of the time) with the majority happening in Year 1.

Several reviews have been done on the timing of US recessions and all reveal the same conclusion. Sy Harding looked at this in 2013 from the "Bear Market" perspective which was defined as a 20% + market decline and found that over the 110 years there have been 25 US bear markets. He noted these were very closely tied to the four-year Presidential cycles. "In the last 18 presidential cycles, a correction has taken place in the **first two** years 16 times or 89% of the time" and the average correction was 25%, and 12 of the 18 occurred in year one. So knowing that we do get a recession every 4-5 years on average and that the last one was 8 years ago and that we are now into Year 1 of this cycle it seems prudent to be at least cognizant of how your portfolio would do when the next one comes. That is called portfolio risk management and NOW is the time to be reviewing this.

Yet ironically, in the short term at least, I see all the pieces falling into place for yet another **market melt-up** such as we saw in 1999 and 2007:

-the "Trump Trio" of significant fiscal stimulus, broad tax reductions and deregulation increases the potential for enhanced corporate earnings and the markets have been responding to this optimism.
-the biggest equity market tail wind for 2017 will be the invigorated animal spirits and this will likely pull large amounts of cash from low yielding bonds (and sideline cash levels) into the rising US equity markets. When I look around all I see is **bullish commentary** from all writers which is very infectious this late in the game (think 1999 and 2007). The VIX "Fear Gauge" is currently at 11.5 making it the lowest reading heading into earnings season since 2007 which spells significant complacency and greed. Emotions always run the highest in OT which adds excitement in hockey but this is not the case in the investing game…
-finally, I expect global money will continue to flow into the US in 2017 seeking higher returns as it is the only country raising rates in an otherwise "rate deprived" world!

Consequently I think markets could move (substantially) higher over the next 4-6 months

because of Trumpforia. He has the traditional 100 day "honey moon period" working for him starting January 21-17 and I suspect his honey period could even be longer because of his apprenticeship salesmen "skills".

ALERT

However, because Trump is the most unconventional President ever it is very hard (if not impossible) to have a good feel for any reliable predictions beyond 4-6 months. I therefore aim to be very vigilant as we move past the Trump honey moon period and MOST likely will tactically raise more cash in April or May? I will closely monitor how 4th quarter earnings evolve and CEO Cap Ex spending expectations, and then weigh the Trump positives vs the negatives as we move into the spring.

Investors need to recognize that the markets are now priced for perfection as hope, OT emotions and greed are all aligned. By mid-2017 the Trump "halo" will have lifted and then logic will weigh in on emotions. All past Presidents have over promised and under delivered and Trump is no different. I think Ray Dalio (runs the largest hedge fund in the world) recently summarized the path ahead well when he stated that we will all be waiting to see which President Trump we get **"aggressive and thoughtful or aggressive and reckless"?**

My sense is that 2017 could end up being an overall positive year for the markets (strong first half but with a weaker second half). If this is the case then history tells me to be vigilant in the latter part of 2017 and going into 2018 as we will then be long overdue for a recession! Recall that equity markets usually price in a recession 6-8 months ahead of time.

Investing in this type of uncertain and unpredictable environment requires solid defense and excellent goaltending! Yes you must have equity exposure but this is based upon your asset mix allocation (which accounts for risk, objectives & timeline) and it should be **very defensive** and diversified. Most of the plan should be on auto-pilot so as to minimize the emotional input (as these could soar in 2017), but at the same time you need a definite tactical overlay because of the daily uncertainties surrounding President Trump! Luckily, all of my clients have this in place and I will cover this in more detail in a future note.

Goaltender Terry.

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