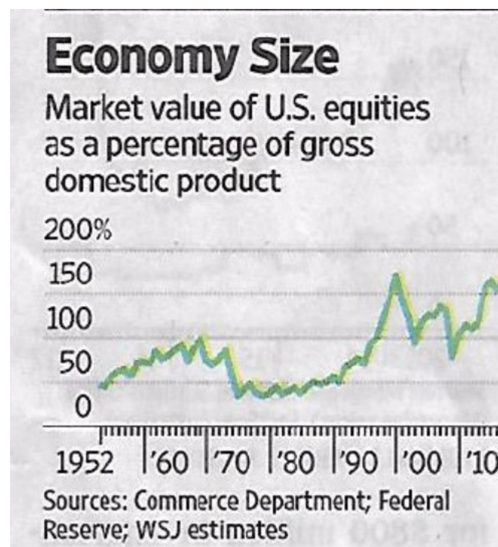
Market Commentary - February 2017 View this email in your browser

Stocks are overpriced—but can they go higher?

Our position since election night has been it is too early to discount President Trump's potential successes. Simply, we didn't (and still don't) know which economic policies will be pushed forward, how they might be received by Congress, and which policies will ultimately prove successful. The stock market rally that ensued was narrow and led largely by "Trump stocks". In our view the November/December rally made an overpriced market even more so.

Here is another metric that points to overvaluation:



The chart above compares the value of U.S. equities to the size of our economy. A higher percentage means that investors are increasing the value of stocks faster than the growth rate of the economy, which is what you would expect to see in a bull market. At the end of 2016, the total value of stocks was approximately 169% of U.S. GDP. That percentage compares with 85% at the end of the last bear market (2008) and 177% at the end of the dot-com bubble in 1999. **We are now near the highest stock/GDP ratio of the past 65 years. Clearly stocks are at nosebleed altitude based on this measure.**

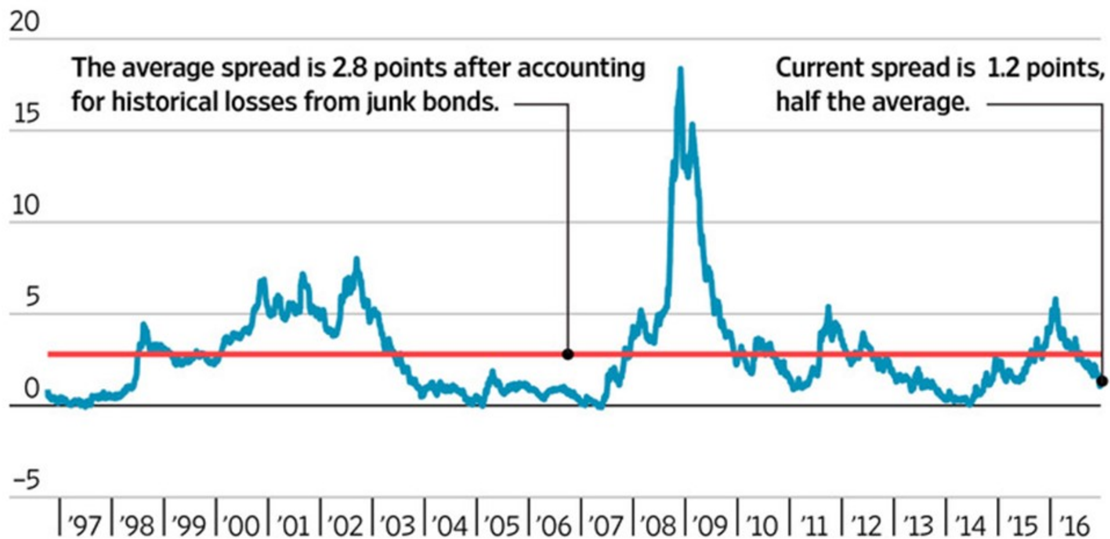
Can stocks go higher from here? Stock prices are a function of two variables; earnings and the price-earnings (P/E) multiple. S&P 500 earnings estimates for 2017 call for 12% growth. That

number may seem ambitious but we are coming out of a five-quarter earnings recession, so year-over-year earnings comparisons are easier going forward. Also, energy companies' earnings are rebounding. Earnings estimates do not yet reflect the possibility (or probability) of lower business taxes or other pro-business actions which could add upside, especially to 2018 numbers.

The major headwind is, however, the P/E ratio that investors place on the market. If interest rates head higher as we expect (possibly much higher if President Trump's pro-growth initiatives are successful), the discount rate on the stock market's earnings will rise which will likely push down the market's P/E multiple. Every one multiple point drop in the market P/E ratio will result in an approximate 6% drop in share prices.

We have two conflicting forces here: Rising earnings and lower P/E ratios ahead based on our analysis. For example, a 12% growth in earnings this year combined with a two multiple point drop is a wash, or no price gain for stocks. Interest rates are key in 2017 and the speed at which they rise will help determine the market P/E ratio and whether we have a profitable year in stocks.

The chance of the bull market extending may have increased with Trump's victory but overvaluation is still our primary concern. Anecdotally, we are having a very hard time finding undervalued stocks at Dow 20,000. As a result, we will error on the side of caution until better opportunities present themselves.



High yield (or junk bond) spreads to Treasuries are currently 1.2% or about 43% of the average of the past 20 years. Narrow bond spreads indicate the bonds are rich or over-valued and therefore lack investor value. **We believe that bond spreads will widen (prices will fall) over the next few years as Fed monetary policy is normalized. Normalization refers to both higher interest rates and the unwind of $4.5 trillion of monetary easing (called quantitative easing) in the U.S. alone. Over time, junk spreads could widen to five plus percent as occurred in 2011 and 2016 causing significant losses to holders of the securities. Chasing yield through junk bond ownership is a mistake and will prove damaging to those who choose to invest.**

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