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Cadence *clips*

FOCUSED ON WHAT MATTERS MOST.

What Just Happened?

November was a month for the record books for a number of reasons. First, the obvious – the presidential candidate that most Wall Street and media elites thought didn't have a chance to win, won. Because those with the big bucks weren't prepared for a Trump victory, markets reacted violently when it became clear that he'd secured the win. This was a fairly predictable and rational response given that Trump represented a rebuke of the status quo and everything that has supported Wall Street in recent years. Where things get strange, and this leads to the second record-worthy event for the month, is that Wall Street and the rest of the global investment community went from a Donald Trump nomination being Armageddon for markets to it being an infrastructure spending and inflationary boon – in a matter of hours! U.S. markets shifted from being down 5% overnight to recovering almost all of their gains. They would go on to close up over 1% on November 9th completely reversing losses.

There could be a couple explanations for this. The first would be that upon recognizing that markets were on track to registering mind-numbing losses at daybreak, the global elites orchestrated an early morning rescue of sorts to prevent a panic situation that had the potential to catch lots of investors leaning in the wrong direction. Bloomberg reported that Carl Icahn, a billionaire investor, left the Trump celebration party early to invest $1 Billion dollars in stocks. One can only imagine that he wasn't alone in doing this. Precedent for this type of coordinated rescue can be found in 1998 with the Long Term Capital Management (LTCM) debacle. It has been well documented as to the role that Wall Street banks and the Federal Reserve played in keeping markets from reacting negatively to the news that LTCM was on the brink of failure. We'd be naive to assume those with an interest in keeping markets afloat on November 9th, weren't inclined to take action as Icahn did.

The second explanation is that this is classic bubble market psychology. The only bad news is that which hasn't yet materialized. Once that bad news becomes fact (a Trump victory in this case), it's spun and rationalized to fit the desired outcome, which in a late stage bull market is higher stock prices. The fact is nothing changed materially from election night November 8th

to the early morning hours of November 9th when it became clear that Trump had won. The new narrative was that Trump would in fact be good for the economy and stocks by enacting his infrastructure spending plan, deregulating industry, and reducing corporate and personal income taxes. This plan wasn't new information that was delivered for the first time in the acceptance speech. It was well known long before election night. If it wasn't good enough to get excited about before, why on earth should it be good enough now? More importantly, if he was such a threat to the system, economy, and markets then, why not now? What's changed? The answer is nothing. The only thing that's changed is how investors are choosing to look at the scenario they're confronted with. What was once bad is now good. And that's very convenient for those with an interest in stocks rising.

Our Take

Having had a little extra time in front of financial T.V. over the holiday due to a particularly nasty respiratory infection, I had the privilege of observing expert after expert generate answers to questions they had no way of truly knowing the answers to. For example, when asked what's been driving stocks up recently, one expert responded with "the consumer's been really strong". In response to a similar question, another pundit responded with "the Trump infrastructure plan is really driving this rally". In an effort to sound cautious and prudent, I heard another mention that he feared this rally was stealing from next year's returns. First off, nobody knows exactly what drives daily market moves, period. Markets are complex systems that are so interconnected that often times what we think might be moving markets may not be the cause at all. This need to always have an answer is misleading to viewers because the answers tend to be contradictory. Here's an example. If stocks go up, it's because of the Trump infrastructure plan and all the jobs and spending it will create. On the other hand if stocks go down, it could also be argued that the Trump infrastructure plan is responsible in that this would pile trillions of dollars of debt on top of an already fiscally perilous situation. These contradictory responses leave investors and viewers scratching their heads. The reality is that neither are the "reason" for the markets daily moves. Unfortunately giving an "I don't know" answer or a "lots of stuff could've caused it" response to the question of why the markets did what they did today just isn't good for the ego or job security, nor is it good T.V. As for that stealing returns from next year comment – well, it's just nonsense. How much were we entitled to earn from the market next year? And how is it that just this little bit of gain toward the end of 2016 is finally "that" chunk of return that will have to be taken from next year? It's a hedging statement and a very paltry one at that.

Our inclination is to be very skeptical of this lightning-fast, 180 degree pivot by Wall Street. Regardless of the new argument or rationale, the fact remains that from a market psychology standpoint, it represents classic bubble behavior of fitting the fact to the argument. That's a huge red flag in itself. In addition, the election result does nothing to change the fact that stocks are currently the 3rd most expensive in history based on a number of valuation metrics, and most expensive based on median Price to Earnings and Price to Sales ratios. Dangerous stock markets have a long history of eschewing inconvenient facts. In 1929, economist Irving Fisher remarked that "stock prices have reached what looks like a permanently high plateau," feeling the likelihood of the market going down was slim. In 1999, many experts argued that earnings didn't matter anymore as long as technology companies continued to grow revenue and innovate. And in 2005, near the peak in the real estate market, when asked whether a collapsing real estate market would lead to a recession, Fed Chairman Ben Bernanke answered, "Well, I guess I don't buy your premise. It's a pretty unlikely possibility. We've never had a decline in house prices on a nationwide basis. So what I think is more likely is that house prices will slow, maybe stabilize". In every case, experts failed to see the risks present and focused instead on the most recent experience which was upward trending markets. This recency bias is human nature and as much as we'd like to believe we learn our lessons, we don't. Bottom line, most believe markets will continue to go up because that's what they've been doing. They'll fashion an argument to match.

We don't necessarily disagree with this. Markets have a tendency to inch their way upward for longer than you'd think possible. Where we differ is that we know stocks are on borrowed time and that downside risk greatly outweighs the opportunity for further gain. In fact this whole notion of the recent rally stealing from 2017's gains is laughable since from a historical perspective the gains of the last few years (forget about weeks) have already stolen from 2017 and likely 2018's gains. The fact that the S&P 500 is trading at over 24 times GAAP earnings (Generally Accepted Accounting Principles) with profit margins toward record highs and earnings being propped up by record levels of corporate stock buybacks funded with cheap debt, means that stock prices are destined to fall when any number of those favorable trends changes course. And yes, that's when not if. A historically average decline of 50% given the magnitude of our current over-valued situation would take the S&P 500 down to levels seen in late 2009! So for all intents and purposes, there is very little left from the future to steal from. The returns investors have received the last few years have already done so and any additional gains will just make losses, not gains, that much deeper going forward.

John Hussman of Hussman Funds writes that based on current stock market valuations, the average annual return over the next 12 years should be somewhere around 1%. After inflation, that return would drop to less than 0% over 12 years. This path would likely involve at least one large decline followed by a recovery, if not a few of each. So this 1% average return before inflation assumes that investors don't lock in big losses by selling when things get tough toward market bottoms. The bottom line is this - there's never been more risk in stocks than there currently is. Even if president elect Trump delivered nothing but economy-goosing policies over the next 12-24 months, it wouldn't be anywhere close to enough economic growth to justify current stock prices or change the math meaningfully over the next 12 years.

Given what we're seeing across different asset classes, we're inclined to believe that markets continue to work through an extended topping process that began in the summer of 2014. Since then, we've seen a number of small corrections followed by recoveries, but markets haven't made much progress at all. In fact when looking at the NYSE Composite Index, we're still below levels established in July 2014.

Until markets break above these previous highs in a relatively uniform way, there's a very reasonable chance that they ultimately turn lower. Like we've already mentioned, given the lofty valuation of the markets and the length of the current expansion (8 years vs. an average of 5), there's much more room to drop than to rise from where we sit. We're using history and common sense as our guide here.

The rally stocks have experienced since the election has been impressive. However, although some indexes have reached new highs, the broad NYSE Composite hasn't. The "Trump Rally" has been fairly consistent with other sharp rallies we've seen since mid-2014 when the broad market began to stall and move in a sideways fashion. In addition, we've seen declining volume across most indices throughout the rally, which gives us reason for pause. As mentioned before, although the rally's impressive, it's fraught with risk.

The real story in our opinion has been just about everywhere else. The dollar has strengthened significantly against foreign currencies, while interest rates have moved aggressively higher on bonds. Gold, a common safe-haven asset, has also weakened in price substantially. All of these moves have been historically large over the very short period of time since the election and should give all investors reason for pause. We'll highlight some of our concerns about these occurrences below, but the overarching issue is this; global markets are the definition of a complex system. They are so intertwined in ways that nobody can fully comprehend, that when variables and factors change, it can have unforeseen effects. These asset moves referenced above certainly have the potential to rattle our complex market system in ways that are impossible to know or articulate. An analogy that may fit the situation would be a giant jumping up and down on the top of a snow-drenched mountain peak. If the snow layers are unstable, there's a good chance the aggressive behavior of the giant could trigger the avalanche. Small asset moves may be more akin to the giant walking around gingerly at the top of the mountain. These recent moves in the dollar, bonds, and gold, have not been small.

Can stocks continue to march higher? Sure, but that's not the question that matters. What's important is how much risk is imbedded in the current scenario. The answer is lots. Here are some of the things that could bring that risk to bear.

- Italian Referendum – This Sunday the 4th, Italy votes on a slew of constitutional changes that would make it easier for the ruling party to pass legislation. A "no" vote could indicate populist pressures similar to those behind the Brexit vote and Trump nomination. This could lead to additional steps in Italy creating momentum toward an exit from the European Union. This is not the desired outcome for those institutions so heavily invested in keeping European markets propped up.

- Debt Ceiling in March - In March of 2017 the debt ceiling, currently set at ~$20 Trillion, will need to be raised in order for the U.S. to continue paying its bills. With annual budget deficits between $600-$700 billion and on their way to $1 Trillion by the end of Trump's first term, the additional $1 Trillion of "stimulus" money that president elect Trump would like to spend may be a hard pill to swallow for some in Congress. Making continued fiscal profligacy even harder to rubber stamp would be the fact that interest rates are on the rise. For every 1% increase in interest rates, the amount of annual interest paid on U.S. debt would rise by ~$100 Billion. There's simply no room for further spending – period. If Congress has any clue as to the importance of sound money and budgeting, this debt ceiling debate should be very lively.

- Dollar Liquidity – Total non-U.S. debt denominated in U.S. dollars has doubled to approximately $10 Trillion over the last ten years according to Societe Generale. With a strengthening dollar, it behooves borrowers to pay back loans as quickly as possible before the dollar gets more expensive. If loans are unable to be paid back, rolling the debt over at the end of the term becomes more expensive and potentially cost prohibitive. In addition, with rising interest rates to boot, rolling old debt into new debt becomes a non-option for some borrowers. This scramble for dollars could lead to tightened lending/credit conditions which rarely leads to good things.

- Interest Rate Increases – With interest rates at exceptionally low levels for an extended period of time, it's not uncommon for lots of borrowing and leveraging to occur. When rates finally rise, borrowing becomes increasingly difficult, and leverage that once helped, now starts to hurt. Credit conditions can tighten. Excesses and vulnerabilities created by leverage and loose credit conditions get exposed. With rates moving from under 1.5% on the 10 year U.S. Treasury to ~2.4%, this represents a very large relative move in a short period of time. There's a very good chance it has created some damage somewhere in the financial system.

- European Banking System – Suffice it to say that European banks are not in super strong shape at the moment. Deutche Bank was the latest large bank to make headlines due to its very precarious financial situation. Italian banks have also been under the microscope, with a host of others in similar shape. In a nutshell, most are holding very weak assets (loans that are not performing well due to late payments or lack thereof), deposits are flat or declining as people are growing increasingly skeptical of the banking system, and low interest rates are making it very difficult to put capital to work profitably. It will be interesting to see what needs to happen for the European banking system to get back on solid footing. Our fear is that if nothing changes, or if any number of factors shift for the worse, we could be facing a very difficult situation as banks one by one move toward insolvency.

Our Path Forward

We hope Trump does good work as our next president. There's no question that what the world needs at this point is structural change, not more monetary meddling. There's abundant evidence that low interest rates and central bank intervention has actually hurt the global economy by encouraging bubbles and slowing the progress of structural change that has the potential to create meaningful improvement across the global economy. However, fiscal stimulus (spending more money) isn't necessarily the answer either. The world cannot afford more debt. It is already being suffocated by it, which is why policies that have historically created growth just haven't been working – and won't work effectively going forward. Our hope is that the world gets serious about paying down existing debt and dealing with the problems at hand before embarking on programs that keep the debt pile growing.

As we negotiate this impasse, markets will continue to be very unsettled. We can expect continued volatility across the board, even in traditionally safer categories such as bonds and gold. There really isn't any category that is impervious to fluctuation and loss. It's the environment we're in. So here's what's most important. Make sure not to get distracted by sideshows. Safer asset categories will fluctuate. Don't be rattled. Don't jump from the frying pan into the fire by investing in too heavily in stocks or chasing returns. The fact remains that risks are the highest in stocks, which means that over a long-enough period of time they will very likely take much bigger hits than the other categories. Our clients have goals that stretch far beyond 2017 or 2018 – they are long-term in nature. Therefore, we have to keep the bigger picture in mind when it comes to markets and their potential movements. We'll keep a lookout for developments that could change our outlook, but for now, we remain steadfast in our assessment. Excessive risk-taking will likely be punished, not rewarded.

Understanding Phantom Income

As December arrives, we've reached the point in the calendar when year-end tax planning takes place. One of the most confusing aspects of this is Phantom Income. Phantom Income is income that is reportable on your tax return, but not necessarily received. When it comes to an investment portfolio, this situation can play out when mutual funds report capital gains at the end of the year that you weren't necessarily in the fund long enough to benefit from. An example would be Fund XYZ bought Apple in 1985 and then sold it in May of 2016 for a gain. That long-term capital gain will be realized by fund XYZ in 2016. That's all well and good if you've owned the fund since 1985, but what if you didn't?

For example, let's say you just bought into Fund XYZ at $10 per share in November and then the fund reported its long-term capital gain of .50 cents per share in December. You will have to report this distribution as a gain on your tax return even though you didn't actually realize this gain on your investment. Not fair, right? At first thought, it's not. To have to pay tax based on gains that you never received elicits a visceral reaction in most. However, when we look at the bigger picture, it may not be so bad.

Because you are reporting that .50 cents of gain this year and paying taxes on it, your cost basis in the mutual fund will be adjusted to reflect this so that you don't have to pay taxes twice. Let's say that you turned around and sold the mutual fund a month or two later at the same $10 per share. Since your cost basis would be adjusted upward to $10.50, reflecting the gain you already paid taxes on, you would actually report a .50 cent loss on the sale essentially offsetting the gain you paid in the previous tax year.

So while it can make sense to keep a lookout for outsized capital gains distributions mutual funds are likely to kick out at year-end, it doesn't always make sense to overreact to them by selling everything just to avoid paying taxes. Any selling at year-end to avoid tax distributions should coincide with a broader strategy with a specific purpose in mind for that particular tax year. Absent this, it tends to all wash out in the end.

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