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“By The Way”

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It took over 6 months, but the S&P 500 has finally hit a new high. Since the low of February 9th, the index has gained over 14%, and just since the start of May, is up more than 12%. While at first the breakout lacked the strong momentum we like to see, and gave naysayers the ammunition to declare it a false breakout, more recent days have seen improved breadth and volume which gives us increased confidence that more gains are coming. In the very short term though, the market has used up a lot of fuel in order to make the breakout, and consequently a period of retrenchment would seem likely. During this period, we will let the market convince us that the bull will continue. As of today, that is my base case.

It gives me comfort that estimates for earnings per share growth are almost universally positive in indices across the globe. There is the caveat that historically earnings per share estimates for any four quarter period will, on average, be revised down 10% by the time the period ends. However, I believe the next 12 months will show a lower than average decline. Price earnings multiples in developed markets while somewhat above average are not overly expensive at approximately 5-10% above their historic average. The S&P 500 at 16.7x forward estimates is the highest, but other markets are more reasonable: Germany is 12.7x; China is 11.6x; Japan is 12.9x and Canada is 14.2x. Given the positive economic outlook these valuations don't appear particularly out of line, but still must be monitored closely.

In the last letter, I mentioned the concern of many market watchers that we are very close to an “inverted yield curve” where short term Treasury rates become higher than long term rates. The empirical evidence is extremely strong that such an occurrence leads to an economic recession within one to two years. A recent study by two researchers at the Federal Reserve Bank of San Francisco indicates that historically the correlation between the two events is between 86% and 89%. These are numbers one ignores at one's own risk. The good news is that while close, (the 2-year yield recently came within 10 basis points of the 10 year) the curve has not yet inverted and close doesn't count (see 1994). Also, if history proves correct, we should have a year or more to get our portfolios in order. Perhaps most interesting, the report found that despite the very high correlation between yield inversions and recessions, the researchers could find no explanation as to “why there is such a significant relationship between the two”. Correlation is not necessarily causation. Unfortunately, the “why” may not matter, given the proliferation of machine and algorithmic trading

(estimated to be in excess of 60% daily) the computers won't wait around to look for reasons but will just hit the sell button. We sincerely hope that board members at the Fed read their own research and will take care to not purposely raise the regulated rate through the 10 year. Their job is not easy though. In 2008 when the situation seemed desperate it was easy to establish policy. Now as we near full employment and the inflation target, the chance of a policy error is much more possible.

The policies of the Fed are not only affecting the U.S. economy, but also the rest of the world. As the Fed raises rates and the U.S. dollar strengthens, the impact on emerging markets is significant. Many of these countries issued bonds denominated in U.S. dollars, now with their currencies collapsing their liabilities are going through the roof. Currently, with the exception of the disaster that is Venezuela, the worst example is probably Argentina where the central bank rate was just raised to 60% in an attempt to stem the flow of funds leaving the country. The peso is down more than 20% this year, inflation is estimated to be near 30%, and the country is petitioning the International Monetary Fund for emergency financing to meet current obligations. Readers might recall my amazement in 2016 that the quest for yield led investors to oversubscribe for Argentine bonds paying 7.14%, despite the country's abysmal track record of recurring defaults. The risk of default is heightened once more, and is in fact likely in my opinion. My concern is these problems will spread to other economies around the globe.

Every morning seems to require investors to recalibrate the trade war outlook. (I believe NAFTA gets done, but not without more anguish.) In geopolitics headlines are often meant to misdirect us to incorrect conclusions. The current situation in Turkey where U.S. sanctions are exacerbating an already shaky economic situation is one example. Trump rants about releasing the pastor in jail, while the real issue in my opinion is Turkey is getting too close with Russia, and needs to be brought into line. Trump remains the master of deflection and deception, so it is not a surprise that his tirades about trade with China and Canada are made at the same time his former aides are being found guilty and the midterm elections are fast approaching. All political leaders do it, he is just the loudest.

There are many red flags to be aware of, but at the end of the day, until we see more evidence of an impending recession or decline in corporate earnings the outlook for stock markets remains positive.

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