WHY CAN’T WE BE FRIENDS?¹

In my opinion, pricing aberrations abound presenting multiple opportunities for which there are many reasons - the incredibly rapid rise in interest rates and the concomitant new highs in the US Dollar, as well as the anticipation of Trumpian policies. The most notable feature of modern equity and debt markets is the tendency to overreact, sometimes outlandishly to new “news” – although truly unique news in the information age is rare. Investment decisions should be based on the discernment of overreactions and the opportunities presented. This is not the easiest thing for an investor to do, that is, try to buy low, as opposed to buying higher. However, if you believe in behavioral economics, we appear to be witnessing a nearly ideal scenario. Magnified by the confirmation of the secular bull market. Nothing like a Dow Theory Buy signal to lift the spirits.

My friend Bob says I should make specific recommendations at the beginning of the piece. So here it goes: Buy energy sectors that could potentially benefit from increased production, heavy on service, midstream, downstream, export, and petrochemicals. Refiners are longer term beneficiaries; even the slight uptick in demand for wells appears to be running into modest bottlenecks so rapid recovery in production is unlikely. Buy the electric utilities which seem to have been clobbered by premature interest rate fears. The modification of regulations could be extremely beneficial. Buy Green Utilities “yieldcos” because the adoption of solar energy will most likely continue and there has been an overreaction in my opinion. Existing facilities are “paid for” and the income streams appear relatively secure, although the weather isn’t always ideal. Buy REITS on the selloff, especially the healthcare REITs that have been devastated by hostile regulation and overbuilding. The population of aging baby boomers needing assisted living will continue to grow. This dynamic also applies to the shares of many major pharmaceuticals and related companies, which surprisingly, have not responded as anticipated. Yes, there will be a peak in the aging population, but, not yet. Buy preferred stock, the smorgasbord is getting sparser rapidly. Ditto for tax free investments. These are more complex than is often apparent so call the office if you want to take advantage of what I believe is a very small window.

¹ Is there a line between the alt left and the mainstream democrat party?
POLITICS

Enough already – the election is over. Take a deep breath. There will always be “principled” opposition, a cherished freedom.

On the other hand, there seems to be a desire in some quarters of the Democratic party to commit Seppuku, or, “ritual suicide,” by allowing the radical fringes of the party to have the loudest voice. The loss of the Presidency is one thing, more important, state and local governments are increasingly “RED” and by greater margins over several elections.

I can understand that many feel the need to replace Speaker Pelosi. I can also foresee a hue and cry for Senator Schumer’s removal given his reputation as a “deal maker” with an eye toward consensus. I don’t believe there will ever be a deal good enough for a portion of the Democrat minority.

Given the constellation of issues and voters that propelled President Trump elect, I believe he has an unparalleled opportunity to move quickly and deliver on a moderate and inclusive platform (apparently Senator Clinton was not the only candidate with multiple personalities). Even modest success could lead to a major political realignment. I can see a path to 3+% GDP growth, lit in neon.

So, my message to my Democrat friends is to be careful, because even a series of modest missteps could continue the historical tide and lead to a Republican super majority in 2018.

EQUITIES

Historically, equity markets perform best when one party controls the presidency and the congress. So, despite stretched valuations, equities are set to continue their bull run and “complete” the secular bull market advance. Jeremy Siegel (Mr. 25,000 Dow), may be right – finally.²

There is/was a post election “melt-up” and many stocks exploded higher. Shorts were forced to cover and many, but not all, indexes posted all time highs. The move was strong enough to generate a Dow Theory buy signal – even though the transports are overbought and below all time highs.

US stocks are relatively expensive to most other asset classes so value aberrations and other areas are most interesting. Looking elsewhere, there are other areas of interest beyond the oceans.³ Take your


³ Everday names if you drink a beer in a green bottle, take many medicines, drink iced tea, clean your ears, eat a sandwich with mayonaise
strong dollars and buy multinationals that sell heavily into the USA. A triple edge sword: strong dollar = depressed valuations; depressed currency = greater competitiveness; selling in dollars with costs in weaker currencies = increased profit margins.

This worldwide effect is not so obvious and varied. Looking at recent market action, the Swiss market has plummeted as has the Indian Market. Major consumer stocks in Europe are at multiple year lows. Each seems extreme, with special factors. The Swiss market basket is replete with major international companies. Good balance sheets and dividends are common, as well as world leading marquee names. Their currency, however, is now loosely pegged to the EURO. The decline toward dollar parity has impacted valuation; the drop in the price of gold has not helped.

The Indian market is suffering from many problems, the most recent, a recall/destruction of large currency bills in essentially a cash economy. I believe this was so stupid on its face that relief must soon occur.

Let me add that European financials have been pummeled and seem to be rising from rock bottom prices.

**INTEREST RATES**

While the picture in equities and energy has improved dramatically, interest rates have surged. I remember the top in rates in 1980, just after I entered the industry. It would have been inconceivable that the trend would last 36 years at the time. It began with a small "top" pattern of minor significance and continued into one of the longest and most durable trends in modern investing. It has been declared over, multiple times by many, and, until the recent rise in rates, the calls were all wrong in hindsight. Is this time different?

The "lows are in" is different than the "trend has reversed." I've made both predictions in the past and have been proven wrong. I'll go out on a limb and say the "low are in," I'm not prepared to think the long term trend has reversed. It very well may, and the recent spike may well be a precursor to that bottom.

From a technical perspective, a top in rates is no different than a bottom in rates, just flip the chart over. However, a fundamental top in rates is very different than a bottom in rates. The 1980 top in rates was brought about by the extinction of runaway inflation through a very harsh discipline of restricting credit.

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4 Especially since the bills were the equivalent of $7 and $14 US dollars.
There were many reasons for that inflationary bust out, and few if any, exist today.

What might bring about a bottom in rates? Where might rates go?

Traditionally, rates rise when there is competition for funds between the private and public sectors of the economy. Crowding out is the shorthand for the phenomena – government borrowing *crowds out* public borrowing. Normally, the larger the budget deficit, the greater the risk of higher rates, or so it would seem. My perception is that the willingness of lenders to take credit risk and interest rate risk is based on the ultimate direction of budget deficits, not the near term. A lender who envisions a deficit growing from here to eternity will demand higher interest rates than a lender who believes that the growth of the deficit can and will be addressed effectively.

Another way of viewing the same issue is to believe interest rates reflect underlying inflationary trends. The current expectation based on the tips/treasury spread is around 2%. Yes, that is much higher than the lows reached in the 1.30-1.4% area this spring, and bears watching, but not hysteria.

Then there is the concept of “taking away the punch bowl before the party gets out of hand” – again another view of the same issue – easy money leads to an overheated economy leading to higher wages, asset prices, and speculative bubbles. So it is the FED’s mission to bring the party under control before it spirals into disruptive economic effects.

I’m pretty certain we see a December rate increase. Next year, assuming the economy responds well to the Trump initiatives, probably two more are in the cards (maybe a 1,2,3,4% yield curve – 3 month, 5 year, 10 and 30 year maturities).

However, the sharp decline in the fixed income markets seems more like the Meredith Whitney⁵ Municipal bond episode and the Taper Tantrum⁶. Both were sharp selloffs across a wide spectrum of income producing assets, followed by a rapid recovery in values as the markets calmed and more reasoned views on the future course of interest rates developed.

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⁵ Meredith Ann Whitney (born November 20, 1969)[1] is an American financial analyst. She is best known for successfully forecasting the difficulties of Citigroup and other major banks during the financial crisis of 2007–08,[2] and then for predicting in 2010 the still-unrealized default of US municipal bonds totaling hundreds of billions of dollars. [https://en.wikipedia.org/wiki/Meredith_Whitney](https://en.wikipedia.org/wiki/Meredith_Whitney)

⁶ Taper Tantrum – Taper tantrum is the term used to refer to the 2013 surge in U.S. Treasury yields, which resulted from the Federal Reserve's use of tapering to gradually reduce the amount of money it was feeding into the economy. The taper tantrum ensued when investors panicked in reaction to news of this tapering and drew their money rapidly out of the bond market, which drastically increased bond yields. [Taper Tantrum Definition | Investopedia](http://www.investopedia.com/terms/t/taper-tantrum.asp#ixzz4S5XedkRo)
Given the likely dimension of the tax law changes, municipals bonds are likely to be slightly less advantaged\(^7\) and qualified dividends will benefit, while the impact on regular interest taxation (likely none), as well as alternate business structures, is not clear.\(^8\)

The most salient characteristic of the income markets today is that once again, yields are competitive with equities, offering a return close to the long term equity average, with what should be less risk.

Stock charts available upon request.

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Bond investments may involve risks including market risk if sold prior to maturity, credit risk, reinvestment risk and interest rate risk. U.S. Treasury securities are guaranteed by the U.S. government and, if held to maturity, offer a fixed rate of return and guaranteed principal value. There is an inverse relationship between interest rate movements and bond prices. Generally, when interest rates rise, bond prices fall and when interest rates fall, bond prices rise. REITs are financial vehicles that pool investors’ capital to purchase or finance real estate. REITs involve risks such as refinancing, economic conditions in the real estate industry, changes in property values and dependency on real estate management.

\(^7\) Rates on higher income tax payers are going down – but so are deductions. This was one hidden agenda in the Reagan Tax cuts that preserved and even increased revenues.

\(^8\) (REITs, MLPS, BDCs)