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The Reagan era, relatively speaking

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As we entered 2016, markets were prepared to expect four Fed rate hikes, presumably because the economy was on the precipice of that long elusive escape velocity that Janet Yellen and before her, Ben Bernanke had been promising us amidst their never before seen levels of Federal Reserve monetary stimulus. Corporate earnings were also supposed to grow modestly in 2016 and expected to accelerate by a comparatively robust 8% or so in the third quarter. While the 3rd quarter did break a string of five consecutive quarters of negative S&P 500 EPS growth, it was still far short of the high single-digit estimates Wall Street was forecasting earlier in the year. GDP was also supposed be running at an annual pace of roughly 2.5% in 2016. Instead, with three quarters in the books, 2016 is ticking along at an average pace of 1.5%--aided more recently by the soybean export spiked 3rd quarter GDP print of 3.2%. Crude prices were supposed to bottom and trade as high as $65/barrel, per many Wall Street prognosticators (i.e. removing the threat of more energy-related debt defaults). The people of the U.K. were supposed to reject the crazy notion of an EU exit and a *steady as she goes* "market friendly" Hillary Clinton would win the Presidential election. So basically, none of the above have happened and in fact, on all fronts, everyone one of the major foreseen market impacting events has "missed expectations." But it hasn't mattered because not much matters to stocks so long as central banks, collectively, can continue to maintain their grips on markets and prevent the markets starving price discovering tentacles from attaching themselves to the morbidly obese host market.

Then, on November 8th, the American people along with the help of the Electoral College process, elected the controversial real estate mogul Donald Trump as its 45th President. While the initial reaction by global markets in the early hours of November 9th were a definitive thumbs down, global stocks quickly bounced with the Dow Industrials staging a furious 1000-point rally over the succeeding three weeks. Alas, what we've witnessed in the immediate weeks following the election is a collision with ongoing massive price discovery interference via the still massive and ongoing record levels of global money printing gratis of the globe's major central banks (primarily the BOJ and the ECB for now) along with a newly discovered cache of *hoped-for* fiscal stimulus that has quickly been monetized (discounted) into substantially higher prices and well into the future for many previously lagging sectors on the assumption that this will finally be capable of tipping us into that elusive economic escape velocity that 8-years of relentless and unprecedented global money printing and global interest rate suppression has been unable to accomplish.

Index	Nov. 30 2016	2016Δ
S&P 500	2199	+7.6%
Dow Industrials	19123	+9.7%
Nasdaq Composite	5324	+6.3%
Value Line Arithmetic	5172	+18.6%
Dow Utilities	633	+9.5%
Russell 2000	1322	+16.4%
Gold (ounce)	$1173.00	+10.6%
Silver (ounce)	$16.48	+19.1%
Amex Gold Bug Index	178.08	+60.1%
Oil (NYM Lt Sweet/barrel)	$49.44	+33.5%
30 Year Treasury Yield	3.02	+0.01%
10 Year Treasury Yield	2.37	+0.10%
2 Year Treasury Yield	1.11	+0.05%

The S&P 500 is an un-managed index of 500 widely held stocks. The Dow Jones Industrial is an unmanaged index of 30 widely held securities. The Russell 2000 index is an un-managed index of small cap securities which generally involve greater risks. There is no assurance these trends will continue. The NASDAQ Composite Index is an unmanaged index of all stocks traded on the Nasdaq over-the-counter market. The Value Line Composite Index is composed of all of the companies that are included in the Value Line Investment Survey. The Dow Utility Average is an unmanaged index comprised of 15 utility stocks. The Amex Gold BUGS (Basket of Unhedged Gold Stocks) Index is a modified equal dollar weighted index of companies involved in gold mining. Inclusion of these indexes is for illustrative purposes only. Keep in mind that individuals cannot invest directly in any index, and index performance does not include transaction costs or other fees, which will affect actual investment performance. Individual investor's results will vary. Past performance does not guarantee future results.

Clearly, an abundance of investors (and Wall Street algorithms) appear to be pretty certain about what lays in front of us as it concerns the kinds of new legislation that will be enacted and what prior legislation eventually gets the axe; and what it will ultimately mean for financial markets. I for one don't have quite the same level of confidence. But one thing I'm pretty certain of is that financial markets, given the previous yet to be expunged massively accrude excesses as well as starting from a point of once inconceivable levels of past, present and ongoing monetary stimulus and its resultant era of record debt proliferation, the laws of financial physics will ultimately have a say in what transpires going forward.

While comparisons to Ronald Reagan's deficit spending "pro-growth" policies abound in the aftermath of the Trump election, the comparisons to the Reagan era really can hardly be more stark. When Reagan took office in January 1981, we went from generationally high interest rates in the high teens to generationally moderate interest rates in the mid-single digits; and from virtually no fiscal deficit spending to enormous deficit spending, relative to the size of GDP. At the time, this two-pronged flip in

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stimulus for the economy ended-up being an enormous level of additional germination of the speculative spirits on the margin. Today, the absolute reverse dynamics are in place leading into the newly anticipated Trump economic miracle rapidly being priced into markets. The Reagan era entailed a transition from extreme economic austerity of sorts to one of relative and multi-faceted forms of fiscal, tax and monetary stimulus. While a case can be made that the Reagan years simply jump-started a 35+ year era of Federal debt proliferation that has since spiraled out of control, with only the party not occupying the White House throughout each intermittent election cycle voicing concerns about it potentially spiraling out of control. However, the eventual market response following Reagan's deficit spending rampage made sense from a prior market posture of relative austerity. Despite that, the market still dropped about 30% over 18-months, from peak to trough, after the initial 10% post-Reagan election rally. Today, whatever reversal of regulation and whatever levels of fiscal and tax stimulus might be forthcoming, on the margin and from a relative basis of a global financial system already grossly steeped in all forms of superfluous stimuli and its resultant mountains of debt (leverage), its improbable to conceive of nearly the kind of ultimate market response that was witnessed in the Regan years. So, I tend to think that whatever rally is left in the initial post-Trump election rally now feels a lot like trying to pick-up dimes in front of a rock crusher.

In contrast to the early 1980's we're already starting from historically elevated level of "*unintended fiscal stimulus*" as the *unintentional* 2016 Federal deficit was $610-billion and $1.4-trillion if we go by the actual amount of additional outstanding U.S. Treasury debt thru the government's recently ended fiscal year in September. Accordingly, we're currently running an *accidental fiscal stimulus* that is already roughly 70% the relative size (to GDP) of Reagan's intentional peak deficit spending year in 1986; and that's just using the CBO's "official" deficit data. The relative starting points for the new Trump Administration in *Federal Debt-to-GDP* will be 106% for Trump versus about 30% for Reagan. Remember, the 2008 financial crisis was caused by too much debt saturated throughout the global financial and banking systems. We've spent the last 8-years attempting to solve that with even more debt. While it's incredibly stimulative throughout the buildup phase, markets ultimately need increasing levels of credit expansion on the margin in order to keep it going. But at some point those laws of diminishing returns become overwhelming and it begins to fall back on itself in the form of stagnation or even crisis. Global interest rates essentially could never have been imagined to have reached a level perceived to be more stimulative as it is today which has been witness to as much as $12-trillion of negative yielding sovereign global bonds as recently as this summer and with short-term global rates in developed economies suppressed at zero for going on eight long relentless years. Also, per a recent *Barron's* article written by *Randal Forsyth*, non-financial debt today stands at 251% of total GDP. When Reagan took office, it stood at just 135%. So as interest rates fell during the Reagan years, corporations also had room to begin adding leverage to their balance sheet. As this occurred it acted as a naturally ensuing additional stimulus. Instead, we're now staring at a situation where if anything, this debt, at record highs relative to GDP today, will act as nothing but a headwind and at worse, heightened systemic risks —especially if interest rates are truly on a sustainable rise.

Furthermore, global central banks collectively are still operating at what could be called maximum, all-time, emergency, never before seen levels of global central banking monetary accommodation with the Bank of England, the Bank of Japan and the European Central Bank, combined, buying up nearly $200-billion worth of bonds each and every month. This is the largest *all-precincts-in* aggregate level of global QE that we've witnessed since this form of monetary propping was first nearly unanimously and universally adopted amidst the 2008 crisis. Reagan took office with Paul Volker in place at the Fed who at the time was bent on fighting inflation—a huge ongoing simulative headwind at the time. By the time Reagan left office, we had gone from the immensely hawkish Paul Volker to the radically dovish, Alan Greenspan, and perhaps the world's most epic serial bubble blowing central banker in history as well as being the architect of today's seemingly dysfunctional central banking backdrop. About the only way to increase global monetary stimulus from current levels would be the equivalent of literally dropping bails of cash from helicopters. Compare that stimulative transition during the Reagan Presidency to what we have today as we are now starting from a very dovish group of central bankers who have already printed $4-trillion dollars and who have raised rates one time in the last 10-years along with every other major global central bank having since duplicated the *Greenspan-Bernanke-Yellen* playbook. Even Alan Greenspan himself has recently voiced concerns about just how far his interventionist policies have been taken. So again, the starting points from where Trump begins his miracle work could almost not be more stark.

An even more glaring contrast, that further foils the Trump/ Reagan comparison, as sited again by *Stephanie Pomboy* in a recent *Barron's* article, is that Reagan ushered in a renaissance of global trade and economic openness. Which in my opinion, was initially an enormous multi-decade form of global economic stimuli. But having gone too far with this in the recent decade as evidenced by the decline of U.S. manufacturing and good middle income jobs amidst the abandonment of some reasonable and easily enforceable global worker protection clauses in our trade treaties it has since fostered perceptions of a gross overreach of global corporatism and perceptions that the majority of trade benefits have nearly totally bypassed the globe's middle class. The last 10-years of trade has essentially been a race to the bottom by global corporate interests in pursuit of the most exploitable labor pools on the planet which has helped spawn the recent global populist flare-up now sweeping thru developed economies, as exhibited by Brexit this summer and more recently the election of Donald Trump and the thumbs down for Italy's recent constitutional referendum. Nevertheless, the initial surge of globalization in the early Reagan years acted as a *"yuuge*" form of global stimulus from the early 80s thru roughly the late 90s. More poignantly, one of Reagan's most sited quotes ever was, as Pomboy sited, "*Mr. Gorbachev, tear down this wall!*" Contrast that with Trump's,"*Build that wall!!"*

In addition, we already have a U.S. stock market that is priced at its second most extreme valuation level *EVER* (including 1929 and 2007) when you take into account most traditional valuation metrics in aggregate. When Reagan took office, the total U.S. *stock market-cap to GDP* was something like 40%. It is currently priced at 196% of current GDP, or 3.9-times more expensive. *Warren Buffett* has called this valuation measure to be among the most relevant of any. The GAAP P/E (Generally Accepted Accounting Principles) ratio of the S&P 500 is at its *second priciest ever*, just shy of the late 1999 tech bubble record. The *median* GAAP P/E of the S&P 500, however, is at an *all-time high*, which captures the more democratic characteristics of today's all-skate asset overvaluation backdrop compared to the more selective 1999-2000 bubble that was laser-focused on the tech and dot-com variety of stocks of the time.

While the post-Trump rally has been nothing short of impressive, the broader market has still gone almost nowhere since its pre-Brexit, global central bank kick-save highs set about 2-1/2 years ago in May 2014. The "average stock" has finally put in a wicked burst of outperformance versus the pre-election mega-cap momentum winners that had been left doing essentially all the heavy lifting since that prior *pre-end-of-QE-III peak* in May 2014. However, the net result is still that

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the average stock, going back to the market peek just prior to the end of QE-III in late 2014, has still gone pretty much nowhere and is actually down by most measures of equal weighted parameters. Since those May 2014 highs for the S&P 500, that index is up just 3.7% at its most recent post-election highs. That's an annualized return that has barely beaten the return on nearly zero yielding CDs, but with innumerable levels of additional risks. The Dow Industrials are made up of just 30 stocks and are therefore among the beneficiaries of the current "*passive investing bubble*" mentality that has permeated the prevailing individual investor psyche but is still up a modest 4.8% from its May 2014 highs. The NYSE Composite Index, however, contains more than 2000 names so is more representative of the "average" stock. While the Dow Industrials have vaulted to new all-time highs, the NYSE Composite Index peaked at 11,255 on May 21, 2015 over 1 1/2 years ago. As of this writing, the NYSE Composite Index at 10,857, is still down nearly 4% from its year-and-a-half ago peak and up less than a percent from its May 2014 highs. The Wilshire 5000, another broad market index consisting of 5000 stocks, is up just 2.0% from its May, 2015 highs.

In the liabilities column, total U.S. *non-financial debt-to-GDP* is now at 250%, well above the roughly 180% at the peak of the 2000 tech bubble. The Federal budget backdrop, as discussed above, is going to take on greater scrutiny in the months to come when Congress begins debating the Trump White House's fiscal proposals. But for now, the bulls are running and the hedge fund boys and girls are in full-on career risk buying panic mode (keep pace with my benchmarks, or its public-school time for little Johnny).

A number of more *intangible bubbles* have also taken hold amidst this era of interventionist central banking policies. The many *intangible bubbles* that have taken flight have aided and abetted this current *everything tangible bubble* environment, including a bubble in "indexing" and "passive investing" as well as the proliferation of robo-advising. So far, as these less thoughtful more mechanized market influences proliferate and account for a growing majority of today's daily market transactions, we've also witnessed a renaissance for technicians and chart reading while at the same time we've seen a simultaneous erosion in the perceived usefulness of traditional fundamental and macro analysis. Again, this, I believe, is being flattered and nourished by the blurring effects of never before seen levels of central bank interventionism. Back in the day, fundamental research pretty much ruled the day. Early in my career the work of Peter Lynch, Warren Buffett, George Soros, John Neff and John Templeton and their ilk were among the folks that were most widely quoted and were among the most revered managers of other people's money. Their words were quoted, parsed and re-quoted endlessly. They were all essentially fundamental stock or market sector pickers with "valuations" acting as the anchor of their work. During their era, the technical chart readers were considered borderline investment quacks feeding at the fringes. At the time, I believe this was an inaccurate and degrading portrayal of the true value of their work. Because of the overriding influences of fundamental stock and macro analysis, the theory posed at the time by folks such as Marty Zweig and other prominent chart readers or technicians were that charts and technicals were able take on common and predictable characteristics, with their leading variables being influenced by the prevalence of actual fundamental buying and selling influences, and ultimately conspiring to produce probable and repeatable actionable markers. In other words, technical analysis was in a way a derivative of the real fundamental influences of real living value and fundamental conscience buyers and sellers. I have always thought this connection, when viewed as a derivative of market fundamentals, made technical analysis a pretty viable and useful secondary tool able to give us fundamental and macro leaning folks some extra assurances when attempting to arrive at our conclusions. Today, however, with the proliferation of algorithmic trading which now accounts for a wide majority of all transactions executed on a daily basis, these algorithms are more or less all programmed to look for the same "technical" markers such as moving averages, breakouts or breakdowns of resistance or support. But they are no longer as much derivatives of what real living and breathing fundamental stock buyers and sellers are doing with their money. Rather, amidst the bizarre world of interventionist central banking, which again, I believe has been a key element for all of this since easy money essentially blurs the lines between good and bad, defers financial gravity and confuses price discovery, technical analysis has essentially mutated into a derivative mostly of itself. In other words, I worry that it is part and parcel to further exacerbating real price discovery, which contrarily used to be predominantly influenced by real breathing value conscience humans capable of interpreting the more nuanced macro and fundamental aspects of a properly functioning market. Today's world of technical analysis, made up predominantly of diodes, and silicon, I'm afraid, is in some ways becoming the equivalent of one Kardashian sister judging another Kardashian sister in a talent contest.

Another post-election phenomena has been a substantial rally in the U.S. dollar and market interest rates. The initial Wall Street narrative suggests that this is nothing more than these two markets adjusting for the perceived forthcoming acceleration of economic growth and the resultant inflationary pressures. Interest rates have now moved a noticeable amount in just a few short weeks since Donald Trump was elected on November 8th. To be exact, since the end of September, roughly 9-weeks ago, the rate on the 10-year Treasury has moved from 1.593% to a recent close on the 10-year at 2.40%--- a nearly 50% increase in the cost of 10-year debt in just about a 2-month span and over 75% from the July lows. I know this is from a very low nominal level, but this is also what makes such moves unprecedented and potentially dangerous. The 8-year post-financial crisis period has been witness to an unrivaled episode of new debt creation, globally, an additional $60-trillion globally since the peak of the 2007 credit bubble, along with innumerable quantities of investments and leverage applied in a desperate chase for yield amidst what has been the prevailing and exhaustive eight year suppression of interest rates; and growing perceptions that this had become a static construct being managed in perpetuity by the "infallible" interventionist central bankers. If stock owners think a sustainable episode of global interest rate increases is bullish for the most leveraged global economy in history, I think these folks might be in for quite a surprise.

We have now seen rates around the world back-up to the point where it has become increasingly difficult to find a single country where an investor can still enjoy the privilege of lending money to their respective government for a 10-year period and not also get to pay that government an incremental amount of interest for essentially stashing their savings for them. The only sovereign bond market still sporting a negative 10-year yield is Switzerland. Ten short days after the U.S. elections, Bank of Japan Governor Haruhiko Kuroda, said that he and the BOJ would be offering to buy *unlimited quantities of bonds* for the first time ever under its new *yield curve control* policy marking yet another sad central banking milestone which calls for a theoretically infinite level of QE required to

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accomplish such a feat. This is a shot across the bow for global yields that have seen JGB yields rise in sympathy with moves in US Treasury's. Japan is the most compromised developed economy in terms of its *debt-to-GDP* at 229-to-1. Japan's debt-to-GDP when Reagan took office was a more modest 50-to-1. Even a meek rise in yields could create havoc for the heavily indebted Japanese economy. And one thing I think we learned from 2008 was that there is really no such thing as a quarantined financial crisis when you're talking about the third largest economy on the planet. So, I'm not surprised that the Bank of Japan has been the first to move. On November 19th, Japan's Prime Minister Shinzo Abe met with President elect Trump perhaps to warn Mr. Trump just how screwed his economy ultimately is if global yields were to rise substantially, or possibly even modestly.

The U.S. dollar has also recently hit a 14-year high against the basket of currencies which make up the counter basket of international currencies in the U.S. Dollar Index. The Bank for International Settlements (BIS) recently warned that the stronger dollar "*poses risks for global markets and financial stability*." While I could hardly think of a better gift for the globe's wickedly starved savers if interest rates could rise and keep rising without it interfering with the ensuing post-election Trump market victory party nor the woefully leveraged global economy, I worry however, with debts, now so spectacularly enormous throughout the globe, and not just in nominal terms but from a total global debt-to-GDP perspective, and with the majority of it being priced in dollars, the current simultaneous trajectory of both the U.S. dollar and interest rates can euphemistically be considered a giant pin traveling precisely in the direction of a giant debt balloon. The only thing yet to be known is the remaining distance between the two. So, while financials have been able to run pretty far with the singular and myopic narrative that suggests that higher rates are undeniably good, the rising risks to their counter party's credit paying serviceability could quickly change that convenient narrative. Additionally, ponder how a sustained rise in bond yields will quickly halt a number of popular financial engineering gimmicks that had only been possible by the *oh so forgiving* global bond markets which have aided the illusion of real economic and earnings growth. This would summarily put a stop to debt financed corporate stock buybacks, among the biggest single sources of stock accumulation since 2012 and a major contributor to financially conjured corporate earnings per share growth. According to a recent Deutsche Bank report, approximately 25% of all EPS growth for the S&P 500 since 2012 has come from the single financial engineering gimmick of mostly debt-financed corporate stock buybacks. There is yet another example of a intangible bubble, stock buybacks, that has only been possible with the aid of the central bank's relentless interest suppression campaign.

So once again, as we transition from a growing recognition that manipulated interest rates and once unimaginable money printing has failed to deliver the promises of its central bank sponsors, folks and machines are uninhibited from proceeding to discount virtually all the possibilities for what a Trump White House might do right, while summarily ignoring any of the previously accrued risks and yet to be discovered negatives. Either way, we're once again witnessing the market put the cart ahead of the horse based on yet another round of fresh new hope but yet to be realized substance and that yet a different form of stimulus, which can only be accomplished with even more mountains of debt, will finally justify the increasingly and grossly disengaged market valuations from their increasingly more suspect valuations. Throughout the past 8-years of the post-financial crisis we've been waiting for stocks to trade on something more compelling than the financially engineered ether that has become reluctantly accepted as the sad Wall Street standard. So what could go wrong?

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