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Major World Events... No Change to Investment Perspective

Where Things Stand

We live in a time when the term "fake news" has become commonplace. While there has always been a tendency for the news media to tell stories from their own perspective--making understanding them a matter of interpretation--we must now sift through some intentionally misleading information to discern truth. Social media has become an indispensable tool for building online community while allowing individuals to immediately disseminate all manner of personal prognostications. My purpose has always been to cut to the heart of matters to educate with real data and history. So let's talk about what's really going on in the world.

General Investment Thesis

The last couple of years have seen a rising dollar take the steam out of overseas investments for American investors. In the first quarter of this year, that trend has reversed and a softening dollar is boosting overseas returns. Generally, outside of local investment performance, overseas investment returns are affected by the relative movement of the dollar vs specific currencies during a period of time.

GDP continues to grow at a slow pace with the end of 2016 clocking in at a 2% growth rate year over year. As always, consumption is 2/3 of GDP so knowing how the consumer is fairing is important for measuring economic health. In the aggregate, consumer balance sheets are strong with record wealth, low debts and record net worth.

My general investment thesis for the last few years has been to expect slow growth in the economy. I haven't been wrong... and it isn't over yet. The "new normal" has been GDP growth of approximately 1.5%/yr--that is the experience of the last 10 years and also the projection going forward. This may portend single digit market growth rates for the foreseeable future. As uninspiring as that sounds, it still beats many traditional investment alternatives.

With interest rates still at historic lows, bonds remain an overvalued asset that I think will eventually see a correction. This correction could happen suddenly (in the case of a failed Treasury auction, for example) or over a period of years. In the case of a sudden correction, bond investors who sought the asset for its low-volatility history will discover that bonds can actually be very volatile... and losses are not easily recoverable. In the case of a long period of rising interest rates, bond investors will find they were little better off than if they had left their investment dollars in cash-alternative instruments. Either way, I don't see the debt markets as a good asset class for long-term holdings--cash has never been a good place for long-term assets. We remain in times when our investment thesis is built around the process of elimination rather than the law of attraction.

The Trump Effect

Let's talk about the so-called "Trump Effect." What is it and does it have weight in the markets? The Trump effect is the anticipated effect on the markets of promised policies primarily on the return of wealth from overseas corporate accounts and a reduction in tax rates. If an estimated $2.4 trillion in cash held by companies overseas were to be repatriated, it could improve S&P500 earnings by 1-2.5%. Reducing the corporate tax rate to 25% could improve earnings by 3%. If corporate rates were reduced to 20%, it could improve earnings 6-7%. Earnings are the drivers of stock returns and the markets are forward-looking.

The World is Changing... Back

Last year, the people of the U.K. voted to leave the European Union ("Brexit"). They had good reason to do so. Although the E.U. started out as an economic partnership, it has grown to be more of an overbearing central government. Essentially, member states ceded the authority given them by the consent of the governed in member countries to faceless bureaucrats. They voted to reclaim their sovereignty. At this point, it doesn't appear that the U.K. is alone in their deliberations as this is one of the overarching issues in other elections such as the French elections, still in progress. Just as the Brits are throwing off the yoke, others in the E.U. are considering their options. This could become a "Eurexit" referendum with enough momentum.

Stay tuned in to Europe. The drama there will likely drive some volatility here for the next few years. What is certain is that the European economy represented by the EU and many member states have not fully recovered yet from the last recession. This represents an investment opportunity for those who see the domestic markets as overvalued.

I think the E.U. has been doomed from the start (as I have said many times before). There is no way to expect to maintain a purely economic union in the absence of political unity. The Brits noticed where this was headed and called for

Continued from the front:

a change of direction. Some in Germany and France have called for the rapid creation of a unified Europe as a response to the Brexit vote. I don't believe the will exists across all of the disparate countries and ethnicities of Europe to make a united European nation. Time will tell. I also believe the countries of Europe will fare better as a whole when they return to their natural state. This is far from over.

What about China?

The reality of China is hard to see from the outside. The real numbers are hidden behind an economic iron curtain. By many accounts, though, China's GDP growth is stabilizing. That has major implications for many regions and Emerging Markets, in particular. Those who anticipated a weakened China pulling down the region have so far been wrong.

Stocks Remain an Attractive Asset

What will likely drive money into stocks will be rising interest rates and falling bond values over the long-term. This will occur as a rotation of assets—in spite of economic sluggishness. While bond values have been rising since 2000, the values in the S&P500 have been falling. Now, the S&P500 sits at historic highs again but the P/E ratio is around 17 times earnings. In other words... while the bond market was becoming overvalued, the stock market was lowering its valuation and becoming more attractive. This may still be a great time to be a long-term investor in stocks.

This doesn't mean that the stock market will only rise from here. Volatility is a natural part of any market. History tells us that the average market correction during any given year is nearly 15% (over the last 34 years)--and that's just the average. Yet, 75% of the time, the stock market finishes the year positive. As long as we have economic growth (even lackluster growth), markets should continue to expand. Don't panic when you see the market behave normally by falling during a long-term trend. "Normal" means a nerve-jarring market correction at some point in the average year.

Much of the recent weakness in the financial markets has been due to the weakness of earnings. Looking deeply into the earnings numbers, though, shows that they were significantly impacted by two main factors: the sudden rise of the dollar and the sudden fall of the price of oil. Nearly half of S&P500 earnings are from foreign sources. As both the dollar and price of oil have stabilized, earnings returned to their long-term trends and this will also bolster forward stock valuations.

As the price of oil has recently risen, some inactivated rigs have been reactivated and brought back into service. This has bolstered crude oil inventories and kept the price of oil banded below $60/barrel. I expect this to continue.

Do Something

What I've said so far shouldn't be an excuse for inactivity, though. Investors should still remain vigilant with their portfolios and review their holdings. Ensure investment managers are remaining true to their disciplines and investment policy statements. I believe this environment is where the best managers will have an edge over "passive" managers seeking to match index performance. Sit down with your financial advisor and make sure your investments are prepared for the future and respect your objectives.

Greatest Risks

What are the greatest risks to market growth and economic stability? In my opinion, the single greatest risk remains government overspending. Because the government is spending so heavily, it will require greater tax revenue to maintain entitlement and interest payments for the long-term. The Congressional Budget Office estimates that interest payments on the debt will double in the next ten years and entitlements alone already account for over 70% of federal expenditures. This will remove more capital from the already struggling economy. I believe the greatest investment risk is in the debt markets as much of the recent action of the Federal Reserve has been to maintain liquidity in the bond markets—primarily in Treasuries—through asset purchases.

Lower demand would mean a lower price and result in higher interest rates. In a failed auction, this could happen suddenly. The Fed's balance sheet has ballooned from less than $1 trillion seven years ago to nearly $5 trillion today.

Summary and Call to Action

Generally, our investment narrative continues to favor equities over debt. The rotation of investment assets from traditional fixed-income to stocks will likely generate returns beyond those warranted by economic growth. This is an environment for a strong investment manager and careful stock selection. Income-oriented investments will likely continue to struggle in a low--and eventually rising--interest rate environment. I think those investors doggedly holding traditional debt instruments will find that there are more ways to lose money in bonds than through issuer default. Credit quality still matters but, in this environment, investors can't afford to ignore the long-term asset trends.

What to do now? **Take the long view with your investment assets** and dust off financial plans. Have you prepared for the changes of life--especially the eventuality of death? When was the last time you reviewed your plans? Are they accessible to your designated decision-makers? Your estate plan should be reviewed at least bi-annually and updated with every change of life. Most importantly, make sure you have carefully delegated who will execute your documents for you. Between birth and death, we have to educate our children, buy cars, maintain homes and manage risks. Whether you need to review existing plans or develop overdue planning documents, you should sit down with a professional to get your financial house in order. Know that you don't have to pay to get your questions answered.