

Independence Asset Advisors, LLC

Three Risks That Could (Eventually) End the Bull Market

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Highlights

With stock prices rising and again at or near record highs, we think it is worthwhile to consider the possible risks that could end this bull market.

We are not calling for a near-term end to the increase in equity prices, but rather we think investors should be more aware of risks as stock prices climb and valuation multiples stretch amid a Fed tightening cycle.

As Americans return from vacations and prepare for the change of seasons, equity markets have offered something of a surprise. After remaining range-bound since February, stocks broke new highs as investor optimism rose. The U.S. stock market has quadrupled since its 2009 lows, economic growth remains solid and earnings are rising.¹

We remain constructive and don't wish to prematurely imply that the rising tides will imminently recede. But as markets continue to rise, we think investors should pay close attention to possible triggers that will, at some point, begin to dominate the market cycle.

Why So Negative when Considering All the Positives?

The economy is presently running efficiently on all eight cylinders. GDP is moving ahead at a pace well above 3%. Corporate earnings are up on the order of 25%. Inflation is rising slowly and remains close to the Fed's target of 2%. There are even signs that Europe and Japan are doing a bit better than they were a few months ago. While valuations are above normal, given (a) the growth rate for earnings, (b) the strength in the economy and (c) the continued low level of interest rates, what is there to fear?

Here are some thoughts:

1. The fuel injection for the strong economy and high-octane earnings, namely the corporate tax cuts and the large increase in fiscal spending, will not repeat in 2019.
2. Many believe that government statistics lag and may not fully reflect increasing inflation expectations.
3. Several early cycle industries appear to be rolling over, including autos, housing and banking.
4. The yield curve is flattening and threatens to invert as the Fed remains on course to increase the Fed Funds interest rates to at least 3%.

Investment Conditions Are Growing Less Certain

On balance, conditions look attractive for stocks. Prices are at all-time highs, excellent earnings are expected to continue to grow (albeit more modestly), inflation remains contained and interest rates remain low. Consensus expectations are that the next recession won't occur before 2020 or even later¹. These positive factors suggest that stocks still have upside. But buyer beware, since stocks look forward, the best of times may now be in the rearview mirror.

Beneath the surface, however, many strategists are becoming more cautious about the economic and market outlook. The consensus may be wrong about the next recession. Inflation and interest rates will certainly move higher as growth continues to improve. The Federal Reserve may become too aggressive about tightening monetary policy.

The U.S. political environment is growing less certain regarding both trade policy and foreign relations. Global geopolitical issues present risks, ranging from a messy Brexit process, rising populism in Europe and Latin America, and increasing tensions between the United States and Iran, Russia, China and even our historically close allies. Add to that the prospect for diplomatic setbacks on the Korean peninsula, and the opportunity for policy missteps multiplies.

We also see fundamental risks, like improving earnings reaching their end, high equity valuations based on overly optimistic earnings forecasts, narrowing credit spreads and growing sovereign and corporate debt levels. While this doesn't mean an end to the equity bull market, these risks are worth paying attention to. We wish to highlight three in particular.

Risk 1: The Next Recession May Be Closer Than Many Expect

Economists are notoriously poor at forecasting the timing of recessions. The U.S. economy remains quite strong, but that is typically the case a couple of years before a recession.

One recession indicator that tends to be reliable is the shape of the yield curve, since recessions typically follow about nine months after the yield curve inverts. The yield curve currently remains positive, but is flattening. It is likely to invert sooner rather than later as long as the Fed raises rates two more times this year and potentially two to three more times in 2019 to bring the Fed Funds rate to a positive real yield for the first time in a decade.

While a recession may not be imminent, late cycle pressures appear to be building. We hear anecdotal stories of labor shortages and supply bottlenecks from hundreds of our middle-market customers. Wage growth is slowly climbing and could accelerate. The Labor Department's employment cost index rose 2.8% in the second quarter, the fastest pace in a decade. We expect inflation will continue to rise, which will put additional pressure on the Fed to raise interest rates.

Risk 2: Earnings Expectations May Be Too High

Corporate earnings and profit margins have been exceptionally strong in the first half of the year. And analysts remain very bullish about prospects for future earnings. At present, consensus expectations are for S&P 500 earnings to rise 14 percent over the next twelve months and long-term earnings to increase by 16% per year.² That growth level was only exceeded during the 1990's tech bubble, and we think it seems extremely high in an economy growing at a nominal rate of 6%.²

As interest rates and wage pressures rise, we think earnings growth is bound to slow. The benefits of the 2018 tax cuts will fade over time and 2019 year-over-year earnings are likely to regress back toward normal. As borrowing and labor costs rise, margins are likely to be squeezed. A slowdown in earnings growth, and resulting earnings disappointments, could become a major headwind for equity prices.

Risk 3: Trade Tensions Remain a Serious Economic and Market Threat

Tariffs are taxes. They result in greater inefficiencies between the producers of goods and consumers, and act as a drag on global economic growth – as any tax does. Perhaps more importantly from an equity investing perspective, current trade uncertainty is complicating forward planning for corporate management teams and causing some to delay capital spending plans.

It is true that countries like China play by different rules when it comes to issues like copyright protection, but trade balances mainly reflect relative economic growth and exchange rates. The great irony is that policy actions such as tax cuts and efforts to boost private investment spending are likely to boost the trade deficit, since they put upward pressure on the U.S. dollar and interest rates. Increasing tariffs won't change the underlying dynamics of the U.S. trade deficit materially and will only extend uncertainty, potentially delaying some corporate investment decisions.

Equity Prices May Keep Rising for Now, but Increasing Caution Is Warranted

There may be a "perfect" time to invest in equities: when markets are cheap, earnings expectations are overly pessimistic and monetary policy is highly accommodative. In fact, that pretty well describes 2009. The environment looks quite the opposite today. U.S. valuations look stretched, earnings expectations are highly optimistic and the Fed is tightening.

What does that mean for U.S. stocks?

We think the fundamentals favor equities on balance, and we expect stock prices will be higher in one year. Returns may be meager compared to what investors experienced over the last decade; however, we still believe stocks will outperform bonds and cash over any reasonable period of time, say three to five years

Sir John Templeton famously said, **“Bull markets are born in pessimism, grow on skepticism, mature on optimism and die on euphoria.”** At this point, it feels to us like this market is in the optimism phase, and that some analyst earnings forecasts could be termed euphoric. While our attitude remains constructive at present, we will be cautiously working to control for increasing risk.

We caution our client partners that the risks discussed above will at some point begin dominating the investment conversation. Further, an as yet unseen trigger can either magnify these risks or introduce new risks that can lead to sharp sell-offs. We encourage active thought and discussion about possible market eventualities and risk management.

Connecting the Dots

With equity markets at all-time highs, it seems to be a good time to rebalance in order to not allow market appreciation to increase equity risk in client portfolios.

When reducing equity risk, less liquid credit funds offer a good trade-off of roughly half the price volatility at a higher and typically variable rate income yield.

We generally favor credit over long-dated, low-yielding government bonds and interest rate risk, but credit quality matters. This appears to be a good time to upgrade credit quality.

This is a good time to deleverage. Although few funds in our portfolios use leverage, new funds being considered must have low leverage and terms that are not subject to margin calls. This is a time in the cycle to be wary of real estate and private equity funds that use high levels of leverage in portfolio construction. Even if a fund's level leverage is low, we are only considering funds that do not over-burden their portfolio companies with excess leverage.

Please call or email us with any questions, concerns, information or opinions on the topics above. We appreciate our partnership and your support.

Scott D. Renninger

General Sources: WSJ, The Daily Beast, Nuveen Asset Management

¹ Source: Morningstar Direct & Bloomberg

² Source: IBES