November 22, 2017

Excuse me stock market, may I order some speculation with a side of complacency?

The 2017 menu of portfolio choices is one that should be read carefully. The average investor may have trouble staying focused on the menu amid hindrances due to headlines involving North Korea, tax reform, countless tweets, sexual harassment scandals, Brexit negotiations, NAFTA discussions, Venezuela's debt default, Catalonian independence, hurricanes, and wildfires. Shockingly, the stock market has been tame and relatively uneventful. Volatility has been non-existent as we hit 67 consecutive days without the Dow Jones Industrial Average moving more than 1% intraday[1]. The year-to-date high for the fear gauge known as the VIX was 17.28, well below the historical average of around 20 and the second lowest in 25 years[2]. Amid the headlines, speculative investments have been the fad of 2017. Here, speculative investments refer to securities that are bought based on their sex-appeal and past performance, with little consideration given to the fundamental value or the inherent risk in the position. To witness such speculation, one does not need to look any further than the performance of technology stocks and emerging markets equities. Year-to-date performance of these two investments have been strong at 36.46% for emerging markets equities[3], and FAANG stocks (Facebook, Apple, Amazon, Netflix, Google/Alphabet) have outperformed the broad equity market by 30% as measured by the S&P 500[4]. We have also seen high yield debt and emerging market bonds rally to a point where the yield differential (i.e. additional compensation to hold a risky investment) between these bonds and Treasury Bonds (considered a risk-free asset to many) is only 3.62% for high yield bonds and 2.9% for emerging debt.[5][6]

Some investors have picked their investments in the same manner as a restaurant connoisseur selecting his or her entree, while others have ordered by pointing randomly at the menu like an American tourist in Kazakhstan. When ordering in this manner, you could end up feasting on the best meal you have ever had. However, you may find yourself spending most of your day on the Дәретхана (toilet in Kazakh). Investor complacency has been a theme for the stock market in 2017. One possible example of investor complacency is chasing returns of high yield bonds despite the bonds providing only minimum compensation over risk-free assets (e.g. Treasure Bonds). The forecasted default rate for 2018 is hovering around just 2%, so some investors are thinking why not pick up the extra yield? Consider this, the current recovery rates are sitting around 35%. This means, you are expected to lose 65% of your investment if you own the bonds of a company going into Chapter 11 bankruptcy. With a 2% estimated

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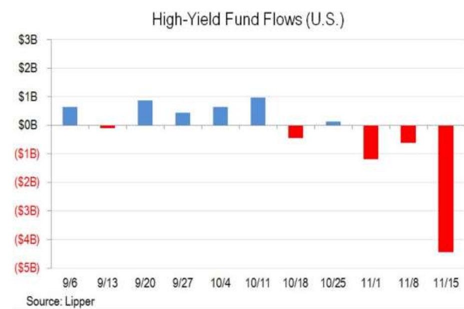
[1] Dow Jones Industrial Average. 11/22/2017.
[2] CBOE, BoFA Merrill Lynch. 1/1/1992 – 11/17/2017.
[3] As measured by the MSCI Emerging Markets Index. 11/22/2017.
[4] Teletrader, MSCI, Daily Shot, WSJ. 11/22/2017.
[5] Goldman Sachs. 11/17/2017.
[6] As measured by the Bloomberg Barclays High Yield Index and the J.P. Morgan Emerging Markets Bond Index-Global. 11/22/2017.

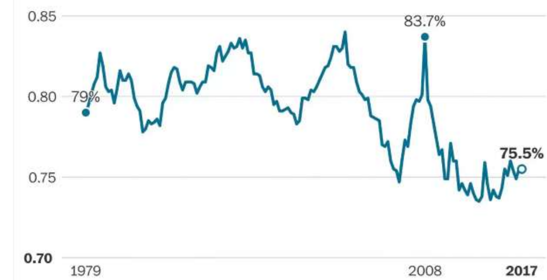
default rate and a 65% loss, one would expect to lose 1.3% of their yield due to defaults. If we subtract this 1.3% from the current yield advantage of high yield bonds (3.62%) over treasuries you are left with 2.32%. At 2.32%, you have little room for error. Now, consider that high yield bonds are seldom bought and sold with ease during a crisis, a concept referred to as liquidity risk. Therefore, investors should require additional compensation for this risk and this is referred to as the "liquidity premium". For high yield bonds, the liquidity premium is estimated to be 2.2%[7]. Once we subtract the liquidity premium of 2.2% from the residual amount above, which was 2.32%, we are left with only 0.1% of wiggle room to compensate for the risk that our default assumptions are correct, a scary thought considering defaults are hovering near cycle lows. Recently, it appears the market has begun to acknowledge this risk. In the week ending 11/15/2017, high yield bond funds experience outflows of $6.7 billion, the 3rd largest week of outflows on record.[8]

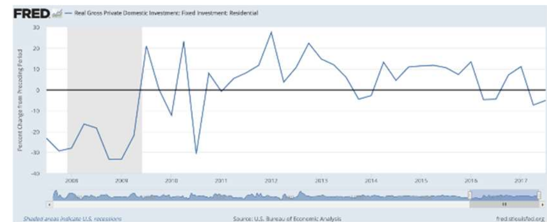


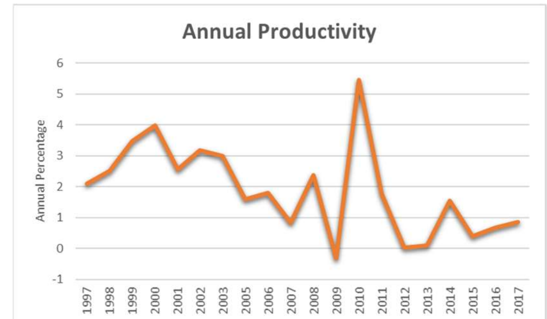
The S&P technology sector is trading at a price to earnings multiple of 52 times the estimated forward earnings! This is a high level when you consider the S&P 500 is only trading at around 18 times the estimated forward earnings.[9] The expectations that these companies will continue to deliver are lofty. Netflix alone is trading at a price of 196 times its earnings over the past year.[10] How will Netflix manage to generate the earnings necessary to justify the current valuation? To have a comparable price to earnings valuation as the S&P 500, Netflix would have to increase earnings by about 989%, from $1.001 to $10.91 per share![11] Why would investors be buying this stock at present values? What if the Lobster Casserole on the menu was $199? I can imagine your reaction. Now, what if everyone in the restaurant was ordering the Lobster Casserole? In this situation, you might think you will miss out if you do not order the Casserole. This concept is referred to as "regret aversion bias" in behavioral finance. Specifically, through an error of commission, an investor may end up buying an investment they would typically not be comfortable owning due to the fear of missing the returns.

[7] LPL Research, Moody's, Bloomberg, Barclay's. 2/10/2017.
[8] BoA Merrill Lynch. 11/15/2017.
[9] FactSet. 11/10/2017.
[10] Yahoo Finance. 11/22/2017.
[11] Calculated by using trailing earnings per share over the past 12 months of $1.001 and a closing price of $196.32. Yahoo Finance. 11/22/2017.

Earnings of S&P 500 companies have been solid this year. Labor costs have taken a decreasing share of revenues over the years.[12] Since labor is usually a company's greatest expense, firms have enjoyed lofty profit margins at 10.5%.[13] The muted wage growth we have witnessed over the course of this expansion may be reversing. 59% of firms reported they were hiring or trying to hire and 88% of those hiring or trying to hire reported they were unable to fill the position due to few or no qualified applicants.[14] 35% of small business owners reported job openings where they could not fill the position; this was the highest number since November 2001. Wage growth for the year was 3.22% in September.[15] This is a great improvement from the prior quarters, however, significant progress needs to be made to get wage growth back above 5%.[16] The 5% level has been reached in every expansion going back to 1960. The conundrum we face, is that productivity must exist for employees to have an ability to negotiate their wages. Paradoxically, productivity must also exist for firms to maintain profit margins. If both employees and employers are seeking higher productivity, why have we not seen a meaningful increase? Many pundits point to the fact that capital expenditures (i.e. outlays for equipment and capital to make their workers more productive) have been weak this entire expansion. Instead of reinvesting into a company's future, publicly traded companies have chosen to fund their dividends and share buybacks through the issuance of debt.[17] This financial engineering of a company's balance sheet may be beneficial in the short run, but it will be difficult for these companies to stay competitive in the long run. Companies are catching on to this and have increased their investments for future growth, a positive development to the U.S. expansion.[18] Fitting, as productivity came in at 3% last quarter.[19]







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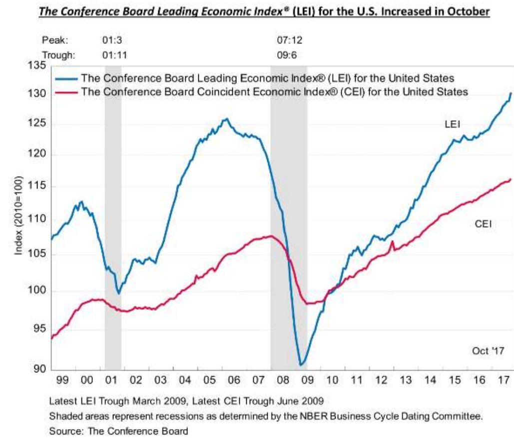
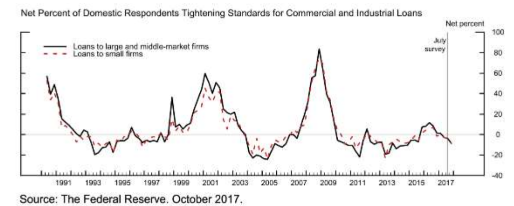
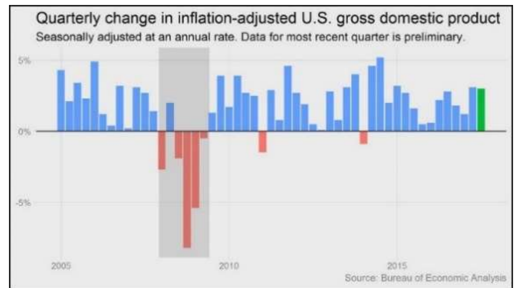
[12] Economic Policy Institute. April 2017.
[13] FactSet. 11/10/2017.
[14] NFIB Small Business Optimism Index. 10/2017.
[15] Bureau of Labor Statistics. September 2017.
[16] U.S. Bureau of Economics. 9/2017.
[17] INTL FC Stone. October 2017.
[18] Saint Louis Fed. Bureau of Economic Analysis. 3rd Quarter, 2017.
[19] Bureau of Labor Statistics. 3rd Quarter, 2017.

Amid investor complacency and valuations that may be stretched, a correction in the stock market is a plausible scenario. Yet, as the U.S. expansion becomes more durable, the risk of a recession should cede. Still, few economic indicators are showing signs of caution. The Leading Economic Index aggregates forward looking measures to provide real-time insight on the economy. When the index turns negative, on average, a recession follows within the next 14 months. When this index is positive, the chances of a recession within the next 12 months are low.[20] In October, the Leading Economic Index rose 1.2% to the highest level ever, an encouraging sign for the economy.[21] Another indicator to watch is the Federal Reserve's Senior Loan Officer Survey, a gauge on the general attitude of lenders in the marketplace. There's an adage that a rolling loan will never default. Using this logic, the rate of defaults should be low over the next 12 months if banks are loosening their lending standards and providing loans, and vise-versa. When the survey indicates banks are tightening standards, this survey has been a reliable indicator of near term defaults and a collapse in the prices of high yield bonds. Currently, the Senior Loan Officer Survey points to a tranquil lending environment.[22]





Another positive dynamic of the U.S. economy is the Goldilocks growth environment. Here, a Goldilocks environment describes a scenario where economic growth is not too hot and not too cold. If we can avoid running too hot, we may mitigate the risk of the Fed hiking rates aggressively which has halted bull markets in the past. If the economy is not growing too slow, the chances of slipping into a recession are reduced since growth must decline by a greater amount before the economy stops growing (i.e. a recession). This Goldilocks environment has partly contributed to muted interest rates. Fundamentally, interest rates in the long-run should be the sum of the real GDP growth rate and inflation expectations. Through subdued inflation expectations[23] and GDP growth,[24] we have formed a synthetic cap on interest rates. When interest rates are weighed down, higher valuations can be justified. Ideally, an investor buys a security for the prospect of receiving the future cash flows of a company. The present value of a company (i.e. the value today) is lifted when the future cash flows are discounted back at a lower rate. *As an exercise, divide $100 by 10%, then divide $100 by 2%, dividing by 2% results in a value that is $1,250 greater.* This is an oversimplified explanation of a method some analysts use to arrive at the intrinsic (or true) value of a

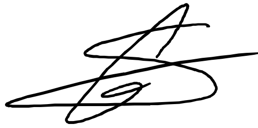


[20] LPL Research. 03/20/2017.
[21] Conference Board. October 2017.
[22] The Federal Reserve. October 2017.
[23] University of Michigan. November 2017.
[24] U.S. Bureau of Economic Analysis. 3rd Quarter, 2017.

company. In short, valuations are a concern, but less so when factoring in today's interest rate environment.

This piece is designed to help investors take a step back and invest rationally to avoid a misstep with their hard-earned savings. Presently, I classify my position as cautiously optimistic. I'm convinced a pause in stock market returns would be a healthy development as it would give investors time to reassess their risk tolerance, and realign their portfolios in a manner consistent with their investment goals. This year, the investment menu has become complex. Still, you should be able to order a hearty meal that satisfies your appetite.

So, order wisely and enjoy the experience!



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