Points to Ponder

December 20, 2019

The First Tee...

The Skies the Limit…stock values continue to rocket to multiple new record highs:

- Investors are chasing the bull market for fears of missing-out…pushing the S&P 500 up 27% this year:
  - Stagnant corporate earnings growth has been ignored, as investor emphasis has been focused on the easing of monetary policy by the Fed and prospects of a trade agreement with China.
  - A majority of this year's stock gains have been the result of expanding valuations *(mass momentum!)*:
    - The S&P 500's fourteen-week relative strength index (a measure of market velocity) has moved over a 70 reading, a level many analysts consider an extreme indication of exuberance…the S&P 500 traded at 26.3 times five-year normalized earnings last Friday:
      - Despite the relative strength index exceeding the 70 threshold 27 times since 1933, this has historically not spelled the end of the rally
        - The following 6-months after the RSI initially broached 70, the S&P has continued to rise at an average 6.1% pace 75% of the time.
  - Momentum buying is strong and is expected to persist despite the elevated cost for shares:
    - Since the start of the 4th quarter, over $50 billion dollars in new money has been invested in equity exchange traded funds…more than double the pace of inflows seen during the first three quarters of this year.
  - Inflated stock valuations have ceased to be a consistent warning-sign of future market performance:
    - Since 1990, the S&P's cyclical adjusted earnings ratio (a multiple based on 10-year earnings) has run 85% higher than the its mean level seen over the first 90 years of the 20th century…Investors basing investment decisions solely on valuation levels would have resulted in reducing their equity gains by 10% per year since 2000 *(riding the wave!)*:
      - Several secular factors have contributed to equity multiples trading at elevated levels during the past couple of decades:
        - Transformation of the U.S. economy from a manufacturing emphasis to service-based has resulted in the economy being less cyclical…**before World War II, the U.S. was in recession about 50% of the time, the past 30-years it's been less than 10%.**
        - The technology revolution has made stocks more growth oriented, a characteristic producing higher valuations.
        - Inflation has remained low and stable since the 1980's, making equity returns more appealing to investors.
        - More individual investors are investing in the stock market (401k's), helping to enhance market liquidity.
- Fed to the rescue, again…the Central Bank resuming bond purchases has fueled the fall stock rally:
  - The Fed has been adding $60 billion a month to its balance-sheet since August…pushing assets back over $4 trillion:
    - When the Fed is purchasing securities, it is increasing reserves in the banking system adding to over-all liquidity:
      - This added liquidity improves lending conditions, helping improve the outlook for business and economic growth.
    - The Feds purchase of Treasury Bills, and the 75 basis-point reduction in the benchmark rate target, has helped the yield-curve revert from its inverted posture…helping to reduce the fears of a recession (an inverted curve is inflation indicator):
      - The spread between the 3-month T-Bill and 10-year T-Note bottomed out at negative 50 basis points in August; today the spread has widened to positive 40 basis points (a 90 basis point swing)…the S&P 500 has rallied 8.4% during this period.

Zero Sum Game…Fed worried low interest rates becoming permanent part of economic landscape:

- Extended periods of low or negative interest rates threaten financial stability *(and depress me!)*:
  - Low rates negatively impact financial company profits, causing some firms to take-on added risk:
    - An erosion of lending standards increases the vulnerability to the financial sector and subsequent shocks.
- Countries in the European Union have been operating in a negative yield environment:
  - Besides declining credit issues, EU countries have seen a large deterioration in pension fund footings
    - Sweden, who has had a negative rate target for the past several years is preparing to increase its benchmark deposit rate back to 0%, despite its inflation-rate continuing to trend below the targeted level, as the country has a growing number of pensions moving into underfunded positions…more EU countries are expected to follow suit.
- President Trump is pressuring the Fed to lower its target rate to below zero percent:
  - The President feels the U.S. should not have to pay a higher rate on government debt compared to foreign countries who have economies that are not as strong or performing as well as the U.S.:
    - The reason these countries are at negative rates is because their economies are struggling *(negative rates have not helped!)*

At the turn...

The Back Nine…

Heavy Lifting…consumers are economy's hope to keep the expansion moving forward:

- Consumer spending comprises an outsized portion of the economy compared to other developed nations…U.S. consumption comprises 70% of GDP, while in China it is only about 40%:
  - Business investment and manufacturing have been slowing as companies hedged for the trade war:
    - The pace of hiring has slowed, and long-term investments have been postponed…manufacturing activity hit a 15 Year peak a year and a half ago but has slowed to its lowest level in 4-years during the last few months.
- Household consumption has averaged a 2.9% growth rate through the first 3 quarters:
  - Consumption spiked during the 2nd quarter to a 4.6% annualize pace (the highest in almost 2-years):
    - Household consumption has averaged a 2.4% annual growth rate during the ten-year economic expansion.
    - Consumers have been empowered by unemployment at 50-year lows, wage growth that is the highest in 11-years (the number of workers quitting for better paying jobs is close to record highs) and low inflation that is not eroding the wage gains.
- Plastic Pandemic…spiking credit card debt could be fly in consumer buying ointment *(card contagion)*:
  - Revolving debt has expanded to $1.09 trillion outstanding, the highest in ten years *(leveraged liabilities)*:
    - The number of individuals with access to credit cards reached a record high of 200.5 million in the 3rd quarter:
      - The share of revolving debt borrowers who are at least 90 days past due on their accounts is the highest since 2010:
        - The pace of credit card delinquencies is accelerating…5.4% of cards originated in 2018 were past-due in 9-months (up from 4.5% in 2017).
    - Major card issuers have warned they are starting to tighten credit standards…in anticipation of the next economic slowdown.
- Department store Desperation…brick and mortar retailers continue to lose market share:
  - Retailers, in the midst of the holiday buying rush, are spending extra to get shoppers in the door:
    - Despite their efforts, larger shares of the holiday spending dollar are going to on-line buying *(let your fingers do the walking!)*
      - What is becoming a painful holiday aftermath (besides the bills for gifts) are the stores that will be closing in the 1st quarter.

Lower Education…small private colleges are stressed as student demographics change:

- Moody's estimates that one in five of these schools are under financial duress:
  - Most of the schools have heavy debt burdens…some have offered bond holders as little as 10 cents on the dollar to retire debt:
    - The number of high school graduates is projected to stagnate over the next few years and start falling in 2026:
      - Shrinking size of the student population will up the competition between schools, placing additional pressure on finances:
        - Enrollment growth at not-for-profit private colleges slowed to 165k between 2000 and 2007, down from 440k gain seen in the 1990's.
    - To survive, many small schools are merging, re-structuring debt, cost cutting or filing for bankruptcy:
      - Rising student debt loads have created challenges…the declining job market for liberal arts degrees has also been a hindrance.
    - Campaign promises to make public college tuition free would dramatically reduce the draw to many private schools.

19th Hole...

Good enough never is. Debbie Fields

Ross Elford, First Vice President

Direct: 314.746.3679 I Mobile: 314.223.9739 I Fax: 314.746.8737