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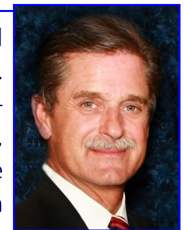
Scott's Thoughts —

INSIDE:



Scott Husband

It is not the same market. It changed in late January. Interest rates, stocks, oil, and gold all had been heading higher while volatility continued to decline to record lows. There was some news, but nothing out of the norm that would have caused a directional change. The S&P500 declined 10% and the market leader, the NASDAQ 100, declined slightly more. Oil, which had surprised nearly everyone by moving up to the high $60s, declined about 10%, which led to the oil related equities declining much more. The major oil exchange traded fund (XLE), declined 16% while the oil service sector (OIH) declined 25%. Importantly, the FANG stocks actually declined more than the broader averages. Facebook down 23%, Amazon and Netflix down 16%, with Google down slightly more. Tesla, which is not part of FANG declined from $390 to $250. Even the financials, which had become the newest "liked" sector (because interest rates were moving up) declined more than the broad market, even as rates continued higher! Morgan Stanley declined 12% while Wells Fargo was down 22%.

The reasons came to light in the following weeks. The Atlanta Fed announced in early January that the expected GDP first quarter growth was going to be over 5%. By mid-March, the expected growth was lowered to 1.75% which is not a stellar expectation. Consumer sentiment was the highest since 2004, new unemployment claims hit a 45 year low, and consumer debt reached $1 Trillion, but retail sales were weak (?). The budget deficit is expected to touch $1 Trillion, with an omnibus spending bill that displeased no one except the budget hawks, and we got tax cuts especially for the corporations but not the very rich. But the additional $1 trillion deficit must be paid with currency that is currently elsewhere. What will be sold to buy the additional trillion dollars in bonds?

This is the second longest bull market ever. The most margin debt ever (borrowing money to buy stocks) which always occurs at the highs. The Producer Price Index had the highest reading in four years (+2.8%), but the consumer price index was a muted 2.2% which lessened inflation fears. Stock buy-backs are running at $5 Billion a day, but below the record $10 Billion of last year. Corporate debt is at record high levels. US Government debt is once again going to new highs. But interestingly, as interest rates are moving up from historic lows, the Federal Government is borrowing more short term which costs them less today, but does increase the risk of paying much more down the road (recall that in the great recession, companies that lived off short term funding were the first to go broke). Sometimes it is better to pay 3% for 30 years than a lower but floating short term rate. The Fed expects to increase rates 3 times this year and perhaps 4 times next year. No longer is the Fed a net buyer of bonds (with newly printed money) but is instead taking money out of the economy. The effect should be higher interest rates, and no longer does "loose" money offer a tail wind for higher equity prices. The "tech" sector represents 25% of the S&P500, nearly double the norm and about what is was at the top of the Dot.com mania. The relationship between tech and utilities (aggressive vs defensive) is also the greatest since the top of the Dot.com era. Last year we had no daily moves of 2%, we have had 7 so far this year. The Daily Sentiment Index for both S&P 500 and Nasdaq futures reached the most extreme levels in their history. The S&P 500 has lost value, on average, when the ratio hits 2:1, it is currently 4.7:1. A similar history for the Schiller P/E ratio exists, on average the market loses money when the index exceeds 18, it is 30 today. 87% of the time, the market trades cheaper than today (based on prices relative to GDP). Adjusted CAPE, is now beyond both the 1929 and 2000 extremes, placing current market valuations at the richest level in U.S. history. Most of these relationships were valid a year and two years ago, yet the market continued higher. We may be going through an adjusting period prior to another leg up. The economy and politics must provide no downside surprises or the first quarter will become normal. The past few years have been different, but the question is always; for how much longer?

Bond rates fuel the world. When the world's central banks took rates to zero and below, the value of a dollar of stock dividends increased, the value of growth increased, housing values increased, collectables increased, and the list goes on. But interest rates bottomed in mid-2016 and have been rising since. A line could be drawn on a chart that showed declining interest rates for 35 years. That line is now broken. Since mid-year 2016, the long bond generated an income of 2.7%, and a loss of 20.4%, netting a loss of 17.7%. The 10 year bond earned 2%, and lost 12% in value for a net of -10%. The five year bond netted a 5% loss. Short bonds (less than 2 years) actually had a positive return.

Scott's Thoughts (continued)

But the bond market may be telling us what is troubling stocks. A yield curve shows the relationship among rates at varying maturities. Normal might be a 4% short term rate, a 6% intermediate maturity rate and perhaps a 7% rate for the long term maturity. Historically an investor would be paid more for a longer commitment. Thus, 4% for short term bonds and 7% for longer term bonds. In mid-2016, the 2, 5, 10, and 20 year rates were .9%, 1.4%, 1.8%, and 2.25% respectively. The 5 year rate was half again higher than the 2 year rate, while the long bond was 2½ times higher. Today the rates respectively are 2.3%, 2.5%, 2.7%, and 2.9%. The 5 year rate is not half again higher but instead only 1/10 higher, and the long bond is not 2½ times more, but only a quarter more. This is termed a "flattening yield curve". An inverted yield curve is when short term rates are higher than long term rates. Think back to 1980, the curve was inverted when a short term CD paid 24%, and the long bond paid 15%. Inverted yield curves typically occur just prior to and during recessions. By necessity, an inverted yield curve is always preceded by a flattening yield curve. The bond market is worrying investors because it is acting as though a recession may be coming. The bond market is a smart asset group, but its' concerns do not always become reality. Stocks, are watching the bond market and their volatility reflects the bond market's concern with the economy's future.

The markets may very well get back to recent norms, as extraordinary as that is, but the markets seem more fickle today. As an example: The Consumer Price Index (CPI) number was going to be announced on Wednesday the 14th of February (not the March announcement mentioned above) at 8:30 in the morning, an hour prior to the NYSE opening. The CPI was anticipated to be near a .2% increase for the month of January. Annualized this would work out to nearly 2.5%, which is only slightly more than what has been the norm lately. At 8:30 the number was announced, a .5% increase in the CPI, double the expectations. Immediately the Dow Jones futures dropped 500 points. The thinking was that if inflation was actually heading higher, the FED would be justified raising rates quicker than expected and equities tend to dislike higher interest rates. Bonds moved much lower, raising interest rates to this year's highs and gold shot straight up as it normally does when inflation becomes a concern. However, the stock market opened up, wiping out the anticipated 500 point decline, and closed the day up nearly 250 points. Why? In the hour prior to the opening of the NYSE, traders began to think that if inflation was increasing, and the FED might raise rates quicker, then obviously the economy is doing better than everyone had thought. And if the economy is better than expected, why wouldn't you buy stocks?

The morning traders who took the stock market down 500 points reacted to the higher CPI number as one would expect, they sold. Which, historically was the right thing to do. But not always is "bad" news bad. Sometimes "bad" news is good, and February 14th demonstrated that.

We should expect more economic uncertainty resulting in more market volatility. And surely the mid-term election will impact the "Trump rally" (whichever way it goes).