October 23, 2017

Dear Client:

As has become a trend, the quarter just ended witnessed a good deal of noise but very little signal (with the possible exception of escalating tensions with North Korea), giving us an opportunity to tackle a critical question: Where are we in the lifecycle of the ongoing bull market, which dates all the way back to March 2009?

There is an irritating tendency that we've observed among economic and market commentators in the popular press, which gets worse as a bull market wears on, to be perpetually calling for its end. This kind of covering-one's-posterior pessimism is convenient because one will inevitably be correct eventually, yet utterly useless because these pundits almost never spell out the mechanism and timing of the impending collapse. (To be clear, we're not saying that all negative commentary is valueless, merely that it should be nuanced and specific, and that forecasters should hold themselves accountable.) Let's examine a handful of the most common rationales we've encountered recently for why the market is bound to roll over sooner or later, from the simplest to the most sophisticated.

The current bull market has already lasted longer than any other since the Second World War save that of the 1990s, so it's bound to come to an end soon. This is the laziest of all the arguments for why the end is nigh, and we dealt with it near the end of our previous letter. In short, economic expansions and bull markets do not have expiration dates or life expectancies; they die of concrete and observable causes (in retrospect if not in advance, that is). Of course, an exogenous shock could come along at any time and decimate the market, but that is always the case (we touch on a handful of potential sources of such a shock later on, as we do in virtually every letter). Meanwhile, the endogenous economic indicators that typically signal when the business cycle is entering the contraction phase are far from flashing red. The ongoing expansion has been remarkable for its gradual and moderate nature as much as for its duration, the former likely having helped to cause the latter by curbing the buildup of economic distortions and speculative froth. And in the absence of such excesses, there is no inherent reason why the recovery and bull market cannot go on for longer still.

P/E ratios are high, and since P/E's are mean-reverting, we can expect subpar returns over the next decade or so. This too is a simplistic line of argument, and it exhibits a crippling blind spot: The P/E ratio as a data point has no intrinsic worth apart from the prevailing interest rate environment. Put it this way: Given an interest rate of X, you might be willing to pay price P for the forecast earnings of a company or the stock market as a whole. But if instead interest rates were $.5X$, holding everything else constant, you would likely be willing to pay substantially more than P for those same future cash flows. Why? Because you could earn only half as much elsewhere in bonds. To look at the actual numbers, the last time so many commentators could be heard talking about a stock market bubble was with IT stocks in the late 1990s – a bona fide bubble indeed – when the forward P/E ratio of the S&P 500 eclipsed 25; in late 1999, both the fed funds rate and the rate on the 10 Year Treasury were north of 6%. Today, by contrast, the fed funds rate is 1.25%, and the 10 Year is at 2.38%; the P/E ratio on S&P 500 forward earnings is roughly 18 – somewhat high historically when taken in isolation, but not in the context of extraordinarily low short- and long-term interest rates. And as for mean reversion, one could expect P/E ratios to revert to historical norms only if inflation and interest rates were to do the same, of which there is no guarantee over the short to intermediate term and in fact a great deal of evidence to the contrary (we will get to the crucial subject of inflation and interest rates in just a moment).

*The Shiller CAPE ratio (the **C**yclically **A**djusted **P**rice-to-**E**arnings ratio of the S&P 500 based on average earnings over a trailing ten-year period) is now above where it was in 1929 and has been higher only once, during the dot-com bubble – an ominous indicator for valuations.* Here we have a somewhat more nuanced version of the more straightforward P/E ratio argument above, but it suffers from the same basic shortcoming and an additional one to boot. While Shiller CAPE is worth paying some attention to by virtue of adjusting for the noise of short-term earnings fluctuations, it still has no immediate utility outside the context of inflation and interest rates. Moreover, it just so happens that, at the present time, the trailing ten-year window over which the average earnings in the denominator of Shiller CAPE are calculated still encompasses the Great Recession, one of the worst earnings slumps in modern U.S. economic history. As the horrendous

period from the end of 2007 through late 2009 drops off the back end of that average over the next couple years, the Shiller CAPE ratio will no doubt come down dramatically no matter what equity prices do.

The current bull market has been driven overwhelmingly by easy money – and with unemployment having fallen to 4.2%, inflation is bound to pick up soon, forcing the Fed to raise interest rates and thereby end the party. At least this argument takes account of interest rates and features a clear causal mechanism and implicit timetable, but we nevertheless take issue with both its premises and its conclusion. First of all, while we clearly believe that historically low interest rates have helped to fuel the market, they have not been the only thing sustaining it; earnings growth has been consistently respectable since late 2009. In addition, as we've discussed in depth in previous letters, we believe that the headline unemployment rate continues to mask significant slack remaining in the labor market – as evidenced by the generationally low labor force participation rate – in the form of discouraged, temporary, and underemployed workers. Whether or not all of these people are capable of returning to full-time occupations commensurate with their training and education, their mere existence around the margins of the economy has the effect of increasing the potential supply of labor, thereby keeping a lid on wages and inflation. Moreover, even if we're wrong on this point and the labor market has tightened meaningfully of late, then it must be the case that the Phillips Curve – the theoretical and historical inverse relationship between unemployment and inflation – has broken down somewhere along its causal chain (the globalization of the labor market would likely play a role here by allowing employers the luxury of responding to any incipient wage pressure by shipping jobs overseas). One way or the other, inflation remains moribund – and without any inflationary pressure to speak of, the Fed will have difficulty raising interest rates much beyond where they are now.

So, having dispensed with the foregoing arguments, let us return to the original question: Where are we in the lifespan of the current bull market? While it is impossible to say with real precision, we see no reason to believe that we are definitely in its late innings. If anything, the domestic and global economies appear to be picking up a bit – but, as we just discussed, without the sort of inflation that would compel monetary tightening. Although notoriously difficult to predict (and as a wise man once said, prediction is difficult, especially about the future), earnings continue to look broadly healthy. And as noted above, the relevant economic indicators do not paint a picture of an expansion in its late stages, whether due to overheating or to running out of steam. Perhaps most important of all, ours remains the most unenthusiastic bull market in recent memory; there can be seen virtually none of the exuberance that typically characterizes market tops. If and when such exuberance appears, as it did with technology in the late 1990s and housing in the middle of last decade, it will be an indication that all potential buyers are already in the market – and that is when we would start to question the market's valuation.

In the meantime, it is much more likely (as is usually the case) to be the *E* part of the P/E ratio that does the market in. While, as we talked about above, earnings do not yet appear to be under pressure from factors intrinsic to the business cycle, there are extrinsic variables to consider. Both the domestic and the global political environments are highly volatile, to say the least. With respect to the burgeoning nuclear standoff with North Korea, we have no analysis to add to the conversation and really nothing to say at all except that we fervently hope the recent saber rattling remains just that. As for the domestic picture, while financial markets doggedly continue to shrug off the ongoing political melodrama, that does not mean they are destined to do so forever. And as we explained in our most recent letter, likely our greatest concern here remains the question of what happens if the economy and/or the stock market begins to roll over even slightly as a result of any number of mundane variables. Whereas in a more placid political environment such a scenario would not necessarily be cause for alarm, in the current context even a comparatively run-of-the-mill downturn could turn into something more serious. Needless to say, we will continue to monitor domestic and international political developments closely and reserve the right to reposition our portfolios as we believe to be necessary.

That said, as should be clear by this point, our basic assessment of the underlying economic environment as it relates to the twin factors that matter most to stock prices – earnings and interest rates – remains broadly unchanged. The ongoing expansion continues along the "goldilocks" path of slow-to-moderate growth – neither cold enough to risk rolling over nor hot enough to be in danger of overheating – accompanied by levels of inflation and interest rates that remain extraordinarily low by historical standards. In such a climate, equities continue to be the only game in town, and we remain bullish on the stock market.

If there have been any changes in your investment objectives or in your personal or financial circumstances, or if you have any questions or comments, please give us a call.

Sincerely,

Michael G. Hofkin

Benjamin J. Hofkin

(A copy of our disclosure brochure is available upon request.)

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