

October 4, 2018

*If it walks like a duck and quacks like a duck, then it is probably a duck. By the same token, if central bank reserves are shrinking, the US dollar is rising, and emerging market currencies are cratering, we probably face a liquidity squeeze.*

Louis-Vincent Gave, 09/10/2018  
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**On the U.S. stock market (or, “Are portfolio managers ever really happy?”).**

I have some good news and some bad news: the U.S. stock market, as measured by the S&P 500 index, reached a new all-time high in September.

The good news: The new high level mark in our stock market reflects many positives in our economy, including the highest sales and earnings ever reported by the businesses represented in the U.S. stock market, the highest quarterly economic growth since 2015 (4.1% 2<sup>nd</sup> quarter GDP growth), the lowest unemployment rate since 2000, the highest consumer confidence since 2000, the highest level in the ISM services index since created in 1997 and the highest small business confidence reported in 45 years.

The bad news: The stock market also reached a new all-time high valuation as measured by the price-to-sales ratio in the 3<sup>rd</sup> quarter. Price-to-sales on the S&P 500 is calculated by taking the market capitalization of all the stocks in the index (market capitalization of a stock is the price of the stock times the number of shares outstanding) and dividing that by the combined sales of the underlying businesses over the last 12 months. This is not a short-term indicator of stock market direction. It is one of my favorite long-term valuation metrics and is highly correlated with future stock market returns over 10-12 years. All else being equal, a new all-time high in stock market valuation means it will be harder to make money in stocks going forward (not that the world always stays equal!).

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3<sup>rd</sup> Quarter and year-to date index returns:

Index	3rd Quarter 2018	Year to date 2018
S&P 500 (U.S. stocks)	7.71%	10.56%
Dow Jones Industrials (U.S. stocks)	9.63%	8.83%
EAFA (Europe and Japan stocks)	0.71%	(-3.08%)
U.S. Aggregate Bond Index	0.02%	(-1.60%)

U.S. stocks have been the place to be in the first 3 quarters of 2018. Negative returns for the year in international stocks and U.S. bonds have clearly been a drag on diversified portfolios (for now). While U.S. stocks have been more volatile this year than in 2017, heading toward a more “normal” level of volatility, the returns in the S&P 500 and the Dow year-to-date have made it worth the ride.

As noted in the “good news” section above, U.S. economic statistics are strong. Outside of some sluggishness in housing, autos and specific businesses impacted by tariffs, optimism is high. On the fiscal side, tax cuts and additional deficit spending have provided a stimulus to domestic growth. On the monetary side, Federal Reserve interest rate hikes and unwinding of quantitative easing (QE)

do not appear to have become a material drag on U.S. growth. Overseas, Europe's and China's manufacturing numbers have been slowing. How tariffs and trade disputes with the U.S. are factored into these slowdowns is hard to determine, but a recent step forward on updating the NAFTA agreement between the U.S., Mexico and Canada seems to have eased some of the worst-case scenario fears around the current synchronized global growth backdrop. Finally, U.S. interest rates have continued to tick up with Federal Reserve (the Fed) interest rate hikes. As I write this on October 4<sup>th</sup>, the yield on the 10-year U.S. treasury note finally broke above this past May's high and reached 3.2%, the highest since 2011. As interest rates move higher current bond prices are depressed, but the long-term benefits of higher interest rates on future bond market returns is a welcome sight!

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### **Ten years after.**

It's hard for me to believe it has been ten years since we entered the depths of the Great Recession. Acknowledging that participation in the recovery and subsequent growth in our economy and asset prices has been unevenly distributed, in large part rewarding asset owners disproportionately, the overall results to date have been far beyond my most optimistic outlook from that time. However, before we pat ourselves on the back for a job well done, there are a couple of disturbing facts that indicate the road to global financial health is long and winding:

- 1) The European Central Bank and the Bank of Japan still have negative interest rates and are still printing money to buy financial assets.
- 2) According to the Institute of International Finance, total global debt has increased from \$142 trillion at the end of 2007 to over \$247 trillion at the end of the 1<sup>st</sup> quarter of 2018. As a multiple of total global economic output, the amount of debt has grown from 269% to 318%, the highest ever.

### **Global liquidity and the U.S. dollar.**

When the Fed is tightening monetary policy domestically, it is also shrinking global liquidity. The U.S. dollar is the dominant global reserve currency. According to the Federal Reserve Bank of New York, 85% of all currency trades include the U.S. dollar and 39% of outstanding global debt is denominated in the U.S. dollar. In the quote that opens this letter, Mr. Gave identifies symptoms of a global liquidity squeeze that are already being felt. A liquidity squeeze means it is harder for borrowers, starting with the "weakest" borrowers, to refinance or repay their debts (and harder for imprudent lenders to get paid back!). The big picture warning is that a contracting world money supply can lead to an economic slowdown and, potentially, a global recession. Ten years after the worst financial crisis of our lifetime, as Peak scans the economic landscape for problems that could ignite the next crisis, contracting global liquidity is starting to expose some cracks.

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We appreciate your business and we continue to work hard to earn the trust that you have placed in us. Please let us know if you have a friend or family member that could use our assistance.

John McCorvie, CFA