Economic & Market Update, March 2017

Is the Stock Market in an Historically Dangerous Bubble?

By Richard Morey

This month we are going to share research and insight from three of the best economists in the country. The topic is the price of stocks today. We will begin with Dr. John Hussman, who has been one of my main sources of investment information every week for the last 15 years. The reason I decided to include excerpts from two of Dr. Hussman's recent market commentaries is that they are eerily similar to what he wrote at the top of the market in January of 2000 and from late 2007 until the market crashed in 2008. In both of those time periods he warned, again and again, that the market was in grave danger.

Of course, in 2000 and 2007 the financial media and most investors either ignored or ridiculed Dr. Hussman. The ridicule was particularly intense in early 2000 when he said his models showed NASDAQ would need to decline by 83% in order to be fairly valued. The ridicule eventually stopped, particularly when the tech-heavy NASDAQ index had dropped exactly 83% at its bottom in 2002! (The broad stock market indexes such as the S&P 500 dropped over 50%.) Going against Dr. Hussman's analysis of how over-priced stocks are is dangerous to one's financial well-being!

As you can read below, Dr. Hussman is now warning that a stock market collapse worse than what occurred in both 2000-2002 and 2008-2009, and surpassed only by the carnage that began in 1929, is now essentially a certainty. And while he has never attempted to tell us exactly when it will occur, his warnings are now more "stern" than I have ever read – including right before the beginnings of the 2000 and 2008 crashes.

I would also note that while Dr. Hussman has never been able to specify exactly when the stock market will collapse, he actually has been able to call the bottom, within approximately 1-2 months, for every bear market in the last 30 years. This is an incredibly important and valuable fact, as I assure our readers I will be listening closely when he says we have reached the bottom and it is now time to begin buying stocks. (Note: The full text of Dr. Hussman's reports can be found at www.hussmanfunds.com).

February 13, 2017
Time-Stamp of Speculative Euphoria

John P. Hussman, Ph.D.

If there's any point in U.S. stock market history, next to the market peaks of 1929 and 2000, that has deserved a time-stamp of speculative euphoria that will be bewildering in hindsight, now is that moment. Perhaps there's room for this burning wick to shorten further, but across every effective, value-conscious, historically-informed classification method we use, the estimated downside risk of the market overwhelms its upside potential…

The difference between value-conscious investors and speculators is that when they encounter a sign that says "Warning! Dynamite" and see a lit wick at their feet, every inch the wick shortens is a signal for the value investor to step further away. The speculator instead moves closer, taking the delayed consequences as evidence that it's different this time, and the sign is wrong. There have certainly been longer and shorter wicks, but ultimately, the consequences have always arrived.

On valuations, earnings, and taxes

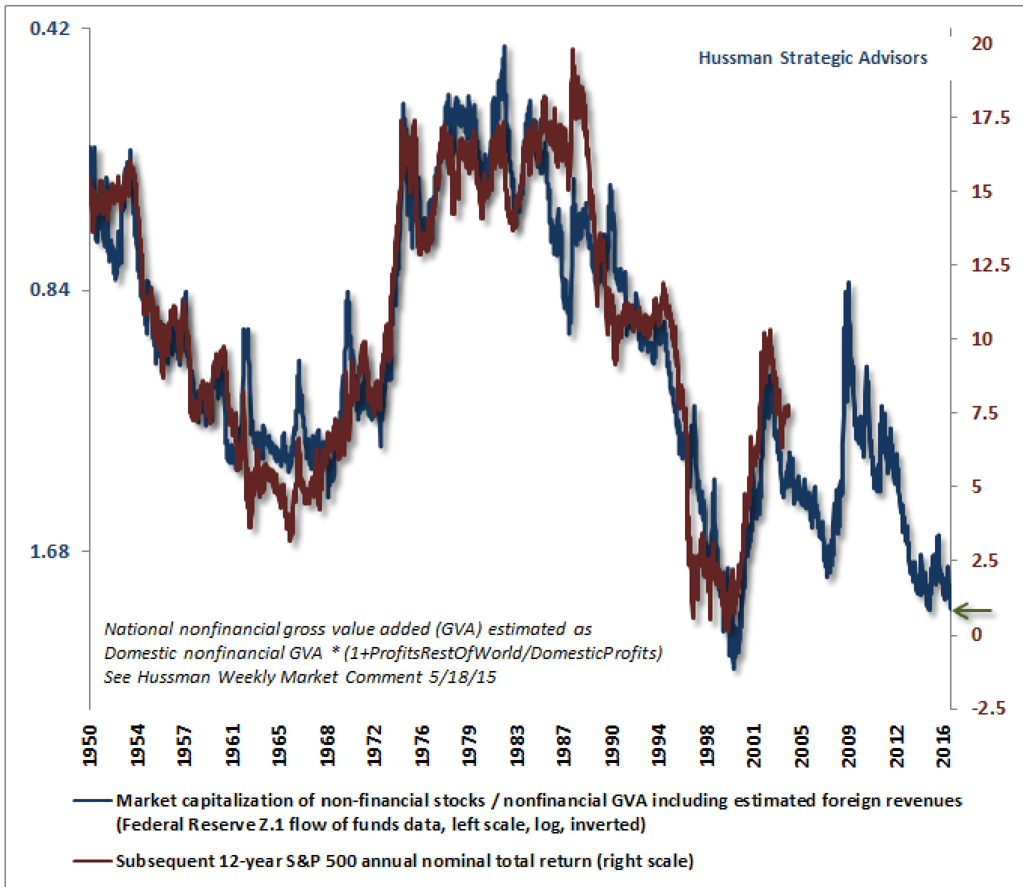
We can't be certain that current extremes won't be eclipsed, as higher valuations were observed for nearly three months approaching the March 2000 market peak (based on measures that have the strongest correlation with *actual subsequent* returns in market cycles across history). Still, we don't encourage relying on that as a target…

The fact is that the present speculative episode features what are already the most extreme *median* stock valuations in history…

The late-1990's bubble focused the greatest distortion on technology and internet stocks, and was followed by a -50% loss in the S&P 500 and an -83% collapse in the tech-heavy Nasdaq 100. The next bubble into 2007 was broader, but was still dominated by financial and mortgage-related speculation. That bubble was followed by a 55% loss in the S&P 500 during the global financial crisis. The current bubble has been driven by years of Fed-induced yield-seeking speculation, and has infected risk assets from global debt, to junk bonds, to every corner of the equity market. My friend Jesse Felder of The Felder Report appropriately calls this the "everything bubble."

The chart below shows the ratio of nonfinancial market capitalization to corporate gross value-added (MarketCap/GVA), which we find to be better correlated with actual subsequent market returns across history (and even in recent market cycles) than numerous popular measures including price/earnings, price/forward operating earnings, the Fed Model, Tobin's Q, the Shiller cyclically-adjusted P/E, and even Warren Buffett's old favorite, market capitalization/GDP. MarketCap/GVA is shown on an inverted log scale (blue line, left scale) along with the actual subsequent S&P 500 average annual nominal total return over the following 12-year period (red line, right scale).

At present, our estimate based on this and other reliable measures is that the S&P 500 is likely to scratch out a barely positive total return between now and 2029, with all of that gain coming from dividends, leaving the S&P 500 Index itself lower at that date than it is today. That shouldn't be a terribly surprising statement. The S&P 500 didn't durably break its March 24, 2000 high of 1527.46 until March 5, 2013. I expect the completion of the current cycle will not only revisit that level on the S&P 500, but that it will also wipe out the entire *total return* of the S&P 500 since 2000. Those are the long-term consequences of extreme overvaluation, and they have been throughout history.



Remember that the S&P 500 registered negative total returns for a buy-and-hold strategy for the nearly 12-year period from March 2000 all the way to November 2011. I expect that's about what we'll observe from current extremes. While investors seem eager to lock themselves into passive strategies that have performed well in the rear-view mirror of this climb to obscene valuations, I expect the greatest asset to investors in the coming decade will be adherence to a flexible approach that reduces risk in response to extreme valuation and divergent market action, and embraces risk in response to material retreats in valuation that are coupled with early improvements in the uniformity of market action. As I noted last week, my view is that passive, value-insensitive investment strategies are at the beginning of another long winter, while value-conscious, risk-managed, full-cycle investment disciplines are approaching the first day of spring…

Changes in tax policy are unlikely to alter matters much. Investors should recognize that effective corporate tax rates (actual taxes paid/pre-tax income) have already declined from 50% in the 1950's to less than half that level at present. Even if the effective corporate tax rate was suddenly and permanently cut in half, the incremental long-term boost to the level of corporate profits, from here, would be hardly 10%. Our view is that the U.S. equity market currently prices in all of the potential benefit, and none of the prospective instability, that the current administration is likely to introduce…

As for prospective losses, we continue to expect a collapse in the S&P 500 in the range of 50-60% over the completion of the current market cycle, which would actually only bring the most reliable measures of valuation to historically run-of-the-mill norms.

My sense is that these estimates of prospective loss seem as preposterous as those I correctly projected at the 2000 and 2007 peaks…

We know how this works, because we've seen it in real-time before. When the market begins to lose several percent of its value by the day (and I believe it will), I suspect that investors will wonder why they were so profoundly eager to chase potential gains that had little chance of being durable or worth the risk, and why they were so profoundly averse to accepting the risk of small losses in defensive positions that could have ultimately prevented or reversed their misfortune.

… Here and now, our estimated return/risk classifications remain sharply negative, and we observe a preponderance of risk signatures that we associate with steep losses or sharp interim drawdowns on nearly every horizon beyond a few weeks.

February 20, 2017
When Speculators Prosper Through Ignorance

John P. Hussman, Ph.D.

"No Congress of the United States ever assembled, on surveying the State of the Union, has met with a more pleasant prospect than that which appears at the present time."
- Calvin Coolidge, December 4, 1928

"There can be little argument that the American economy as it stands at the beginning of a new century has never exhibited so remarkable a prosperity for at least the majority of Americans."
- Alan Greenspan, January 30, 2000

"We believe the effect of the troubles in the subprime sector on the broader housing market will be limited and we do not expect significant spillovers from the subprime market to the rest of the economy or to the financial system."
- Ben Bernanke, May 17, 2007

"Investors haven't been this optimistic on the global economy since 2011... A full 23 percent of investors expect an outright 'boom,' according to a survey released Tuesday by Bank of America Merrill Lynch... 'The U.S. economy is not only humming on all cylinders, but in our view the optimism associated with a clean sweep by the Republicans in Washington is likely to create a self-fulfilling period of strong markets and at least the potential for strong growth.' The optimism comes amid forecasts global growth will pick up and as Donald Trump promises to cut taxes, boost fiscal spending and loosen regulations in moves that could boost corporate earnings. 'Macro optimism is surging,' wrote the team."
- Bloomberg, February 14, 2017

As Benjamin Graham observed decades ago, "Speculators often prosper through ignorance; it is a cliché that in a roaring bull market, knowledge is superfluous and experience is a handicap. But the typical experience of the speculator is one of temporary profit and ultimate loss."

The reason they (strategies that profit when stocks drop but lose when stocks rise) are underused, even in hyper-valued markets, is because of a herd-following anomaly of temperament among investors, which allows them to tolerate losses that occur when other investors are also losing, but to practically burst a vein if those losses occur in periods when other investors are gaining. Those investors often abandon their positions at the worst possible point in the market cycle, and it may be best for them to avoid alternative investments entirely. The main objective can then be simply to align their exposure to various long investments according to their risk-tolerance and investment horizon.

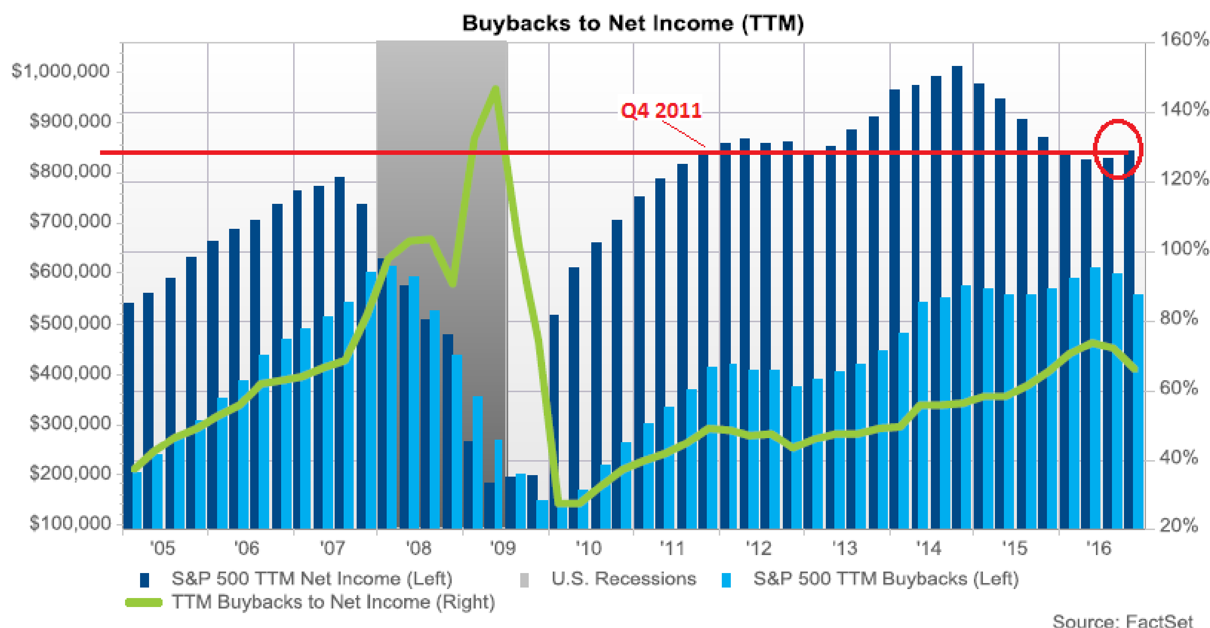
For now, Wall Street seems to love every bit of it. Then again, we should repeatedly have learned that once blinded by speculation, Wall Street has never had the capacity to recognize a massive toxic liability until it implodes and rains havoc on the entire country. Given historically offensive overvaluation, extended by a post-election blow-off (see Time Stamp of Speculative Euphoria), an economic environment lacking the precursors for sustained growth (see Economic Fancies and Basic Arithmetic), and a mode of governance that practically courts disruption (see On Governance), I expect that the next few years will not go well for risk-seeking strategies, except those explicitly constructed to benefit from market weakness and volatility. The word "risk" has taken on a purely theoretical connotation in recent years, to the extent that it is now seen as equivalent to "return." Investors are likely to rediscover that its actual meaning is quite distinct, and devastatingly real.

Additional Perspectives

While Dr. Hussman's views tend to be indisputable, backed by an enormous amount of research and historical facts, we of course always draw upon a small but trustworthy group when forming conclusions about the economy and markets. The following information on corporate earnings comes from David Stockman (at www.contracorner.com) . I have found Mr. Stockman to be an invaluable resource, particularly when it comes to finding the "real" numbers from all the reports and opinions put forth each month by the government as well as the financial media. He has a big advantage in this respect over most economists and analysts, having been the Budget Director of the United States. We'll first look at the actual state of corporate earnings. If you listen to CNBC, Fox Business News, or Bloomberg, you will almost always hear them saying last quarter's corporate earnings turned out to be much better than expected, while earnings are projected to be phenomenal over the next year. Here are the actual facts on the topic of earnings:

"With over 90% of companies reporting their results for the fourth quarter, the S&P 500 companies earned $26.37 per share last quarter. This was less than the $26.48 a share they made in the fourth quarter of 2013." The chart below, from FactSet, shows that the companies in the S&P 500 have seen their net income (revenue minus expenses) fall all the way back to where they were in the 4th quarter of 2011 (see the red

line). <u>So corporations haven't improved financially for a full five years, yet their prices are at all-time highs?</u> Something has to give.



In discussing the fact corporate earnings peaked in 2014 and have been falling since that time, in a recent report David Stockman warned of two other key worrisome financial facts:

1) Bank lending has now started to go down. About this development Stockman wrote, "So the fact that loan and lease credit is now shrinking implies loan performance troubles and losses ahead, not an eruption of new business activity and profits.

2) After peaking (at a paltry 2%) in 2015, as of January of this year real average hourly earnings growth has now fallen to 0%. Stockman's view of this is, "Consequently, real average hourly earnings have now returned to the zero-bound on a year over year basis. And there is no historical ambiguity about the meaning of that development. The U.S. economy – especially the current debt saturated variant – has never launched into a renewed pulse of growth 92 months into a business cycle expansion – with real wage growth at 0.0%."

We will conclude this month's report by sharing research and insight from another of the best group of economists in the country. The following comes from 720 Global, an "investment consultant, specializing in macroeconomic research, valuations, asset allocations, and risk management." Their most recent report was entitled "*Second to None: Valuations Compared to Fundamentals.*"

"*Today's equity market valuations have only been eclipsed by those of ~~1929~~, and 1999*." Given the continuing equity market rally and multiple expansion, the quote above from prior articles had to be modified slightly but meaningfully. As of today, the S&P 500 Cyclically Adjusted Price to Earnings ratio (CAPE) is on par with 1929. It has only been surpassed in the late 1990's tech boom."

The remainder of the article was devoted to explaining why the stock market is actually at much greater risk today than it was in 1999. Even though stocks were (slightly) more overpriced in 1999, making it the largest bubble in U.S. history, the economy is now much, much weaker today than it was at the end of the 1990s. The following chart illustrates this fact quite clearly:

720GLOBAL	1995-1999	2012-2016
GDP Growth	4.08%	1.90%
GDP Trend	2.30%	1.80%
Productivity Growth	1.84%	0.49%
Federal Debt (Trln$)	5.36	17.47
Federal Debt : GDP	60.23%	101.40%
Personal/Corp. Debt (Trln$)	15.493	41.11
Personal/Corp. Debt : GDP	156.09%	220.13%
Govt. Deficit (% of GDP)	-0.33%	-3.29%
10-Year Tsy. Rate	6.05%	2.13%
Fed Funds	5.38%	0.18%
S&P 500 3yr Earnings Growth	7.53%	-3.84%
S&P 500 5yr Earnings Growth	9.50%	0.49%
S&P 500 10yr Earnings Growth	7.74%	0.89%

Their article then concluded with the following:

"Given the declining trend of GDP and the correlation of earnings to GDP, it is fair to deduce that GDP and earnings growth trends were healthier in the late 1990's than they are today.

As shown, economic growth in the late 1990's was more than double that of today, and the expected trend for economic growth was also more encouraging than today. Trailing three, five, and ten-year annual earnings growth rates contrast the current stagnant economic growth versus the robust growth of the 90's. Additionally, various measures of debt have ballooned to levels that are constricting economic growth and productivity. Historically low interest rates are reflective of the current state of economic stagnation…"

"Equity valuations of 1999, as proven after the fact, were grossly elevated. However, when considered against a backdrop of economic factors, those valuations seem relatively tame versus today. Some will likely argue with this analysis and claim that Donald Trump's pro-growth agenda will invigorate the outlook for the economy and corporate earnings. While that is a possibility, that argument is highly speculative as such policies face numerous headwinds along the path to implementation. Economic, demographic and productivity trends all portend stagnation. The amount of debt that needs to be serviced stands at overwhelming levels and is growing by the day… Given such a stagnant economic outlook, there is little justification for paying such a historically steep premium for what could likely be feeble earnings growth for years to come."

Summary

The stock market is now in the second largest bubble in history – second only to the tech bubble that ended in 2000 with 83% losses for the tech-heavy NASDAQ index and 50% for the broad stock market. Yet the risk today is actually substantially higher, as the economy is so much weaker today than it was then.

When you put all the pieces together, we find the stock market is more dangerous today, and is nearly certain to experience larger losses, than at any time other than during the Great Depression.