SMALL BUSINESS OPTIMISM HELPS LARGE CAP COMPANIES

- The U.S. economic expansion is now eight years old and has a chance of being the longest on record, surpassing the decade long run of the 1990s.
- The U.S. stock market is expensive, but continued strong corporate earnings growth is keeping valuations in check, allowing for continued stock gains in the presence of low inflation and a slow-going Fed.
- Stock market volatility has been largely absent for years. A shallow stock market correction of 5-10% is all but inevitable as the natural tendency of all things is to revert to the mean. The timing, as always, is unknown.

US ECONOMIC OUTLOOK FOR THE SECOND HALF OF 2017

Believing we can offer precise expectations for US economic growth, as measured by Gross Domestic Product, over the final two quarters of the year is hubris. To accurately predict the GDP of even a current quarter of a massive economy is rather difficult. The estimates at the beginning of the quarter change virtually daily as new information is gathered. Forecasters who get the number closest are initially celebrated, then later panned as there are several revisions months later due to refined data. So we generally focus on three factors, of which precise forecasting is not a consideration. First, will the economy surprise to the upside or the downside? Second, what factors are contributing or detracting from overall growth? And, third, are we going into a recession?

But, it's a fun exercise. And we really do have to come up with some number to focus on those first three factors. We expect US GDP to be about 2.3% in 2H 2017, which is above 2016 growth of 2.0% and the average of 2.1% for this entire expansion. (We will see if we are right in seven months, then wrong in seventeen months!)

We are typically hesitant to get too far into the weeds on this math. Not because we're necessarily concerned about releasing some sort of propriety algorithm, rather because most readers find it…boring. Talk of the National Financial Conditions Index, the ECRI Weekly Leading Index, or the ISM Manufacturing & non-Manufacturing Indices, or Initial Claims for Unemployment Insurance (still with us?) does little to further the conversation. But, geeky as we are, we enjoy this sort of stuff, so we'll share some of it. Also, we'll share some of it because it validates much of what else we say. We want you to trust what we say, but we also want to provide verification.

The overview is as follows. No individual economic indicator we track, and consider reliable, is flashing recession to us. Most are showing growth or trending toward growth. This is constructive not only because of the obvious (nothing is bad; most are good), but also because this means the breadth is positive. In other words, there are no individual components that are turning over to suggest others

may follow. Not to say that couldn't change quickly, but to get a number of individual indicators to begin turning down simultaneously is typically more of a process, not an event, suggesting that any recession is currently past the proverbial horizon.

Factor one: We are too close to consensus to invest based on the expectation of under- or over-performing. Factor two: Contributing factors are widespread and strengthening. Factor three: No recession.

Maturity isn't always a good thing

The U.S. economic expansion is eight years old this month. That makes it the third longest expansion on record, following the nine-year-long expansion of the 1960s and the decade-long expansion of the 1990s. The average length of expansions since World War II has only been about five years.

It is important to note, expansions do not die of old age. They die of excesses reverting to the mean. In the 1960s there was a tremendous amount of fiscal spending in an effort to fund the Vietnam War and the Great Society polices, as well as accommodative fiscal policy. The resulting high inflation had to be fought by reverting monetary policy to the mean (higher interest rates) at the same time much of that fiscal stimulus reverted to the mean (i.e. went away). In the 1990s the technology expansion became a bubble, and the reversion to the mean was stalled capital expenditure spending as well as stock price valuations leveling off.

This expansion has the possibility of becoming the longest on record since it doesn't appear to have the same type of excesses that cause economic growth to contract. Fiscal policy, it can be argued, has been neutral. There was the American Recovery and Investment Act of 2009, but since then there was a government shut-down and long, stretched-out flirtations with breaching the Treasury debt limit. Interest rates have been going up, but at a very steady pace. The stock market, we would argue, is expensive, but certainly not in bubble territory. Also, job creation has been broad-based throughout industries which is a positive because multiple sources of growth suggest a more stable economy that could last longer.

US Equity Outlook for 2H 2017

On the subject of "reversion to the mean", can we all just agree that the stock market will (soon?) correct 5-10% and that we will all be ok? Aside from some relatively mild movement around the Presidential Election, volatility for stock prices has been virtually non-existent for two years. Three-and-a-half times per calendar year the stock market corrects five-percent from an intermediate top, on average. And, on average, the stock market corrects 10% every fourteen months. It is going to happen. And it is not going to be fun when it happens. But it does happen. And we do all forget about it shortly thereafter. This time, because volatility has been so low for so long, one could reasonably argue that the emotional pain points we typically feel will be augmented and/or felt earlier in the decline. We believe that this pain will be short-term.

There was certainly volatility in the final months of 2016, as the stock market whipped to the upside after a mild five percent pullback followed by a surprise Republican victory for the presidency and the ensuing rally in stocks. As 2017 unfolded, much of the stock market hope of deregulation, infrastructure spending, and tax cuts were pushed off as health care reform struggled. Still, the stock market went up.

We propose that the stock market did not go up on hope alone, but rather that the timing of that narrative was coincident to stock prices shrugging off a healthy dose of skepticism after that aforementioned five percent pullback while corporate earnings growth became healthy again after six quarters of stagnation.

Can "hope" be a reason for some of the rise in stock prices? Absolutely. Hope, or "optimism" by another name, allows for animal spirits to come alive and it manifests in hiring, investing, consumption – the things that make the economy and corporate earnings grow. But the rate and timing of the change in corporate earnings growth and its turnaround was more about the business cycle than it was politics. Nonetheless, so-called soft data such optimism and confidence can be and historically has been very good at flaming hard-data, such economic growth. The stock market has risen mostly based on fundamentals, but possibly some of those gains had been amplified by an expectation of pro-business government policies that did not yet come to fruition.

The second half of the year faces challenges. Some of that optimism priced into the market may go away if policy expectations fade, or flop. But more important than politics are earnings. Part of that earnings rebound was due to easy year-over-year comparisons. Those comparisons get harder by the fourth quarter of 2017. But comparisons are not a massive headwind in so much that 1) they are known (a small increase off a good number is still a good number) and 2) the market reacts more to surprises (i.e. the stock market does little when forecasts are met; the stock market moves more when there is a positive or negative surprise away from an expectation).

The bigger concern is not politics, or comparisons. The bigger concern is valuations. For decades I've cursed the conversation of valuations because it is part art, part science, and completely subject to manipulation to offer whatever narrative supports the argument you might want to make. In other words, there are a lot of metrics to gauge valuation. No matter which metric you wish to use, the stock market is expensive on an absolute basis.

(On an "absolute" basis means not relative to inflation or interest rates. Our use of "absolute" is a good example of manipulating valuation narratives – we want to be bearish in this assessment, but we can reasonably mitigate the bearishness by framing the comparison. But in this instance, we are being transparent to you and we are aware, so bias and observational fallacies are –we hope – filtered out).

The good news is that even considering the stretched absolute level of high valuations, multiples have been in check this year as earnings have also continued to grow alongside stock prices. So long as corporate earnings continue to improve (and inflation and interest rates stay low), the threat from elevated valuations can be contained. If not, then something larger than the ordinary 5-10% correction may be needed to bring valuations back in check.

Valuations aside, we are not relying on the hope of fiscal stimulus. Historically, the government has struggled to stimulate in post-election years. The cynical person might argue that it is because a presidential campaign wants the stimulus to really hit in the third and fourth year of a Presidential cycle because it is closer to election season. Whether the cynicism is warranted or not, the fact remains that historically post-election years tend to lack fiscal stimulus and tend to be challenging years for the stock market. If you mix that with the likelihood of higher short-term interest rates and full-employment often times triggering higher inflation, concerns of 2017 could create for a challenging 2018.

So we will keep our eye on those concerns. For now we see no reason to abandon our long-standing belief that we are in a secular bull market, or our more short term belief that any correction will be short-lived in both duration and magnitude. The positive trend of the S&P 500 has not only kept the index above its 200-day moving average, but the 200-day moving average itself has been rising. Most topping processes include failed rallies where that momentum is lost and the 200-day moving average begins to trend down. The correction-of-duration, or time, (as opposed to a correction of price drop) from early-March to mid-May was not enough to drive down the technical positives. Aside from fundamentals, the tape is still strong enough for us to be attracted to US equity positions.

As discussed above, the economic expansion is maturing. So, too, is the stock market. The Federal Reserve has what is called the Financial Accounts report and it can be used to compare current allocation of equities and cash to past moments in order to determine if investors are fairly fully invested, or if they have a lot of cash on hand to flow into stocks, thus pushing stock prices higher. But, unfortunately, that excess cash scenario is not indicative of today’s environment. To the contrary, most of these measures suggest that the bull market is at some stage of maturity, thus limiting long-term upside potential.

The largest holder of stocks is households. Today households have $21.3 trillion of equity holdings, which happens to be 39.2% of total household financial assets. That is comparable to the 1968 and 2007 peaks. A similar story is told by looking at institutional holdings as well as foreign holdings. When investors are fairly fully invested in stocks, the returns over the next decade are relatively poor compared to historical returns.

Excess cash held by investors is not a savior. Measures of public cash are not as underweight as 2000, but the levels are in a zone where stocks have struggled to appreciate faster than average. Unfortunately, the news gets worse. We cannot be hopeful for alternative sources of buying power by households as stockbrokers have allowed client margin debt to hit record levels.

The stock market appears to have more upside to it for the next couple of years, even if it must contend with a 5% correction here or a 10% correction there. But in the long-but-not-quite-so-long-term, we fear the effect of a recession on stock prices.

Small Business Optimism helps Large Cap Company Earnings

The U.S. NFIB small business optimism index recently hit 104.5 for the second month in a row, down from its first quarter surge to 115.3 but still well above the levels prior to the U.S. presidential election and the 2016 average of 95.3. We'll spare you the interesting details that you can dissect from this survey and instead focus on the bigger picture. The NFIB survey number predicts GDP growth of 4.3% for this quarter, above the 2.7% expectation from the Atlanta Fed's GDPNow. (OK, a couple quick interesting details. The NFIB small business survey leans right, and under Democratic presidents the average forecast error underestimates GDP growth by -0.87 percentage points, and under Republican presidents it overestimates by 0.65 percentage points. Normalizing for the traditional errors, it appears that small businesses are still more optimistic than the Atlanta Fed's numbers.)

As expected, small- and mid-capitalization companies have been performing exceedingly well. Less expected, the stock prices of large cap companies have been outperforming the stock prices of small-cap companies year-to-date. That is no reason, by itself, to chase large cap performance. Short-term performance discrepancies are normal for a variety of reasons and, quite frankly, are shrugged off by all but traders (who, admittedly, do make money) and investors manipulated by fear and whim (who lose money). We don't trade – when we invest in a position we are expecting to hold it for a long time (though, to be certain, we'll sell earlier if we either make our money or the market turns on us).

Though we are now becoming more attracted to European equities, we have been invested in virtually all domestic equities for years now (which is not always the case). Part of our duties is managing portfolio risk, which means diversifying across asset allocations, including exposure to small- and mid-cap positions for growth-oriented investors. Allocations to these asset classes, while diversifying away risk, have added gains to client portfolios as we successfully move clients closer to their goals. So we do not expect to abandon positions that are currently adding both gains as well as diversification. That is not today's conversation. Today's conversation is more about what it means as a signal to the bigger picture that small-caps have been underperforming large-caps this year.

For a while now we have been neutral on the idea of investing in Large Caps versus Small Caps. We are shifting toward being relatively more constructive on Large Caps because there appears to be a maturing of the bull market. In a mature bull market, cash flow into equities tends to be toward lower beta and less cyclical names, favoring large caps over small caps. Heightened optimism tends to be an indicator of a mature bull market. As indicated earlier, there are high levels of optimism nationally. High optimism, even when not correlated to a maturing stock market, tends to favor low-beta large-caps over high-beta small caps. This supports relative bias toward large-caps over small caps, and further supports the hypothesis that the bull market is maturing. A maturing bull market is not necessarily a good thing or a bad thing on its own. But it is part of the information we need to consider when contemplating asset class and sector allocations in your investment portfolio.

Another indicator of a maturing bull market is a flattening yield curve. A flattening yield curve is when short-term interest rates are going up while longer-term interest rates are going down. For example,

the Federal Reserve is raising short-term rates as the U.S. hits full employment while inflation is roughly at its target rate, so as to stay ahead of inflation. At the same time, the rate of the ten-year Treasury has been suppressed, implying weaker economic growth. A flattening yield curve supports our use of large-cap versus small-cap stock price discrepancy as a tool to suggest a maturing bull market. In this environment large-caps tend hold up well to small-caps as the lower-beta large-caps tend to offer more safety.

All that said, small-caps have been performing well as earnings growth has supported rising stock prices. Also, thus far, investors have seemingly felt encouraged by the trailing year-over-year earnings growth of small-caps, which has been nearly triple that of large-caps. Small-caps are a good investment, but they are beginning to tell us a story that suggests the next eight years of investment performance will be dramatically less than that of the previous eight years.

More so than the last eight years, maximizing the probability of a successful retirement will mean proper Social Security and Medicare planning, as well as having an up to date financial and estate plan. If you have not worked with BMM recently to be sure you have the latest information you need, please do bring it up with one of your BMM representatives and we will walk you through the process.

Risks to Large-caps versus Small-caps

Above we discussed using recent outperformance of large-caps versus small-caps to suggest a maturing bull market. We also said to disregard the outperformance of large-caps versus small-caps if your inclination is to chase performance. And while investors no doubt understand the need to diversify your portfolio to protect you on the downside, that part of the conversation is often forgotten in favor of a question like, “if large-caps have gone up faster than small-caps, why not buy more large-caps”?

The answer is, we will. Probably. If further evidence supports doing so, yes, we will. But not just because of a price movement. One of two fatal flaws to investors is to chase performance. The other is to sell when the stock market corrects. Admittedly, sometimes – often times – chasing performing, in retrospect, is the correct thing to do. Trends can last. But six-months does not a trend make. Nor a year, for that matter. One sector or asset class can out- or under-perform another asset class for a short-period of time and still be a good asset class. The marathon runner who comes in second is still a pretty good marathon runner.

The stock-market has been consolidating for two-months now. A consolidation is, in essence, a stealth rolling correction. If it breaks to the upside, high-beta small caps could outperform. Also, the small-cap outperformance at the end of 2016 was, in part, driven by expectation for faster U.S. growth spurred by tax cuts and deregulation, which would have been net positives to small-caps over large-caps. Fading small-cap strength has occurred while the Trump administration’s efforts to do so have been slow. If the so-called Trump Trade gets reinvigorated by a faster legislative process, small-caps could outperform (especially if that expected economic growth triggered a stronger dollar, which is more important to small-caps because they get less of their profits from overseas).

EUROPE

With few exceptions, most regions of the world have been performing well economically and appear as if they will continue to do so. In some ways, this is a new phenomenon. For example, global exports have risen for five months after two years of decline. For Europe, in particular, the accommodative monetary policy, improving real income, and rising consumer spending have led to more stable economic growth.

After growing by 1.7% in 2016, the Euro Zone expanded by 0.5% in Q1 2017, an annualized rate of two percent. While some countries obviously fared better than others, the breadth of growth has been a positive in projecting continued stability. For the current quarter, mild improvement is expected. Interestingly, surprises to the upside for economic data (i.e. actual numbers coming in better than forecasts) have been steadily improving, while the number of positive surprises for a similar metric in the U.S. has have been trending down.

The improvement we have seen in fundamentals supports the advance we have seen in the relative strength of European ETFs compared to US stocks. This trend in relative strength has picked up considerably since December 2016's oversold condition, catching our attention. Our attention has grown to mild attraction with the confirmation of asset flows into funds that hold European equities.

Considering the reduced political risk (one-year post-Brexit), increased inflows after an oversold condition, absolute and relative equity strength, relatively attractive valuations, and continued accommodative monetary policy, we are getting bullish on European equites.

BOTTOM LINE

BMM's longer-term bullish view toward global equities is supported by the tailwinds of a secular bull market, accommodative global monetary policy, behaved inflation, solid employment, and trending technical. Our shorter-term concerns involve a potential for a price ceiling in the market due to high valuations, and a likely reversion to the mean in terms of volatility.

The stock market appears to have more upside to it for the next couple of years, even if it must contend with a 5% correction here or a 10% correction there. In the long-but-not-quite-so-long-term, we fear the effect of a recession on stock prices.

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The Dow Jones Industrial Average (NYSE: DJI, also called the DJIA, Dow 30, INDP, or informally the Dow Jones or The Dow) is one of several stock market indices, created by nineteenth-century Wall Street Journal editor and Dow Jones & Company co-founder Charles Dow. The Dow average is computed from the stock prices of 30 of the largest and most widely held public companies in the United States. Clients of BMM may have portfolios that differ substantially from the composition of the DOW and therefore, their performance may vary significantly from that of the Dow. The Dow is used for illustrative purposes only, as one indicator of the overall US economy, and its past, present, or future performance should not be viewed as an indicator or comparison point for BMM client performance.

BERKSHIRE MONEY MANAGEMENT

The Knowledge and Experience to Build Your Wealth

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