ALTERNATIVE PERSPECTIVES

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An Unsustainable Divergence

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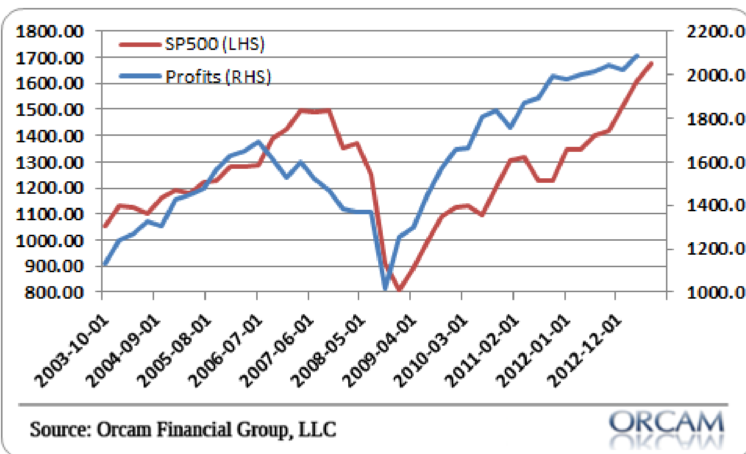
We're starting to get to one of those phases in the equity cycle where the evidence leads me to seriously question the pace of the advance. It's not that I don't think the rally in 2013 or since 2009 is justified. It is. There has been real fundamental improvement in the economy, but I do have to wonder if the *pace* of the advance doesn't warrant even greater caution with every one of these quick upside advances. Let me explain.

Long story short—A little skepticism is healthy.

A number of analysts and market participants have tried to explain away the 2009-13 rally under the idea that it's largely fake and manipulated by the Federal Reserve. Quantitative Easing is often described as a false market driver that adds liquidity and not much else. But that's clearly not true because corporate profits have surged since 2009 and correlated closely with the



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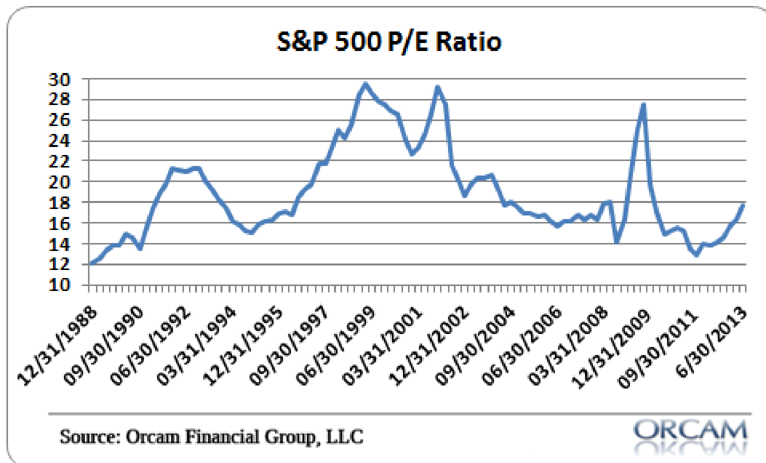
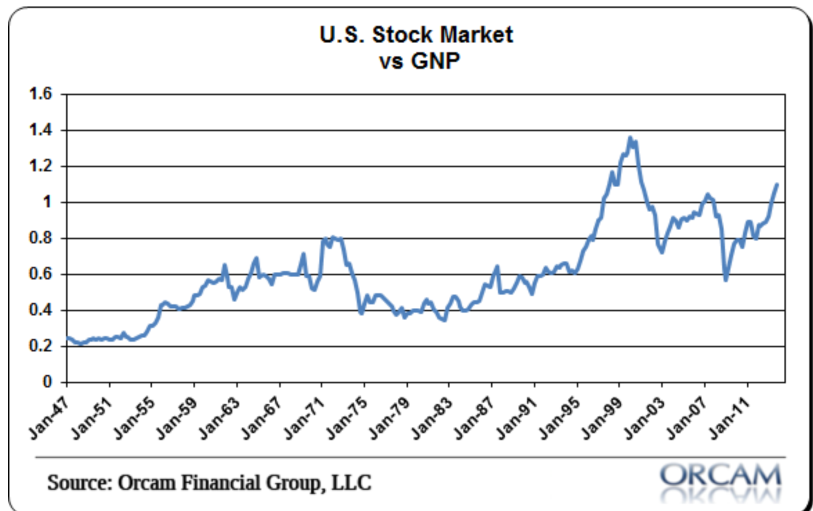
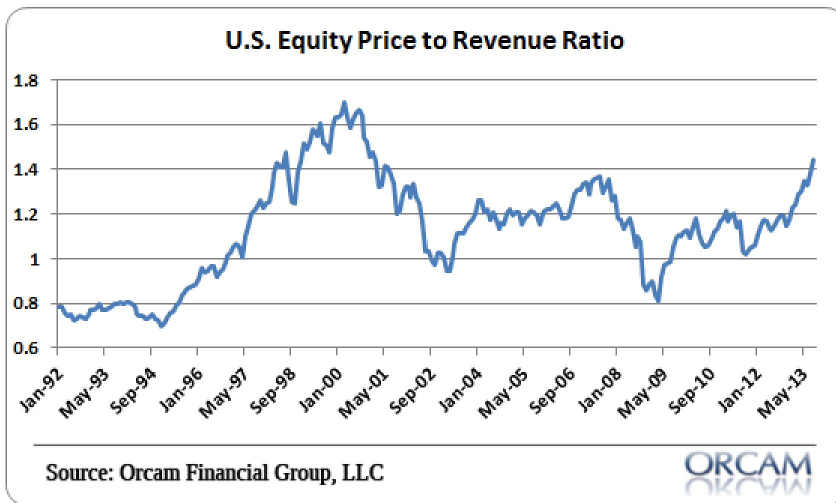
rally in equity markets. This has been a very fundamentally driven market for the last 4 years. On the other hand, in the last 6 months we've started to see some signs that make me wonder if this is sustainable. The biggest concern from a macro perspective is that corporate profits have slowed to a much slower pace of growth than we've seen in recent years 4.5% as of Q2). At the end of the day equities simply give owners access to underlying profits. If the growth of those profits slows we should begin to see the market reflect this. Instead, we've seen continued optimism in profits which means that buyers are simply willing to pay more for each dollar of S&P 500 earnings because they expect this profit growth to increase. I don't see the catalyst that leads to double digit profit growth in the coming quarters. I believe muddle through profits are much more likely.



The P/E ratio of the S&P reflects this substantial change in psychology since 2011 when the forward P/E was just 13 and has since jumped to 17.5 as corporate profits slow and market participants spend more per dollar of earnings. We're still far from nosebleed territory, but precisely at pre-crisis levels.



This trend can also be seen in broader macro indicators. The total market cap vs GNP shows an alarming surge in relative value. The current reading of 109% was only surpassed during the Nasdaq bubble.



Sales relative to the total market cap are showing a similarly alarming trend. The current reading of 144% was only seen during the Nasdaq bubble.

These are worrisome divergences between fundamentals and market prices. I still don't think we're at risk of a substantial equity market decline because every single year over year 25%+ equity market decline in the USA has occurred within a recession, but I do think that we have to start getting much more skeptical about the overall market advance.

The urge in a market like this is to chase the equity market performance, but as Hyman Minsky once said "stability creates instability". The market becomes increasingly fragile as prices rise because market participants are expecting that much more from future fundamentals. If those fundamentals don't deliver then you get a market correction. As we begin to see corporate profits slow to a pace in the low single digits I think the market should be demanding LESS from the equity markets. Not more. And that explains the clear divergence we're beginning to see in many of these broader indicators.

In short, this isn't the panic alarm. I am not ringing the bell on the equity market. But I do think we have to be extremely skeptical of this idea that every bit of news (good or bad) is good news just because the Fed might implement more QE in the future. So stay strategically bullish, but let's remain skeptical of the market from a tactical position and really pick and choose how we decide to execute our use of cash. We're getting to a point in the equity market cycle where chasing market performance is increasingly less likely to pay off.

As for fixed income, I still think you have to be extremely bullish here as QE is unlikely to end, the economy will remain weak and interest rates will remain low.

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