

The Outlook: Oct. 11, 2017

Not the headline; the whole "Big Picture."

"Bull Market Reaches Epic Proportions!" was the headline over an analysis by Morgan Stanley, which seemed to be saying, "Sell everything and run for the hills!", if we're correctly translating Morgan Stanley's remarkably high-sounding jargon. There have been a lot of headlines and stories like that lately . . . and they will continue right up until the moment—3 hours or 3 years from now—when the next Bear Market actually begins. We've made a lot of money lately, and we positively hate the idea of losing it. Are Morgan Stanley and the others right?

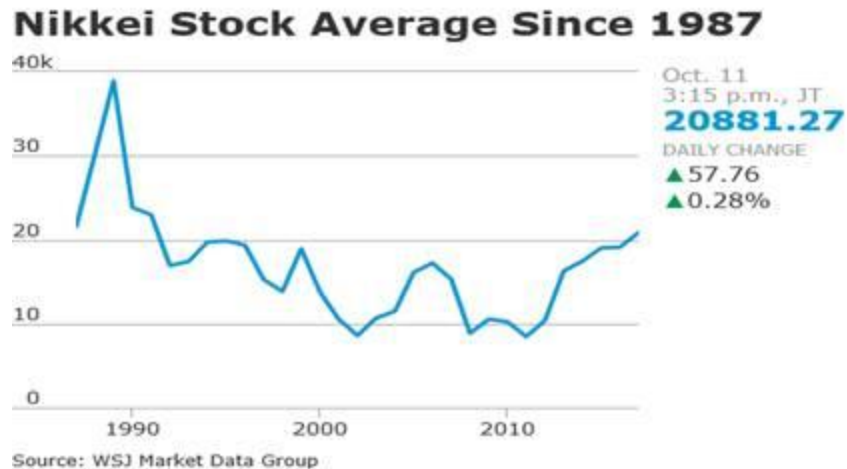
One of the oldest of sayings is "Don't believe what you read in the papers." When we are young, we all hear that kind of remark and nod wisely . . . but in fact we don't agree at all. "The papers are filled with stuff to read—surely it's mostly right?" is how we feel about it, when we're young. Then a divergence happens. For some reason too deep to analyze at the moment, a great many of us never change our minds. We keep thinking, "The papers are mostly right," no matter how old we get. But a certain number of us spin 180 degrees at some point, so that by the time we've been through a few decades we indeed doubt most of what we read in the press, and nearly 100% of the headlines.

The main reason the papers are in fact "almost always wrong," rather than "usually right," is they never explore the whole story: every corner of the picture, from bright to dark. They give us the splashiest headline and the splashiest corner of the big picture, which seems to support that headline. Let's look beyond Morgan Stanley's splashy corner, at a few more corners of the "Bull Market Reaches Epic Proportions" notion.

- "We say this not as hyperbole, but based on a quantitative perspective," said the team at Morgan Stanley. "Dispersions in valuations and growth rates are among the lowest in the last 40 years; stocks are at their most idiosyncratic since 2001; and equity hedge fund beta is at its highest since March 2008."

When we said "high sounding jargon," we meant it. This is a gold-medal contender, in the "high-sounding jargon" event. We point to it simply because a lot of the great crowd of "lifetime believers in the papers," we suspect, stay that way because they are impressed by people who sound smart, who use language we can hardly understand. But roughly translated, Morgan Stanley's blather means, "Stocks are at insane valuations, watch out below!"

- "Japanese Market Hits Two-Decade Highs!" That was the Wall Street Journal recently, and it suggested a nice, independent corroboration of the Morgan Stanley theme. But the chart inside the story was a little troubling.



Japan was all the rage, in the 1980's, as the unbeatable Asian Superpower. We can see its market peak in 1989 . . . at 40,000. And we can see that "Two Decade High" event, just now . . . 20,000. Hmm. This looks considerably more like the story of a terribly sick economy, stagnating for upwards of 30 years—which is exactly what Japan has endured, due mainly to what can only be summed up as "Big Government" controls, taxation and "management" of Japan's domestic economy. So that "Two Decade Highs!" headline was technically accurate, but distinctly misleading—when we consider the whole picture of Japan and its market. ("Technically accurate but distinctly misleading" might fairly describe around 99% of journalism's headlines.)

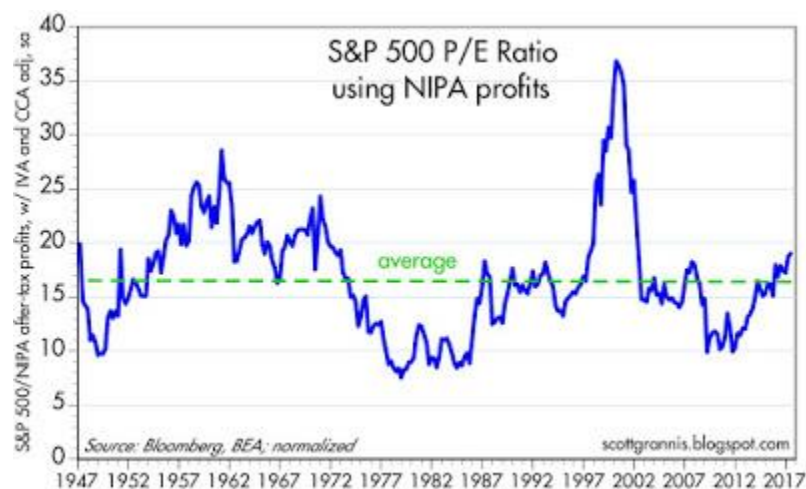
- Oddly enough, the same Morgan Stanley which gave us the "Epic Bull Market" warning also gave us a remarkably calmer analysis only a few days ago, carrying the following data about the market as a whole:

	<u>Current</u>	<u>25-Year Average</u>
Forward price/earnings	17.7	16.0
Dividend yield	2.1%	2.0%
Price/book value	2.9	2.9
Price/cash flow	12.4	10.7
EY minus bond yield	1.3%	0%

The red items might be called "over-valuation signals." The green items, "under-valuation signals." And the black item is "neither." Balanced, aren't they? And even the warning signs aren't exactly in "run for the hills" territory. No, this Morgan Stanley analysis doesn't quite call for a "Bull Market Reaches Epic Proportions!" headline. In fact, the firm presented it as a kind of debunking of the "Watch Out Below!" sentiment. What's going on?

Outlook's guess is that Morgan Stanley, as a company, knows very well that anybody who is in the "Call the Market" business will get their head handed to them, eventually . . . unless they can show that no matter what happens in the future, somebody in the company predicted it. Yes . . . the only safe way to be in the Call the Market business is, as a matter of principle, to always stand firmly on both sides of the fence. (Without editorial comment, we note that plenty of investment bankers eventually go into politics.)

- Here is more of the Big Picture about the market, courtesy of economist Scott Grannis.



“NIPA” profits are defined by the National Income and Product Accounts, which measure the size and behavior of the entire U.S. economy, among other things. Mr. Grannis likes NIPA’s calculation of corporate profits because it adjusts for changes in corporate taxation and accounting methods, making it more useful to compare past and present. From this perspective, the market is valuing profits slightly higher than the historical average . . . but miles from “Epic Proportions.”

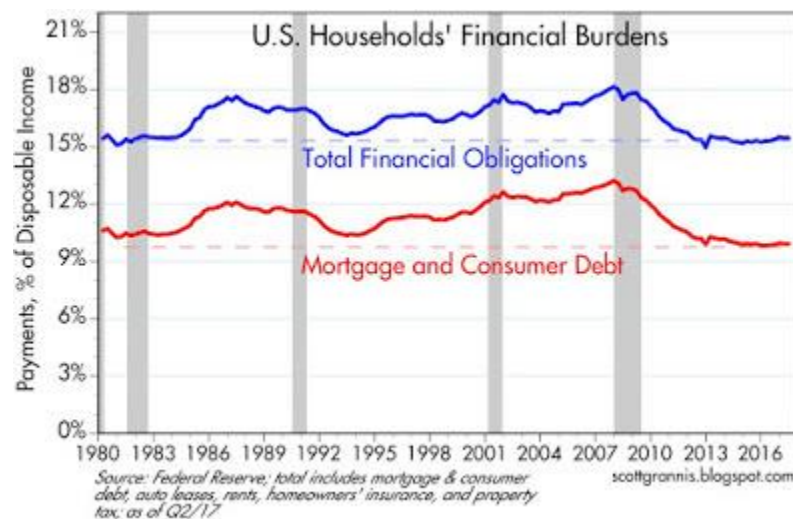


And here’s an even more interesting corner of the Big Picture. That’s a 67-year chart. It shows the market’s persistent determination to return to a certain long-term trend in average annual price gains: a 6.7% trend. When it has speeded up too much for too long, it slows down; when it has slowed down too much for too long, it speeds up. This chart says, “2001 marked the end of a truly “Epic” bull market—which slammed on the brakes twice in the next decade, ending with the Calamity Bear Market bottom of 2009. In the next 8 years, it has swung back toward that 6.7% magnet, and a little beyond it . . . but not much beyond it, at all.”

- If “Bull Market of Epic Proportions” is a misleading statement about the market, what’s the truth of it? Let’s end with Mr. Grannis and Mr. Brian Wesbury as a team.

On Monday Mr. Wesbury noted that if the current U.S. economic recovery lasts another couple of years, it will be the “Longest Recovery Ever.” “Not the best,” he remarked with emphasis, just the longest.” In the 1980’s expansion, the economy grew a total of 39%. In the 1990’s, it was 43%. And 8 years into the 2009 – 2017 expansion? 19%. (Hence Mr. Wesbury’s term, “The Plow Horse Economy.”) The economy got on that Plow Horse, we might sum up, because of all the bruises and breaks it suffered during the Calamity and Financial Panic of 2008 – 2009. Caution, and the determination to prevent a repeat, governed the behavior of most of the private sector of the U.S. economy: from consumers to companies. People act like that, when they’ve been hurt or badly scared. Emphatically adding to the drag was a rising tide of government taxes and regulations, and politicians’ determination to jump up and down on the banking sector until its value as a political scapegoat had been wrung out to the last drop. Taken as a whole, that’s a formula for “slow, halting growth” if there ever was one.

And finally Mr. Grannis shows us one of the truly important corners of the “Big Picture:” the chunk of take-home pay American consumers must give their lenders, over the past 37 years.



Hmm. The debt burden for U.S. consumers is at or near a 37-year low. Not quite a danger signal of “Epic Proportions,” is it? Instead, households’ debt burden went from a 30-year high, as the Calamity reared its awful head, to a 37-year low, 8 years later. Yes—people certainly do behave normally, and sensibly, when they’ve been hurt or badly frightened . . . and that behavior does indeed prevent a repeat of the terrible experience for a good long time.

Well, if it’s not at “Epic Proportions” right now, when will this Bull Market end? Not being in the “Call the Market” business, at Outlook we’re free to say, “We haven’t the foggiest.” The market can do anything at all—for a while. But the question that matters to us, as investors, is: “If the market suddenly does “anything at all,” will we be hurt so badly, and for so long, that we should be selling everything right now, and running for the hills?”

On that question we’re not foggy at all. American consumers and companies have acted, as a whole, with caution and determination these past 8 years. They are emphatically strong, financially. They can handle a knock considerably harder than the Calamity, even, because of that emphatic gain in strength. Some stocks—Tesla, Netflix, et.al.—are indeed valued “idiosyncratically” (thanks again, Morgan Stanley), but

most are certainly not—and quite a few (especially the energy and commodity-based companies which suffered their own Bear Market from 2014 – 2016) are solid bargains. When we own companies which can unquestionably endure a very hard knock, whose stocks are valued somewhere between “reasonable” and “cheap,” we hold on, and buy more . . . and let the market do “anything at all” whenever it pleases.

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