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RISING TIDES, CHANGING NEWS. SHOULD I CHANGE MY MARKET VIEWS?

Based on a steady, broad-based flow of positive reports from around the world, the tide of global economic growth is rising. And as a strategist, I take stands on the markets based on my interpretation of the facts. So, when the facts change, I need to decide whether or not to change my outlook. The facts have definitely changed with the recent news flow. While I anticipated slower growth rates in Europe, China and the United States this quarter, the exact opposite occurred. Growth has accelerated in almost all regions. The eurozone is seeing a rise in consumption and exports; US manufacturing and employment are improved; and China, Taiwan and South Korea are all posting better trade numbers. While GDP growth does not dictate earnings growth or return on equity, it does provide a favorable backdrop. Additionally, the margin and profit pressures we had been predicting did occur, but only briefly, and now we are seeing margins and profits rise again in the third quarter.

Contrary to my early 2017 view that wages would rise and squeeze company operating profits, wage costs have not risen quickly, even as unemployment has fallen. Therefore, many companies are experiencing better pricing power and better revenue growth. To add to the positive mix, long-term interest rates have been mostly range bound, corporate bond prices have held firm and the cost of borrowing remains little changed from last year.

Inflation, the long-dreaded curse for investors, has not yet been rekindled. As a result, investor confidence has soared, even if the roots of low inflation could have deleterious impacts over the long term. Aging demographics, heavy debt burdens and advances in automation and digitization are among the factors restraining prices — factors that investors will need to contend with for some years to come.

Volatility, too, has been unusually depressed. During 2017 we've barely experienced as much as a 3% pullback in the S&P 500 Index. October has historically been among the more volatile months — recall that the stock market crashes of 1929 and 1987 were October events — yet this year both the VIX (S&P 500 implied volatility) and MOVE (Merrill Lynch's US Treasury-bond volatility index) are close to all-time lows as of mid-October. So the picture for risk takers is one of extraordinary calm and confidence. The markets seem to go up daily — even negative headlines do not disturb them.

From cautious to confident?

So, with unemployment low, volatility seemingly nonexistent and inflation muted, should I change my outlook from one of caution to one of confidence?

No, I'm not changing my view. I agree that the fundamentals have played out better than I'd predicted, but I'm not recommending that investors suddenly pursue risk again, as I had for seven years. I maintain that a capital preservation bias, while expensive in the short term (when you consider opportunity costs), is still the right way to invest. Here's why:

1. **Valuation:** Valuation does not determine short-term market returns. To be sure, markets were expensive a year ago and have only gone up. But for long-term investors, entry valuation matters a lot. We have lots of data that show that entering the market when the S&P 500 price/earnings multiple is above 20 — as of 19 October we are at 21 — means that annual returns 10 years down the road tend to lag the return on T-bills, and usually with many more headaches along the way. Right now, most world equity markets are in the richest 10% of their historical valuation range, so it's very hard to find cheap sectors or cheap markets.
2. **Cycle risk:** The US business cycle has entered its ninth year, making it one of the longest cycles ever. The saying goes that business cycles don't die of old age, but the longer this cycle goes, the higher the odds are of it ending.
3. **Challenges to global trade flows:** Much of the profit accruing to the owners of capital in recent years has been the result of cost savings from global trade. But now, with contentious trade negotiations underway from China to Mexico to Great Britain, it appears clear to me that the world is moving toward less global trade, not more.
4. **Assets are expensive globally:** Other asset categories are expensive too. Bonds in the US, Europe and Japan are all quite rich relative to history, some extremely so. With almost all investment vehicles historically expensive, some investors have gone so far as to speculate in things like cryptocurrencies, such as bitcoin, and the like. That seems unlikely to end well.
5. **China's wild debt ride:** No one is worried about the world's second-biggest economy blowing itself up soon, but China's use of debt, at the state, corporate and personal level, has gotten way above historical norms. At best, this pile of claims could slow growth. At worst, it could trigger a repayment storm. Someday, it could haunt investors.
6. **Relatively untested instruments:** Lastly, I worry about the untested waters of new financial structures. Since the last recession and market downturn, there has been huge growth, measured in trillions of US dollars, in index-tracking vehicles, some of which are highly levered. These new structures have never been truly tested by an influx of sell orders, though the "flash crash" of August 2015 offers a cautionary reminder of what can happen when the herd stampedes for the exits. Spookily, market historians are reliving the events of 30 years ago this week, a market break known as the Great Crash of '87, and one conclusion is clear: Stock market crashes are not caused by fundamentals; they're caused by panics. Back in 1987, a combination of untested debt-financed risk arbitrage deals and new types of portfolio insurance fueled a collapse in prices that did not coincide with an economic event or recession. We don't know with any great precision where the hidden fault lines are, but nine years of cheap money and excess cash reserves piling up around the world suggest that financial assets may be vulnerable. Not today and maybe not tomorrow, but someday the tide of money will go back out.

It haunts me that the later stages of market cycles are often marked by certain repeatable phenomena, such as a rise in day traders, a new "story" that replaces the old story, a fresh sense of confidence that the world of investing has been fixed and, of course, a sense that high market prices are justified.

All of these are happening today. Worse, investors are tempted back into risky assets by stories of their neighbors' big gains, by the fear of missing out. Don't feel left out. The easy money was the rise in the S&P 500 from 2009 to 2016. Then, fundamentals were good. The rising tide of recovery, pushed by easy money and cautious confidence, was supported by low or average price earnings valuations.

That's not the case today. The hour is late, prices are high and hidden currents and rip tides lie beneath the seemingly placid surface of the incoming tide. This is not a call to sell all, but a call to be cautious, for investors to be wary and sober. Against this backdrop, a cautious mix of assets is best. The time for market heroics has passed.

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