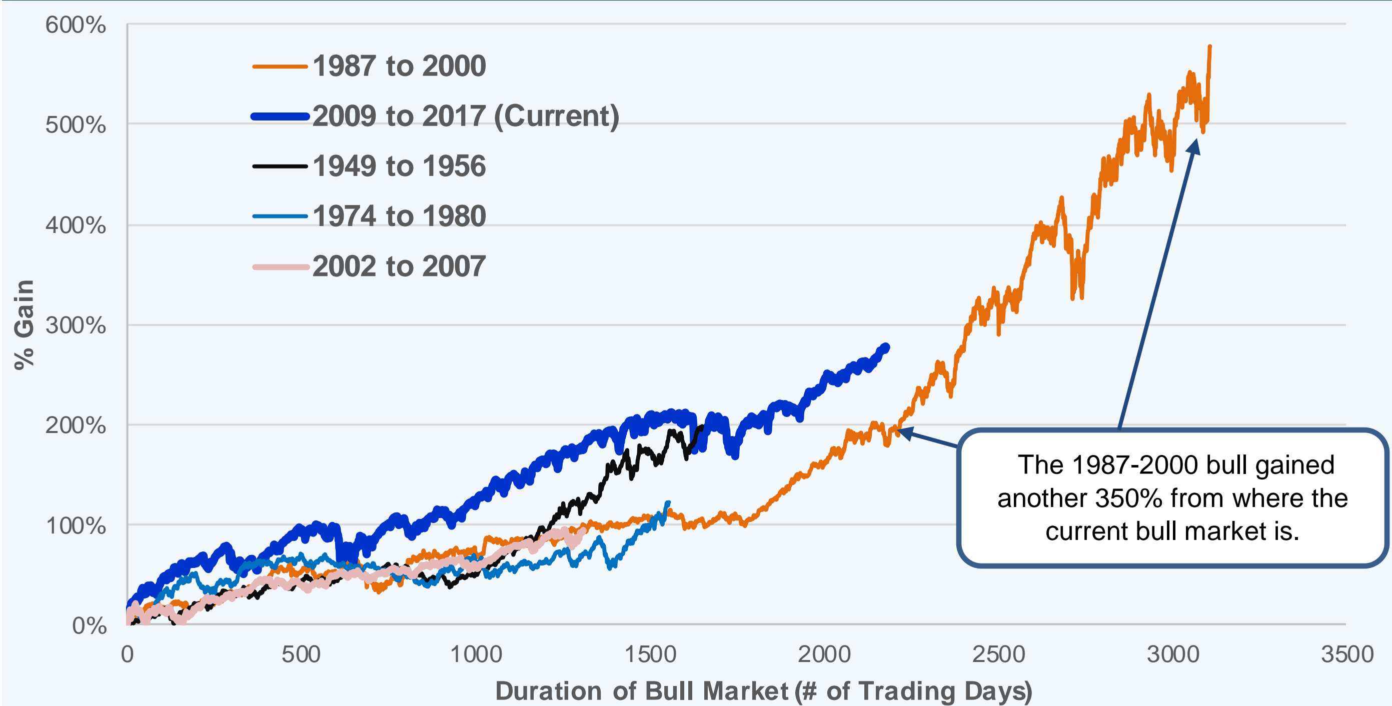
Are We There Yet??

A Guide to Investing with Markets at All-Time Highs

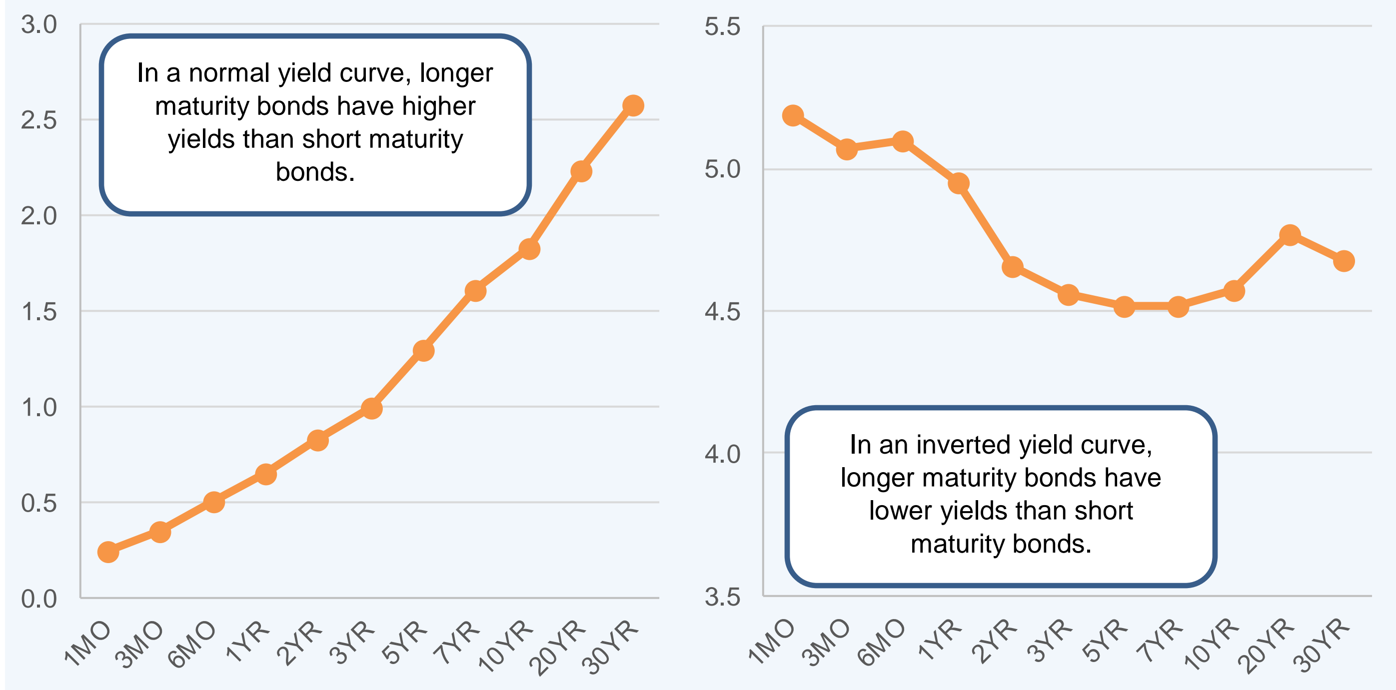
A unique characteristic of baseball that differentiates it from the other major American sports is that the game is not constrained by time. Barring extra innings, a baseball game is nine innings in length, with each team required to record 27 outs to win. While the number of innings is defined, the amount of time it takes to play nine innings varies. Low scoring pitching duels can be wrapped up in under two hours whereas high scoring games can last over four hours.

A market cycle is similar to a game of baseball in that it is unconstrained by time. Market cycles have lasted as short as two years and as long as thirteen years. Yet unlike baseball, an observer cannot be certain as to what inning the cycle is in. The current bull rally that began in March of 2009 is now the second longest and the second strongest in terms of percent gained on the S&P 500 Index since WWII. From the bull market's onset eight years ago, prominent investors and economists have been predicting its demise, yet so far, none of them have been correct. In fact, instead of showing signs of decay, the market has actually accelerated over the last twelve months. Since last year's presidential election, the S&P 500 Index has gained 21% and hit 54 record highs while volatility has approached all-time lows. The market's most recent run has investors asking, are we witnessing a late inning rally or is it just the fifth inning of a high scoring affair?



Measuring the Health of the Bull: A Look at the Yield Curve

While markets are by nature unpredictable, there are economic barometers that can help infer where the market is at in the cycle. One of the more reliable measuring sticks has been the shape of the yield curve. The yield curve plots the interest rates of similar credit quality bonds that have different maturity dates. In normal economic conditions, the yield curve is upward sloping meaning that longer maturity bonds have higher interest rates than short maturity bonds. This makes sense rationally because investors holding long-term bonds should be compensated for the additional risk of the bond issuer defaulting in the long-term. On the other hand, an inverted yield curve occurs when the interest rates of short



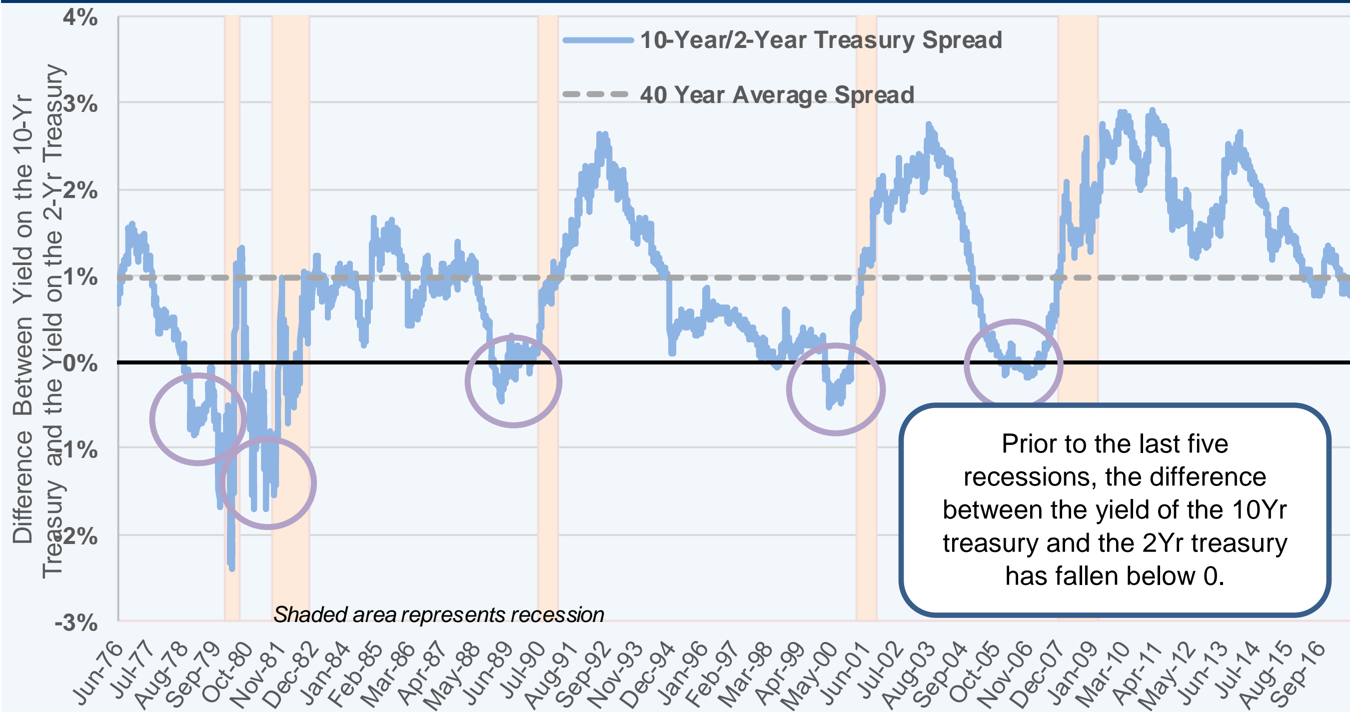
maturity bonds are higher than the interest rates of long maturity bonds. An inverted yield curve does not make rationale sense because investors in long-term bonds are taking on more risk (inflation risk, interest rate risk, credit risk, etc.) and yet are receiving a lower return than investors in short-term bonds. When a yield curve is inverted it usually suggests that the economic outlook is poor and that investors are piling into long-term debt as a flight to safety.

The slope of the yield curve is defined as the mathematical difference between long-term interest rates and short-term interest rates. When the difference between long-term rates and short-term rates is decreasing, the yield curve is said to be “flattening” and when the difference is increasing, the yield curve is said to be steepening.

The shape of the yield curve is important in context to the economic cycle because a steep yield curve usually indicates that the market is expecting future growth whereas an inverted yield curve means the market is anticipating weak economic growth or even contraction. Historically, the yield curve has served as a canary in the coal mine for an economy heading into a recession. In fact, the last five economic recessions in the US have all been preceded by an inverted yield curve. As you can see from Figure 3, the yield curve inverts (falls below 0), prior to the recessions (the shaded areas). The timing however is not an exact science. In 2006, the yield curve inverted, but the recession did not begin for another two years.

In 2017, the yield curve has flattened as the Federal Reserve has pushed up short-term interest rates, but long-term rates have remained steady. The difference between the 10Yr and 2Yr treasury yields started the year at the year at 1.23%, but the spread between the two rates has dropped to 0.61% as of November 15th. While the curve is clearly flattening, the current slope is still close to its 40 year average and is not on the verge of inverting. The lack of an inverted yield curve suggests that there are still innings left in the game.

Figure 3: The Shape of the Yield Curve has been a Reliable Recession Predictor



Other Major Equity Drivers Trending in Right Direction

Not only is the yield curve suggesting that a recession is not imminent, but the most recent equity gains have come on the back of improving economic fundamentals at both the micro and macro levels. On the company level, corporate earnings are experiencing a major revival. US corporate earnings growth surpassed 10% in Q1 and Q2, which was the first time since 2011 that corporate earnings growth hit double digits in consecutive quarters. Outside the US, earnings growth has been even more robust with the stocks in the Stoxx 600 (European) Index posting their highest earnings growth since Q3 2010 in Q1 2017. Corporate profits are also surging in emerging market economies as the MSCI Emerging Market Index is on pace to see earnings growth north of 20% in 2017.

At the macro level, economic activity is also improving almost unilaterally across the globe. Japan's economy has grown for seven straight quarters, which is its longest expansion since 2001, while the Eurozone is experiencing its fastest GDP growth rate since 2011. Domestically, the ISM Manufacturing and ISM Non-Manufacturing (Services) Indexes both hit 12 year highs in September and US GDP growth has topped 3% for two consecutive quarters. Aggregated together, global GDP growth is on target to hit 3.6% in 2017, which would be 12% higher than 2016's growth rate of 3.2%.

Looking ahead, the International Monetary Fund is expecting that global economic growth will tick higher in 2018 to 3.7%, with emerging markets expected to see the largest year-over-year increase. With central bank policy expected to remain accommodative, corporate earnings improving, and global economic activity picking up, there is ample opportunity for equities to make further gains over the coming year.

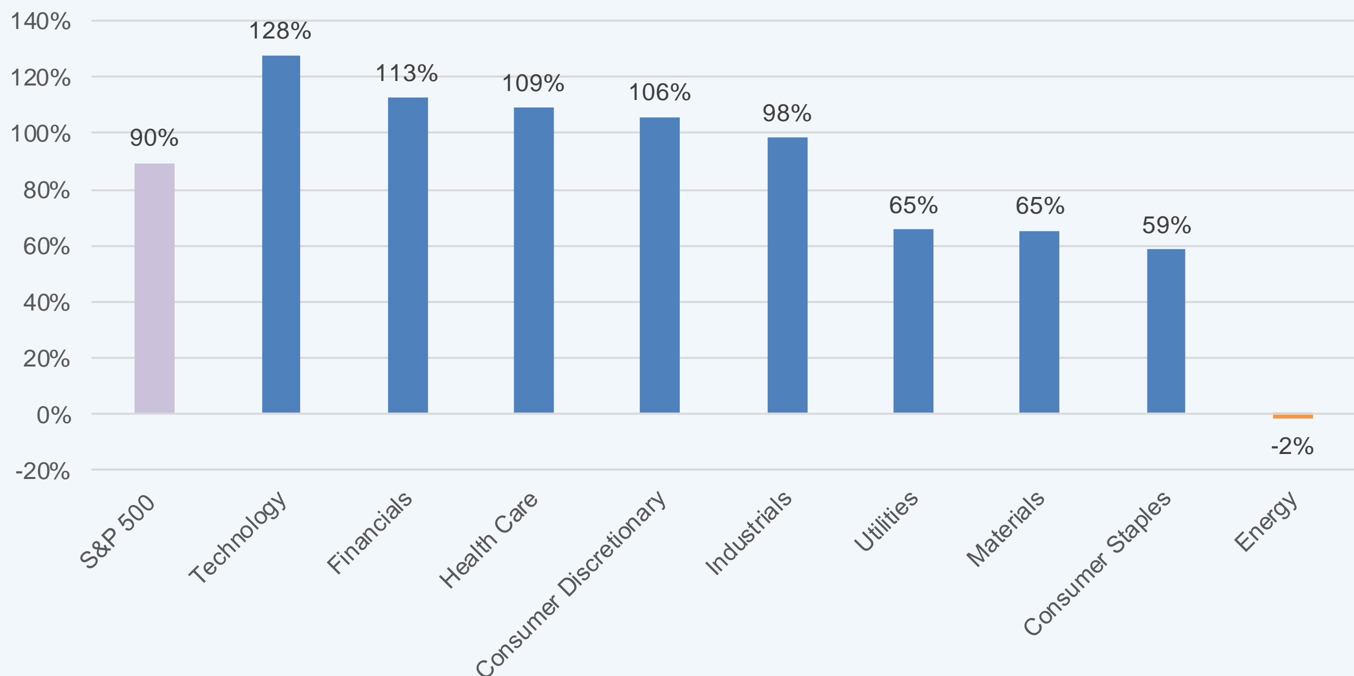
The Search for Value in the Global Marketplace

Even though economic growth and earnings are trending in the right direction, it can be hard for an investor to rationalize buying into US markets when they are at record highs. Although US equity markets have enjoyed an eight year bull run, there are still areas of the equity universe trading below their pre-recession highs. Employing a diversified portfolio that has exposure to undervalued areas of the market can help add value even if US markets do not continue to appreciate at their current clip. Listed below, are a few asset classes that have underperformed the US markets over the last few years, but we believe have potential to outperform in the coming months and even years.

Energy Sector

While the S&P 500 has increased 90% over the last five years, not all of its constituents have participated in the upside. In fact, the energy sector is the one major outlier when looking at the trailing five year return of all of the S&P 500 sectors. Energy stocks are closely correlated to the price of oil and one of the major market developments over the last few years has been the precipitous decline in the price of oil. After hitting $105 a barrel in late July 2014, the price of WTI oil plummeted 60% over the following twelve months and reached as low as $26 a barrel in February 2016. Oversupply, lackluster demand, and a strong US dollar created a perfect storm for a freefall in oil prices. While the commodity asset class is no stranger to boom and bust cycles, the rapid deterioration of oil prices caught energy companies by surprise. Large oil producers, such as Exxon Mobile (XOM), saw their earnings fall by more than eightfold while many smaller companies failed to stay afloat. In 2016 alone, there were 72 energy related bankruptcies in the US and Canada and so far in 2017, another 44 energy companies have filed for bankruptcy.

Figure 4: Energy Sector has Lagged Over Past Trailing 5-Yr Period



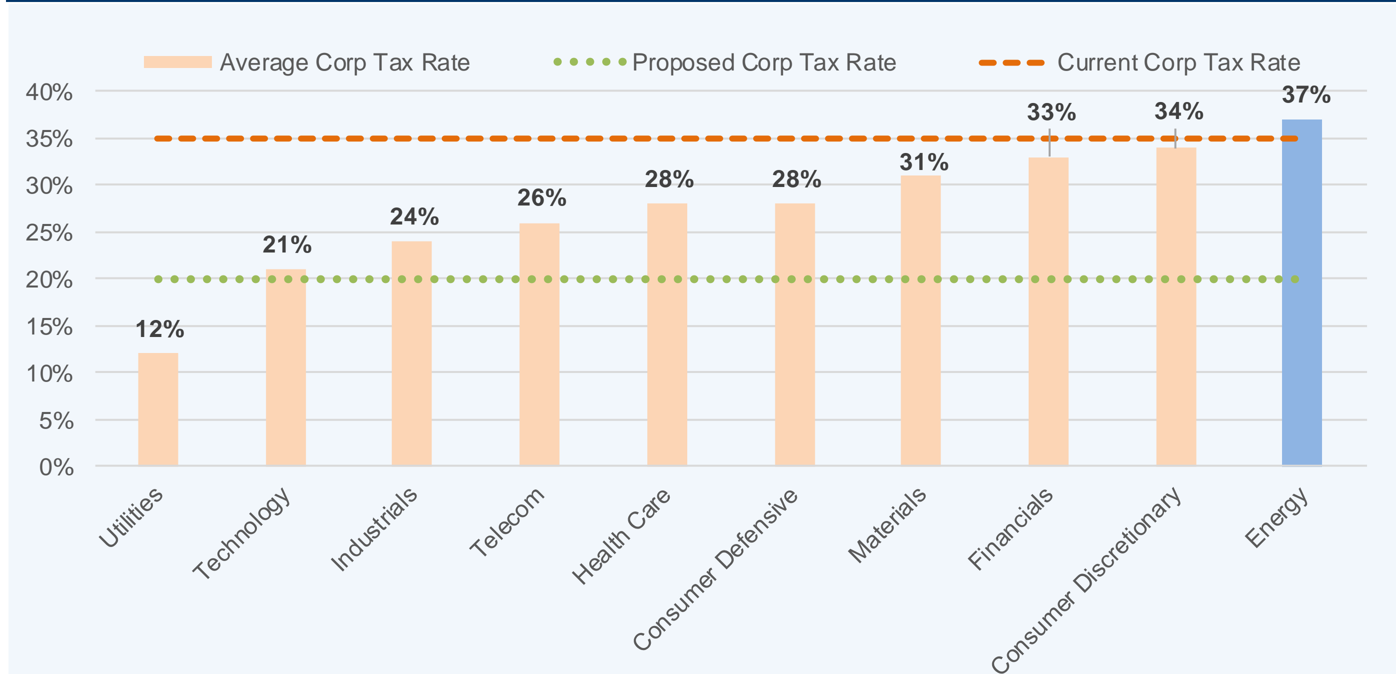
However, the tide seems to be turning for oil and energy stocks. The consortium of headwinds that created the massive downward pressure on the price of oil seem to be fading or even reversing.

- **Supply/Demand Imbalance Resolving:** Overproduction was the primary driver of the decline in oil prices from 2014 to 2016. The shale boom revolution in the US turned America into a major oil producer and one that could profit at a much lower breakeven price than many OPEC countries. In addition to supply rising, demand also fell during this period as economic output in China waned and overall global GDP growth slowed. In Q3 2015, world production of oil was outpacing world consumption of oil by more than 1.5M barrels per day. Last year, however, OPEC countries agreed on supply cuts and the oil cartel has largely abided to these restrictions, which has helped reduce the supply. On the other side of the equation, improving global economic activity has created an uptick in the demand for oil.

- **US Dollar Depreciating:** Another major factor in the decline of oil prices was the appreciation of the US dollar. Oil, like many commodities, is priced in US dollars. When the value of US dollars appreciates, it reduces the purchasing power of other currencies thereby reducing the demand for oil. It was no coincidence that the US dollar index (DXY) was reaching record highs during oil's dramatic decline from 2014-2016. Yet in 2017, the trend has reversed. The US dollar index is -8.4% YTD whereas the price of oil is +2.1% as of November 15th.

Not only can rising oil prices be a boost for energy companies, but corporate tax reform would also be a tailwind for the sector. As the chart below shows, energy companies currently pay the highest average effective corporate tax rate out of all of the S&P 500 sectors. The current tax reform bill proposed by the House would lower the corporate rate to 20% which would be 45% lower than the rate currently paid by energy companies.

Figure 5: Corporate Tax Cuts Would be a Boost to Energy Companies



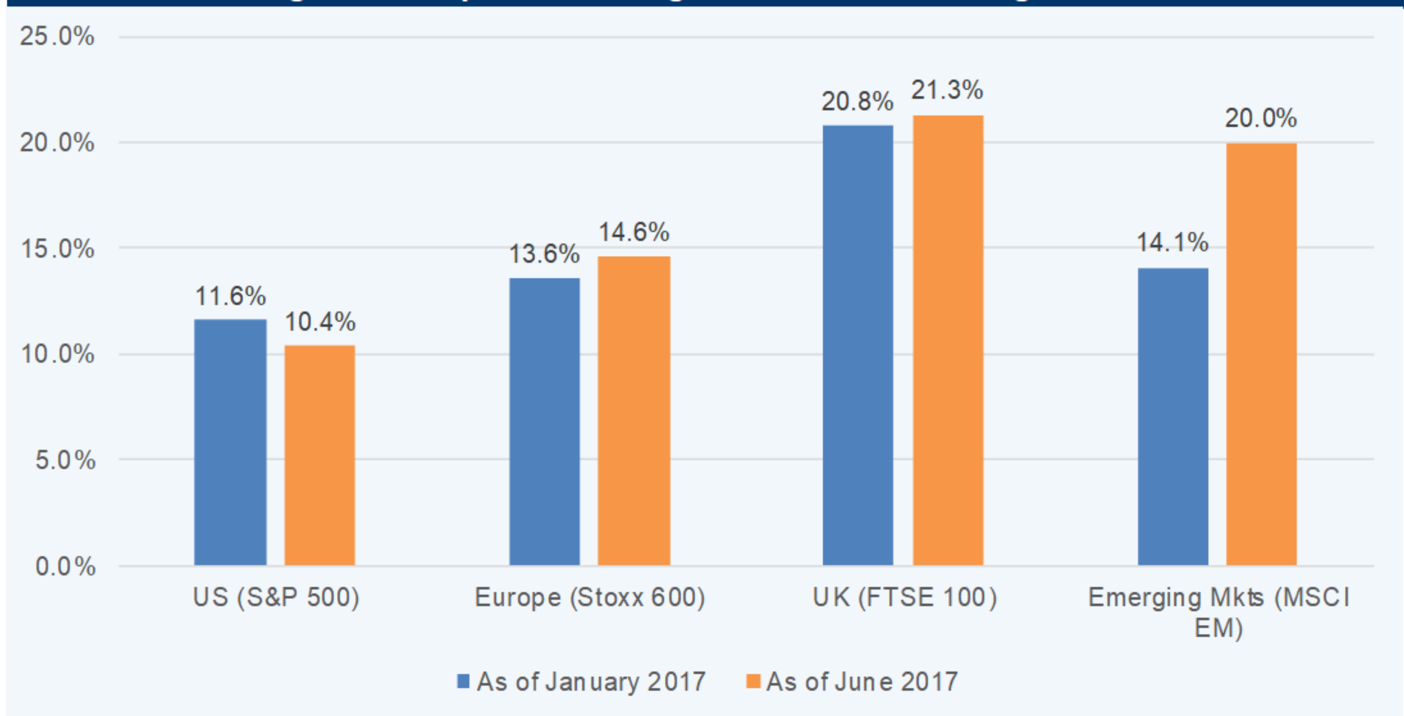
The energy sector pays the highest average corporate tax rate out of all of the S&P 500 sectors.

Investing in energy stocks is not the only way to access undervalued areas that are correlated to oil. MLPs or master limited partnerships have also underperformed US equities over the last few years. MLPs are publicly traded limited partnerships that typically deal with the processing, storage, and transportation of oil and natural gas. MLPs have a unique tax structure which has the benefit of paying no tax at the company level, but they are required to distribute at least 90% of their profits to investors. This structure means that MLPs pay a high income stream to their investors, with average yields ranging from 3% to 10%.

International Developed and Emerging Markets

Since the pre-recession market peak in October 2007, the relative performance of US equities and their foreign counterparts has been stark. US equities, measured by the S&P 500 Index, are more than 60% above their pre-recession highs, whereas international developed equities (MSCI EAFE Index) and emerging market equities (MSCI EM Index) are still trading more than 10% below their 2008 highs. The glaring performance differential between the indexes is a reflection of the economic recovery in each region. The US economy was able to gain a footing faster after the recession and has been able to consistently grow at a 2% annual clip. The Eurozone, however, has been mired in debt and political crises and its economy has not been able to eclipse a 1% annual GDP growth rate. Emerging market economies have also been roiled by the decline of commodity prices, specifically oil, and have also been hurt by a strong US dollar.

However, like the energy sector, the headwinds that were holding back foreign equities are subsiding. Economic growth has picked up in both Europe and in emerging markets in 2017. The Eurozone Manufacturing Index hit its highest level in over five years in October and the region's unemployment rate fell to 8.9%, which is its lowest reading since 2009. The US dollar has also depreciated in 2017, which is a positive especially for emerging market economies.



Furthermore, as Figure 6 demonstrates, corporate earnings growth rates abroad are substantially higher than in the US. There is significant room for earnings improvement for both emerging and international developed equities because their economies are a few years behind the US in terms of recovery. We have begun to see the rotation to international developed and emerging markets in 2017. As of 10/30, emerging markets (MSCI EM Index) were +32.3% and international developed equities (MSCI EAFE Index) were +21.8%, both of which were outpacing US equities (S&P 500) which were +16.9%. If economic growth can continue to improve in these regions, foreign equities will have the opportunity to outperform US equities for years to come.

Keeping a Long-Term Perspective in Mind

With all of the major US indexes sitting near record highs, it can be easy to focus on the downside possibilities rather than the upside potential of the markets. However, just as baseball games don't abide by a clock, bull markets don't die of old age. Just because the US markets are at all-time highs, doesn't mean that they can't move higher. In fact, if you looked at the present market environment without knowing what the markets had achieved over the last eight years, you would think that the current conditions would be a goldilocks zone for equities. Interest rates are low, economic growth is improving but not overheating, and corporate earnings are growing by 10%. While volatility may not remain as low as it has been in 2017, the major economic indicators are not flashing blaring warning sides that a recession is looming either.

This is not to say that the markets won't experience a pull-back. 2017 has been abnormal in that there has not been even a 3% drop. Yet instead of believing that the markets are due for a correction or becoming complacent with the current uptrend, investors should be looking to find the most attractively valued segments of the market to add to their portfolio. There are areas of the market, such as the energy sector and foreign equities, that have not enjoyed the same success as the US markets over the last few years but could be poised to do so going forward. Finding out-of-favor areas of the market that have potential catalysts behind them can help investors stay proactive instead of reactive with markets at all-time highs.

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Figure 1: Five Longest S&P 500 Bull Markets – Shows percent change in the price of the S&P 500 Index over the five longest bull markets since WWII. 1987 to 2000 = return from 12/4/1987 to 3/24/2000. 2009 to 2017 = return from 3/9/2009 to 10/31/2017. 1949 to 1956 = return from 6/13/1949 to 8/2/1956. 1974 to 1980 = return from 10/3/1974 to 11/28/1980. 2002 to 2007 = return from 7/23/2002 to 10/9/2007. Source – ychats.com

Figure 2: Normal Yield Curve (11/1/2015) vs Inverted Yield Curve (11/1/2006) – Shows the yield curve of US treasuries on 11/1/2015 versus the yield curve on 11/1/2006. Source – US Department of the Treasury

Figure 3: The Shape of the Yield Curve has been a Reliable Recession Predictor – Shows the historical difference in yield between the 10 Year Us Treasury and the 2 Year US Treasury from 1/1/1976 to 10/31/2017. Source – US Department of Treasury

Figure 4: Energy Sector has Lagged Over Past Trailing 5-Yr Period – Shows the return of the different S&P 500 sectors from 11/15/12 to 11/15/17. The return for each sector is represented by its corresponding SPDR sector ETF. Consumer discretionary = XLY, Consumer staples = XLP, Energy = XLE, Financials = XLF, Health care = XLV, Industrials = XLI, Materials = XLB, Technology = XLK, Utilities = XLU. S&P 500 Index = SPY. Source – ALPS Portfolio Solutions Distributor

Figure 5: Corporate Tax Cuts Would be a Boost to Energy Companies – Shows the average corporate tax rate for each S&P 500 sector vs the current US corporate tax rate (35%) and the proposed corporate tax rate under the current House tax reform bill (20%). Source – Wall Street Journal.

Figure 6: Corporate Earnings Estimates Increasing Abroad – Shows the estimates of the price to earnings for different global indices as of January 2017 and June 2017. Source – JPMorgan