As we step into the second half of 2017 the bears continue to hibernate despite a persistent drumbeat by market Cassandras outside the cave. High valuations have not abated in the US equity markets, even as the new Administration’s pro-business platform remains stubbornly jammed in low gear with a plethora of distractions – some glaringly insignificant and others gravely important – acting to impede progress. Nevertheless, valuation multiples hover well above long-term averages in expectation of fiscal expansion coupled with tax and regulatory relief. At the same time, corporate earnings have improved and systemically important banking institutions have passed stability tests, while the Fed has provided strong support via low interest rates and accommodation in the form of asset purchases. In the Eurozone and Japan, strengthening fundamentals are also underpinned by Quantitative Easing (QE) from monetary authorities, yet the central banks are now starting to ponder a post-QE world.

The market observer’s job often entails trying to explain the inexplicable. “What happens next?” may be the most relevant question, but prognostications depend on myriad factors on an uneven and slippery floor of ever-changing data. A critical step in the process is to understand what has already happened, and why. Most of the time a few standard relationships hold. At other times, the usual rules seem not to apply, like now. The old equity/fixed income tradeoff seems to be suspended: low bond yields reflect excess demand driving up prices, and high equity valuations point to similarly strong demand. The current environment says invest in all asset classes. What is going on? Below, we examine this apparent conundrum, review markets, and look at recent Fed talk and plans to begin unwinding its QE program while also raising rates to stay ahead of any spike in inflation.

1. Superforecasters and High Market Valuations

In their 2016 book, Superforecasting: the Art and Science of Prediction, Professor Philip Tetlock and journalist Dan Gardner explain research showing that the best forecasters not only examine history but are especially adept at integrating new information and revising their views, and they believe in "return to mean," in which outlier events eventually revert to long-term averages. In contrast, most people embrace an initial impression – a "heuristic" according to Tetlock, relying on Daniel Kahneman’s framework in Thinking: Fast and Slow (2011) – and then seek information to support that gut instinct. As we look at current market valuations in both equity and fixed income, it requires some mental gymnastics to arrive at an explanation. Market moves that respond to the latest economic data on hiring, home sales, and confidence show that investors do attempt to revise outlooks, and the aggregate judgment gets reflected in market pricing. The question is whether those outlooks will accurately reflect what lies ahead.

Yet, despite mixed economic signals equity valuations remain lofty. The table below shows 8%-plus gains in the Dow Jones Industrial Average and the S&P 500 through June as the indices hit new peaks, while the Nikkei and Eurostoxx indices have registered 4.6%-4.8% gains in the first half.
The pricing strength of these indices show valuations that continue to stay above long-term averages (see P/E chart below), with the S&P 500 at 21.5x as of June 30th, somewhat below its March 31st level of 21.8x and its historical dot-com era high of over 26x, but still higher than in recent years. Both Eurostoxx and Nikkei P/E ratios are settling in below their 2015-16 peaks, both now under 20x.

Major Market Price/Earnings Ratios in Late Cycle (avg. 2001-2017)

While these valuations may ultimately turn out to be justified – corporate earnings did turn positive on a year-over-year basis in 1Q17 – we highlight the fact that bond yields remain low despite three Fed rate increases since December 2016. At the same time, after posting yield contractions during 2016, UK Gilts and Japanese Government 10-year bonds have experienced only a few basis points of yield increase, while German Bunds are up about a quarter percent through June. The resulting yields make developing market sovereigns outside the US unattractive relative to US Treasury bonds. As such, money managers attempting to keep up with benchmarks have little choice but to remain invested in the US, and this preference helps to keep Treasury yields down.

Still, why the simultaneous strength in equities and bonds? In the past, during brief periods of market panic all asset classes have dropped in value simultaneously as investors moved to cash and short-term high-grade sovereign debt in a “flight to quality”. This happened, for instance, during the Russian debt default of 1998, and during the worst period of the Great Recession, in late 2008, when even the creditworthiness of overnight commercial paper came into doubt. Now, the logical opposite has appeared: all asset classes gaining in value, and this amidst an environment of low inflation. We see a possible explanation in leverage, as cheap money allows margin purchases of stocks. In the chart below we show the Fed funds rate and the aggregate margin balances for customers of New York Stock Exchange dealers (see chart below). Historically, these move at something of a lag in response to interest rate movements. The Fed drops rates, and a while later margin balances rise. The Fed hikes rates, and it takes some time for leverage to fall. But since late 2008, when the Fed dropped rates virtually to zero and started building its
balance sheet through long-term asset purchases, margin balances have taken off on an upward trajectory. As of June 30\textsuperscript{th} they stand at about 2.6% of total S&P 500 market cap, which is about one standard deviation above the average of 2.2% since 2000 (range 1.4% to 2.9%). Thus, both on a standalone basis and on a relative basis the amount of margin leverage is high, which can accelerate and magnify the effects of a market downturn.

Stock Market Margin Level and the Fed Funds Rate

Low interest rates may help to explain equity valuations, but the attractiveness of bonds still mystifies. To get some insight, we note that risk-seeking behavior can be seen in the appetite for debt issued by corporations. Issuance is high, with investment grade debt tracking to nearly match 2016’s peak of $1.2 trillion (according to JP Morgan), while leveraged loans are on a run rate to reach a new record, with $740 billion issued in 1H17 (with 70% used for refinancing activity, according to Thomson Reuters). Corporate bond risk premiums have continued to contract across the board, keeping their downward trajectory since the end of 2015 (see table below). Emerging markets high yield debt and investment grade corporates have reached multi-year low yields.

<table>
<thead>
<tr>
<th>Risk Premium Required Above US Treasury (%)</th>
<th>3Q16</th>
<th>4Q16</th>
<th>1Q17</th>
<th>2Q17</th>
<th>Change in Bps</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bloomberg High Yield Corporate Bond Index</td>
<td>5.49%</td>
<td>7.29%</td>
<td>4.94%</td>
<td>4.29%</td>
<td>3.76%</td>
</tr>
<tr>
<td>Bloomberg High Yield Energy Corporate Bond Index</td>
<td>9.43%</td>
<td>13.71%</td>
<td>6.82%</td>
<td>5.29%</td>
<td>5.00%</td>
</tr>
<tr>
<td>Bloomberg EM High Yield Corporate Bond Index</td>
<td>8.93%</td>
<td>9.15%</td>
<td>6.04%</td>
<td>5.29%</td>
<td>4.52%</td>
</tr>
<tr>
<td>Bloomberg Investment Grade Corporate Bond Index</td>
<td>1.38%</td>
<td>1.71%</td>
<td>1.45%</td>
<td>1.28%</td>
<td>1.24%</td>
</tr>
<tr>
<td>Bloomberg Investment Grade EM Corporate Bond Index</td>
<td>2.97%</td>
<td>2.86%</td>
<td>2.24%</td>
<td>1.98%</td>
<td>1.87%</td>
</tr>
</tbody>
</table>

2. The Fed, Waning Accommodation and Global Leverage

By June most governments have reported or revised their economies’ vital statistics for the prior year. We can attempt to shed heuristics and read patterns to arrive at a reasonable prognosis for the next 12 to 18 months. From these data we believe that the second half of 2017 likely holds further uncertainty. In the US, this includes fiscal policy and the ability of the White House to coordinate with its Republican-led Congress to enact legislation to push forward its pro-business fiscal agenda. Europe and Japan face QE wind-down questions, and globally any of several brewing geopolitical storms could instigate a correction or affect economic recoveries in all the major economic zones.

Amid that backdrop, the Fed must grapple with unwinding its own $4.5 trillion balance sheet at the same time that it telegraphs its intent to hike interest rates. As we have previously noted (see chart below), in response to the 2008 financial crisis the Fed dropped interest rates precipitously, and followed that with QE asset purchases, buying long-term assets on the open market to inject cash to the system. The combination of those accommodative measures made a difference in helping move the US economy toward recovery, but the resulting leverage and easy credit it created could engender future troubles. It is for this reason that the Fed has, over the last few months, begun to stage the framework under which it plans to reduce its balance sheet while raising interest rates.
BIS Warnings. The recently issued 87th Annual Report of the Bank for International Settlements (BIS) focuses on what the BIS calls the “sustainability of the current expansion,” in which it identifies what it considers to be the four most likely threats, apart from geopolitical crises, that could lead to recession. These are: 1) a spike in inflation that prompts central banks to hike rates rapidly, 2) serious financial stress in one or more markets, 3) a retrenchment in consumption with no corresponding uptick in investment, and 4) anti-growth effects of protectionism. In addition, the BIS notes that, since 1990, recessions have been preceded by a run-up in debt and housing prices, with this situation exacerbated in emerging economies by high dollar-debt exposure through a “debt service burden” mechanism in which paying interest and principal on outstanding USD debt becomes more difficult at high debt-to-GDP levels. To examine this, we look at the trends in Debt-to-GDP over the last decade:

Debt-to-GDP Trends 2006-17 (in %): Government and Private (Households & Corporations)

Among these major economies public sector debt has increased significantly compared to GDP. Household and corporate debt has increased modestly in several of them. The private debt-to-debt ratio in China fell over the period, but to a level that remains the highest among the group at over 200% of GDP. Importantly for those Superforecasters attempting to adjust their outlooks, these BIS data may indicate potential stress in some economies. The last global recession was sparked by a financial crisis, but recessions before that have generally followed the more traditional path of demand driven price spikes and inflation that lead central banks to tighten monetary policy, which in turn clamps down on both consumption and investment.

The BIS highlights further heightened risk conditions its annual report (p.13): "From 2009 to end-2016, US dollar credit to non-banks located outside the United States – a bellwether BIS indicator of global liquidity – soared by around 50% to some $10.5 trillion; for those in EMEs [Emerging Market Economies] alone, it
more than doubled, to $3.6 trillion." Its early warning indicators highlight a number of countries that could be vulnerable, particularly China, Canada, Indonesia, Thailand and Mexico. On trade and protectionism, the BIS notes (p.103): “Global trade has barely grown in line with global GDP. This is striking given that trade has consistently outpaced GDP since the mid-1800s, with the exception of the interwar years.”

3. **Real Economy Indicators Continue to Show Strength**

Globally coordinated monetary accommodation and fiscal stimulus aside, key indicators of economic activity appear to show continued, if not extreme, strength going into the second half of 2017. The forward looking Purchasing Managers Indices, reflecting corporate planning, continue above 50 (meaning strength) in the US and Eurozone, while China's measure just dipped below that level.

**Key Purchasing Manager Indices (PMIs) 2013-17**

![Graph showing PMI growth](image)

Meanwhile, the "hard data" of Industrial Production continue to move up slightly in the US and Eurozone, while China's measure keeps to the 6%-7% range it has shown for several years. These indicators show that, despite the potential threat of rising rates to stifle demand, both planning and production are keeping their momentum.

**Industrial Production in the Major Economies, 2000-17**

![Graph showing industrial production](image)

4. **Market Effects and Portfolio Strategy**

At its June meeting the LISI Investment Committee voted to maintain its current Tactical Asset Allocations across its five risk models. We continue to be wary of heightened market sensitivity to potential geopolitical crises, particularly in light of the coming QE windup across regions, yet see support for equity valuations in improving corporate earnings. Accordingly, across asset classes we favor the following in terms of allocation:

- Fixed Income – We recommend shortening duration and accepting somewhat higher credit risk to mitigate the anticipated rate hike cycle. Emerging markets debt may experience higher volatility under targeted tariffs and other market disruptions

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• Equities – We maintain our positive view on equities and recently increased allocations given improving EPS, potential support from fiscal stimulus, and the Fed's announced slow and steady approach to hiking interest rates

• Alternatives – We continue to favor the inclusion of alternatives for portfolios large enough to accommodate them

• Cash – We recommend keeping a small allocation in cash to capitalize on any market dislocations

While the BIS warnings seem not to sound the loud sirens needed to awaken market bears, the high leverage it has identified unmistakably introduces uncertainty to the currently tepid global economic climate. A wide range of potential risks, geopolitical and otherwise, remain. These include a powder-keg of potential crises in East Asia, from North Korean nuclear saber rattling to China's island building and the responses of affected or threatened countries in the region. It also includes the Middle East, where conflict can interrupt oil supplies. The simultaneous high valuations on equities and low yields on bonds present a conundrum for any aspiring Superforecaster. It remains to be seen which asset class "returns to mean" first, and how fast.
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