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Something to Think About

OAKWORTH CAPITAL BANK

COMMON CENTS

Perhaps it is a little fitting the movie with the most Oscar nominations this year, with 14, is one entitled "La La Land." By virtually all accounts, it is more than a fine film, but I will undoubtedly wait for it to come out on Netflix or Amazon Video. While the movie industry had its second best year in history, in nominal terms, in 2016, I haven't been inside a theater since 2014.

I say it is fitting because much of the country seems to be in la la land, particularly the stock market.

In the simplest terms, stocks rally result when more money flows into the market than comes out. Basically, there are more buyers than sellers at the time, for whatever reason. However, stock prices usually come back to a few things: corporate profits (and expectations for future profits), how much investors are willing to pay for them, and the availability of attractive investment alternatives. We all want to make it more complicated than that, and some of our jobs depend on doing so, but that is about it.

While very few things are completely unprecedented, I might argue the recent 'multiple expansion' in the stock market is a little unusual in light of the Fed having raised the overnight lending AND promising to raise it several more times. Ordinarily, this would cause corporate debt service to go up and, therefore, earnings to go down. Further, a tight (tighter) money policy should reduce inflation expectations, which should drive down the long-end of the yield curve. As the gap between borrowing and lending narrows, banks would ordinarily 'slow' credit expansion. Presumably intuitively, this should slow overall economic actively which should slow corporate earnings growth. Also, the dollar should strengthen as deposit rates in the US climb due to the Fed. This compresses foreign earnings at US multinationals, as they translate their, say, euro back into fewer greenbacks. Finally, as interest rates increase, bonds and cash become more attractive as viable alternatives.

...or so the traditional logic would go. However, this doesn't seem to be the case this time around.

On 12/16/2015, the FOMC raised the overnight lending target 0.25% to an effective target of 0.50%. This was the first 'tightening' since 12/16/2008, an even 7 years. *Trust me, that is a long time for the Fed to not tamper with the overnight target.* The trailing P/E multiple on the S&P 500 was 18.35 that Friday, 12/18/2015. This means investors were willing to pay $18.35 for every $1 of reported Earnings Per Share (EPS).

Then, the Fed essentially took a year off before raising the target rate another 0.25% to a whopping 0.75% on 12/14/2016. THAT Friday, 12/16/2016, the index's trailing P/E was 21.10. Recently, and continually, Janet Yellen has made no secret of the fact the Fed would like to raise rates another 3 times, which would take the rate to 1.50%. Regardless, the S&P 500's P/E remains relatively elevated at 21.53, as of today.

Over the those 14-15 months, we have had Brexit, 1.6% GDP growth (US), stagnant earnings, geopolitical turmoil, and arguably the most contentious Presidential campaign in decades. In truth, and in hindsight, you could probably make a better argument for multiple contraction than expansion…..but you would be wrong, at least up until now.

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Unprecedented? I haven't done the necessary math to make that claim. A little unusual? Yeah, I think so, and maybe I should have used a stronger word than think.

However, there are two things going for stocks right now: 1) the prospects for higher earnings despite anything the Fed might do, and; 2) the lack of attractive alternatives.

First, while tighter credit should have a detrimental impact on corporate earnings, lower corporate taxes certainly wouldn't. I admit I haven't crunch all the necessary numbers on President Trump's corporate tax cut plans, but I have read some experts believe they could increase EPS by up to 10%. But what would that mean for stock prices?

Currently, the trailing EPS for the S&P 500 is 108.90. Estimated forward EPS is 129.73, which I imagine probably has some measure of tax reform imbedded, and the estimated P/E is 18.123487. Let's assume it doesn't, and assume the anticipated tax law changes take trailing EPS to 119.79 and forward to 142.703. If the estimated P/E remains constant at 18.12, the S&P 500 would vault to 2,586.28 from today's 2,351.16 close. Obviously, that is right at a 10% increase.

According to Bloomberg, the current, rounded market capitalization of the index is around $20.94404 trillion. As such, a 10% increase due to changes in the tax code would result in an additional $2.0944 trillion in market capitalization. Poof. Obviously, that is a lot of wealth, even if only on paper.

But, what would if stocks don't budge a penny after said tax reform? Well, that would take the forward P/E down to, what, 16.4759. By this measure, US stocks would be the cheapest they have been in, quite literally, years. This would fuel investor appetite, and stocks would rally as a result.

Clearly, I would argue, much of the rally thus far this year has to do with the prospect for higher corporate taxes. Since economic activity alone likely won't be the cause of a huge surge in profitability, changes to the tax code will have to drive a significant increase in EPS. It appears investors are expecting this to happen. They will be extremely disappointed if it doesn't.

Second, what are your options? Banks haven't moved deposit rates in tandem with the Fed, largely because the loan to deposit ratio in the banking system is currently only around 80%. Put another way, the collective banking system has about $2.4 trillion in deposits that haven't found their way into a loan yet. It doesn't need the money, in aggregate, so it isn't going to 'pay up' to get your deposits. Even so, the Fed Funds target is still only 0.75%, which is about 1.25% BELOW the markets' 10year inflation expectation of 2% and around 1.00% BELOW the 3-5-year expectation. So, keep your money in cash and watch inflation gobble it up. How does that sound?

Then there is the bond market. Right now, it is primarily only good for diversification and the subsequent reduction in the standard deviation of portfolio returns. You sure can't generate much absolute return. After all, the current Yield to Maturity of the 10-Year US Treasury Note is 2.42%. That, my friends, is the baseline for bond market returns for the 10 years after you read this sentence. If you throw a few corporates and a couple of mortgages in there, we might be able to squeeze an additional 0.25-0.50% annualized out of it for you.

So, you stand to make a little more than inflation in the bond market over the next decade, but nowhere near the historical norm of around 2.50%. You might make a 'real' return of 0.50-1.00%. Then there is that nagging thought in the back of everyone's head: "how can rates stay so low when the world is awash in debt? It doesn't make sense, does it?" Well, it does if maintenance is more important to you, as an investor, than any sort of growth in purchasing power.

As Meatloaf sang: "two out of three ain't bad." Corporate profits stand to get a boost from Washington AND stocks still provide the best potential for both an absolute and relative return. As for how much investors are willing to pay for EPS, no one knows for certain. However, as long as real interest rates remain as low as they are, stock multiples stand to remain elevated relative to the historical….all other things being equal and the world economy doesn't collapse.

Low interest rates….higher than normal multiples….potential changes to the tax code...continued modest economic activity….stagnant (for the most part and in aggregate) corporate earnings? Yep, la la land.

The only problem with living and investing in la la land is the complacency which comes with doing both. When I look

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at the houses being torn down in my neighborhood I get a slight twinge of déjà vu. When I think about the negative interest rates so prevalent in Europe and Japan, I wonder how that won't all end badly or somewhat badly (at a minimum). When I ponder the mountain of debt in the global economy, I speculate which country will be the first to literally turn on the printing presses to satisfy its obligations. When I consider the data which shows the vast number of Americans which will start hitting the Social Security rolls over the next decade, I question the pragmatism of those people looking to expand benefits.

If you don't mind, let me stop there. Suffice it to say, I am not as complacent as it would seem so many are. In fact, I have recently begun to tell clients we might (will is too strong a word for how I feel at this time) start getting a little more defensive in our asset allocation IF Washington doesn't start seriously tackling the tax code by the end of 1Q. Even if it does, we might still do the same by the end of the year, particularly if we get than 10% tax code bump. Heck, there would be no reason not to do so….the money will be all in at that point.

No, I don't necessarily think the world is going to fall apart. However, how much easier can the money get than it has been thus far this year? With that said, nothing has changed with that 17 year forecast I had last week. I still strongly believe stocks/ownership are the best way to grow paper wealth. Further, taking risk is still the best way to earn a high rate of return. All of it...nothing has changed.

However, where the rubber meets the road, no one ever went broke realizing profits and you can live in la la land too long.

Disclosure