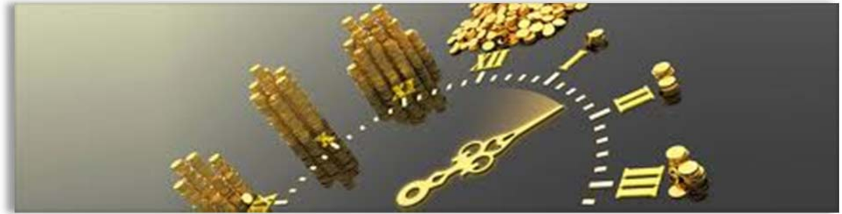

Investors Quarterly

Timely Insights into Markets and the Economy

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Equities

- Every quarter brings its share of issues to worry about. Currently, the big one is the escalation of a *global trade war*. While the implications aren't precisely clear, investors worry nonetheless over potential impacts on the markets and their portfolios. Our research is numbers-driven; and so we wait to see how the data may change (or not.)

- Investors are normally confronted with a raft of *headline headwinds* on a month-to-month basis. Perceived worries come and go, but lately the list consists of geopolitics, political turmoil, the lack of fiscal discipline, corporate debt, consumer debt, margin debt, the rising interest rates and attendant worries over a recession either on or just over the horizon, and just so it won't feel completely ignored - The Volatility Index (VIX). It's a long list!

- Some of this is real and some is runaway imagination. Being a numbers guy, I prefer to pay attention to things I can see and measure. The good news for the markets is that earnings and revenues continue to benefit from a still growing economy. The *earnings recession* we were in from 2014 to mid- 2016 has reversed and trailing earnings on the Dow Jones Industrials stand at historic highs.

- On the economic front, current reporting supports a growing economy. Corporate earnings, especially the *"hard numbers"* (trailing twelve months) are up over 19% compared to a year ago. That's almost a repeat of the 2016-17 rate of change, but it largely goes unreported.

- At the end of the day, it all comes down to the earnings, that have to be there to support higher stock prices. I've read commentary suggesting this market looks like the tech bubble back in 2000. *It doesn't*. The main difference today is that, although led by tech stocks, those companies have growing earnings. That's a big deal.

Fixed Income

- The game may change moving forward as the Fed continues it's return to normal narrative. They have hiked several times over the past two years and promise to do so again, by some accounts, twice more in 2018.

- That has two effects. The first is that it creates a *competing asset class* for investors. The Zero Interest Rate Policy (ZIRP) in place over the past 10 years, forced many investors into a "Risk-on" mode and helped drive the rise in equities as investors entered the markets in search of dividend income and/or capital gains. What happens when rates become attractive again?

- The second thing to consider is the shape of the yield curve. Much has been written about this indicator, particularly about an *inversion* (short-term rates pay more interest than longer-term maturities) and how such an event pre-sages a recession. This has been an accurate leading indicator for decades; and so investors can't be blamed for watching and worrying about such an occurrence.

- We've created a *Recession Predictor* that is based on the yield curve, which you can review in the Market Monitor section (bottom chart). Long story short, it measures the difference in short and long term rates and suggests the odds for recession. Once both indicators are at or near 100%, a recession is likely to occur, accompanied by a bear market in equities. This has been a reliable *warning-bell* since at least 1970. We'll let you know if it rings!

Conclusions

- The main take-away for the quarter is that the market fundamentals remain strong and intact. The technical picture also turned positive in May after being in negative territory since February. The trend remains up and there is little to compete with stocks for being the "only game in town." For now.

- Funny things happen on the "return road to normal." When rates are falling, consumers postpone purchases, thinking they can finance at lower rates next week. When they are rising, there tends to be a surge in consumption, as people rush to buy things ahead of the next rate hike, which ends up *fueling inflation* . We're watching the CPI carefully.

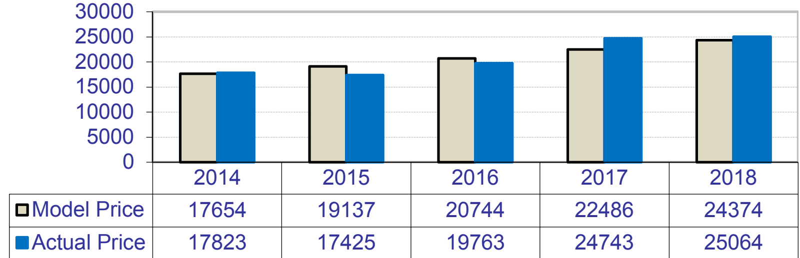
- We are not market forecasters. We are, however, observers of the markets and employ tools we believe helps us filter noise and potentially separate fact from fiction. The next crisis in the markets is seldom like the last one, so don't look to 2007-09 for hints. The problem (always) is that we don't know what we don't know! But we're working at it every day.

Market Monitor

Relative Value

Nominal Price	24,216.05
Model Price	24,264.45
Difference	-48.40
Average % (since 1988)	8.38%
Implication	Neutral

Compares the DJIA (blue) to a hypothetical price (Beige) based on he long term cumulative average growth rate of the Dow. Data for the past 5 years is presented here.

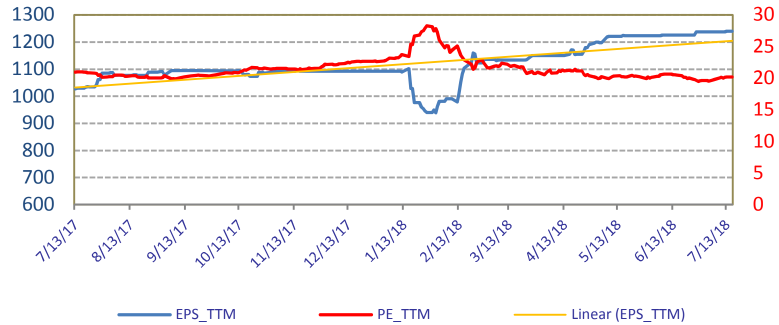


	2014	2015	2016	2017	2018
Model Price	17654	19137	20744	22486	24374
Actual Price	17823	17425	19763	24743	25064

Earnings Growth

Time Period	*% Change*
1 Month	1.19%
3 Month	7.59%
6 Month	13.27%
Y-O-Y	20.49%
Trailing PE Ratio	19.57
Implication	Positive

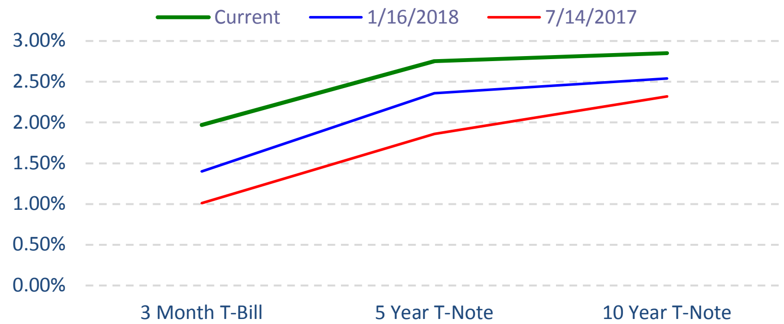
Presents the rate-of-change in the DJIA trailing earnings (blue) and also the relevant PE ratio (red) based on those earnings. Growing earnings support current prices.



Yield Curve

Maturities	*% Yield*
3 Month T-Bill	1.88%
5 Year T-Note	2.73%
10 Year T-Note	2.85%
Long-Short Spread	0.97%
Risk Implication	Rising

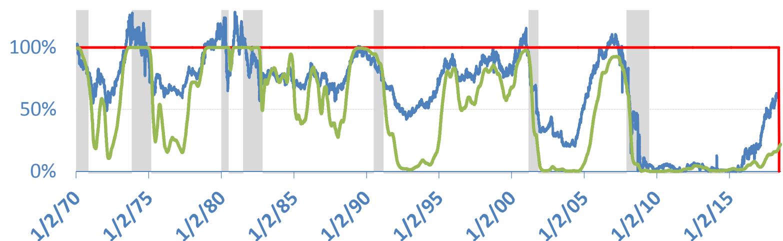
The prospects for continued economic growth are improved when the yield curve slopes up. This graphic presents the yield curve over the past year.



Recession Predictor

Yield Curve Score	65.96%
Recession Probability	20.91%
Risk Implication	Rising

The Yield Score (blue) and Probability Odds (Green) both must approach/exceed 100% prior to a new recession (gray).



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