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Market Overview | October 4, 2018

"U.S. stocks are trading at their highest premiums to international shares in years, reflecting bets among investors that the domestic economy will keep powering past its peers around the world." WSJ, October 2, 2018. The article goes on to report a Bank of America Merrill Lynch opinion that the premium is the highest since 2009.

When we finished June, the S&P500 was up about 2.6%. International markets were down about 2.8%, and the bond market was down about 1.6%. Since that time, the S&P500 rose more than 7%, putting year to date gains at just above 10%. At the same time, year to date gains for international markets and the bond market are still negative. Hence, the increasing gap between U.S. and international markets. Once again, assuming that the three main components of a diversified portfolio are U.S. stocks, international stocks and bonds, two of the three components are negative so far this year. So both bonds and international stocks have subtracted from performance.

Only one of the three components gets widely reported every day (U.S. stocks) and so when U.S. stocks dominate, one can begin to believe that everything is up. When a diversified portfolio produces smaller returns, they then can ask why invest in anything else? The two simple reasons are that most of the world's potential future growth is present overseas over the next 10 to 15 years. U.S. companies are not going to capture all of that growth. Second, either because of a portfolio's cash flow requirements and/or because of a person's risk tolerance, portfolios need some level of bonds for ballast.

It is worth looking at the period of 2008 through 2013. The following entries list the 1st, 2nd and 3rd place finishers in performance for those years.

2008: Bonds, U.S. stocks, Foreign stocks
2009: Foreign stocks, U.S. stocks, Bonds
2010: U.S. stocks, Foreign stocks, Bonds
2011: Bonds, U.S. Stocks, Foreign stocks
2012: Foreign stocks, U.S. Stocks, Bonds
2013: U.S. stocks, Foreign stocks, Bonds

So over this six year time frame, each category of investment came in first place two times. It is true that over time we would not expect bonds to be at the top of the list. Bonds can outperform when there is market volatility and stock markets decline. That is when the ballast they provide is quite valuable.

Stocks can produce returns that are a multiple of an economy's growth rate. The growth rate potential of many international markets is higher than that of the U.S. International markets are cheaper than the U.S.

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Moving on to speculation about the future: It is fair to question whether the gap in valuation between U.S. stocks and international stocks can continue, and how the gap might close. Will the U.S. market reverse? Or will international markets outperform? Last quarter's note stated that earnings gains over the first six months, along with a close to flat market, allowed the market's valuation to drop materially back to more normal levels (valuations fell about 12%). When I use the term valuations in this way, I am referring to the relationship between earnings gains and the market's appreciation. So, when valuations fell 12% during the first half of the year, it means that the actual market's gains were 12% less than the actual earnings gains. If earnings increased 14%, then the market only gained 2%. During the third quarter, the market resumed its pattern of racing ahead of actual earnings gains, and valuations rose about 4%. So the market rose about 4% more than actual earnings gains. For the mathematicians out there, consider the above an approximation.

Is a 4% rise in valuations bad? It is not necessarily a bad thing. But during a period when interest rates are continuing to rise, and earnings growth may slow, I question whether it can continue. Perhaps the U.S. market is getting a bit ahead of itself. I would prefer to see the market rise along with earnings, not ahead of earnings.

On another note, during this year, we have been reviewing and making changes to the bond portfolios to make sure that we are comfortable with holdings through the next downturn. The standards used in credit underwriting (or lending money) do not remain static. After lenders make bad decisions by being too lenient, they become much more restrictive to whom they will lend money and under what circumstances. Then after a period of time, they forget that bad things can happen, and they begin lending seemingly without regard to whether they will be repaid. And then they suffer losses, and the cycle continues.

I mention this because there is evidence that the lending cycle is beginning to enter the careless stage again. A growing number of more indebted borrowers that are closer to the edge can create more fragility in a system. Or to put it another way, when things go bump in the night, more things tend to fall over. Something to pay attention to, but also something that we are already addressing.

Please call with any questions or concerns.

Best regards,

Peter B. Harre, CFA