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Four Observations in Markets Today
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The market is fabulously efficient at pricing-in the consensus forecast around important variables like interest rates, economic growth, currencies, and recessions. The problem is, sometimes consensus is wrong, which creates wild volatility and distress. At extremes, consensus around many variables all interconnected can be wrong, creating a whirlwind of opportunity. Today, consensus forecasts seem to be extrapolating the most recent past – the most dangerous and erroneous type of forecasting. Here are my observations of the current markets:

1. Disconnect between equity markets and fixed income markets: equity and fixed income markets don't always tell the same story – today, they're telling polar opposite tales of the future.
    a. The fixed income market today is akin to a warning on the dashboard of your vehicle, flashing RED – danger ahead! Investors have flocked to low or even negative-yielding bonds in Europe in exchange for "safety." The fixed income market would have you believe we're already in a recession.
    b. The US equity markets hover within 2% of all-time highs and high valuations which would normally indicate good times are ahead. No RED flashing light from the equity markets.

2. US Economic Strength: The US economy has been the envy of the developed world over the last decade. The recovery has been slower than average, but the duration has been impressive and many other developed countries have had much less growth. This has resulted in US equity market returns that have trounced other developed global equity returns and more money pouring into US equities from abroad with the expectation of further outperformance. Coupled with higher US interest rates compared to Europe and Japan, the US dollar has strengthened significantly and many assets that weaken upon dollar strength (emerging market equities) have been priced for the extrapolation of strong US economy and dollar.

    Will the US equity market and economy outperform the rest of the world forever?

3. Interest Rates: rates are low, as we all know, but the forecast calls for lower yet, and longer. The 30-year US treasury bond yield dipped below 2% last month and today sits at 2%. At 2%, assuming a 37% tax bracket, the after-tax return is 1.20%. If inflation runs at the current 1.7% the owner is locking in a -.50% per year loss. If inflation returns to 3% (historic average) investors would lose -1.8% per year.

    Will investors accept a negative return, for how long?

4. Recession: the fear of recession has never been more broadly discussed. In fact, we've been hearing about a recession risk since 2010 when a double-dip recession was feared. Interestingly, this fear has been fully priced-in for some businesses, while not affecting others in the least. Some industries are more susceptible to a recession than others (think Caterpillar versus Starbucks), but a recession is a negative for nearly all industries and sectors. Today, because interest rates are SO low, many stocks that produce reliable earnings and dividends have been bid up 30-50%, even though a recession will hinder growth and earnings. Let's call these stocks "bond proxies" because valuations are being calculated based on yield, not earnings, although obviously the earnings produce the yield! Other businesses without earnings or profits haven't been affected by recession fears – I guess if you're losing money today after ten years of economic expansion, you're not trading based on fundamentals, so if fundamentals deteriorate, who cares! On the flip side, some dividend-paying stocks with cyclical earnings have performed as if the recession is here and it's a serious one.

How can this be? Some businesses with exposure to the economy are trading as if a recession will be a boon to business while others operating in the same economy are trading as if we're headed for a 2009-type recession. Still others aren't being valued with any impact from the economy at all.

It's terribly difficult to predict the future. In fact, the global economy is the compilation of billions of people and trillions of transactions and decisions, all made by unpredictable, emotional humans. BUT, the markets are valued and priced based on predictions of the future, so one cannot avoid the prediction business. Historically, when the market gets too confident in its ability to predict the future it leaves little room for error. Today, we see the markets forecasting more of the same – basically extrapolating every trend of the last decade. Our approach has always been to assume everything is cyclical – including interest rates, markets, and economies and to think about this cyclicality happening over the long-term, not next week.

Here are our long-term predictions:

1. Fixed Income: returns will be lousy, maybe negative after tax and inflation until rates rise. We're keeping bond portfolios short-term until returns compensate for the credit and ever-present interest rate risk (i.e. inflation).
2. Equities: returns will be better than fixed income, although we believe equity valuations are high and we'll continue to hold dry powder for opportunities. We favor global developed markets, emerging markets, and business with wide moats, good balance sheets, and prolific cash flow.
3. Interest rates: we could see rates rise – at some point in the future to accurately reflect the risk of inflation and credit risk of some borrowers (e.g. Greece's bonds, a much riskier credit, yield roughly the same as US treasurys). Today, it seems impossible to think interest rates could ever rise again. Interestingly, thirty-five years ago investors wouldn't purchase 14% 10-year US treasury bonds because no one could imagine rates would ever decrease again.
4. Recession: we'll see a recession (now that was obvious), but businesses valued as "bond proxies" and non-cash flow-producing businesses could see their stocks fall more than businesses priced as if we're in a recession today.

So in summary, we favor equities over bonds, international equities over domestic equities (although we'll continue to hold at least 50% domestic), short-durated bonds over long bonds, and businesses producing cash flow to those that do not.

Sincerely yours,

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