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Peak Capital Management

Fair Value or No Value?

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One of the most important issues investors must constantly evaluate is whether the stock market represents compelling value or if equities are overvalued. The positioning of portfolios and expectations for future returns are largely determined by what conclusions you come to about valuations. The problem, however, is whether you are a novice investor just starting out or a seasoned professional portfolio manager, there is no clear standard of how to gauge stock market valuations.

History is clear that if you buy stocks when valuations are high, the expected future returns are much lower than if you buy stocks when valuations are low. How you choose to determine valuation can lead to vastly different conclusions. Wall Street consensus valuation models use a discount rate based on WACC (weighted average cost of capital) or the profitability level necessary for a project to move forward. Analysts peg the discount rate for the broad market to short-term interest rates since many large companies and institutions can borrow at very low costs. As a result of the ultra-low interest rates, price-to-earnings ratios can rise without analysts believing the market is overvalued.

While this approach makes sense and is widely followed, it is not necessarily the best gauge of actual valuations of the markets. Another method of valuing stocks is to look at the ratio of total market cap (value of all US listed equities) versus GDP. This valuation method is not impacted by a discount rate and provides a very different look at valuations today. The chart shows that valuations today are higher than they have been since 1970, including the dotcom bubble in 1999. The Buffet Indicator data goes back to 1900 and is a type of price-to-sales versus GDP. That chart suggests only in 1929 were stocks more overvalued than they are today.

Valuations tend to swing like a pendulum over time, moving from undervalued to overvalued and back again. Crestmont Research models suggest the stock market is more than three standard deviations overvalued, a level we would be foolish to ignore, and suggest the pendulum may soon swing in the opposite direction. One of the valuation metrics I track closely is the Tobin's Q Ratio. This compares the value of stocks against their replacement costs. When something trades at a price significantly above its replacement costs you typically see a mean to reversion occur. Tobin's Q ratio is at 120% and has only been higher in 1999 at the height of the dotcom bubble.

There are many arguments as to why the stock market can continue to march higher in the face of nosebleed valuations. You could refer to these arguments as the "this time is different" thinking. The most compelling reason that today is different is the actions of the Federal Reserve to keep interest rates artificially low. Because yields are so low, many investors feel forced into allocating to higher risk assets like stocks and real estate. While this argument makes sense, it will not soften the blow when the stock market is down 30%-40%.

> **The Laws of Economic Gravity cannot be ignored forever: valuations at today's level are not sustainable indefinitely.**

Some argue that stocks are safer today because bonds are even more overvalued. This argument ignores the long term history of the importance of valuations and assumes that status quo will remain; a faulty premise if ever there was one. I would certainly agree that bonds can be viewed as grossly overvalued unless you believe a recession is imminent. Regardless, my recommendation would be to find ways to make your portfolio less dangerous rather than ignoring the risk level that today's valuations represent.

Bear Market or Recession: Chicken or the Egg?

There is a lot of discussion this long into the current bull market as to whether a recession will cause the next bear market, or will a bear market cause the next recession. They are deeply entwined as a slowdown in economic growth leads to lower corporate earnings and less appetite for stocks. Conversely, a 20% drop in stock prices causes a negative wealth effect with falling 401k values, and makes consumers less likely to spend freely. In the end, it really does not matter which comes first as forecasting either is prone to error.

The Laws of Economic Gravity cannot be ignored forever: valuations at today's level are not sustainable indefinitely. The more stretched to the upside the markets become the more pain that will be inflicted when the correction comes. Take heed to make sure your portfolios have sufficient risk mitigation in place.

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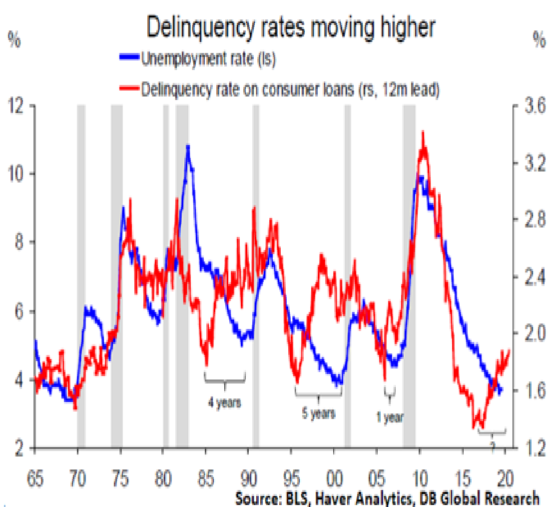
Getting Late in the Late Cycle



While timing an economic downturn with any precision has proven difficult if not impossible (economists have predicted 5 of the last 3 recessions), there are signals of where we are in the economic cycle for those who care to pay attention. The signals today suggest we are near the end of the late cycle, with an economic downturn likely sooner rather than later. Not only are delinquencies moving higher as seen in the chart, bank lending standards are tightening, making it harder for companies to access credit. The Fed is cutting rates in an attempt to stimulate loan growth, but lenders are not cooperating. Add to the mix that the latest consumer confidence surveys suggest people are more optimistic about their current situation than confident about the future — an ominous sign for growth.

- Corporate profits as a share of GDP peaked in 2015 and have been falling since, even as stock prices march higher in a compelling sign we are at a very late stage in the cycle.
- A leading indicator that is often ignored is the utilization of temporary staffing positions. The growth rate has turned negative by the largest amount in over a ten-year period.
- The gap between consumer confidence and corporate confidence has reached levels consistent with prior recessions, as CEO's start to retrench before consumers are impacted.

The Devil in the Details

DJIA: Top Five Non-GAAP EPS > GAAP EPS for Q3 2019

COMPANY	TICKER	NON-GAAP EPS	GAAP EPS	DIFFERENCE (%)
Walt Disney Company	DIS	1.07	0.43	148.8%
Merck & Co., Inc.	MRK	1.51	0.74	104.1%
Dow, Inc.	DOW	0.91	0.45	102.2%
Walgreens Boots Alliance Inc	WBA	1.43	0.75	90.7%
United Technologies Corporation	UTX	2.21	1.33	66.2%

Source: Factset

If you are a long time reader of the PCM Report, you are familiar with the nuances of how earnings per share (EPS) can be reported, coupled with how these nuances can drive stock prices. Publicly traded U.S. companies report earnings using generally accepted accounting principles (GAAP). Some companies also report non-GAAP earnings. Non-GAAP earnings can give a more in depth picture of what is driving earnings, particularly in terms of operations. The issue with non-GAAP earnings is that they are not standardized, leaving wiggle room for companies to use non-GAAP earnings when they are beneficial to earnings reports. It takes a very well-trained, careful eye to determine the most accurate reflection of earnings, as analysts set out to determine the potential earnings have in driving a stock price up or down.

- Since 2016, 73% of companies in the Dow Jones Industrial Average have reported non-GAAP EPS (Factset).
- Since 2016, 75% of companies of companies in the DJIA reported non-GAAP EPS that exceeded GAAP EPS (Factset).
- Among DJIA constituents, Walt Disney Company led the delta between Non-GAAP EPS and GAAP EPS with a 148% difference.
- The top five companies showing the greatest difference between GAAP and non-GAAP EPS drops off with United Technologies at #5 with a 66.2% difference.

Equity Returns During Election Years

Year	S&P 500 Index	Candidates
1928	43.6%	Hoover versus Smith
1932	-8.2%	Roosevelt versus Hoover
1936	33.9%	Roosevelt versus Landon
1940	-9.8%	Roosevelt versus Willkie
1944	19.8%	Roosevelt versus Dewey
1948	5.5%	Truman versus Dewey
1952	18.4%	Eisenhower versus Stevenson
1956	6.6%	Eisenhower versus Stevenson
1960	0.5%	Kennedy versus Nixon
1964	16.5%	Johnson versus Goldwater
1968	11.1%	Nixon versus Humphrey
1972	19.0%	Nixon versus McGovern
1976	23.9%	Carter versus Ford
1980	32.5%	Reagan versus Carter
1984	6.3%	Reagan versus Mondale
1988	16.6%	Bush versus Dukakis
1992	7.6%	Clinton versus Bush
1996	23.0%	Clinton versus Dole
2000	-9.1%	Bush versus Gore
2004	10.9%	Bush versus Kerry
2008	-37.0%	Obama versus McCain
2012	16.0%	Obama versus Romney
2016	12.0%	Trump versus Clinton

Sources: Morningstar and Wells Fargo Investment Institute, November 5, 2019. For illustrative purposes only. **Past performance is no guarantee of future results.** An index is not managed and not available for direct investment.

Much has been written over the years about the relationship between stock returns and presidential elections. At first glance, we might casually assume that equity returns are more volatile during elections, given the potential uncertainty about either an incoming president or an incumbent getting reelected. Given that we are reaching new highs for most major equity indexes, and some economists are suggesting that stocks are overvalued, it stands to reason to be somewhat inquisitive about past performance around the election cycle. The historical record, however, doesn't seem to suggest that there's any more (or less) volatility around presidential elections.

- Based on the historical record, as shown in the table to the left, there have been 23 elections going back to 1928 (Hoover vs Smith). Out of these 23 elections, there have been four instances where the S&P 500 Index has delivered a negative return, with the worst calendar year return coming during the financial crisis of 2008 (equities lost roughly -37% for the year).
- The volatility of annual returns during election years, however, isn't necessarily higher than the long-run average volatility of all equity returns going back over the same time period. In other words, an election on its own doesn't seem to lead to higher volatility of returns. An administrative change (i.e. a new president) doesn't seem to tilt the scales all that much either. Overall, an election year shouldn't be a determining factor for investing in equities.

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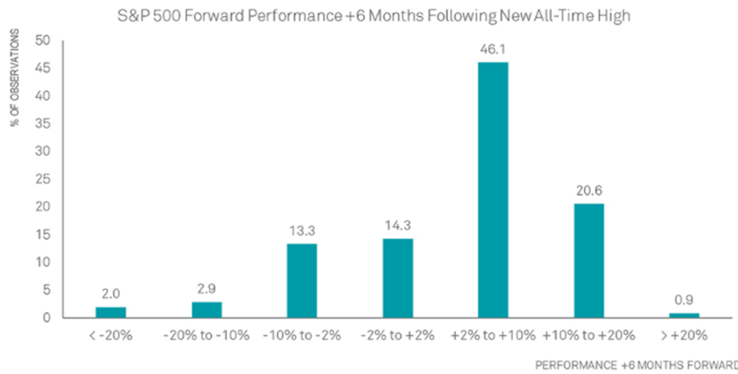
Macro View – Making Sense of New Highs

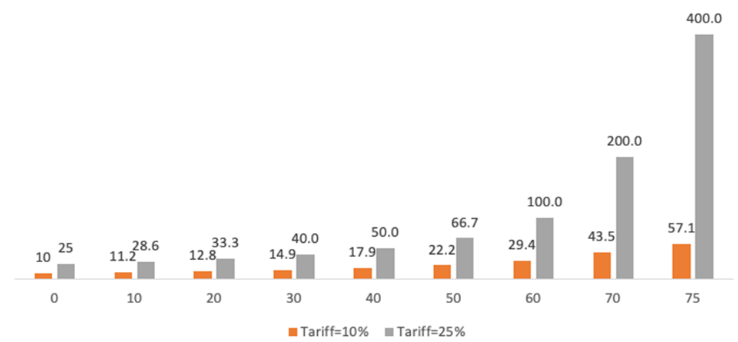
The recent highs in the market have investors euphoric and analysts wringing their hands. It is not lost on industry experts and investors that since the first all-time high of this bull market on March 28, 2013, the S&P 500 has almost doubled (BNY Mellon). The chart below shows S&P 500 performance six months following a new all time high in the index. The data went back to 1950, with 1120 total observations of a new all time high over six months following the previously set all time high in the index. About 67% of the time, the market is at least 2% higher six months after a new all time high. Further, over 20% of the time, the market is 10% higher six months after a new market high. The lesson is that investors are served well by adhering to a disciplined process that evaluates risk, can capture meaningful positive returns, and reduce the possibility of severe market drops.



Data since 1950, 1120 observations. As of 6/24/2019. Source: Strategas.

Taking Stock – Apple and Trade War

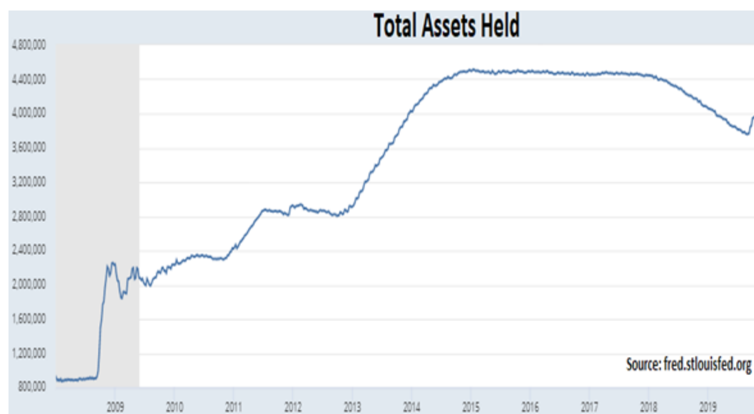
President Trump imposed a 25% tariff on $250 billion in Chinese goods. The tariff raises questions for multinational companies like Apple. For example, there are over 10 Chinese companies involved in the production of the iPhone. In 2009, there was one Chinese company involved in the production of the iPhone. China has set out to reduce the burden of the tariffs on their economy by devaluing their currency. The chart below shows the impact devaluing the Yuan has on a 10% tariff and a 25% tariff with the X axis showing the percentage of foreign value add embedded in Chinese exports. The impact of a 10% vs. a 25% tariff is meaningful. A 25% tariff requires a 28.6% depreciation of the Yuan to counterbalance the negative impact of the tariff. It is not surprising that Apple is looking to countries outside China as suppliers for the iPhone.



Source: Xing (2019).

Fixed Income - Rooting for the Home Team

Fed Chair Powell recently announced that the Fed would begin increasing their balance sheet, stopping short of calling it quantitative easing — a difference without distinction for many. Powell made the announcement in response to the inverted yield curve that spiked recession concerns. At the heart of Powell's message was the need to react to negative interest rates in Europe and Asia. High rates in the U.S. relative to the rest of the developed world has caused the U.S. dollar to remain stubbornly high, hurting the competitiveness of domestic companies. Powell is hoping that the Fed's action will stem the dollar's rise and result in more robust export growth. While the shift in policy may succeed in the short-term, it is likely that the law of diminishing returns kicks in and low interest rates no longer represent the stimulus they have in the past.



Technical - Reversing the Trend

It has often been said that if something is not sustainable it has to change, and that is likely to happen soon in the trade dispute between China and the U.S. The chart below shows how dramatically exports from China to the U.S. have fallen since the onset of the trade war and how much it is impacting the Chinese economy. The trade war is a major narrative and risk for the stock market, so forecasting a settlement, even a minor agreement, could result in a sharp period of buying lifting the markets to new highs. There are political reasons at home also for making a trade cease fire compelling. With impeachment hearings dominating the daily news feed, a deal with China on trade that includes relief for U.S. farmers would be a welcome respite in the White House.

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Equity Valuations

Clint Pekrul, CFA

We have discussed equity valuations in past reports, mainly because current valuations are the primary driver of future returns. Investing at high price multiples, whether based on price-to-earnings, price-to-book values, etc., could subject investors to a reversion to the longer-term valuations. That is, equity prices could fall to valuations that are more in line with longer-term averages.

Of course, there is no magic formula or universally accepted method for determining when equites are "expensive" or when overall price levels are due for a reversion to the mean. Equity prices can remain at elevated levels for some time, particularly in a bull market, so market timing can be difficult. But if history is any guide, we know that eventually, market values tend to revert to longer-term norms.

One popular measure of equity valuations, although not without criticism, is to compare the ratio of U.S. gross domestic product (GDP) to the market capitalization of a broad equity index, such as the Wilshire 5000, which measures the total capitalization of 5000 publicly traded companies. The rationale for the comparing GDP to the total market capitalization of an index like the Wilshire 5000 is that over the long-term, corporate profitability should be roughly in line with economic growth, or GDP.

Chart 1 below illustrates the historical relationship to the Wilshire 5000 Index market capitalization and GDP. The chart begins in 1971 and goes through today. The right-hand index measures market value in trillions of dollars. As we can see, the blue line (i.e. the market value of stocks) sometimes falls below the green GDP line, suggesting that stocks could be undervalued. Conversely, at times the blue line shoots above the green line, suggesting that stocks could be overvalued.

Source: gurufocus.com

Chart 2 below simply takes the ratio of the blue market cap line and the green GDP line from Chart 1. As chart 2 shows, we are currently approaching valuations (i.e. stock market capitalization to GDP) not seen since the waning years of the tech boom in the late 1990s, when equity valuations reached roughly 150% of GDP.

Source: gurufocus.com

What stands out from the charts is where we currently stand today in terms of the blue line's gap above the green line (in either absolute or percentage terms). Not only is the market cap for stocks above the value of GDP, its been trending above GDP for some time. However, it's difficult to make an investment decision, or more precisely, an investment *timing* decision, based on the valuation metrics shown in the chart.

The reason, in our estimation, is the unprecedented intervention in the financial markets by global central banks after the financial crisis. Their policies have effectively kept interest rates low, which in turn has buoyed asset prices. Twenty years ago, investors had alternative to equities, given that government bond yields were as high as 7%. Today, they hover at or below 2%. Simply put, investors have fewer places to go today, so it's difficult to gauge how long the positive gap between market capitalization and GDP can go. This uncertainty about the future path of equity prices is why we suggest following a tactically managed strategy, whereby a portfolio is positioned to rebalance across various asset classes and incorporate hedges against heightened volatility if needed.

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Q: How likely is a trade deal between the U.S. and China before the end of the year?

As I wrote about in Analyst Corner, I believe the initial outline for a trade agreement with China is imminent and will occur before the end of the year. Just this week China finally took some action to strengthen the legal protection of IP (intellectual property) and is expected to announce a modest change to laws requiring a technology transfer for companies selling into China. China's willingness to move on these items has been at the heart of the trade war, and should pave the way for the first phase of what should be a long-term mutually beneficial trade agreement between the countries.

Making an announcement on how many new jobs will be created or protected by the trade agreement will be a win the Trump administration will be seeking to change the narrative away from impeachment and Ukraine. Looking at the political map for the 2020 election also plays a critical role in the negotiations. As we enter 2020, Trump knows he must be popular across the Midwest and the Rust Belt to win states he narrowly won 4 years earlier. There will likely be aspects of the trade deal that will be economically beneficial to those economies.

Both the U.S. and China have compelling reasons to announce a deal before the end of the year, which suggests a deal gets done. It is possible that the deal will be light on details and not market moving but both leaders will be able to declare victory.

I'm not sure there will be a final resolution to the trade tensions between the US and China, at least while Trump is in office. The president will continue to use tariffs as a political weapon, despite any compelling economic theory that they actually work. Likewise, president Xi isn't just going to acquiesce to Trump's demands. How many times have we heard from either Trump, or Treasury Secretary Mnuchin, or economic advisor Kudlow, that we are close to a deal, only to backtrack? I hope something of substance materializes by year end, but I'm not holding my breath. Furthermore, the tariffs with China can't just be "canceled" if nothing materializes, not even for the next president or the next three presidents. A narrative has been created for the American public that China has been sticking it to the US. To backtrack on that narrative would be political suicide. Bottom line is that the trade policy Trump has created might be with us long after he leaves office, let alone be solved by the end of the year.

Q: Are there unintended consequences of the impeachment hearings?

If there are, they are relatively miniscule in my opinion. While the die may seem cast today, I expect the drama in the House to play out differently than the consensus view of the political elite. I think the Democrats running the House will not take a formal vote on Articles of Impeachment. I believe the "inquiry" has really been an attempt to publicly repudiate the President and damage him politically, but they never intended to actually force an impeachment vote.

There are many reasons for this view, but two really stand out. First, there are 31 Democrats running in districts Trump won in 2016 that do not want to have to abandon the party or alienate voters. It is a political nightmare for them that Pelosi will likely not make them endure. Second, a trial in the Senate would likely be a disaster for Democrats, especially those running for President in 2020. Since Republicans control the Senate, they will be able to call whomever they wish as witnesses, and they will not hesitate to call Hunter Biden, the whistleblower, and many members of the Obama administration. Forcing impeachment into a Senate trial would be a miscalculation of massive proportion I believe.

The markets have ignored impeachment as evidenced by hitting a new all-time high on the same day as the first public hearings. It is a situation where the highly partisan nature of politics today actually provides a level of stability.

My thought from the beginning is that the impeachment proceedings might very well backfire on the Democrats during next year's election. First, as I've mentioned before, I don't think the Democrats will have enough senators get on board (they need a two-thirds majority, which is highly unlikely at this point). So from the very beginning, I thought the impeachment proceedings were a non-starter. In other words, impeachment would never actually lead to legal proceedings that could force Trump out of office. Second, if the impeachment proceedings do fizzle in the Senate, Trump could make the campaign into a single polarizing issue - the Democrats, after spending countless hours and resources on the impeachment process, failed in their "witch-hunt." I think Trump will ultimately use a failed impeachment effort to his advantage, and that's the unintended consequence for the Democrats come the election.

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All weights as of December 1, 2019

Income	
Mortgage Backed Bond	45.54%
Investment Grade Credit	13.26%
High Yield Bonds	13.56%
Preferred Stock	14.22%
US Dividend Equities	5.62%
US REITs	7.78%

Balanced Income	
US Dividend Equities	15.30%
International Dividend Equities	18.79%
US REITs	15.75%
High Yield Bonds	31.31%
Long Term Treasuries	18.85%

US Growth	
Low Volatility Factor	16.05%
High Quality Factor	12.86%
Small Cap Factor	13.74%
Value Factor	14.90%
Momentum Factor	11.44%
Long Term Treasuries	30.99%

Global Growth	
Low Volatility Factor	8.53%
High Quality Factor	6.22%
Small Cap Factor	7.21%
Value Factor	7.28%
Momentum Factor	5.36%
Developed Market Equity	20.83%
Emerging Market Equity	16.87%
Long Term Treasuries	27.70%

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