PACIFICUS
CAPITAL MANAGEMENT

Markets, Politics and Hypocrites

"A vacation is having nothing to do and all day to do it."
- *Robert Orben*

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It finally happened. Long-time and high-profile market bear Jeremy Grantham, co-founder of the Boston based asset management firm GMO (Grantham, Mayo, & van Otterloo) has thrown in the towel on his bearish market outlook. Mr. Grantham, a highly-regarded value investor, who correctly called and dodged the Japanese, dotcom, and housing busts declared in a recent quarterly letter, "This Time Seems Very, Very Different" that we may have entered a new period of higher stock market valuations.

Mr. Grantham had been a leading voice over many years regarding what he believed to be unsustainable stock market valuations, observing that markets tend to revert to their long-term averages. But in a June 1, 2017 interview with the Financial Times he stated, "I've dedicated my life to financial bubbles, and I don't think this is a bubble. This is the broadest market of all time… That is not the nature of a bubble."

Using the historic price to earnings ratio on the S&P 500, Mr. Grantham breaks data down into two distinct sets - Pre-1996 and Post-1996. He found that Pre-1996, the P/E ratio of the S&P 500 was 13.95 while Post-1996 it was 23.36. Arguing this time is different, Mr. Grantham believes valuation metrics have climbed to a new higher long-term average and summarizes that, "Stock prices are held up by abnormal profit margins, which in turn are produced mainly by lower real rates, the benefits of which are not competed away because of increased monopoly power."

As a past government bond and interest rate derivatives trader turned investment manager, I have built my career analyzing markets based on a top-down, macro (big-picture) approach. For some time now, many of us, myself included subscribed to the view that equity valuations could remain higher than historically normal, due to much lower than average interest rates. If the market believes low interest rates will be sustained for a very long period of time, markets should discount this into present stock prices and value future earnings higher today. This is plainly just the math behind basic discount cash-flow models' analysts employ. However, another way of looking at this is to think in common-sense terms – if the best an investor can hope for by holding a five or ten-year U.S. Treasury bond to maturity is 2% or less annually, why not roll the dice and buy something that bears a bit more risk but has the potential for greater upside? Many have done just that.

Obviously, there is a limit to extrapolating this sort of thinking into the future. At some point, investors will conclude that high valuations placed on an asset's future earnings are not worth risking a significant loss of capital. However, that day of reckoning I believe will likely correspond with a significant increase in interest rates along the entire yield curve. Economic policy makers are worried about this, many market analysts have been warning about this, heck anyone who has profits to protect is probably worried and thinking about this. And this is one major reason why I believe barring a shock, interest rates – from overnight to thirty years - will continue to stay lower for longer. Too much rides on low interest rates, from risky asset values such as stocks and real estate, to servicing both our government and household debt payments.

As an investor, what can you do to protect yourself? Diversify. Diversify your assets. There are times to be greedy and there are times to be cautious. U.S. stocks and many real estate investments have had an amazing run since the depths of the financial crisis. There is no telling if this continues, or if we are in store for a near term correction, but nothing is cheap anymore. In markets where prices move higher, a prudent investor becomes more cautious. In markets where prices move lower, a prudent investor becomes greedier. Today's environment, in my opinion, justifies a cautious yet optimistic approach that emphasizes risk control.

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All day every day, it's Trump 24/7. Do people still say 24/7, or am I dating myself? With financial markets humming along, many people have lost interest. Good news drops, markets go up. Bad news drops, markets go up. No news drops, markets go up. I think you get the idea. Nowadays, politics and more specifically President Trump watching is the new spectator sport. I'm exhausted by it all. This cannot be good for our country.

Regardless of where one lies on the political or philosophical spectrum, from liberal to conservative, communist to capitalist, atheist to believer what many of us despise is hypocrisy.

That preachy do as we say, not as we do attitude. With that said, I was a little shocked to read a May 14, 2017 Politico article, "Reckless stock trading leaves Congress rife with conflicts," as I thought this ethical issue had been addressed and dealt with a few years back. In 2012 Congress passed the Stock Act, a law which created new disclosures about lawmakers' stock trading and for the first time explicitly barred Congress from insider trading. If it wasn't for a "60 Minutes" episode in 2011 putting a spotlight on dubious trades done by our lawmakers' these shenanigans would still be perfectly legal. Is it any wonder many citizens see the system as fixed in favor of the wealthy, powerful and connected? I don't mean to make my readers blood boil over, but both the 60 Minutes video segment and the Politico article are linked above and worth taking the time to view.

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Summer is finally here and I for one plan on taking advantage of the nice weather and time outdoors. Outside of family there is little that makes me happier than spending my days near the ocean or in the mountains. My wife, daughter and I have trips planned and memories to make. I hope my clients and readers alike have the opportunity to do the same. Engaging in professional pursuits such as financial markets and geopolitical analysis can be interesting, challenging and full of rewards, but nothing beats the good times spent with family and friends in nature. That's what it is all about for me.

Sincerely,

Justin Kobe, CFA
Founder, Portfolio Manager & Advisor