Profits, Earnings and the Bottom Line

As stock prices sit near all-time record highs, and as we enter year nine of the current bull market, I remain amazed and amused at the brazen disregard by the financial media for important basic economic concepts like supply & demand, interest rates, and rising profits. If the stock market was a doctor's patient, over the last decade, bloggers, pundits, talking heads, and pontificators have been ignoring the improving, healthy patient's vital signs, while endlessly predicting the death of the resilient stock market.

However, let's be clear – it has not been all hearts and flowers for stocks – there have been numerous -10%, -15%, and -20% corrections since the Financial Crisis nine years ago. Those corrections included the Flash Crash, debt downgrade, Arab Spring, sequestration, Taper Tantrum, Iranian Nuclear Threat, Ukrainian-Crimea annexation, Ebola, Paris/San Bernardino Terrorist Attacks, multiple European & Chinese slowdowns and more.

Despite the avalanche of headlines and volatility, we all know the net result of these events – a more than tripling of stock prices (+259%) from March 2009 to new all-time record highs. With the incessant stream of negative news, how could prices appreciate so dramatically?

Profits

It's quite simple. Stock prices have more than tripled since early 2009 because profits have more than tripled since 2009. It's no surprise either that stock prices stalled for 18 months from 2015 to mid-2016 when profits slowed. After profits returned to growth, stock price appreciation also resumed. The reason stock prices have continued to move higher and higher is because profits have grown fatter and fatter every year

Over the years, the explanations by outside observers have changed. First, the recovery was explained as a "dead cat bounce" or a short-term cyclical bull market within a long-term secular bear market. Then, when stock prices broke to new records, the focus shifted to Quantitative Easing (QE1, QE2, QE3, and Operation Twist). The QE narrative implied the bull advance was temporary due to the non-stop, artificial printing presses of the Fed. Now that the Fed has not only ended QE but reversed it (the Fed is actually contracting its balance sheet) and hiked interest rates (no longer cutting), outsiders are once again at a loss.

It's unfortunate for the bears that all the conspiracy theory headlines and F.U.D. (fear, uncertainty, and doubt) over the last 10 years have failed miserably as predictors for stock prices. The truth is that stock prices don't care about headlines – stock prices care about economics. More specifically, stock prices care about profits, interest rates, and supply & demand.

Interest Rates

When you could earn a +16% on a guaranteed CD bank rate in the early 1980s, do you think stocks were a more or less attractive asset class? If you can sense the rhetorical nature of my question, then you can probably understand why stocks were about as attractive as rotten milk or moldy bread. Back then, stocks traded for about 8x's earnings vs. the 18x-20x multiples today. The difference is, today interest rates are near generational lows (some even below zero), and CDs pay near +0.0000%, thereby making stocks much more attractive. If you think this type of talk is heresy, ignore me and listen to the greatest investor of all-time, Warren Buffett who recently stated:

"Measured against interest rates, stocks are actually on the cheap side." – 2016 Interview

Supply & Demand

Another massively ignored area, as it relates to the health of stock prices, is the relationship of new stock supply entering the market (e.g., new dilutive shares via IPOs and follow-on offerings), versus stock exiting the market through corporate actions. While there has been some coverage placed on the corporate action of share buybacks – about a half trillion dollars of stock being sucked up like a vacuum cleaner by cash heavy companies like Apple Inc. (AAPL) – little attention has been paid to the trillions of dollars of stock vanishing from mergers and acquisition activities. Yes, Snap Inc. (SNAP) has garnered a disproportionate amount of attention for its $3 billion IPO (Initial Public Offering), this is a drop in the bucket compared to the exodus of stock from M&A activity.

Consider the trivial amount of SNAP supply entering the market ($3 billion) vs. $100s of billions in major deals announced in 2016 – 2017:

- **Time Warner Inc.** merger offer by AT&T Inc. (T) for $85 billion
- **Monsanto Co.** merger offer by Bayer AG (BAYRY) for $66 billion
- **Reynolds American Inc.** merger offer by British American Tobacco (BTI) for $47 billion
- **NXP Semiconductors** merger offer by Qualcomm Inc. (QCOM) for $39 billion
- **LinkedIn** merger offer by Microsoft Corp. (MSFT) for $28 billion
- **Jude Medical, Inc.** merger offer by Abbott Laboratories (ABT) for $25 billion
- **Mead Johnson Nutrition** merger offer by Reckitt Benckiser Group for $18 billion
- **Mobileye** merger offer by Intel Corp. (INTC) for $15 billion
- **Netsuite** merger offer by Oracle Corp. (ORCL) for $9 billion
- **Kate Spade & Co.** merger offer by Coach Inc. (COH) for $2 billion

While these few handfuls of deals represent over **$300 billion** in disappearing stock, as long as corporate profits remain strong, interest rates low, and valuations reasonable, there will likely continue to be trillions of dollars in stocks being re-purchased by corporations. This continued vigorous M&A activity should provide further healthy support to stock prices.

Longest Rally Since….

The stock market has been like the Starship Enterprise on "Star Trek." It continues to "boldly go where no man [or woman] has gone before." The S&P 500 has been setting new record highs with only two significant corrections since March 28, 2013, when it was 1569.19. It is up 58.5% since the prior bull market record high as of the most recent record high of 2508.91 set on September 18.

In other words, it has been 1,594 days in outer space. During the previous bull market of the 2000s, it was in outer space (i.e., exceeded the previous bull market record high) for only 133 days. Granted, the air is thin in outer space, as measured by various valuation gauges. However, there's no gravitational pull either, so the Starship S&P 500 can continue to fly as long as it doesn't run out of rocket fuel. The fundamental gauges for the S&P 500 that we watch show plenty of solid rocket fuel for the time being:

It has now been 311 days since the S&P 500 last experienced just a 3% pullback. As shown below, this is the 2nd longest streak of all-time without a 3%+ pullback. To break this record, we'll need to go another 59 days without declining 3% from today's close.

Longest 3%+ Rallies w/o 3%+ Correction

Start	End	Start Price	End Price	% Change	Days
12/8/1994	12/13/1995	445.45	621.69	39.56%	370
11/4/2016	9/11/2017	2085.18	2487.00	19.27%	311
4/26/1993	2/2/1994	433.54	482.00	11.18%	282
2/25/1958	11/17/1958	40.61	53.24	31.10%	265
9/21/1953	5/28/1954	22.88	29.19	27.58%	249
6/28/1965	2/9/1966	81.60	94.06	15.27%	226
7/17/2006	2/20/2007	1234.49	1459.68	18.24%	218
11/15/1949	6/12/1950	15.75	19.40	23.17%	209
10/25/1960	4/17/1961	52.30	66.68	27.50%	174
11/22/1963	5/12/1964	69.61	81.16	16.59%	172

"In politics, absurdity is not a handicap "- *Napoleon Bonaparte*

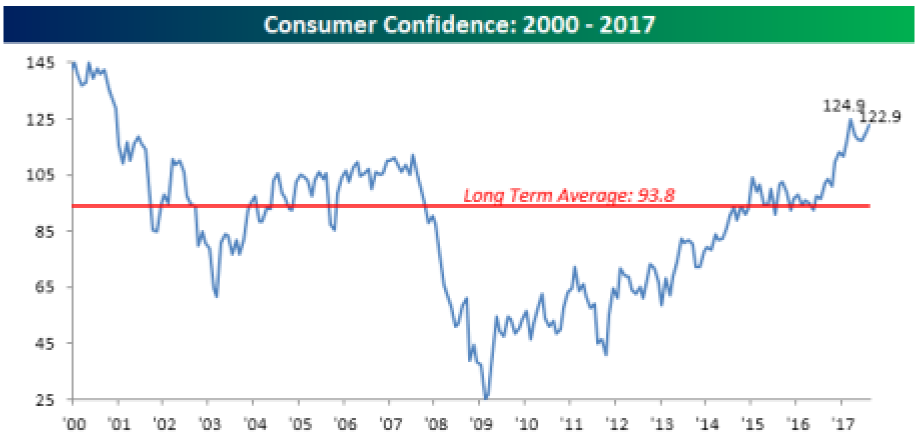
On the political front, the only thought that comes to mind is as follows.

*The **Call of the Wild*** is a short adventure novel by Jack London. It was published in 1903 and set in Yukon, Canada during the 1890s Klondike Gold Rush. The central character of the novel is "Buck," a large and powerful, but domesticated, St. Bernard-Scotch Shepherd dog. Buck is stolen from his home at a ranch in Santa Clara Valley, California, and sold to be a sled dog in Alaska. He becomes increasingly wild as he is forced to fight to survive and dominate other dogs. By relying on his basic instincts, he emerges as a leader in the pack.

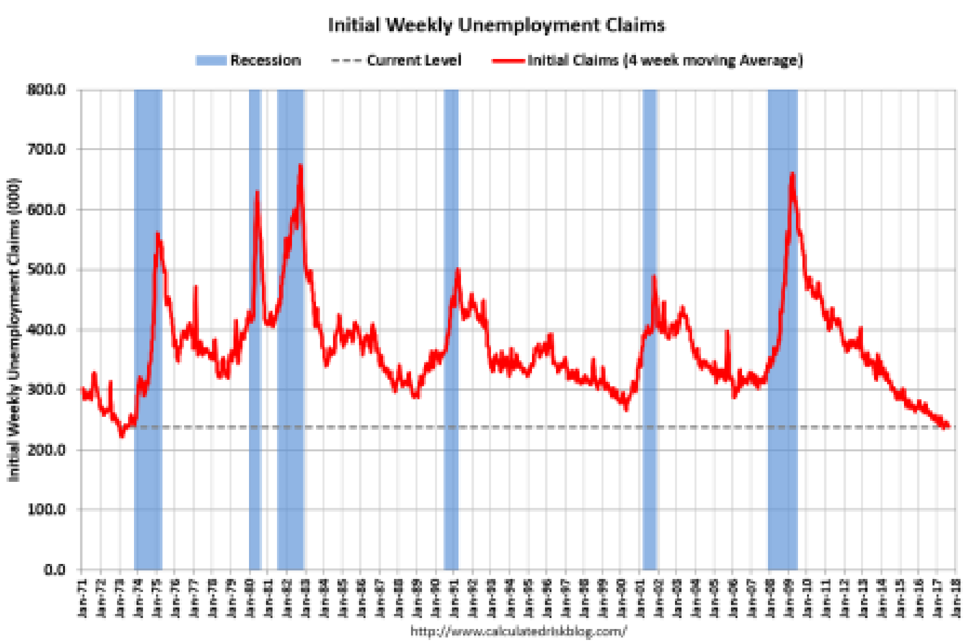
This story seems to portray current developments in the White House and, more broadly, in Washington, DC. It also captures the essence of what we may be starting to see in the stock market. Following the stock market debacles of the early and late 2000s, retail investors retreated from the stock market and turned relatively domesticated, with more of their savings going into liquid assets and bonds. Since Election Day, they seem to have heard the call of the wild. Their feral instincts have been awakened, triggering a gold rush into both domestic and global stock markets.

Over the past 12 months through June, a record $357.8 billion has poured into equity exchange-traded funds (ETFs), led by $236.2 billion going into domestic ETFs and $121.6 billion going into ETFs that invest globally.

Consumer Confidence Builds:
In spite of messy geopolitics and Washington gridlock, consumers are beginning to become desensitized to all the pessimistic noise. Two-thirds of our economy is driven by consumer spending, and with rising confidence (see chart below), this augurs well for the economy, corporate profits, and the stock market.



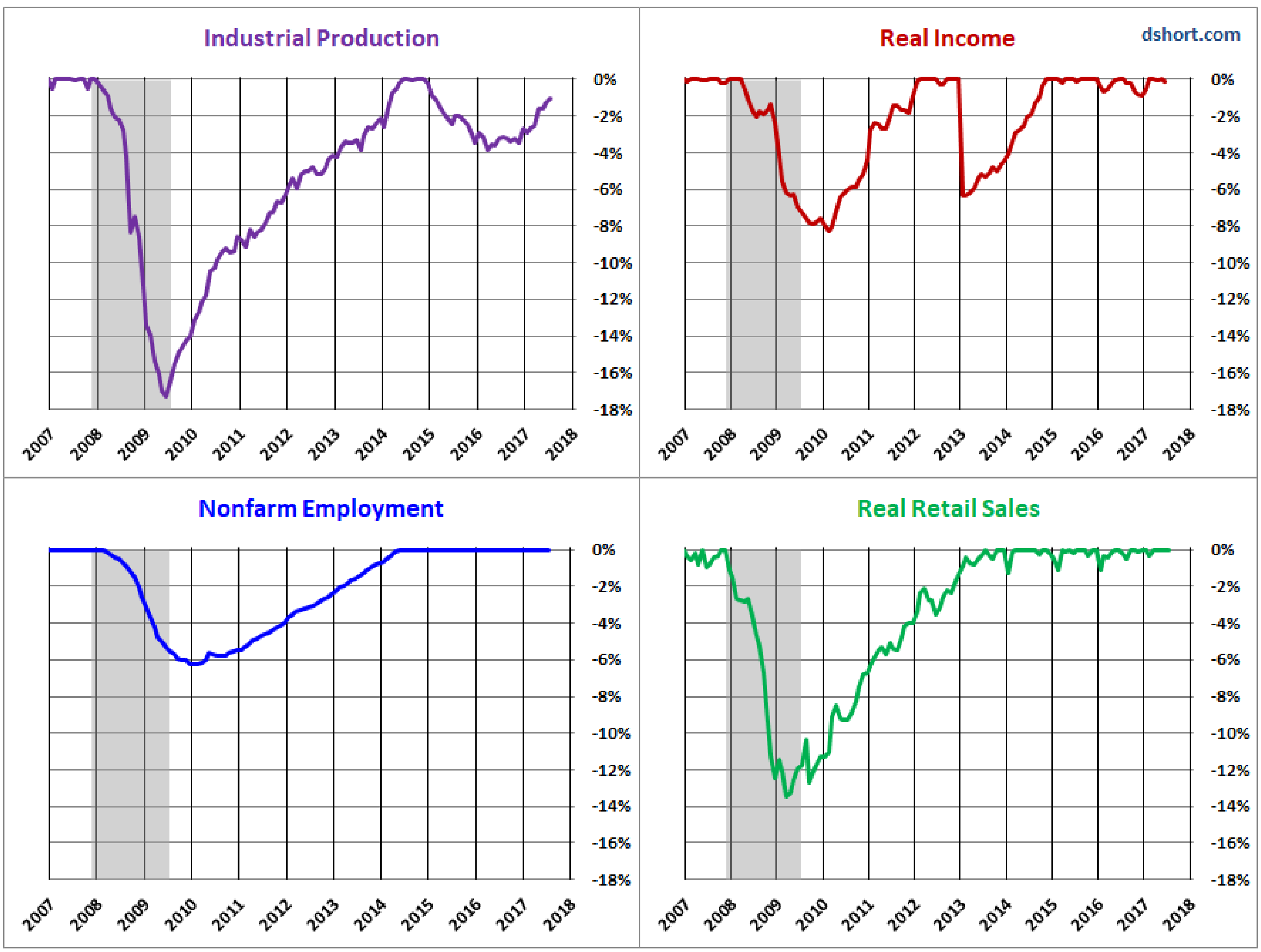
Strong Jobs – Low Unemployment:
Confidence is great, but you need to make money before you can spend it. And in order to make money, most people need a job. The good news is unemployment is at extremely low levels. In fact, as you can see from the chart below, unemployment claims are at the lowest levels since 1973. The unemployment rate of 4.3% also impressively dipped to a 16-year low. More discretionary income has also led to a sustainable recovery in the housing market, despite the low inventory of homes.



Overall, while the newswires are buzzing with stories of political and natural hurricanes, there have been an abundance of positive factors that have pushed stock values to new record highs. The media loves politics, doom, and gloom, but your investments care more about profits, interest rates, and the economy. Do yourself a favor and do not get emotionally involved in the panic headlines du jour. Instead, focus on the big picture and the many other opportunities for investment growth and preservation,

The Big Four Indicators and Recessions

The charts above don't show us the individual behavior of the Big Four leading up to the 2007 recession. To achieve that goal, we've plotted the same data using a "percent off high" technique. In other words, we show successive new highs as zero and the cumulative percent declines of months that aren't new highs. The advantage of this approach is that it helps us visualize declines more clearly and to compare the depth of declines for each indicator and across time. Here is our four-pack showing the indicators with this technique. As you can clearly see, There is no current evidence in the data that a major or even minor recession is anywhere on the horizon (8 – 12 months). Until these data points start to soften and show signs of major weakness. the probabilities suggest the economy will keep a slow stead grind upward.



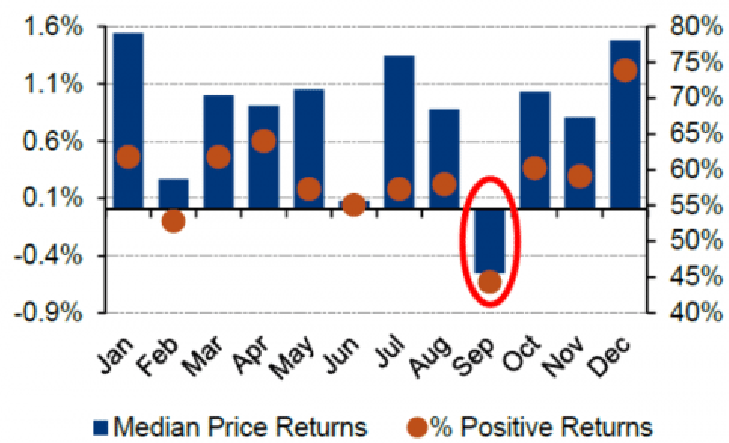
Risk Assessment

As you know by now we use an array of risk management models to gauge not only when to get in and out of the stock market. but they also give us concrete measurements to how probable they will signal a "go to cash" maneuver in the next 1-2 months. At this point all models we monitor have a less than 0.05% chance of a recession starting in the next 3-4 months and keep reiterating that a fully invested position is still prudent given the macro economic data and financial market heath as we measure it.

We always Look to buy in September

Given the strength of all the data. We often use our statistical database and look for key periods of the year to make some small tactical adjustments. In the last 100 yrs. September has been on average a down / weak month just naturally. so you will see some adjustments in the models to try and take advantage of this "dip" if it comes.

Chart 19: September is seasonally the weakest month of the year



Source: BofAML US Equity & Quant Strategy, S&P, Bloomberg
Note: Based on S&P 500 price returns since 1928

Closing Thoughts

"If you limit your choice only to what seems possible or reasonable, you disconnect yourself from what you truly want, and all that is left is a compromise."

― **Robert Fritz**, **The Path of Least Resistance**

John C Neyland
Sincerely,

John Neyland

John Neyland

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