LMCG INVESTMENTS®

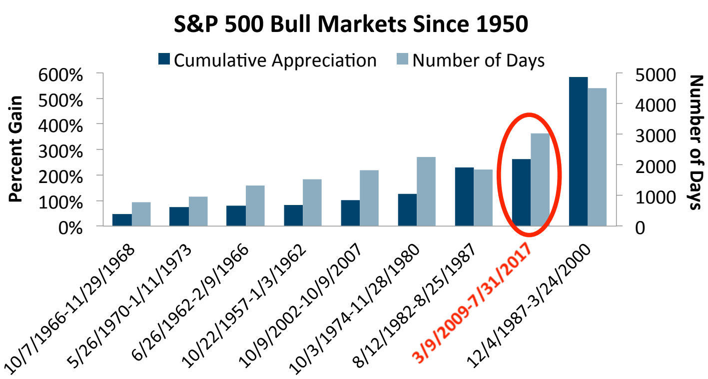
UNFILTERED

EDITION 9 | AUGUST 2017

MONTHLY INVESTMENT COMMENTARY FROM LMCG

Does This Bull Market Have Legs?

The bull market turned eight years old on March 9, 2017. Certainly, eight years is an impressive run and perhaps it becomes even more so when viewed in a historical context. There have been eight bull markets – defined as an advance of at least 20% without a correction of at least 20% – since 1950. As the graph below indicates the current bull market is the second longest in duration and ranks second in terms of capital appreciation (and third longest going back to 1929).



Source: FactSet and Yardeni Research

There are many factors which influence the duration and magnitude of bull markets. We believe four of these factors are perhaps the most influential:

- Earnings growth levels
- Valuation levels
- Investor sentiment
- Attractiveness of competing asset classes.

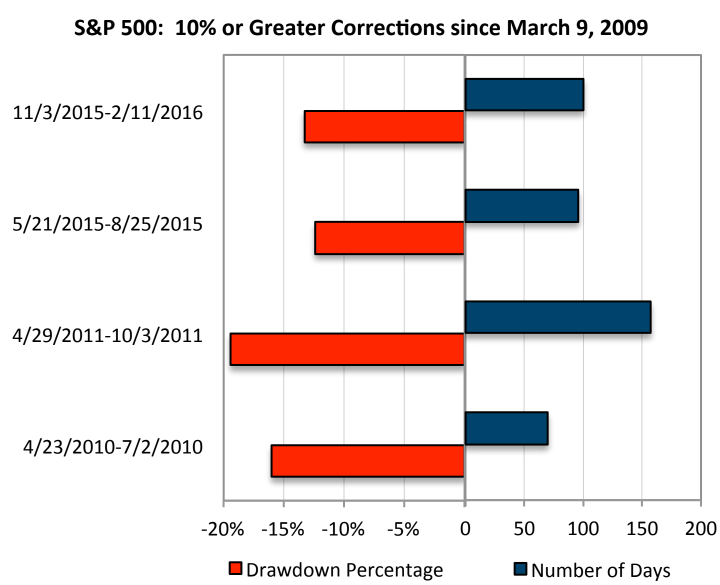
So, how healthy is the current bull market? Are investors likely to miss out on an additional leg of this market if they take profits now? Or might they avoid a downturn – or worse – if they exit now? Within the Private Investment Management group here at LMCG, we believe there are certainly a few yellow caution flags beginning to appear, but there are also some positives that suggest the bull market may persist for some time. But before we get into the discussion of the current bull market, it's worth revisiting some key themes that we think investors should keep in mind:

1) Market timing is EXTREMELY DIFFICULT to execute with any degree of accuracy.
2) An investor's asset allocation should be more centered around the investor's risk tolerance and time horizon than a short-term view of the capital markets.
3) Pullbacks or corrections are critical to the long-term health of the equity market.

We encourage our clients to re-assess their asset allocation on a regular basis. Can they afford to weather a correction or worse? This often depends on the timing of when they might need the assets that have been allocated to equities.

This 8+ Year Bull Market Has Not Been Straight Up

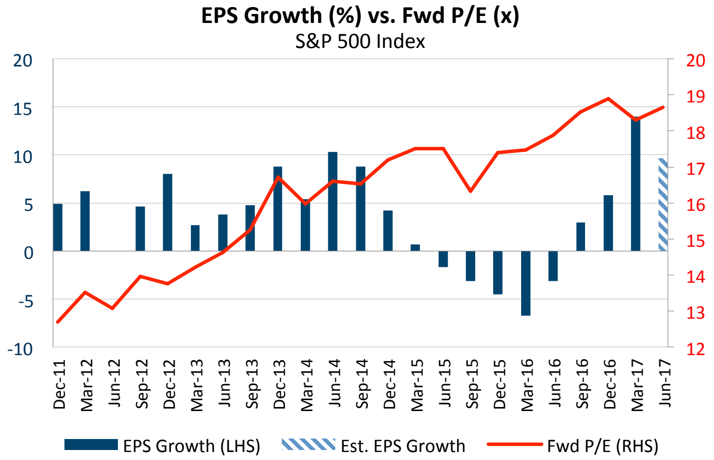
It's important to remember that, even though this bull market has more than tripled since its nadir, there have been four corrections – defined as declines greater than 10% – in the past seven years. One of them – in August 2011 – came within one percent of bear market territory. So even though we have had an extraordinary percent increase in the past eight years, but for a percent or so the advance would be materially less, and would be not be so notable for its duration.



Source: Yardeni Research

Drilling Down – The Current Bull Market

Let's look at each of the four factors we have identified as influencing the duration and magnitude of bull markets. Earnings growth – importantly S&P 500 earnings – have begun to recover since February 2016. As the bar graph below shows, earnings growth had been very paltry prior to recent acceleration. Higher earnings growth levels factor into valuation levels. The price earnings ratio (P/E) is an important metric that investors use to evaluate relative attractiveness of the equity asset class. Historically, P/E ratios for the S&P 500 Index have averaged 16.7x trailing earnings over the past 15 years. The graph below shows the P/E ratio over the past six years. When we graph the P/E ratio adjacent to the earnings growth metric, one can see the positive impact earnings growth has in terms of muting P/E ratios. So while the current P/E ratio is above average, it is slightly below its recent peak.



Source: FactSet

Investor Sentiment: This bull market has been called the most "unloved" in history, and the evidence has been measured in investors' high cash positions, longstanding bearish sentiment indicators, and the growth of investments in alternative asset classes. The sentiment that permeated the post-financial crisis era was one of "winning by not losing," protecting assets even at the cost of missing upside performance. That sentiment is giving way now to optimism, sustained rallies in stocks through the summer, and flows into equity funds. This is something of a mixed blessing. While "capitulation" is often thought of as essential for a bear market to end, the embracing of risk is perhaps true of market tops. Another change in sentiment about equities has been the reversal of leading performance of "bond surrogates," i.e., stocks that pay high and historically reliable dividends. Low interest rates created a demand for yield and a rejection of growth stocks in 2016 – this, too, has reversed in 2017 as investors are comfortable taking on more growth exposure. And finally, the volatility index, "the VIX,"[1] has fallen to new lows indicating a low sense of risk in the equity markets.

Bond Market Blues

Another important consideration is competing asset classes. Simply put, what choices do investors have for their savings/retirement assets? Fixed income securities are typically viewed as the obvious alternative to equities. Another would be non-US equities, which we will discuss shortly. Real estate and commodities are other choices, but have not really reached the mainstream like equities and bonds. It's difficult to make a bull case for bonds right now – the 10-year Treasury hovers near its low yield of the year (and of the last 60+ years) and the Federal Reserve has initiated a tightening program – with a 25 bps increase in the June meeting and guidance towards another hike later in the year. This creates a headwind for the prices of fixed income securities. We do not believe this translates into a material drawdown (i.e., *negative* return) for fixed income securities – but we do think it limits the upside in the next 3-5 years. The level of yield on the 10-year Treasury Bond correlates highly with the total return of the asset class on a prospective basis – which would suggest a fairly nominal total return expectation over the next 3-5 years. It's important to note that bonds have historically dampened portfolio volatility and reduced the overall effect of equity market drawdowns vs. 100% equity portfolios. Therefore an allocation to fixed income makes sense for many investors – but it's hard to make the case for increasing one's exposure to this asset class, even given the challenges of the US equity market noted above.

Portfolios without Borders

Another choice for investors is non US equities. As many of you know, the Global MultiCap team at LMCG has been bullish for some time on this asset class. In fact, we have been at/near our maximum weighting of 40% since year-end 2013. Recently, this has benefited the Global MultiCap strategy. With the $US weakening over 9% (against most major currencies) YTD and non-US markets performing fairly well, our allocation to non-US stocks has provided a nice tailwind of late. As we discussed in our recent Unfiltered, currencies have tended to move in cycles – and we believe the cycle of a weaker $US could persist for some time.

Summary

The current bull market has provided a strong recovery for investors who were willing to stay the course after the Financial Crisis. It's true that from a duration perspective the current bull market has a few miles on it and is stretching historic valuations, at least in the United States. While we currently do not see a catalyst for a significant correction in the US market, we believe there is a benefit to complementing a US equity portfolio with a non-US portion. The diversification by economies and currencies may play a key role in wealth accumulation for US-based equity investors.

[1] VIX is a trademarked ticker symbol for the CBOE Volatility Index, a popular measure of the implied volatility of S&P 500 index options; the VIX is calculated by the Chicago Board Options Exchange (CBOE)

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