# GKV Capital Management

## Market Update

February 6, 2018

# Correction vs. Bear Market: Likely Scenarios

*"The market can stay irrational longer than you can stay solvent."* - John Mayanard Keynes, Economist 1883-1946

Our quarterly update for the year-end 2017 went to print on January 23rd, which was only two weeks ago. At the time, the S&P 500 had already gained 6.2% from the beginning of the year. In our Opening Thoughts, we remarked that the global growth picture looked great, corporate earnings are strong and that the recently passed tax cut is adding even more fuel to the fire. And then we considered what might derail the bullish outlook. We concluded with the statement that "if we had to pick any one concern, it would be inflation. For the moment it is not a factor but it should be watched closely." On January 1st the U.S. 10 year treasury bond yielded 2.46%. By the 23rd of January the yield had increased to 2.63% and hit 2.84% last Friday. Suddenly the prospect of inflation has become a material factor affecting both equity and fixed income valuations.

Since 2008 the entire global economy has been awash in cheap capital. Historically low interest rates made access to capital cheap, stabilized the financial system, and enabled a recovery from the over-leveraged mortgage mess. Rates around the world were pushed towards zero in an unprecedented coordinated stimulus campaign. U.S. 10 year Treasuries went below 1.5% in 2012 and fell below that level again in 2016 as the global growth stalled due to the collapse in energy prices. In Europe bond rates actually descended past 0% into negative territory. Slowly the economic footing improved led by the United States.

Consider for a moment 10 year bonds paying 1.5%. You are loaning the bond issuer, generally an indebted government like the U.S., money for 10 years at a fixed rate of 1.5%. Such a rate won't keep up with inflation and in our view is an impractical, losing investment, for most investors. The low rates provide an abundance of cheap capital but they made most bond investments impractical, encouraging considerably more investment to be directed into stocks. Low interest rates inflated stock valuations.

The U.S. 10 year Treasury bond yield is a good indicator of investor expectations in the near-term. The yield fluctuates based on investor demand for bonds being sold by the U.S. Treasury. If investors anticipate increasing inflation in the near future, they will demand a higher yield. Why buy a bond yielding 2.5% today if in a few weeks the going rate will be 3.0%? The expectation of higher future rates will immediately be reflected in the price of bonds today. When the economy slows or a recession is expected, rates fall as growth slows and governments work to stimulate growth with cheap access to capital and greater money supply.

Ironically, it seems that the Tax Cut and Jobs Act may have added more fuel than the economy can handle. GDP growth

| | **2012** | **2013** | **2014** | **2015** | **2016** | **2017E** | **2018E** | **2019E** |
|---|---|---|---|---|---|---|---|---|
| S&P 500 EPS | $96.82 | $107.30 | $113.01 | $100.45 | $106.626 | $124.13 | $154.39 | $169.86 |
| EPS y/y growth | *0%* | *11%* | *5%* | *-11%* | *6%* | *17%* | *24%* | *10%* |
| S&P 500 Index | 1426 | 1848 | 2059 | 2044 | 2239 | 2673 | **2649** | |
| Index y/y return | *13%* | *30%* | *11%* | *-1%* | *10%* | *19%* | *-0.9% YTD* | |
| Trailing P/E | 14.7x | 17.2x | 18.2x | 20.3x | 21.1x | 21.5x | 21.2x | |
| Forward P/E | **13.3x** | **16.4x** | **20.5x** | **19.2x** | **18.0x** | **17.3x** | **17.2x** | **15.6x** |

Source: GKV Capital Management

forecasts have been adjusted higher to reflect the impact of the tax cuts, particularly on U.S. corporations. The International Monetary Fund increased its U.S. GDP forecast to 2.7% in 2018 from its previous forecast of 2.3%. In 2019 a significant 0.6% was added to the forecast, resulting in expected U.S. GDP growth of 2.5% from 1.9%. Corporate earnings have also been adjusted significantly. The consensus analyst estimate for combined earnings for the S&P 500 in 2018 has been increased from $145.80 before the passage of the Tax Cut and Jobs Act to the current estimate of $154.39, a staggering increase of more than $8 per share. Of course most of this gain is from tax treatment and not operating gains, but investors are calculating P/E multiples based on the earnings estimate irrespective of how the cash is being generated.

The other near-term impact of the TCJA is a rapidly rising Federal deficit. In the near-term the tax cuts must be paid for. The hope is that in the long-term greater economic activity will replace the lost tax revenue. Until then (if ever) the U.S. Treasury must issue more debt in the form of bonds. With low unemployment and positive wage growth, which are both positive for the economy but also two of the biggest drivers of inflation, investors are demanding higher yields.

So, the economic outlook is still positive but there are legitimate concerns that we are adding too much fuel and that we will quickly overheat the economy resulting in a necessary slowdown sooner than if we continued our slow growth trajectory. While economic growth is positive, rising too quickly raises the prospect of greater inflation. With higher costs of capital and an increase in the attractiveness of fixed income investments, the P/E valuations of stocks decline, which is what we have been experiencing the last several trading sessions.

We have been aggressively reducing our asset allocation to equities as the 10 year Treasury bond moved higher and the market began to correct. All of the equity gains for 2018 in the S&P 500 and the DJIA have been wiped out except for a 1.6% gain in the Nasdaq. The table on the previous page shows earnings, growth and P/E multiples for the S&P 500. As interest rates move higher, we may see equity valuations move back towards a more historically normal level of 16 times earnings from the overstimulated 20 times level due to ultra-low interest rates.

We do not see the correction in the market as a portent of negative economic activity in the near-term. Our expectation is for continued strong economic growth but with some longer-term concerns around inflation, rising interest rates, and government debt. The current correction is a reset of asset pricing brought on by a fundamental change in the interest rate outlook. For this reason we expect the correction to be short lived and do not anticipate a broad negative economic deterioration. The markets do have a tendency to overcorrect however. In our desire to protect capital we will continue to reduce our equity exposure. Once the valuation recalibration has run its course we will look for new opportunities in the equity markets.

Please don't hesitate to contact us if you have any concerns or questions.

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