In the world of investing, math matters.

It may not feel that way at times, especially when emotion is pushing markets one way or another, but at its core the market responds to mathematical fundamentals. At the most basic level, market fundamentals simply assign values to future earnings of corporations, which are represented in the stock price. The higher the price, or premium, one is willing to pay in order to own a piece of those future earnings, the more they have at risk. Naturally, we assume that the more risk we take the greater potential return, but as fundamentals become stretched and values get distorted, that's not necessarily true. At times, the premium begins to exceed what is considered fair payment for the normal range of future values, due to anticipation of some unrealized future catalyst.

It is important to keep this tendency for excess in mind, particularly now that parts of the market have rallied aggressively based upon the results of the US Presidential election. Investors have interpreted policy proposals for deregulation and tax cuts on corporate earnings as foregone conclusions. Thus we saw a large amount of rotation out of sectors like Technology into sectors that were viewed as those that would most benefit from such policy, Energy, Financials and even Biotechnology.

As discussed in previous Commentaries, the price to earnings ratio is the quintessential fundamental tool, and probably the best known and most widely utilized measurement for market pricing. By dividing the earnings reported for any individual company (or even an index of companies) by the current stock price, you get a ratio that simply and quickly denotes the "risk premium" of any given equity. For the purposes of this Commentary let's stick with the S&P 500 as it is a broad representation of corporate America, including the top 500 companies based on market size, liquidity and industry sector.

Historically, the cumulative price of all the S&P 500 stocks has averaged between 12 and 18 times the cumulative earnings being made by those 500 companies. Below 12 is usually when the economy has softened and equities have sold off and above 18 when economic growth is robust and the expectation of greater earnings growth exists. In other words, when the ratio is below 12 the market is cheap as the price of stocks, relative to future upside potential, is low and when the ratio is above 18 the market is expensive as the premium you pay to own that future upside is higher.

Now there are a number of ways to think about the earnings portion of the price to earnings ratio. It can be what is reported from the previous year (Trailing Twelve Months or TTM), it can be averaged over a rolling 10-year period (known as Cyclically Adjusted Price-to-Earnings Ratio or CAPE, developed by Robert Shiller) or it can be an estimate of what is expected in the coming year (Forward Looking PE). The current PE ratios of each are 25.59 (TTM), 28.26 (CAPE) and 18.35 (Forward).

The lowest that the Trailing Twelve Month ratio has ever been, across the entirety of the market's history, is 5.31 and the highest is 123.73. For the CAPE, that range is 4.78 to 44.1 – obviously a tighter range reflects some smoothing out of the peaks and valleys shorter-term data can give. What we get from each of these, though, are pretty similar averages.

From December of 1917 through May of 2009, the median P/E for the S&P 500 on a Trailing Twelve Month basis was 14.65 – the mean was 15.64. For the CAPE, starting in 1920 through December of 1999, the median was 16.09, with a mean P/E of 16.72.

So as we can see the TTM and CAPE are both currently a fair degree higher than historical averages. The Forward on the other hand, while still above the TTM and CAPE averages, is less overpriced. So which to follow?

Our reply would be all of them. What the P/E tells us cannot always be traced to a set outcome – how or when a reversion to the historical mean occurs is not a mathematical certainty. But the market has shown, repeatedly, that fundamental standards such as PE ratios will always be relevant. In other words, it is never "different this time." So we have to be very careful when we catch ourselves trying to explain away imbedded risk by saying that the old norms are not worthy of the new reality. Many times the new normal is the same as the old.

As investors, instead of trying to explain away risk we should recognize that it exists and prepare our portfolios accordingly, relative to our tolerance for loss, our time frame, and our goals. That is what we do here at Northstar and given current conditions we maintain our opinion that market risk is higher than average right now. Stocks are pricey relative to the earnings that were made over the last 12 months, and fairly priced relative to the expected earnings for next 12 months.

And on that point, we cannot help but turn to the fact that the new President represents a significant shift in economic policy. Speaking purely from an earnings standpoint, we view the proposals for deregulation, tax cuts and fiscal spending to be positive catalysts for growth in the near-term. There are some costs associated with each of these pro-business positions, however, which might cut into earnings long-term. And the new administration's stance on trade policy may dampen some of the near-term benefits as well.

Deregulation

As we saw from the immediate and decisive post-election surge in financial, pharmaceutical and energy stocks, investors feel that the process of deregulating various industries will create the opportunity for greater growth in those companies. Repeal of the Dodd-Frank Wall Street Reform and Consumer Protection Act and the Affordable Care Act, together with a softening of environmental regulations and labor laws, are all seen as providing greater potential for companies to grow their bottom line. That potential is enough to boost the range of future earnings, making the current P/E seem more reasonable.

Dodd-Frank is a large, complex bill that arguably stymies lending, especially amongst small and mid-size regional banks. But we have seen some of the ill effects of deregulation, being only 8 years removed from the financial crisis and Great Recession which can be linked directly to the repeal of another Act, Glass-Steagall, during the Clinton Administration. The long-term cost of allowing the financial industry to create its own rules turned out to be a near-collapse of the very institutions that fought for repeal of the rules, and a tax-payer funded bail-out for those same institutions. So finding the right mix between the free market and independent oversight is crucial. As advisors, we understand the burden of trying to meet regulations that are onerous and nonsensical. But we also recognize that, in a boundless market, many in the financial industry have little incentive to defend clients against their own profit motive.

Tax cuts

Tax cut proposals have been presented for corporations, individuals and estates. Under the floated plan, individual tax rates would be compressed into only three brackets, and lowered, with a total elimination of the Alternative Minimum Tax. Personal exemptions would be higher, in effect reducing the value of itemized deductions for many filers. These changes would certainly simplify taxes for many, and the subsequent increase of household cash flow will, theoretically, promote consumer confidence and consumption. Recently, however, increases in wages have resulted in a higher savings rate, or paying down of household debt. There is no indication that additional cash flows from tax savings would be used any differently, as many households are still, 8 years later, trying to recover from the financial crisis. An increase in savings may impact stock prices, as more funds are added to 401K and other investments – but without a concurrent increase in earnings, this trend will only stretch valuations even further.

From an earnings standpoint, corporate tax-rate cuts would have the most benefit. The proposal on offer is to reduce the rate from 35 % to 15 %, but it would also create an environment where any number of employees could be classified as independent contractors, which would allow employers to avoid the expense of Social Security and Medicare taxes, as well as insurance coverage and other employee benefits. The subsequent savings on labor costs, together with a reduction in corporate rates, would better position US companies to compete globally as well as create an incentive for companies to repatriate the trillions of cash stored overseas. While a lower overall tax burden for business makes a lot of sense to us, we are not optimistic about the economic effects of a significant increase in (structural) self-employment. There is a growing shortfall in Social Security funding as the number of new retirees continues to outpace the number of new workers. If many of those new workers must fund Social Security on their own, it will become harder, politically, to make the case that Social Security funding is more important than funding their own retirement through a private account.

Fiscal Spending

In dealing with a number of people in the fixed income market, we find that the appetite for US debt remains high. Bond traders generally agree on the ability for the US to fund a massive and comprehensive infrastructure revitalization effort with a sizable Treasury issuance. There are some that feel the US could finance such spending by issuing a 50 or 100 year bond now, with a very low interest rate. Others feel there could be a revitalization of Build America Bonds (BABs) which are bonds that individual states/municipalities issue that are backed by the US Treasury. Such bonds are taxable, and that has appeal for investors that don't normally trade in municipal bonds (such a pension funds, or IRA investors).

There is speculation that any proposal will not be federally funded, but will instead involve Public-Private partnerships and tax credits for firms that successfully bid on federal/state initiatives. We feel this could be the one area that will enjoy broad support across political lines, but we will need further details before we can estimate the impact on corporate earnings. Any level of construction activity will be a boost to growth, in theory, but shovel ready projects need employees and there literally may not be enough workers to fill several large construction jobs all at once.

In the long run, any effort to revitalize and repair the nation's aging infrastructure would be boon, not only economically, but also in terms of America's security, stability and social mobility and dynamism. It would be well worth any sizable increase to the deficit. But the economic benefits may take a long time to manifest, and even in areas with broad support politicians, and investors, are apt to give in to short-termism.

International Trade

Globalization has been cited as the catalyst for both the "Brexit" vote and the success of a stream of populist political candidates, including Donald Trump. The free flow of capital and, in particular, labor across borders is blamed for bestowing hardship on a large pool of workers in developed nations. Whether or not the trend toward globalization is actually the root cause of the dwindling employment prospects for the Western middle-class, the fact remains that the large majority of our clients benefit greatly from this trend, and so we are concerned about the economic impacts of its reversal.

One need only review how the Smoot Hawley Act, so small in scope at the outset, grew to cover thousands of products. The impact of that Act also illustrates what happens when you enact a tariff against another country. Tariffs are a two way street and once the protectionist Djinn is out of the bottle it becomes as self-perpetuating phenomenon. Of any proposed economic policy, this is the one we find most concerning. The emotional satisfaction of a tariff fight with Mexico or China would do little to assuage the real economic harm that any significant halt to global trade would cause. Without even considering the impact of potentially eye-popping price inflation and the choking off of credit markets, the threat to stock valuations is acute. Most S&P 500 companies have a significant stake in overseas markets – either in the form of supply chains or direct customers. All the benefits of a tax break on repatriated assets would, in a protectionist policy cascade, simply mitigate the cost of lost earnings. The P/E of most firms would mirror the levels seen in 2008 when the economy ground to a halt for lack of liquidity in credit markets.

Similarly, the tax savings that individual may realize after the proposed cuts are adopted will be absorbed entirely by the swift increase in the cost of living that would necessarily accompany a halt to trading with our largest trading partners. The suggestion that domestic production efforts, employing only US workers, could fully replace such imports at a cost that is anywhere close to current pricing ignores the reality of cost-push inflation. Companies will not absorb the higher operating costs, or any fees/ tariffs imposed on parts/products that simply can't be made here – they will instead pass them on to consumers. In such a scenario, a corporate earnings recession would predate a recession in the real economy – an unusual sequence of events.

We here at Northstar do our best to ensure that clients are able to continue their standard of living regardless of inflation or recessionary trends. We have purposefully included a higher than average inflation rate in all of our projections and modeling assumptions for the retirement income plans that we develop. And we have been working to make sure that those clients who draw income from their investments have enough set aside from the markets to provide funding through any potentially prolonged dip in stock prices.

This has been the focus of many conversations lately, as eight years removed from the second worst financial crisis in US history we find ourselves with a "late in the cycle" feel. While the shallowness of the recovery, due to the depth of the crisis, has created a longer than normal cycle (as if like a rubber band the more normal recovery pattern of memory had been stretched out and thinned) we must be aware that cycles do not last forever and ultimately we will have economic regression.

We do not feel that regression is around the corner. This expansion could last much longer, and equity returns could continue to be made, if the right mix of policy is employed. But we must accept the fact that the math tells us that valuations are full, that market appreciation cannot be based solely on hope. Instead growth must occur in actuality, to justify the risk that such high stock prices currently represent. Prudent, well-conceived, policy must be created and enacted in order to provide the environment for sustained expansion to continue or, as it has done many times in the past, that market will regress to the mean and prices will fall.

Should you have any questions regarding your planning or your portfolio Julia and I are always available to talk things through with you. We can be reached by email at julia@nstarfinco.com and steve@nstarfinco.com or by phone at 800.220.2161.

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