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Boenning Morning Comment

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For the second time in recent months, stocks fell sharply based on fear related to remarks from President Trump. Weak earnings from key retailers added to the mix.

With stocks trading at close to 20x trailing twelve month earnings per share, valuations are high by historic standards. Obviously, the high valuations are related, in part, to the extremely low long term bond yields and muted inflation expectations. A lot of the lift to stock prices this year relates to an 11% decrease in the trade-weighted dollar index since early in 2017 at the peak of euphoria over the possibilities of that the Trump administration and Congressional Republicans could move forward an aggressive economic agenda. So far, little has passed Congress and we are not at the point where President Trump and Senate Majority Leader McConnell are pointing fingers at each other.

Of course, the Trump remarks that sparked yesterday's selloff were not his thoughts about McConnell but rather his reiteration of harsh verbal threats aimed at North Korea. No one has been able to present a cogent solution to the North Korean threat. Perhaps Trump's statements, in part, are meant to provoke China to be more proactive in forcing President Kim to become less aggressive both verbally and militarily. But no one knows what lies ahead. Markets hate uncertainty and this is uncertainty of the highest order. Logic suggests the verbal retorts back and forth will prove to be harsher than actual actions. One hopes stepped up diplomatic efforts can avert or postpone military action. But both Kim and Trump are unknowns albeit in different ways. That doesn't provide all that much comfort.

As I noted, in a period with little other major market moving news, the emergence of the North Korean fears quickly dominate. I don't want to overstate the fears. The market is barely down 2% so far, hardly a major reaction. And few expect any imminent military response from either side. But the VIX options volatility index has quickly rallied by over 50%. There are few signs tensions will dissipate soon. The move in the VIX strongly suggests we are coming into a period of elevated volatility.

Bull markets often end when expectations get too high. Sometimes that is due to excessive optimism. Sometimes that reflects the inability to see an economic contraction around the corner. While there are few signs of any pending recession and inflation remains subdued, some industries (e.g. autos) face increasing headwinds. But the real issue of the moment is concern of overall excessive optimism reflected in historically high P/E ratios, not just for the FANG stocks but for a large chunk of the overall market. One of Warren Buffett's favorite ways to test the climate of investor optimism is to look at the ratio of total stock market capitalization to GDP. Both the numerator and denominator are numbers no one can fudge. The numerator is the value of all equity assets. The denominator is government data, the sum of all goods and services within our economy. Today, the ratio is at near record levels. That could reflect very low interest rates and it could reflect a belief that corporate profits are beginning to accelerate.

But the 11%+ increase in corporate profits in Q2 includes a 500%+ increase in energy earnings, something not likely to be repeated, plus the benefits of the sharp aforementioned decline in the value of the dollar. While the dollar could continue to weaken, that may not continue if U.S. growth begins to improve while growth overseas slows are even possibly reverses. It is much more likely that Q2 or maybe Q3 will be peak growth quarters for earnings and the dollar will not fall at a 20%+ annualized pace for much longer. Should interest rates start to rise for any reason (I'll leave that prediction to the bond experts), the gap between current expectations and future reality may widen and cause at least a temporary adjustment in equity prices.

Valuation corrections are not to be feared. They can be harsh but they tend to be brief and they serve to reset buying opportunities. All stocks aren't overvalued here and all companies don't face the same financial prospects. Let us not forget that under any logical current scenario, we are not in a recession and earnings are rising. That are two potent tailwinds. Some like to think that because interest rates are low now, we might be in some kind of new valuation paradigm. That is unlikely. Yes, low rates do mean P/Es should be above historic norms today and if you compare current P/Es to yields on long term junk bonds, markets aren't vastly overpriced. But if growth slows and fears rise, junk bonds, current yielding 5%+, could move to 6-7% quickly. That would set off a reasonably potent correction in equity values. That isn't a prediction. Rather it is a warning meant to shake us out of a complacent state.

The conclusion, as always, is to stay disciplined. Don't be afraid to take some gains and don't let the thought of having to pay some capital gains taxes stop you from making proper portfolio decisions. We may not see a serious valuation correction for months or even a couple of years. If it were to happen soon, the total size of a correction would be within historic norms, i.e. 5-15%. If, however, the market becomes truly euphoric and continues rising at the same pace as the past 12 months, then the subsequent correction could be larger and more painful. Maintaining discipline is key. Don't overpay and chase. And stay true to your asset allocation. Finally, remember my two day rule. One bad day has no meaning if there isn't any follow through. I have no idea what today brings. If we see another decline like yesterday or even worse, I would be concerned short term that a near term correction is more than a minor possibility. On the other hand, if stocks can keep losses modest today or even recover and end positively, my fear gauge will dissipate in a meaningful way.

Today, Chris Hemsworth is 34. Viola Davis is 52. Hulk Hogan turns 64. Apple founder Steve Wozniak is 67.

James M. Meyer, CFA 610-260-2220