Summa Global Advisors

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Roger Johnson

The Top of the Ninth Inning?

It ain't over 'till it's over! – Yogi Berra, 1973 National League pennant race.

History is a great teacher for those who choose to study and, more importantly, learn from it. Success or failure is measured in one's ability to apply those lessons and achieve a favorable outcome. Throughout history, investors have faced challenges in investing, and presently, a number of critical issues confront all investors.

Economic and political challenges

One major issue is the ongoing political and economic turmoil in the world's largest economy. For over a generation, the inability of the Congress to agree upon and pass responsible legislation has created a fiscal crisis of growing and unimaginable debt, with estimates ranging from $80 to $200 trillion, including unfunded liabilities.[1] "Sometime this year, world public and private debt plus unfunded pensions will surpass $300 trillion—not counting the $100 trillion in U.S. government unfunded liabilities."[2] There will be difficult choices ahead. Voters must decide how to fulfill these debt obligations, causing some level of political duress and consequently economic turmoil.

By not effectively addressing the spending crisis, our nation is now facing a near record debt to GDP ratio of 106.1%, not seen since WWII (See Chart 1).

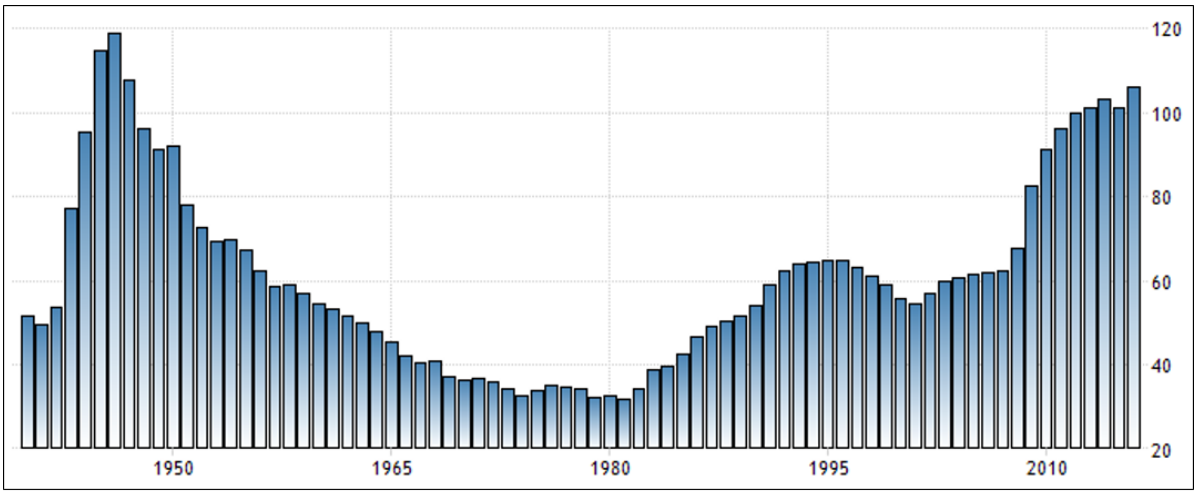

Chart 1. U.S. federal debt to GDP.
Source: TradingEconomics.com; U.S. Bureau of Public Debt

While some current events resemble circumstances we have faced in the past, there are also notable differences. Economic and social circumstances have changed drastically over the past 70 years. Expanding deficits, exacerbated by mandated entitlements, were not a budget item of significance

immediately after WWII. Today they are critical economic and social realities. This substandard economic recovery of two-percent GDP growth will not fund our nation's growing debt!

Challenges faced by the Fed

Eight years of accommodative monetary policy from the Fed has distorted the capital markets. The last time interest rates were held artificially low was between 1942 and 1951, in order to fund WWII and to control post-war monetary inflation. Interest rates will likely rise as they did after 1951. However, in the 1950s and 1960s the nation experienced higher GDP growth and undertook prudent fiscal policies. Given the current political hostility and rising debt, it seems likely that the consequences of the Fed's policy will instead result in significant monetary inflation.[3] The Fed alone cannot provide effective solutions to long-term and structural problems.

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Implications from passive and computer-driven investing

During the past decade, passive investing through ETFs (exchange-traded-funds) has been a major trend in the stock and bond markets. Indexing was approximately 8% of managed assets in 2007. Today indexing represents nearly 40% of stock market ownership, according to ICI, an investment-industry advocate. Passive investing is less expensive, and an easy and seemingly efficient way to allocate capital. The primary risk of these investments is that they are unproven in a volatile, declining bear market. During the October, 1987, market meltdown, bids were withdrawn on the buy side. Your author had placed a "sell stop order" on PepsiCo. The order filled over 20 points below the last trade. (A "stop limit order" was thereafter placed.) Rather than getting a good trade execution, I had been executed. History's lesson! Because of the ***high market concentrations of ETFs, it is possible that there will be liquidity risk should the market fall apart***.

Quantitative investing, driven by super-computers and mathematical algorithms, increases volatility risk for investors. Today much of the daily stock market volume comes from institutions and their reliance on computers. Since quantitative investing is purely algorithmic, various computer models generating large orders could cause a wider price gaps between buyers and sellers, which, on rare occasions, has led to "flash crashes" (See Chart 2).

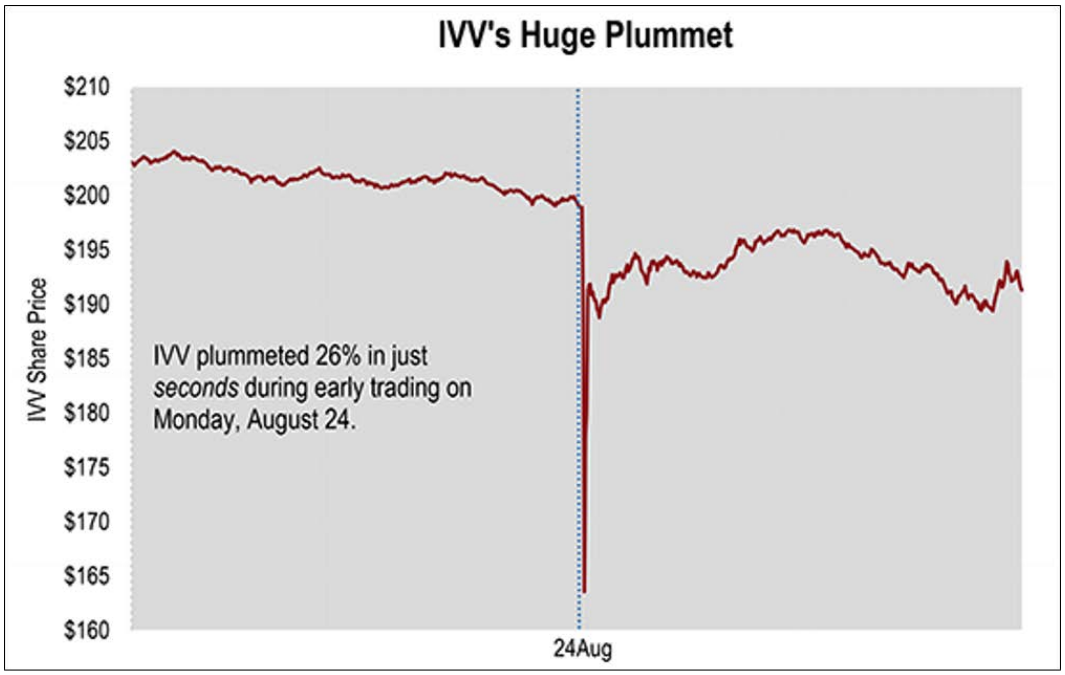

Chart 2. iShares S&P 500 ETF (IVV) experienced significant price volatility during Aug. 24, 2015 opening.
Source: Thomson Reuter; Casey Research

If you are a true long-term investor, these challenges can play to your advantage. The best way to mitigate short-term quantitative volatility is to be a long-term buy-and-hold investor.

Technical indicators, in the aggregate, remain bullish and there are no signs of an impending recession The U.S. Dollar has weakened over the past 6 months, making our goods and services cheaper to foreign buyers. The broad market P/E ratios suggest that equity valuations remain extended historically (Chart 3).

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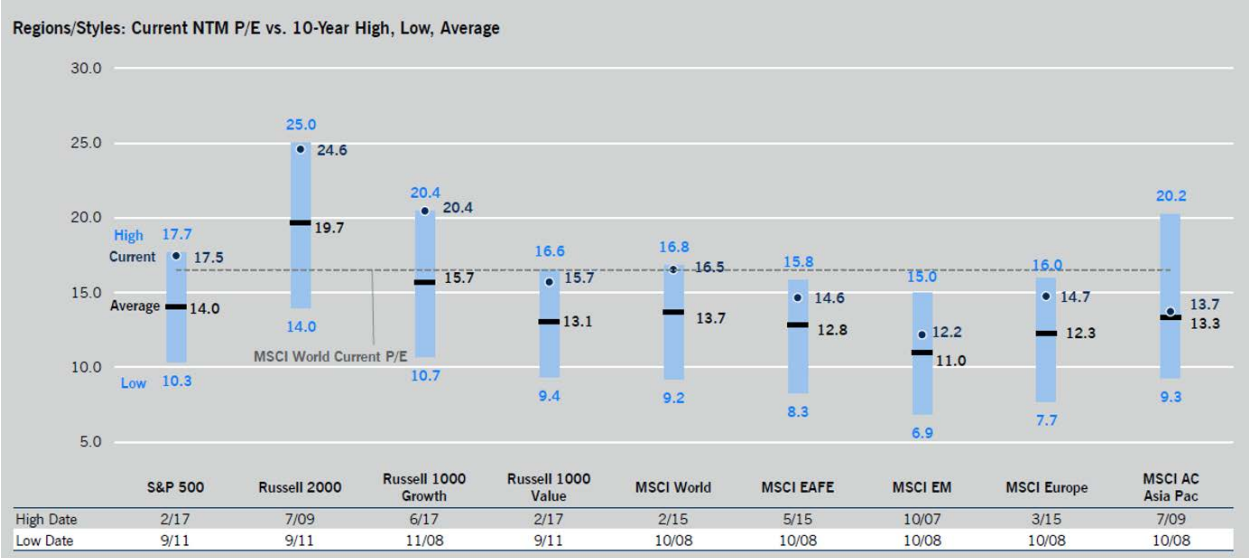

	S&P 500	Russell 2000	Russell 1000 Growth	Russell 1000 Value	MSCI World	MSCI EAFE	MSCI EM	MSCI Europe	MSCI AC Asia Pac
High Date	2/17	7/09	6/17	2/17	2/15	5/15	10/07	3/15	7/09
Low Date	9/11	9/11	11/08	9/11	10/08	10/08	10/08	10/08	10/08

Chart 3. Price-to-earnings ratios of major global benchmarks, Aug. 2007 to July 2017.
Source: Eaton Vance Monthly Market Monitor, July 2017.

Domestic and international political and economic dysfunction, near record domestic debt to GDP and record global debt to GDP, untested Fed monetary policy, ETF prevalence, quant-driven institutional trading, increasingly volatile technical indicators and near record stock and bond market valuations confront today's investors. These factors, along with other indicators, have now significantly increased investment risk. We may be at the top-of-the-ninth or we may go into extra innings. Investors should heed Yogi Berra's observation and stay in the game!

References:

[1] http://bit.ly/2uBDgOD
[2] https://seekingalpha.com/p/2z263
[3] http://bit.ly/2uBQta3

