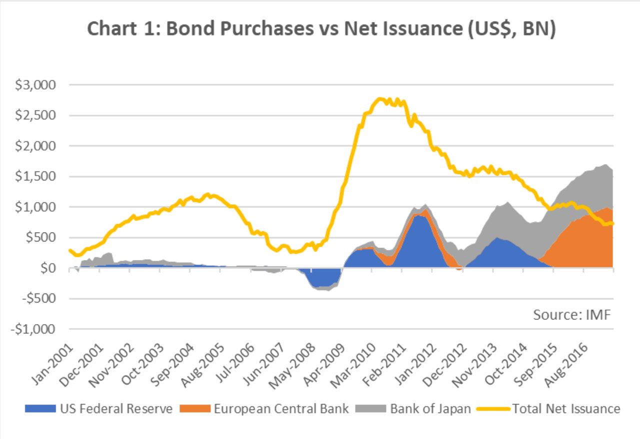
TOMLINSON RESEARCH

FEBRUARY 2018 COMMENTARY

THE WORLD GOT SCARIER

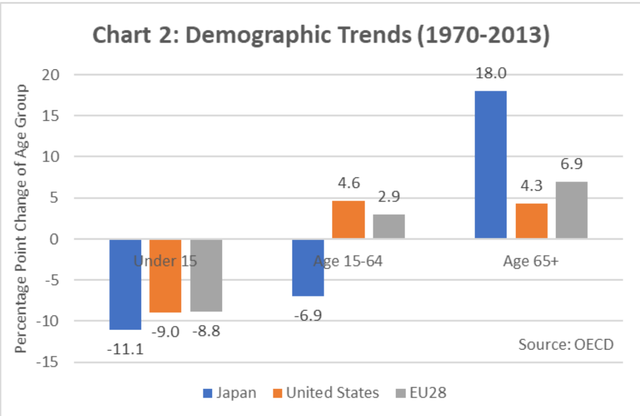
In Steven Spielberg's film, *The Post*, Meryl Streep plays Washington Post CEO Katharine Graham, who famously faced down the Nixon White House over the Pentagon Papers in 1971.

Graham risked going to jail by publishing them, but by doing so completely undermined the case for the war in Vietnam. Once these facts became clear, public opinion shifted. High stakes and great real-life drama.



Ironically, nobody in government was interested in these papers when they were first written, which is what prompted Daniel Ellsberg, one of the authors, to leak them, first to the New York Times then the Washington Post.

There is a brilliant *Lunch with the FT* article from late last year where Ellsberg, now 86, is interviewed about the Pentagon Papers, for which he too was nearly sent to prison. Today he is worried about nuclear weapons, an area where Ellsberg is an expert, which he points out are worryingly subject to human error.



Ellsberg has been trying to get his new book on the subject, *The Doomsday Machine*, published since 1975. Nobody was interested in it until this year. Any number of facts may have changed, but when asked why now, Ellsberg simply replies, "the world got scarier."[1]

FED SPIGOT OFF, TREASURY ON

It's not too hard to work out what has scared the markets this year. The global recovery that began when markets bottomed in March 2009 is in its ninth year. One lingering feature is quantitative easing, central banks actively purchasing bonds but also stocks in some cases. This extraordinary period is ending rather abruptly, as the ECB began sharply curtailing its purchases late last year.

For the past two years, central banks have bought more sovereign bonds than have been issued, effectively shrinking the market. The scale of the coming change is eye popping: from over $1.5 trillion of QE globally in 2017, dropping to an expected $121 billion in 2018, a 92% reduction (Chart 1).[2]

The US Fed stopped their purchases in 2014, the year of the taper-tantrum, and now looks to slowly shrink its balance sheet by selling securities back to the market. In addition, the US Treasury will now be issuing up to $1 trillion more bonds because of large scale tax cuts recently enacted.

Whilst this is generally a happy ending for QE, most major economies and stock markets have regained prior peaks, the question is how will bond markets cope with these ongoing demand and supply shocks. Long-term interest rates have moved significantly off generational lows touched in 2016, affecting all financial asset prices.

The shift to tighter monetary but looser fiscal policies is a game changer.

GOLDILOCKS REDUX

The economist David Schulman coined the phrase "Goldilocks Economy" in 1992, as Chief Equity Strategist at Salomon Brothers. His observation that low inflation and moderate economic growth would support rising equity valuations still carries on post-2008.[3]

---

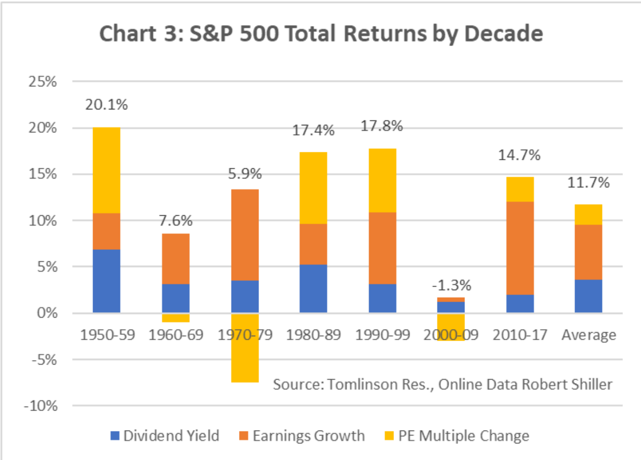
[1] https://www.ft.com/content/c7f058bc-d9b5-11e7-a039-c64b1c09b482

[2] Neuberger Berman, Solving for 2018, 24 January 2018 p. 17

[3] http://www.anderson.ucla.edu/faculty-and-research/faculty-directory/shulman

But since then, global growth has persistently lagged pre-2008 levels and, despite recent upward revisions, this looks set to continue. World GDP is forecast to grow 3.9% in 2018, advanced economies +2.3% and emerging ones at +4.9%, according to the IMF's latest figures. All of which means this year we will still be below the averages of the previous decade, nine years into a recovery, though with very little spare capacity.[4]

The big economic problem over the medium term is an aging population, acting as a kind of brake on growth in developed economies, as the aging process shrinks the workforce (Chart 2).[5]



One significant trend is the dominance of passive index-based investing, now larger by assets than active management. Passive investing is not new, it was well argued by Burton Malkiel in his excellent 1973 book, *A Random Walk Down Wall Street.*

Malkiel claimed then, "A blindfolded monkey throwing darts at a newspaper's financial pages could select a portfolio that would do just as well as one carefully selected by experts."[6]

THE MONKEY DID BETTER

The SPDR ETF offered by SSGA has a gross expense ratio of 0.09% and net assets of $292 billion, tracking the S&P 500 index nearly perfectly. The underlying benchmark is a large and deep market with continuous pricing, even in crisis conditions.[7]

Generally, S&P 500 returns can be described as having three components, the starting dividend yield, earnings growth and the change in the market multiple (PE ratio). Looking at returns by decade since 1950, each decade tends to have a dominant feature (Chart 3).

The most recent decade has earnings growth of over 10% *per year*. The long-term average is 6%. But – no prizes for spotting the outlier - this is simply a recovery from the disastrous 2000-09 period, where the S&P fell 1.3% per year in nominal terms.

The steady rise in the market PE multiple adds on average over 2% per year since 1950. Prospective returns are rarely attractive when starting at a high PE ratio, doubly so with demographics weighing on growth. Using our model, we looked at the expected returns for various earnings growth and market multiple assumptions over the coming decade, starting with the current 1.8% dividend yield.

The mid-point estimate is a 4.3% annual return in nominal terms, which compares well to the 2.8% yield on the 10-year US Treasury bond. But if investors are expecting the 1950-2017 average of 11.7%, they are likely to be disappointed (Table 1).[8]

This mid-point infers a modest 2.5% earnings growth and no change in PE ratio; 5% growth gives an even better 6.8% return. Earnings may well grow at 5%, but the bigger challenge is the currently high PE ratio.

Table 1: S&P 500 10-Year Expected Returns Matrix				
		Ann. Earnings Growth		
		0.0%	**2.5%**	**5.0%**
	+2.0%	3.8%	6.3%	8.8%
PE Ratio Ann. Change	**0.0%**	1.8%	4.3%	6.8%
	-2.0%	-0.2%	2.3%	4.8%
Source: Tomlinson Research, Online Data Robert Shiller				

If this were to decline at 2% per year, from the current 23x to a still-high 19x a decade hence, total returns would range from -0.2% to 4.8%. These returns would be a steep decline from the recent past and could lead to an exodus, especially if the bond market sells off sharply.

Investors should be just as careful picking an ETF as they are an active manager. The choice of reference index, sampling method and underlying

[4] http://www.imf.org/en/Publications/WEO/Issues/2018/01/11/world-economic-outlook-update-january-2018

[5] https://www.imf.org/en/Publications/WEO/Issues/2017/09/19/world-economic-outlook-october-2017 (p. 9)

[6] (Malkiel, 1973) 24

[7] https://us.spdrs.com/en/etf/spdr-sp-500-etf-SPY#

[8] http://www.econ.yale.edu/~shiller/data.htm

assets matter. Given low yields and high valuations in public markets just as QE is ending, even Malkiel's dart throwing monkey may disappoint.

AN OUTLOOK WITHOUT FIRE OR FURY

Michael Wolff's exposé of the Trump White House's first 100-days, *Fire and Fury*, is apparently being adapted to TV. We can only hope the incoherent Brexit negotiations never are. Our working assumptions for both these populist oddities is they will charge ahead until they bump into reality.

Table 2: Key Risks	
1.	Interest rates trending up
2.	Equity valuations at multi-decade highs
3.	Credit spreads low, especially European
4.	Rising protectionism impedes global trade
5.	Rising commodity prices and inflation

The US administration seems content to harass trading partners, with the rhetoric for the benefit of the domestic US audience. Though the US tax cuts and regulatory reform will likely boost growth, this unfortunately comes at the very moment there is little spare capacity. Boom then bust seems likely.

On the other side of the Atlantic, Brexit is becoming a "fudge", illustrated most recently by an agreement to avoid a hard border between Northern Ireland and the Republic of Ireland, interpreted afterwards in diametrically opposed ways by each side. In any case, there does not seem to be enough votes in the UK Parliament for a "hard Brexit" and a "soft Brexit" is pointless.

In our view, security selection has never mattered more. Equity valuations and bond yields are not particularly attractive, as we note above in our look at potential S&P 500 returns over the coming decade. European, Canadian, Asian and emerging markets are more attractive for stock pickers, particularly small and micro-cap.

We can summarise our thoughts for the coming year with a list of five key risks (Table 2). These look for all the world like the late 1960s and early 1970s, except the demographics are less favourable. Probably not a scenario that favours passive strategies.

Keith Tomlinson, CFA