



MORNING BRIEFING

August 17, 2016

Rushing Bull

See the [collection](#) of the individual charts linked below.

(1) Stock phrases. (2) The first year of presidential terms can be challenging. (3) Presidential candidates: Who is the worst of them all? (4) Is investing in stocks as fair as competing in the Olympics? (5) Central bank officials providing the steroids. (6) From irrational exuberance in stocks to rational desperation in bonds. (7) Why pessimism is bullish for stocks. (8) Global industrial production growing slowly, but doing so in record territory. (9) Judging the debate between active and passive money management. (10) A great rotation, or just another cycle?

Stocks: Bull on Steroids. “This may all end badly,” as widely feared. There could be an “endgame” to this game. We may have no choice but to keep “kicking the can down the road.” However, it’s probably a one-way road with a cliff at the end of it. Those have been a few of the stock phrases used by the bears to warn that the current bull market isn’t sustainable and “cruising for a bruising.” The bull has been on a “sugar high” and “running on fumes.”

Joe and I agree that one day, within our lifetimes (he is younger), there will be a bear market in stocks. If stocks continue their current melt-up, there could be a wicked correction and even a bear market next year. Even if stocks continue to rise at a leisurely and seemingly sustainable pace, there could be trouble next year. That’s because the first year of presidential terms tends to be recessionary for the economy and bearish for the stock market ([Fig. 1](#) and [Fig. 2](#)). (See our [Presidential Election Cycles](#).)

Our hunch is that a selloff early next year would be more likely if Donald Trump is our next president. That’s not a politically biased view, but rather our objective assessment that the bull market prefers the status quo, which would be more likely if Hillary Clinton wins. We could be wrong, of course, and the reverse could be true if Trump cuts taxes, but backs off on trade protectionism, while Hillary goes full-bore socialist.

Perhaps the most likely political scenario is that whatever the outcome of the presidential race is, it won’t trip up the bull at all. He has stumbled a few times since March 2009, but somehow has managed to charge ahead to new record highs. Over the past few days, the bull has been a race horse--winning a couple of daily trifectas, with the S&P 500, DJIA, and Nasdaq all finishing together at new record highs.

Of course, the bull would be disqualified from competing in the Olympics. That’s because he has been injected numerous times with steroids provided by the world’s major central banks. The bears have been saying that’s not a fair game. Maybe so, but investing in stocks isn’t an Olympics event. Doped-up Russians were prohibited from competing in the games this year by Olympics officials. Central bank officials are the ones who usually end the race for stock market bulls. This time, they are doing everything they can to keep the rushing bull charged up and charging.

On Monday, in his *WSJ* column, James Mackintosh [presented](#) a similar perspective on the current bull market as we have been presenting since it began. It was titled “Central Banks Could Be This Market’s

Pets.com.” He compared the current state of the stock market to the market’s condition in 1999. Back then, valuations were driven to record highs by the extraordinary optimism of investors on the outlook for technology companies. There were plenty of cheaper suitable investments available for more conservative investors, but it seemed that everyone wanted to ride the high-tech boom. The bubble burst when the dot.coms (like Pets.com) burned through all their cash and then burned investors.

This time, there is no euphoria among stock investors. Instead, there is much trepidation about the sorry state of the global economy. Central banks have responded to weak global growth by lowering interest rates to zero and even below the so-called “zero bound.” Now it is bond prices that seem ridiculously overvalued. While bond investors have enjoyed solid capital gains, they aren’t jumping for joy. Instead, they continue desperately reaching for yield. Today “rational desperation” in the bond market has replaced the “irrational exuberance” of the stock market during the late 1990s.

Mackintosh nicely sums up the impact of all this on stocks: “Pessimism has depressed bond yields, reducing the discount rate and so making even fairly stagnant future profits look more attractive in today’s money. Higher prices are justified, without needing much in the way of earnings growth.”

Global Economy: Record-High Production. While the central bankers are increasingly getting most of the credit for the current bull market in stocks, let’s not forget that workers are still going to work and managers are still managing their businesses every day. Central banks have responded to slow global economic growth by flooding the global economy with liquidity. Business managers have responded by working harder to bolster their revenues, to cut their costs, to increase their productivity, to boost their profit margins, and to grow their earnings. A recession is always a good excuse for not doing any of these things beyond slashing costs. In a slow-growing business environment, there are no good excuses for not at least trying to do better.

On a global basis, all these efforts continue to pay off in growth, albeit slow growth. However, it is mostly slow growth to record-high territory. Consider the following:

(1) *Global industrial production.* As Debbie discusses below, global industrial production (excluding construction) rose 2.0% y/y to a new record high during May ([Fig. 3](#) and [Fig. 4](#)). That’s not much growth, but it has a positive sign rather than a negative one, and it is happening in record-high territory.

(2) *Advanced vs. emerging economies.* We aren’t as pleased by the industrial production index for advanced economies. It has been flat-lining for the past couple of years roughly 5.5% below its record high during January 2008 ([Fig. 5](#)).

On the other hand, the index for emerging economies jumped 4.2% y/y during May to a new record high ([Fig. 6](#)). Production is at or near a record high for the following EMs: Indonesia (up 6.4% y/y through June), China (6.0%, July), Poland (6.0%, June), Malaysia (4.6%, June), Czech Republic (4.6%, June), India (2.3%, June), and Mexico (0.3%, June).

Strategy: Staying Active. It’s been a difficult year for stock pickers. Most actively managed funds have underperformed passively managed ones. The *WSJ* posted an [article](#) on 8/12 titled: “Stock Pickers’ Very Bad Year.” It noted: “In the decade that ended in 2015, an average of just 37% of large-cap mutual funds outperformed the Russell 1000 in any given year, according to Bank of America Merrill Lynch. In the first seven months of this year, only 14% outpaced the benchmark.”

This underperformance of active funds and the substantial outflows from them have put the age-old active-versus-passive investment debate at the forefront of investors’ minds. Is active management dead? We don’t think so. *Barron’s* featured a cover [story](#) at the beginning of last year that hailed the

return of stock picking. It obviously made that prediction a bit too soon. I asked Melissa to have a closer look at this issue. Here is her assessment:

(1) *Great rotation.* Actively managed US equity funds had net outflows of \$32.9 billion during July, according to an 8/12 Morningstar [report](#) by Senior Analyst Alina Lamy. That was a record outflow, based on data starting in 1994. Passively managed US equity funds had net inflows of \$33.8 billion last month. For the year, outflows from actively managed US equity funds totaled \$211 billion, while inflows into passively managed ones totaled \$163.6 billion. Currently, about 43% of US equity funds are passively managed. (See technical note below.)

(2) *Fixed baskets.* The underlying problem, according to the *WSJ* article cited above, is that the great rotation out of active and into passive funds has made stock selection less effective. Stocks have been lumped into baskets with their prices more tightly correlated, says Merrill strategist Jill Hall. That's meant less dispersion and, for fundamentals investors, fewer opportunities to beat the market. Furthermore, performance has been driven more by the global outlook than the underlying fundamentals of individual stocks, the article also observed.

Additionally, profit performance has been relatively weak, so fundamentals investing hasn't paid off. And dividend stocks came into favor not because of their underlying fundamentals, but rather because low yields in the bond market have made "bond-like stocks" more attractive. The good news, as the article concludes, is that many of these themes might soon reverse, putting active managers in favor again. If that happens, the tide soon could turn for actively managed funds.

(3) *Nuanced argument.* To bring more clarity to this debate, Morningstar developed an Active/Passive Barometer last year. The 6/25/15 *WSJ* [reported](#) on Morningstar's initial findings: "[A]ctively managed funds have generally underperformed their passive counterparts" and "experienced higher mortality rates, meaning that many have merged or closed." More recently, the bottom line hasn't changed, according to Morningstar's latest semiannual [analysis](#) dated April 2016. However, there may be a few devils in the details.

According to the *WSJ*, the author of Morningstar's report and director of its global ETF research (who obviously has a professional interest in passive funds) acknowledged: "[N]ot all passive funds are created equal, and that they aren't always better than actively managed funds ... 'It's a more nuanced argument than it's been made out to be.' ... There are also successes and failures among passive funds, which are largely a factor of fees." The trick for investors and their investment advisors is to select the funds that are most likely to perform the best, taking risk tolerance and fees into account.

(4) *Long run.* Interestingly, both the Merrill and Morningstar analyses looked at performance over a decade. But if investors are in it for the long run up until they retire, that might be too short a time horizon to consider. That's especially true given that the bull market began nearly a decade ago. Of course, passively managed funds will capture 100% of the downside of their benchmark. Active managers might have more opportunities to outperform in a down market.

We found a helpful [piece](#) of marketing material dated 2/29 on Hartford Funds' website that supports the point that active and passive performance is cyclical. Despite the likely bias towards actively managed mutual funds, Hartford presented a logical and factual argument: "There have been 21 market corrections since 1987. During those corrections, active managers outperformed passive strategies 76% of the time."

Further supporting the point, in a 4/21/16 Morningstar video [interview](#), the interviewer posed the following question to Ben Johnson, the Morningstar report's author: "[I]s it safe to say that the 10-year

period that you captured here ... encompasses a generally upward-trending market, at least over the past seven years?" Johnson responded: "Absolutely. It hasn't paid to play defense for quite some time now, now that we're seven years into a bull market. So, it goes back to the point ... that there will be this cyclical." He also discussed the point that different types of investment strategies (e.g., active or passive) might work for different types of investment styles (i.e., value versus growth and market-cap focus) depending on market conditions.

(5) *Yin and yang*. *Barron's* featured a relevant article early last year that [observed](#): "The two styles, in truth, are less Hatfield[s] and McCoys and more yin and yang." In other words, neither is either inherently good or bad; but rather, the two types of management are intertwined and complementary. Indeed, passive management depends on active management. The author writes: "Think about it: if theoretically, we woke up tomorrow and all investing were passive, there would be no stock movement, no alpha, no nothing. The only movement in prices would come from the flow of money in and out. ... Passive and active investing are thus twined, and the best strategy is to use both wisely." Both will have their opportunities to fare better or worse than the other.

Further, no one fund is likely to represent the absolutely perfect mix of assets and international exposure tailored to an individual investor's needs--not even newfangled clever fund inventions that attempt to blend strategies like [target-date](#) funds or [smart-beta](#) funds. Ironically, Rick Ferri who wrote the book *The Power of Passive Investing* [agrees](#) that "pure passive investing does not exist." Indeed, investing is never a passive activity because an active choice to invest or not to invest always has to be made. That means that investors always will need investment advice. That's good for our accounts, who are all active managers, and good for us.

(6) *Technical note*. According to Lamy, these data include both open-ended funds and ETFs. ETFs are classified as active or passive depending on the specific fund and the strategy that it employs. The majority of ETFs are passive, though. In her report, she makes an interesting observation regarding the top-flowing passive fund during July: "Surprisingly, in July, the SPDR S&P 500 ETF SPY received its highest monthly inflow since December 2014. The S&P 500 returned 3.7% in July, but it had also returned 6.8% in March without a similar spike in flows. We usually see high inflows for this ETF in December, when active managers use it temporarily to place assets before reallocating at the beginning of the new year. If something similar is happening now, we may see some major movement when this money is reallocated in the next few months."

CALENDARS

US. Wed: MBA Mortgage Applications, FOMC Minutes, Bullard. **Thurs:** Jobless Claims 265k, Leading Indicators 0.2%, Philadelphia Fed Manufacturing Index 2.0, Weekly Consumer Comfort Index. (Bloomberg estimates)

Global. Wed: UK Jobless Claims & Claimant Count Rate 9k/2.2%, UK ILO Employment Change (3m/3m) & Unemployment Rate (3m) 153k/4.9%, Australia Unemployment Rate 5.8%, Japan Merchandise Trade Balance (yen) 234.5b. **Thurs:** Eurozone CPI -0.5%_{m/m}/0.2%_{y/y}, UK Retail Sales 0.1%_{m/m}/3.8%_{y/y}, ECB Account of Monetary Policy Meeting. (DailyFX estimates)

STRATEGY INDICATORS

YRI Weekly Leading Index ([link](#)): Our Weekly Leading Index (WLI)--a good coincident indicator that can confirm or raise doubts about stock market swings--slipped for the second week during the week ending August 6 by a total of 1.2%, after rising four of the prior six weeks by a total of 3.4% to a new record high. It has soared 10.3% since this year's bottom in mid-January. Our WLI is the average of our

Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI). Our BBB dropped 1.5% the past two weeks following a nine-week climb of 8.8%. Jobless claims climbed for the second week to 262,750 (4-wa), after falling the prior nine weeks from 278,500 to 256,500. The CRB raw industrials spot price index--another BBB component--moved higher in mid-July but has flattened out since. The WCCI remains volatile, falling 2.8% after little change the prior two weeks.

S&P 500 Q2 Earnings Season Monitor ([link](#)): With 92% of S&P 500 companies finished reporting Q2-2016 results, similar percentages of companies are beating revenue and earnings forecasts as at the comparable point of the Q1 season, but the surprise and y/y growth metrics are mostly better. Of the 460 companies in the S&P 500 that have reported, 71% exceeded industry analysts' earnings estimates by an average of 4.5%; they have averaged a y/y earnings decline of 2.8%. At the same time period in Q1-2016, a slightly higher percentage of companies (72%) in the S&P 500 beat consensus earnings estimates by a higher 4.8% and earnings were down a greater 5.7% y/y. On the revenue side, 53% beat sales estimates so far, coming in 0.1% above forecast and 0.1% above year-earlier results. During Q1, a slightly lower 52% beat forecasts, but reporters missed estimates by a 0.3% on average, with results down a greater 1.4% y/y. The S&P 500 results are much better ex-Energy: The revenue surprise improves to 0.3% from 0.1%, and y/y growth rises to 3.4% from 0.1%; the earnings surprise rises to 4.9% from 4.5%, and y/y growth improves to 2.0% from -2.8%. Aggregate earnings continues to benefit from a reduced share count, but slightly less so than during Q1--shares outstanding is down 1.1% y/y in Q2 compared to a 1.4% decline at the same point in Q1.

US ECONOMIC INDICATORS

Industrial Production ([link](#)): Production increased in July at its fastest pace in 20 months and posted the first back-to-back gains since last summer. The headline number jumped 0.7% (more than double expectations) after a revised 0.4% (from 0.6%) advance in June. Factory output expanded 0.5%--its best performance in a year--after a 0.3% June gain. Consumer goods output increased for the second month by a total of 1.2%, driven by a two-month gain of 3.8% in durable goods output; both reached new cyclical highs last month. Consumer nondurable goods production rose 0.6% last month after a 0.2% fall the previous month. Production of business equipment expanded for the third time in four months by 0.6% m/m and 2.3% over the period. Output of transit and industrial equipment both increased 1.6% over the two months through July, while output of information-processing equipment remained stalled around May's record high. A 2.1% surge in utilities output for the second month once again helped boost headline production; mining output rebounded 0.7%, more than reversing June's 0.3% decline. Total production expanded 1.4% (saar) in the three month through July, based on the three-month average, the first positive reading since last September; manufacturing production increased 0.3% (saar) over the comparable period after falling the prior three months.

Capacity Utilization ([link](#)): The headline capacity utilization rate increased from a recent low of 74.9% in March to a nine-month high of 75.9% in July. Last month's rate is still 4.1ppts below its long-run (1972-2015) average. Manufacturing's capacity utilization rate climbed from a 27-month low of 74.8% in May to 75.4% last month, 3.1ppts below its long-run average.

GLOBAL ECONOMIC INDICATORS

Global Industrial Production ([link](#)): Output in the emerging economies reached a new record high in May; production continues to move sideways in the advanced ones. Global output advanced 2.0% y/y in May--its fastest pace since last August--to a new record high. Production in the emerging economies expanded at a 17-month high of 4.2% y/y, with yearly growth in advanced economies continuing to hover around zero. The latest monthly data by country show that production in many of the emerging countries we track remains on uptrends, with levels at or near record highs in China, India, Indonesia,

Malaysia, the Czech Republic, Hungary, and Poland. Output levels in South Korea and Mexico are stalled at their highs. Production levels in the rest of Asia, Latin America, and Eastern Europe remain around recent highs--except in Brazil and the Philippines, where output is sliding, though may have reached a bottom. Output in Singapore and Taiwan is turning up from recent lows, while Russia's is moving sideways. In the G7 economies, US headline production increased for the third time in four months in July, though remains below recent highs, while Canadian production is moving down from its recent high. Output in the UK remains on an upswing from its recent drop. Japanese production stays in a very volatile flat trend. Data for the Eurozone's three largest economies show production fell for the second month in June in both France and Italy, while it increased in Germany--keeping production in that country near its cyclical high.

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