ANALYTICS INVESTMENT ADVISORS, LLC

"…Exuberance"[1]

Richard C. Hoyt
January 5, 2018

Economists and analysts have offered conflicting opinions as to whether the current upward market trend is exhibiting "rational" or "irrational exuberance"[2]. The following commentary presents evidence and rationale to support the notion that a fundamentally strong and improving economy is very likely to generate another solid year of corporate earnings and stock market gains.

What?

- The U.S. economy recorded over 3% GDP growth in the 2nd and 3rd quarter of 2017, with the prospect of similar performance in the 4th quarter.
- Year-over-year total CPI was up 2.2% for the twelve months ending in October, whereas the core CPI was 1.7% for the same time period.
- Year-over-year retail sales, which is driven by consumer income and confidence, was up over 4% as of December 14, 2017.
- Corporate earnings growth is on pace to post its largest increase of 9.6% since 2011 (12.7%). All eleven S&P 500 sectors are projected to report year-over-year growth in earnings, led by energy, materials, and information technology.
- Strong housing demand generated a 3.3% increase in housing starts in November to a seasonally adjusted annual rate of 1.297 million units. A 1.4% increase in permits for single family homes, and 5.3% increase in single family starts, is approaching the growing demand for housing, a positive implication for GDP growth.
- Year-over-year total industrial production was up 3.4% in November, while capacity utilization rate was 77.1%, 2.8% lower than the long term average, suggesting that the economy has room to grow without negatively impacting inflation.
- The ISM Non-Manufacturing Index was 57.4 in November, down from 60.1 in October which was the highest reading since the beginning of the index in 2008. This level of non-manufacturing business activity is consistent with a 3.3% increase in real GDP growth on an annualized basis.
- The ISM Manufacturing Index rose to 59.7 in December from 58.2 in November, the 16th consecutive month the index has been above 50.
- Total durable goods increased 1.3% in November auguring for continued positive impact GDP.
- Retail sales are outpacing inventory growth, suggesting a resumption of pricing power.

---

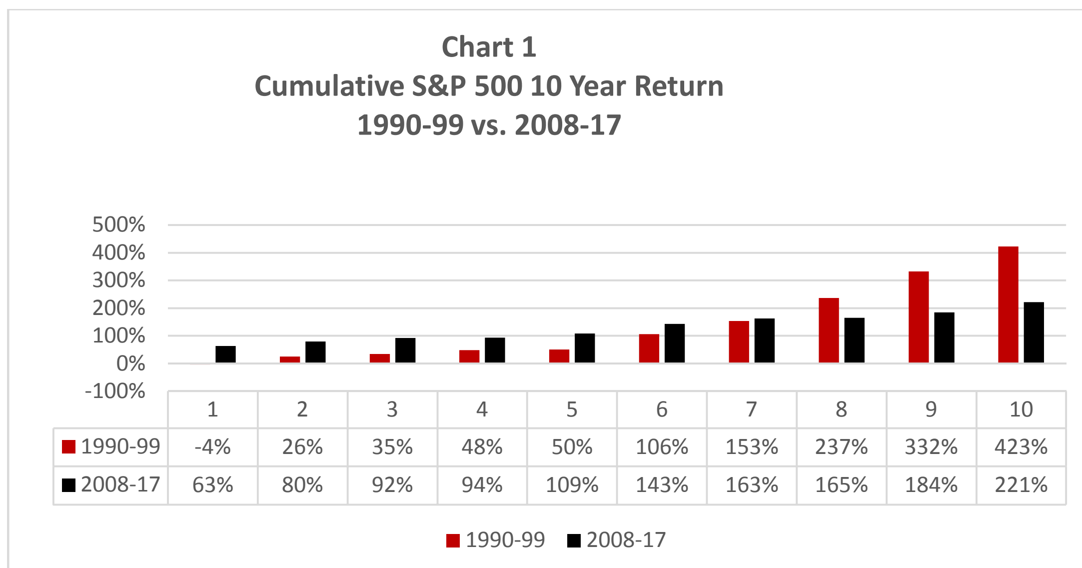
[1] A superabundance of something abstract… The *New Shorter Oxford English Dictionary*, Oxford University Press, 1993.

[2] "Irrational Exuberance" is an expression attributed to Allan Greenspan on December 5, 1996 as a warning that the stock market might be overvalued. Robert Shiller also used the terminology as the title of his book *Irrational Exuberance* in 2000.

- The Leading Economic Index for November increased for the 15th straight month. Moreover, this index grew at a faster pace (3.0%) in the six-month period ending November period than it did in the previous six months (2.4%) as the strength of all 10 leading indicators continues to be widespread.
- Fourth quarter average monthly estimates for the real trade deficit of 65.3 billion (approximately 50% billion with China) is 5.3% higher than the average third quarter deficit of $62.0 billion, the difference of which will have a negative impact on fourth quarter GDP.
- Private sector payrolls increased by 148,000 221,000, and 247,000 for December, November and October respectively; the unemployment rate remained at 4.1% (unchanged from October); the labor participation rate was 62.7% (compared to 66% in November); and, 2.1 million jobs were added in 2017.
- The comparison of the stock market gains between two ten year periods 1990-1999 (the Greenspan era) and 2008-2017 as justification for concluding the current market is overvalued (irrational exuberance) does not seem defensible when put in the proper historical perspective (see Table 1 & Chart 1).

Table 1
S&P 500 Returns

Year No.	Yearly 1990-99	Cumulative 1990-99	Yearly 2008-17	Cumulative 2008-17
1	-4%	-4%	-37%	63%
2	30%	26%	26%	80%
3	7%	35%	15%	92%
4	10%	48%	2%	94%
5	1%	50%	16%	109%
6	37%	106%	32%	143%
7	23%	153%	14%	163%
8	33%	237%	1%	165%
9	28%	332%	12%	184%
10	21%	423%	20%	221%



Why?

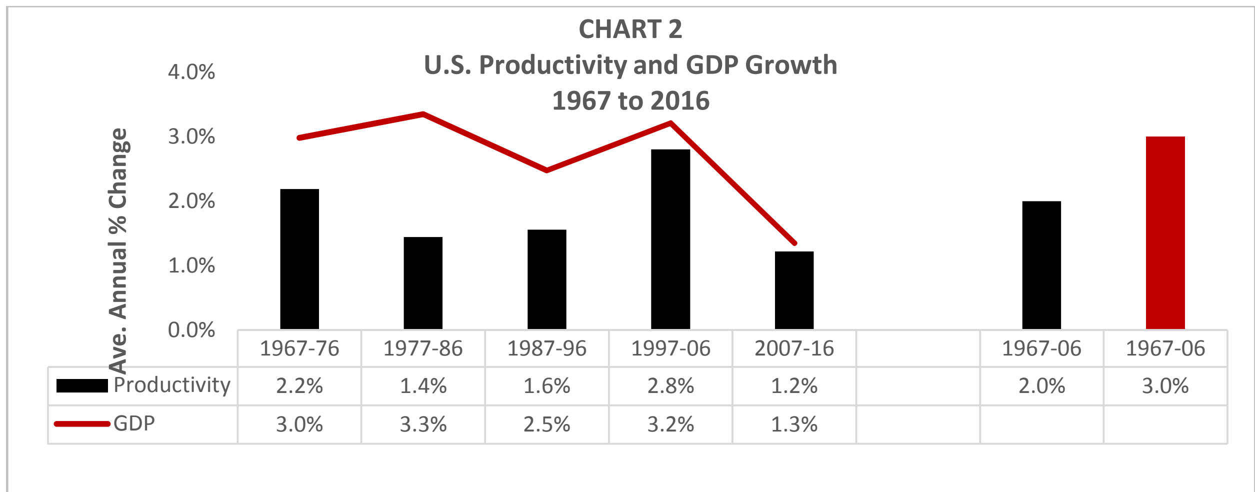
- Conventional wisdom suggests that with an approximately nine year improvement in the stock market, the economy would be approaching middle or late stage expansion stages. However, the recent surge of in high-growth technology and consumer sector business would seem to contradict this nostrum, and imply that the U.S. economy is in an early expansion cycle, due most plausibly to the recent reduction in government regulation and historical tax cut.
- This trend is also evidenced by a lack a movement to defensive issues, which are better positioned to manage low interest rates and slow growth typically experienced later in the business cycle.
- The technology sector and its increasing role in the cloud computing and artificial intelligence has transformed the retail and entertainment industries, a trend that will continue to give impetus to business creation and expansion, while energy deregulation will speed America's quest to becoming energy independent.
- Business Investment will be powered by the new government fiscal reality with incentives for immediate write offs and pass through provisions for small businesses. Greater profits from tax reduction will fuel investments and add to wage growth.
- Productivity, which has been estimated to account for 66% of GDP growth between 1967 and 2017[3] will be positively influenced by new business and government investment.[4]
- Government Investment (spending) on infrastructure will increase GDP generating new employment and income opportunities.

---

[3] See Richard C. Hoyt "Labor Productivity and GDP Growth, Analytics Investment Advisors, LLC Commentary, p.1, April 5, 2017, www.analyticsllc.net.

[4] Ibid. p.1, "A linear regression model comparing these two variables on an annual basis over the most recent 50 years (1967-2016) indicates that for every 1% increase in productivity, there was an average 1.2% increase in GDP.

- Export growth will negatively impact GDP, but new incentives for repatriation of profits and new trade policies, will likely improve, perhaps reverse, decades of U.S. trade imbalances.



	1967-76	1977-86	1987-96	1997-06	2007-16		1967-06	1967-06
Productivity	2.2%	1.4%	1.6%	2.8%	1.2%		2.0%	3.0%
GDP	3.0%	3.3%	2.5%	3.2%	1.3%			

Source: U.S. Bureau of Economic Analysis

How?

- Utilize Exchange Traded Funds (ETFs) to stay invested, emphasizing growth which will outperform value again in 2018.
- Use the market relative calm and low correlations (18% for three month period as December 7, 2017), relative strength, risk return ratios, and liquidity to identify sector ETFs that are likely to outperform in the coming year.
- Make judicious use of trailing stop loss orders to protect gains, most effectively in tax advantaged accounts to eliminate capital gains.
- Use overall market ETFs for diversification, balance, and growth potential.

Strategic Allocations

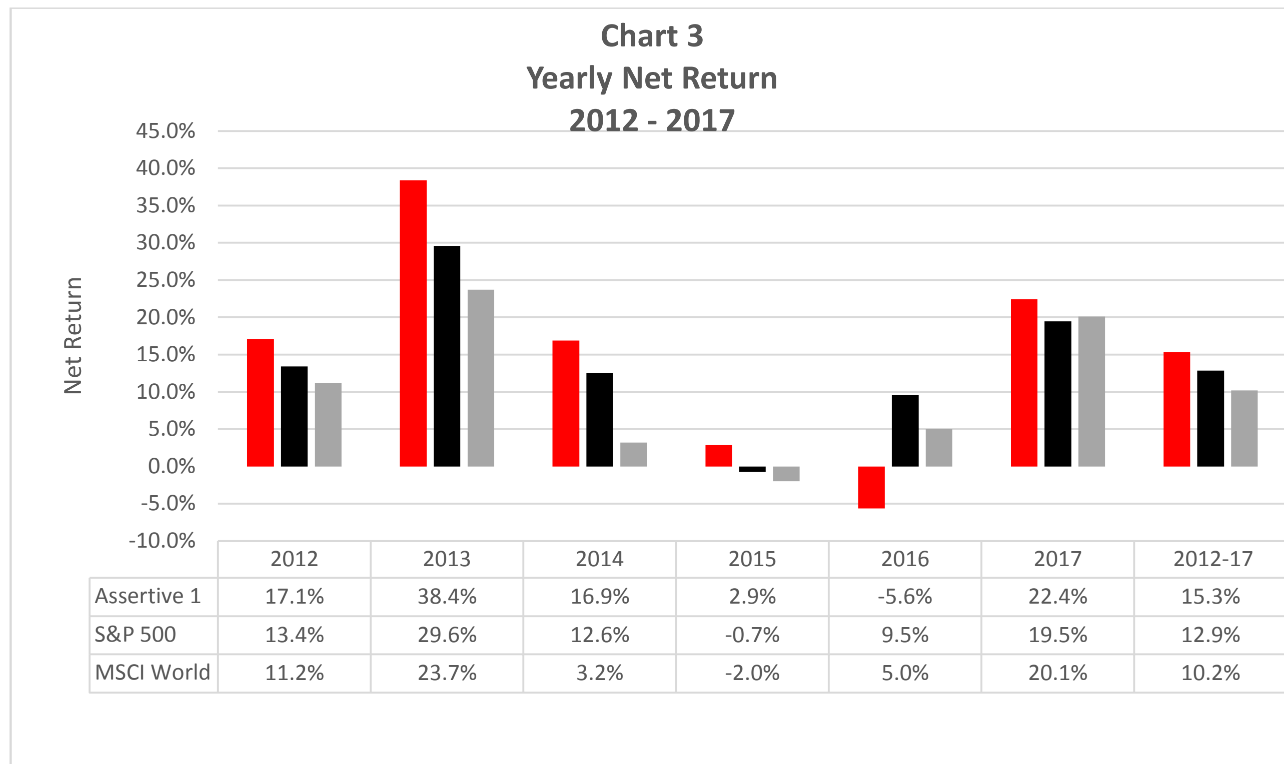
- **Cautious Strategy**: Cautious investors seeking better than nominal returns, but with low risk and emphasis on preservation of wealth (Risk Score: 111-200).
- **Moderate Strategy:** Prudent investors desiring a portfolio designed to accomplish medium to long term financial goals and an investment strategy which accounts for taxes and inflation. Calculated risk is acceptable to achieve good returns (Risk Score: 201-290).
- **Assertive Strategies 1 & 2:** Assertive investors with sufficient income to invest mostly for capital growth. Higher volatility, moderate risk, and more aggressive investments are acceptable to accumulate wealth over time (Risk Score: 291-390).
- **Aggressive Strategy:** Aggressive investors intending to compromise portfolio balance in pursuit of higher long term returns. Security of capital is secondary to potential wealth accumulation (Risk Score: 391-450).

Performance

	2012-2017	YTD 12/31/17			Risk Statistic	
S&P 500	**12.87%**	**19.45%**				
Barclay US TR	**2.48%**	**3.54%**	**%AUM**	**Beta****	**R^{2}****	**SD****
Cautious	9.88%	17.79%	<1%	1.14	0.83	3.20
Moderate	12.81%	20.38%	35%	1.31	0.94	3.59
Assertive 1	15.34%	22.43%	36%	1.43	0.79	4.14
Assertive 2	20.13%	32.38%	13%	1.59	0.83	4.49
Aggressive	22.58%	47.15%	14%	2.74	0.74	8.14

*Net Average Return, Portfolio Center, Schwab Portfolio Technologies. Returns are net of fees, which are negotiable and range between 50 and 125 basis points.
**Risk Return Statistics, Analytics Investment Advisors, LLC; most recent 24 months (computed quarterly).

Beta Expected change in portfolio return per 1% change in market index return.
R^2 Percent of variation in regression equation explained by the independent variable (S&P 500).
SD Standard deviation of the dependent variable (Net Return).



	2012	2013	2014	2015	2016	2017	2012-17
Assertive 1	17.1%	38.4%	16.9%	2.9%	-5.6%	22.4%	15.3%
S&P 500	13.4%	29.6%	12.6%	-0.7%	9.5%	19.5%	12.9%
MSCI World	11.2%	23.7%	3.2%	-2.0%	5.0%	20.1%	10.2%