Dow 1,000,000?

Stocks continued to march higher through the third quarter with the S&P 500, Dow Jones Industrial Average and NASDAQ Composite gaining 12.53%, 13.37% and 20.67% respectively through the end of September.

In last quarter's newsletter, we described our cautious view of the market and focused on the following "crosscurrents": equity valuations that at best seem to represent fair value, earnings growth that has been goosed by a weakening dollar, the much anticipated campaign by the Federal Reserve to begin the "Great Unwind" of its balance sheet, an alarming rise in corporate debt, an acceleration in margin debt to all-time highs, historically high investor allocation to equities, uncertainty over potential tax reform and the accelerated proliferation of price-insensitive ETF investing. While many important signals are flashing yellow, we also warned that a "continued lull from the lack of volatility may call in the sirens of market euphoria". In other words, despite the fact that bargains are scarce and caution warranted, investor enthusiasm and even panic buying may drive prices to levels that may prove unsustainably high.

The market's relentless advance combined with recent reads from important sentiment measures such as the CNN Greed & Fear Index, the AAII Investor Intelligence Survey and University of Michigan Consumer Sentiment Index suggest that we may indeed be honing in on a euphoric phase where momentum trumps valuation and fear of missing the rally breeds investor greed. Have fundamentals changed that might warrant a more enthusiastic stance? To be sure, there is plenty of good news to cheer about. U.S. GDP growth at 3% for the second quarter was the fastest pace in two years and among the best quarterly rates since the Great Recession. The global economy is accelerating on all cylinders too and the IMF recently raised its forecast for global growth to 3.7% for 2018. Estimates for 2018 earnings presently stand at $145.59, implying a reasonable forward PE ratio of 17.5x for the S&P 500. Meanwhile and most importantly, inflation remains muted and the yield on the 10-year Treasury remains subdued at 2.3% despite full employment and strong economic fundamentals.

Perhaps the most important variables that will influence the market's next major move are the outcome for tax and fiscal reform and the Fed's ability to deleverage its balance sheet and continue hiking rates without disrupting the economy's Goldilocks underpinnings. With regard to fiscal reform, the lynchpin to Trump's blueprint is a reduction in the corporate tax rate from 35% to 20%. With approximately $2.5 trillion parked overseas, this reduction would stimulate massive repatriation and give a significant boost to corporate profits, estimated to be an additional $10.50 for 2018 S&P 500 earnings and a subsequently more reasonable 16x forward PE. Other proposed changes to the tax code include a lower "pass through" rate for small businesses, elimination of the alternative minimum tax and estate tax, a reduction in tax brackets and individual tax rates, a doubling of the standard deduction and elimination of the state and local tax deduction. While these potential measures would likely give a cyclical boost to GDP, the potential for widening deficits may ultimately lead to more rapid debt-laden *deceleration* in growth. The ratio of publicly held federal debt to GDP now stands at 77% and is expected to hit 91% in a decade. It is estimated that a $1.5 trillion tax cut would push the debt to GDP ratio to 100% over the same period and also widely recognized that economic growth becomes stunted when debt to GDP ratios surpass 90%. Whether rising revenues will offset expected deficits remains to be seen. The stock market is already in the process of pricing in the likelihood for a new 20% corporate tax, so any disappointment here would be an unpleasant surprise.

As for the Fed's "Great Unwind", October marks the first month where the Federal Reserve will allow $10 billion of bonds to mature without reinvesting, gradually increasing to $50 billion monthly in one year.

While the jury is still out on the ultimate impact of "quantitative tightening", we expect demand by foreign central banks to keep a lid on potential spikes higher in rates. The Federal Reserve is expected to reduce its balance sheet by $300 billion in the coming year, while the ECB, Bank of Japan, Swiss National Bank and People's Bank of China are expected collectively to continue buying as much as $300 billion *per month* over the same period. Even at 2.3%, Treasury yields are significantly higher than that in Europe or Japan, so much of the projected foreign liquidity will find its way into our markets. That said, there is now an almost 80% chance that the Fed will raise rates at its December meeting and the dot-plots suggest that three more rate hikes are slated for 2018. The propensity for policy error will increase as rate hikes inevitably dampen economic activity. With the current expansion already long in the tooth, forthcoming moves by the Fed will be subject to further market scrutiny and may lead to heightened volatility.

The legendary Warren Buffet recently offered us an exceptionally long-term forecast for the markets in stating that the Dow Jones Industrial Average will reach the 1,000,000 threshold 100 years from now. Perhaps more remarkable than the inevitability of such a distant prediction is the fact that the Dow must attain a muted average annualized return of just 3.87% from current levels to reach this milestone. With interest rates so low and the stock market elevated, we have been offering a similarly dimmed forecast for forward returns at 4%. Again, while there is plenty of good news at hand, it was also Warren Buffet who quipped that one "pays a high price for a cheery consensus".

With markets persistently climbing, we must ask ourselves how much of the good news is already baked into the cake of valuation. Meanwhile, significant hurdles remain on the fiscal and monetary policy fronts, not to mention ongoing turmoil overseas in such hotspots as North Korea, Syria and Iran. We remain sanguine in the quality of our core holdings, confident in the prospects for continued earnings and dividend growth therein, and happy to take advantage of the inevitable dips that are sure to come our way both in the short term and over the next 100 years.