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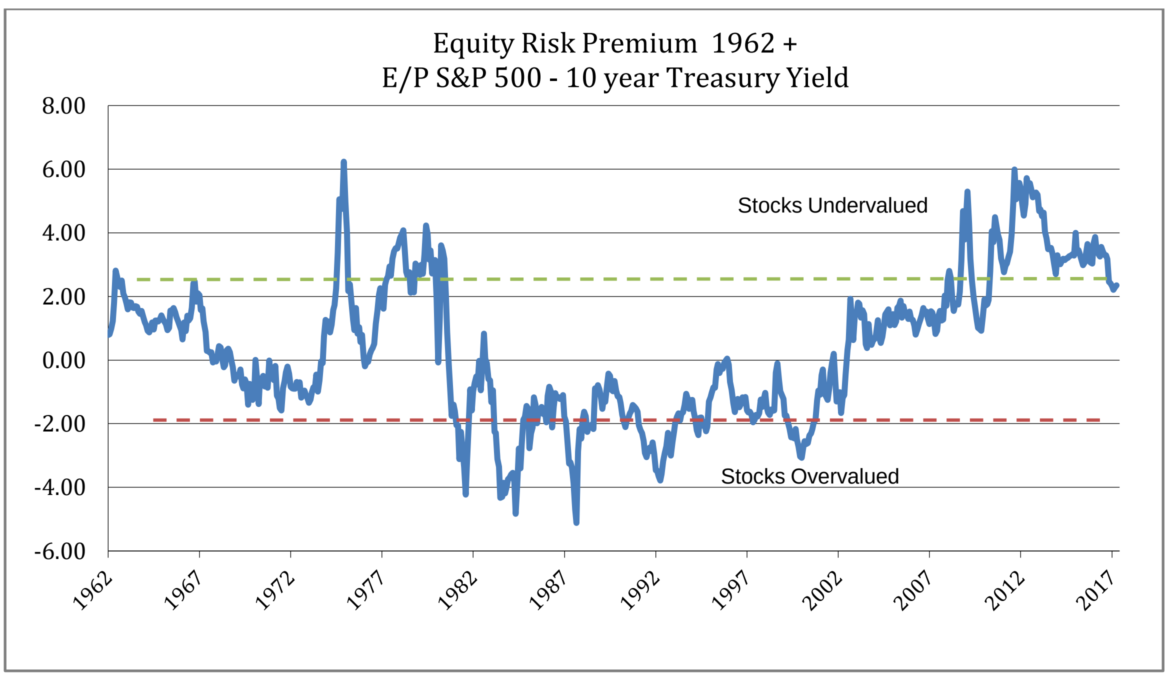
Stocks Versus Bonds

Stocks are cheaper than bonds.

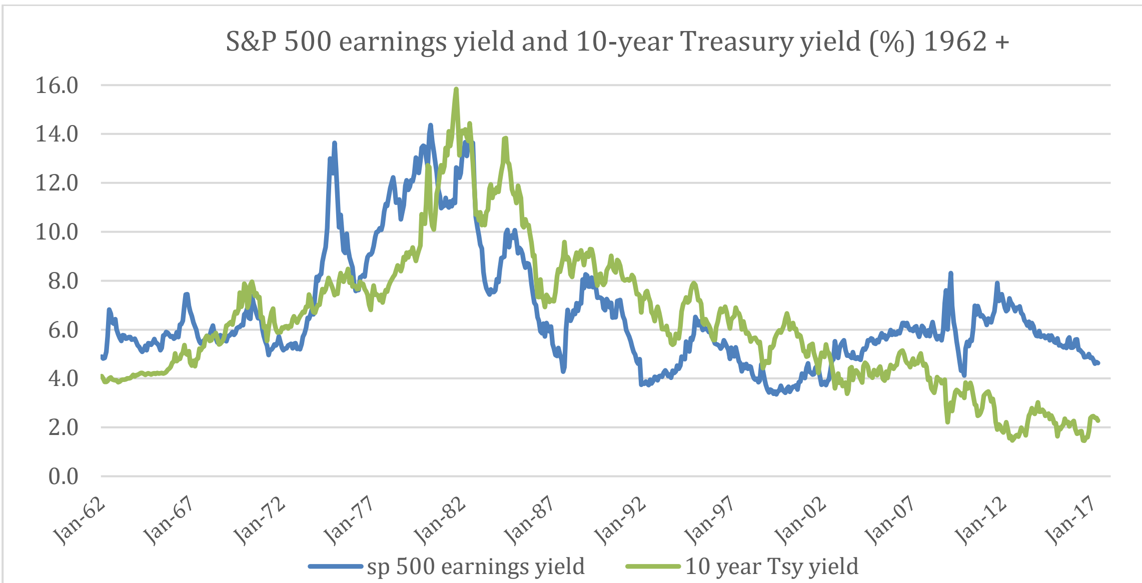
Those five words are the last, best valuation case for owning US equities; not the only investment case of any kind, just the one that should count the most. One by one, favorable stock market valuation alternatives have been swamped in the wake of rising prices. Among these are price-earnings multiples on trailing and projected profits, price to book and price to sales ratios, equity dividend yields above the 10-year Treasury rate, Shiller's Cyclically-Adjusted PE, capitalization-weighted measures, equally-weighted measures, total market cap-to-GDP ratios, and any other metric an investor might dream up. None of these alternatives look attractive compared to historic norms, some are flashing warning signals, and a few are downright scary.

That leaves us with stocks versus bonds, alternatively labelled as the Earnings Yield Spread, the Fed Model, and somewhat erroneously as the Equity Risk Premium.



The premise is simple enough: no asset class stands in isolation; all are priced relative to others, or relative to a benchmark. The most common benchmark is the 10-year Treasury note, which currently offers the prospect of a 2.28 percent annual rate of interest for the next decade, plus a return of investors' capital.

The question for equity investors is this: does the valuation of stocks offer enough yield premium over Treasurys, given the higher risk profile of equities, and considering the historic relationship between the two asset classes?



For the entirety of the current bull market, the answer has been yes, not because hindsight tells us stocks have outperformed bonds, but because the yield premium on equities has been favorable throughout -- at times exceedingly favorable.

The typical pushback on this comparison has focused on the historic low bond yields in the US and around the globe. Naysayers argue that the favorable stocks-versus-bonds condition is caused by a distortion of interest rates, courtesy of central banks, as opposed to favorable equities prices. In other words, stocks are cheaper than bonds because bonds are mispriced, with yields well below normal. Referencing the chart above, we would ask, "what bond yield is normal?" And for year on end, the skeptics have been proven wrong by an ever-rising equity market.

Our opinion throughout has been that it hardly matters what causes the condition, just that it exists and continues to carry predictive power. Indeed, since 1962, when equity earnings yields exceed Treasury yields by more than 200 basis points, stock prices have risen in the following 12 months an overwhelming 84 percent of the time. With a current earnings yield of 4.64 percent, and a 10-year Treasury yield of 2.28 percent, the differential stands at 236 basis points.

Stocks are cheaper than bonds. On valuation, there's nothing else remaining.

Chatting with Stevie

Stevie was the neighborhood's precocious child who grew into a high school wiz-kid, then never stopped lapping the field until landing a job on a Wall Street bond desk. While probably not the brightest mind on Wall Street, Stevie may be the brightest one we know. We caught up recently.

I want to ask you about the Affordable Care Act and the ongoing drama over its repeal and replacement?
Stevie: You mean the abomination known as Obamacare?

That's the one. Here's a wild guess: You don't like it.
What's to like? The whole idea was to scam the American public. It was a fraud from the start.

Maybe it's just a work in progress, off to a rough start.
No, no, no. We might as well start at the beginning. If you like your health plan you can keep your health plan. False. If you like your doctor you can keep your doctor. False. And Obama was opposed to the individual mandate, until he was for it. He must have been drinking the same Kool-Aid as John Kerry.

More on its origins. This was meant to be legislation, which means a bill produced by Congress, passed up from committees to the full bodies. After the House and Senate vote on their respective bills, they get together for a final reconciliation before the legislation is passed. That did not happen with Obamacare. It was crafted in the back rooms of the Administration, written by bureaucrats confident in their ability to swindle the American public, whom they derided as gullible. Then the Democrats in Congress rubber-stamped it.

When Nancy Pelosi said "We have to pass the bill, so that you can find out what is in it", she was not kidding. The original draft was 2800 pages long; how many of those pages do you believe Nancy Pelosi even glanced at?

Can we count pages with pictures?

At least the plan expanded health care coverage, by over 20 million Americans. Certainly that is a success.
First of all, nearly half of that increase was in Medicaid coverage, expansion of a program already in place. If the government wanted to broaden Medicaid, spend more money on it, that was a simple task. We didn't need Obamacare for that expansion.

Second, and this goes to the heart of the matter, increasing health care coverage at any cost to the American public does not define a successful outcome.

How so?
Reducing obesity or heart disease would be favorable outcomes. Lowering infant mortality would be

an outcome. Having insurance is not an outcome. If you buy auto insurance, that does not make you a safer driver. Alternatively, if we had the same health outcomes at a lower cost, that would be a gain in efficiency, which we will call a success. In all the talk about expanded coverage -- basically the only truthful claim the program's defenders can make -- has anyone said that health care outcomes have improved, or that the system is more efficient? If so, I haven't heard it.

There's more to dislike, for instance the hundreds of companies initially granted waivers from the program. And then there is the surtax on investment income and the tax on medical devices. Who in their right mind imposes a tax on the very devices that improve people's health? It makes no sense.

What was the point of that?
The government needed money to make the numbers work. The whole thing turned into a wealth transfer, a subsidy from upper income to lower income, and from young to aging. Health care itself is a side-show in the program.

So where do we go from here?
Well, if we were starting with a clean sheet of paper, anything would be better than the current plan.

So just repeal it?
Not so fast. We now have an entitlement program, and that means millions of Americans who will kick and scream if their benefits are reduced. It doesn't matter that the plan was flawed to begin with. They now have a benefit and want to keep it.

It doesn't matter that the plan is failing?
Consider this idea: our government could provide a stipend to every household, with no means test. Just give people free money. Call it a poverty-killer stimulus plan.

Sounds far-fetched, I doubt any responsible society would consider this one.
Parts of Western Europe are already toying with the concept.

As I was saying.
Stay with me on this. Imagine then, four years later intelligent life returns to Washington, and realizes this plan will bankrupt the nation. Whichever party pulls the plug on the plan will be the loser at the polls. Voters will feel cheated, because they had an entitlement and it was rescinded. Nobody will ask if it was a sensible idea to begin with.

And this is where we stand today on Obamacare?
Right. The minute Republicans reduce benefits, they will own it and answer for it. The trick is to create more winners than losers in any reform. Improving health care is still secondary at best.

So politics will trump policy. Pardon the pun.
Indeed, but this is nothing new. Politics is the world's oldest profession.

I thought prostitution was the world's oldest profession.
What's the difference?

House Speaker Paul Ryan proposed an initial plan to repeal and replace Obamacare, but it was shot down without a vote. What are we to make of that?
A few thoughts.. first, the Democrats have no intention of playing along; nor is it clear they were ever invited. It's the same playbook as was used in passing Obamacare, just with the roles reversed. We'll cram it down your throats and you just have to swallow it. The discourse in Washington is so damaged, it will take real leadership to mend it; that and the passage of time.

Well, we have a new President.
Don't go there, not on this one.

Okay, what else?
The Freedom Caucus, the conservative wing of the GOP House of Representatives, basically killed the initial bill. They had some valid objections, but the word is, they kept moving the goal post. Since then, they have won more concessions and seem to be onboard.

So reform is not dead?
Not at all, it will be revived, and probably soon. A bill could be wrapped up in the House in no time, then sent to the Senate. It would be nice if Democrats were included in the negotiations, to create a broader consensus. But as we discussed, that's not happening.

While I have you, care to discuss our new President on other issues?
Within limits. He has some innovative ideas, but his delivery is awful. Most of his problems thus far are his own doing, and substantive legislation will be difficult to enact. He may end up ruling by executive order, a trick he learned from Obama. Still, a pro-business attitude, including reduced regulation, will help our economy. Banking and energy development will no longer be dirty words. Tax reform would be a bonus, but it's a big leap from a rough outline to real legislation revamping the tax code. There are so many special interests to battle. Almost no one supports Trump's views on trade, but it's his fault for defining the issue in antagonistic terms.

What was the alternative?
To say that NAFTA is more than two decades old, and we should consider revising the agreement, making sure all three nations are well-served by the treaty. Is that so hard to do? You can say the same about China. We open our markets to them, allow them to invest in the US, including acquisitions of American businesses. They do not reciprocate. Their markets are closed to us, or require a local partner. It's not a level playing field, not even close. But stop griping about China being a currency manipulator. That's just a distraction.

Oh, Trump changed his mind on that one. China is no longer a currency manipulator.
Well it is Springtime, and hope springs eternal. Let's end on that happy note.

They Said It, Unfortunately

As reported by The Wall Street Journal and others, Tesla Chairman and Chief Executive Elon Musk is facing ongoing criticism over the company's corporate governance, including composition of its board of directors.

In a recent letter to the company's lead independent director, five Tesla investors, including the California State Teachers' Retirement System and the New York City Comptroller's office -- no lightweights -- wrote, "As long-term investors, we want Tesla to succeed and believe that the company will be most effective if it has the benefit of an updated board and some good governance standards in place".

Mr. Musk's reply, delivered via Twitter: "This investor group should buy Ford stock. Their governance is amazing..."

In March of this year, PRWeek named United Airlines CEO Oscar Munoz, "Communicator of the Year" for 2017, exclaiming:

"Munoz has shown himself to be a smart, dedicated, and excellent leader who understands the value of communications. His ability to connect and share with employees his vision for the airline, and get them to rally behind it, is a key reason PRWeek named him 2017 Communicator of the Year."

The following month, a United Airlines passenger was pulled from his seat, bloodied, and dragged out of the plane on his back. The reason: United wanted the seat for one of its off-duty employees.

In written statements on the incident -- or was it an assault? -- United claimed the passenger was "disruptive and belligerent", and that the airline's actions were in accordance with "established procedures". CEO Munoz also apologized for having to "re-accommodate customers". In the case of this particular passenger, re-accommodation meant a hospital stay.

"I did not run for office to be helping out a bunch of fat cat bankers on Wall Street." So said President Obama, years before accepting a speaking engagement reportedly paying 400,000 dollars, from investment banking firm Cantor Fitzgerald.

Tidbits..

International Monetary Fund raises 2017 global growth forecast to 3.5 percent, expects 3.6 percent growth in 20198.
Federal Reserve raises benchmark rate 25 basis points, expects two further hikes this year.
Federal Reserve suggests it will begin shrinking its balance sheet in late 2017.

Clearest signs of normalcy in nearly a decade.

United Kingdom invokes Article 50, begins process of leaving European Union.

Self-determination, or self-flagellation?

YouTube viewership reaches milestone of one billion hours per day, up tenfold since 2012.

US soda and energy drink sales decline for 12th consecutive year, says Beverage Digest.
PepsiCo beverage sales drop 40 percent in Philadelphia in wake of 'sugar tax', one-fourth of workers at company's local distribution plants to be laid off.

Unintended consequences of social engineering.

General Motors to sell its European operations, Opel and Vauxhall nameplates, to Peugeot-maker PSA Group.

Frontier Airlines, Silver Airways cancel service to Cuba, American Airlines reduces service by 25 percent.

Once open for visitation, banana republics lose their mystique.

US household net worth rises to record 93 trillion dollars at year end 2016.
World Happiness Report says social strains are making Americans less happy, despite wealth.
Pew Research Center poll shows Americans now favor larger government with more services over smaller government.

Global banking fines tally 321 billion dollars since financial crisis, says Boston Consulting Group.
Deutsche Bank wins dubious distinction as first bank fined by Federal Reserve for violating Volcker Rule against proprietary trading.

Better times ahead for banking business.

Trump Administration begins rollback of Obama's climate change initiatives, easing regulations on power plants, coal mining, oil and gas production.
Congress repeals 13 rules passed in Obama's final year in office.
Controversial Dakota Access Pipeline becomes operational, begins shipping oil.
White House moves to impose tariffs on Canadian lumber imports.
Administration unveils outline for major tax cut and tax code simplification.

New sheriff in town, bigly.

Source:
Bloomberg
CNBC Wires
ctwinvestmentgroup.com
Pew Research Center
PRWeek.com
The Wall Street Journal
worldhappiness.report