

Westshore Wealth *Insights*

Taking Stock of the Market at All Time Highs

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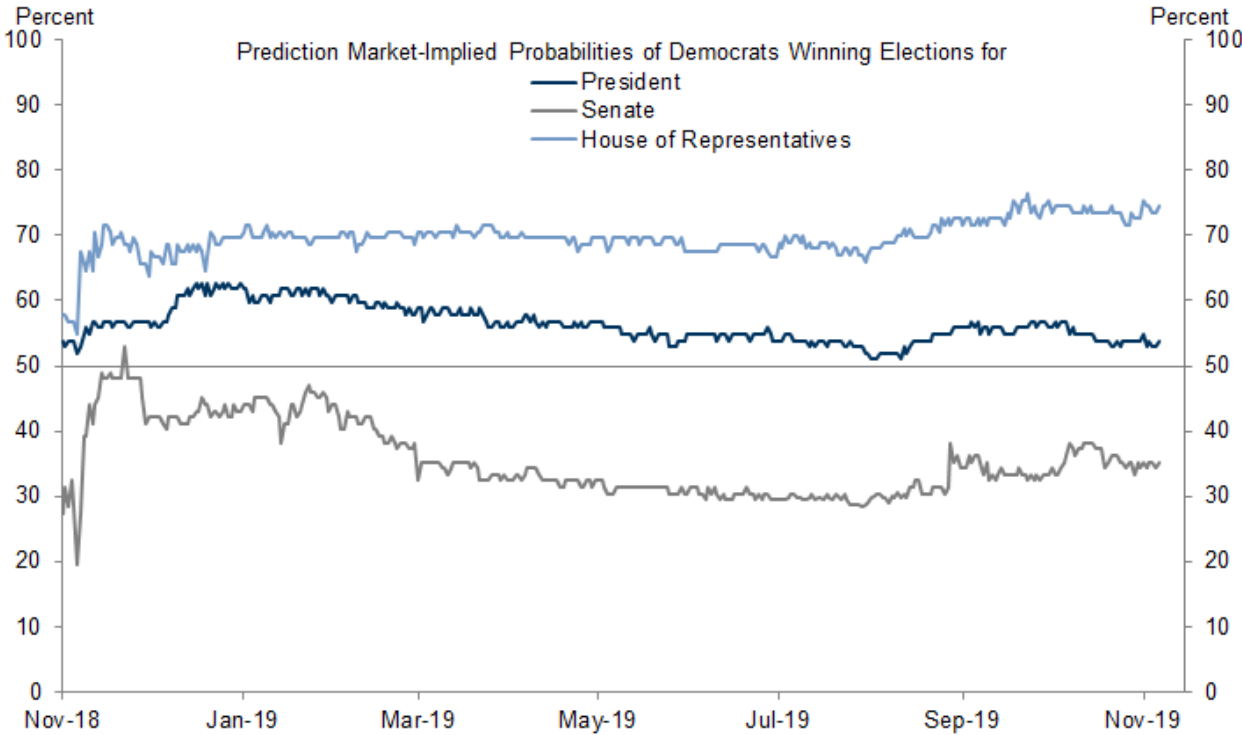
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With the Democratic primary approaching, impeachment hearings ongoing, Chinese trade negotiation uncertainty continuing, and mixed US economic data being reported, there is plenty of uncertainty in the air. Despite that, the stock market seems strangely indifferent and continues to hit new highs with exceptionally little volatility. Efficient market theory suggests that asset prices reflect all available information. Is this to be believed or the market is blithely ignoring impending risk? Let's start by examining each issue.

The Democratic primary has drawn quite a bit of attention from our clients. The four leading candidates, Warren, Biden, Buttigieg, and Sanders all have discussed tax and policy directives that would have profound consequences for corporate profitability and consumption behavior. We identify five separate topics that would cause such a shift. The first is corporate taxation where all candidates propose raising rates by a minimum of seven percentage points and in some cases back to the original 35%. Marginal tax rates for the highest earners would rise back to 39.6% for most, while Sanders would take them all the way up to 70%. Warren and Sanders have each proposed a wealth tax, with ranges that start at 1% and rise to 8%, for those with assets starting as low as \$32mm. Nearly all candidates advocate moving the capital gains tax rate to the ordinary tax rate which has the potential to see it rise from 20% to the highest marginal rate (36.9% up to 70%, depending on the candidate). Finally, Sanders and Senate Minority leader Schumer are calling for restrictions on stock buybacks tied to wage increases at corporations. According to Goldman Sachs strategists, the repeal alone of the Tax and Jobs Act (the law that lowered corporate taxes to 20%) would reduce S&P 500 earnings by 11% in 2021. Regardless of your political affiliation, we think it fair to say that all these policies would be problematic for stock prices. So why hasn't the market reacted? We think the illustration below answers the question. While the election of a Democratic president is slightly better than 50/50, the odds of divided government are exceedingly high with prevailing polls suggesting the House remains under Democratic majority,

while the Senate retains its Republican majority. Divided government reduces the likelihood that any of these policies could move to fruition. Essentially, the market is betting that we maintain the status quo. Frankly, we agree. Our only caveat is the following. If the market is wrong, the consequences for stocks would be dramatic. When we evaluate the consideration set of outcomes, we not only measure the likelihood of the result (which in this case is low), but also contemplate the magnitude of the result (in this case severe). While we think the market is behaving logically, at Westshore, we embed in a higher uncertainty premium than is currently factored into the market.

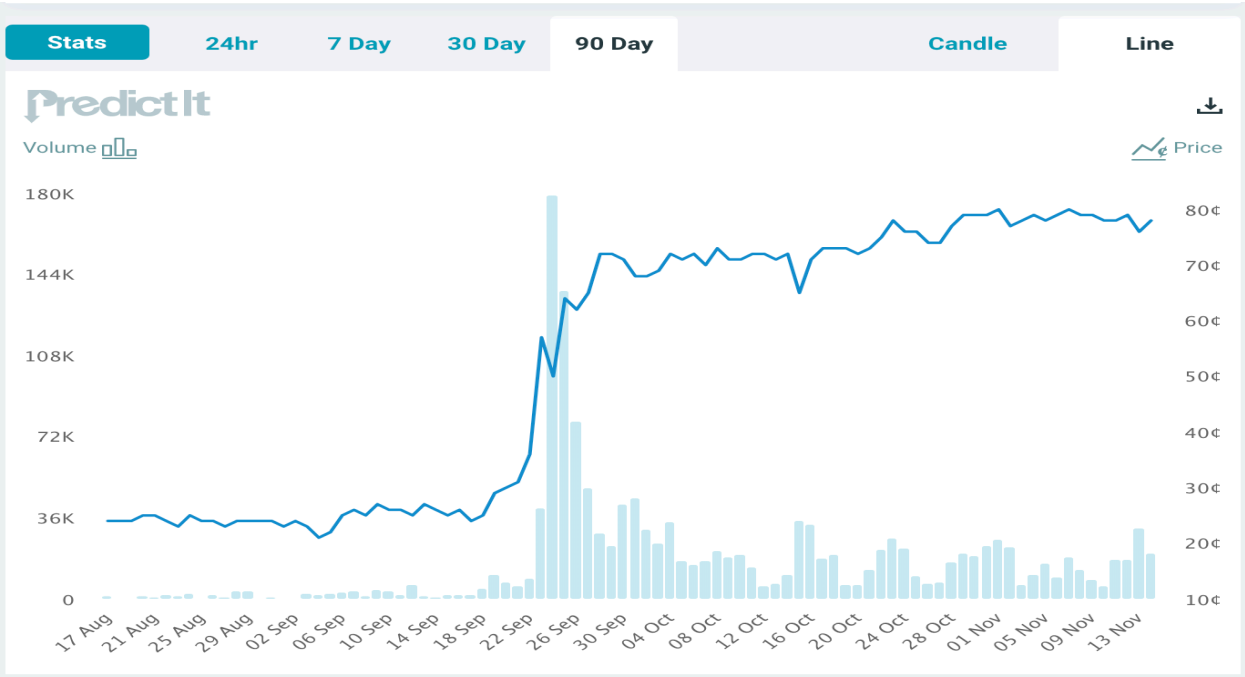
Exhibit 3: Implied Probabilities of House, Senate, and White House Control



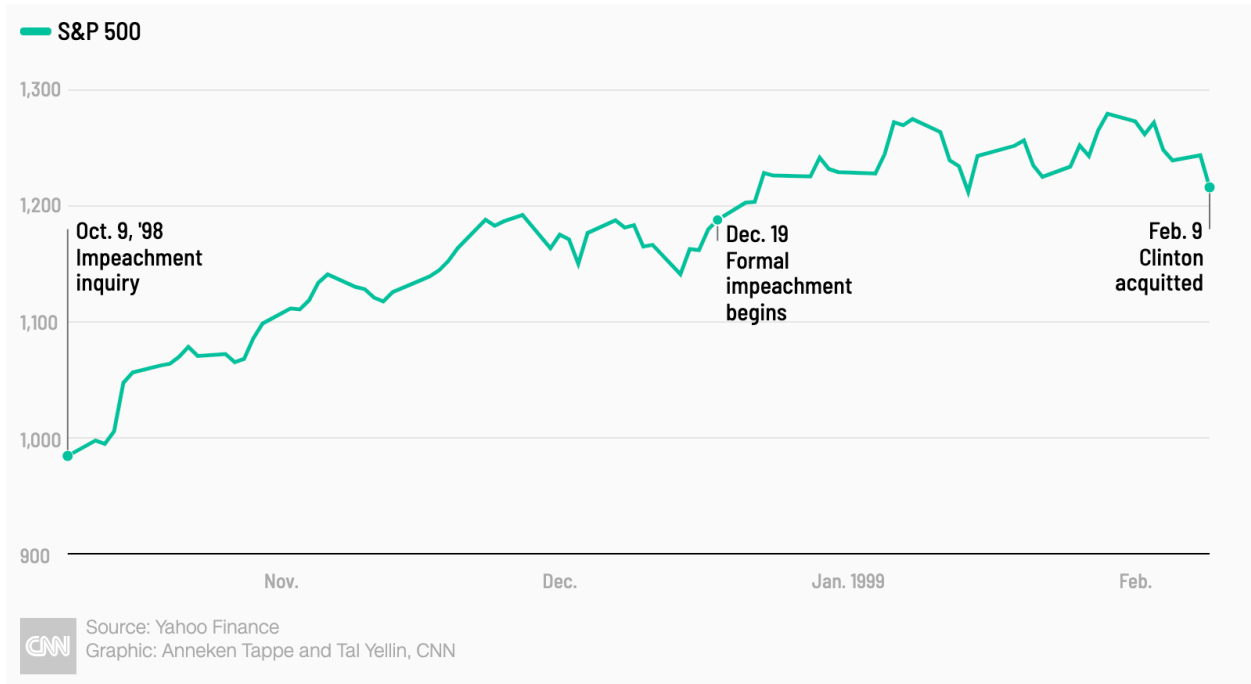
Source: PredictIt, Goldman Sachs Global Investment Research

So, if the election isn't a flashpoint, how about the impeachment proceedings? While national polls suggest roughly half the country support Trump's impeachment, betting websites like PredictIt, suggests a much higher

likelihood of occurrence. As you can see below, gamblers are wagering \$.78 to make a \$1, a ratio that indicates high conviction in an impeachment outcome.



Why the difference? Gamblers recognize that the House is Democratically controlled and have adjusted their probabilities accordingly. However, as we know from our social studies courses, impeachment is a two-step process. The House essentially brings charges, issues an indictment, while the subsequent trial occurs in the Senate. Given that a 2/3rds super-majority vote would be required from a Republican controlled Senate, the market sees almost no risk of Trump’s conviction and removal from office. While this proceeding is in its infancy, the parallel with Bill Clinton’s situation is relevant. The market actually rallied in the period between Clinton’s impeachment and subsequent acquittal (see illustration below). Bottom line, we agree with how the market is interpreting the situation.



When it comes to the topic of Chinese trade resolution, the market remains optimistic that a deal can be reached. The two parties signaled a de-escalation of trade frictions with a Phase 1 agreement reached October 11th, however, details and a final signing have yet to occur. Emblematic of that confidence, stocks with heavy exposure to China trade, like semiconductors, have rallied sharply since that date. So does the market have it right? The answer is yes, but it is nuanced. It's important to understand some context. First, China is firmly committed to moving from being the assembler of cheap, low quality goods, to becoming a global intellectual leader in key industries. The "Made in China 2025" initiative specifically identifies 10 key areas including information technology, robotics, green energy, aerospace, medical devices, and others where they intend to seek dominance. To reach that goal, China needs access to significant intellectual property. Controls on technology transfer, a key sticking point for the US, is at odds with reaching that goal and hence will be a big problem for full resolution. Second, China has expressed very public ambitions to develop a modern-day Silk Road through their Belt and Road initiative. The Silk Road was a network of trade routes connecting the East and West. It became a central force in shaping economic

and political interactions between territories. The Belt and Road initiative has similar goals. It is a massive infrastructure development and investment project that involves over 150 countries, \$4-\$8 trillion of investment, targeting completion in 2049. Some view the initiative as a push for Chinese dominance in global affairs with a China centric trading network. To the Chinese, US efforts to undermine China's industrial ascendancy undermines the prospects that their Belt and Road initiative will be successful. If the US retains its technological leadership, it will continue to be the nexus of power on the global stage. At Westshore, we have long held that China is highly incentivized to settle the matter, but on their terms. The longer the dispute lingers, the more corporations delay and cancel capital expenditures in the nation. The worst case for China is that economic growth stagnates and social unrest spreads. We believe that the Chinese are happy to buy more US agricultural goods, willing to roll back tariffs on American goods, amenable to accepting some loosening of competition in industries like financial services, but will be unyielding on their ability to demand technology transfer in exchange for access to their nation. Thus, we are apt to see some resolution, but those expecting a complete deal will be disappointed. Given that 1/3 of global growth has been accounted for by China, global GDP will continue to operate below full potential. So, taking stock of all those issues, we believe that we will see some relaxation in trade related problems, but that it is unlikely to be the grand conclusion that some market participants are expecting.

Finally, many are pointing to weaker economic data points as a source of recessionary risk and significant market downside. Indeed, the National Purchasing Managers Index, a measure of the health of the industrial economy, fell in August 2019 into contraction territory to a level not seen since 2009. Additionally, corporate confidence has fallen to levels traditionally associated with recession. That said, the US economy has become increasingly service oriented with manufacturing accounting for less than 20% of GDP output. When we examine the health of the consumer, we remain optimistic. The US economy is operating at full employment, wages are rising, and consumer debt service resides near historical lows. Additionally, there don't appear to be any huge structural imbalances that could cause a major

upset. This has led us to believe that the US will avoid recession and we retain that view. Of late, job growth has appeared healthy, jobless claims have been down sequentially, and interest rates have ticked higher supportive of that view.

So, where does that leave us? At Westshore, we are fans of not overcomplicating matters. A scholastic philosopher in the 1300s came up with what is called Occam's razor, which when paraphrased, essentially means the simplest explanation is most likely the right one. Why is the US market levitating in the midst of many exogenous risks? The answer might be quite straightforward. The US market has been the figurative port in the storm for world markets. The US Dollar is strong, the US economy is growing while several in Europe and Asia are in contractionary mode, the US has positive interest rates while nearly 1/3 of global debt has negative yields, the US doesn't have to worry about Brexit, and given our trade deficit, tariffs appear to hurt our counterparties more than us. While the risks outlined in the preceding paragraphs are real, they are reasonably understood and, at least, partially discounted by the market. So, does that mean it all clear and full steam ahead? That's where we take stock of where we are. Despite flat corporate earnings growth, the S&P 500 is up over 25% year to date. The driving force for this performance has been investors increasing what they are willing to pay for those earnings. The price/earnings multiple has risen to 19x relative to an average closer to 16x. That is rich by historical standards, occurring less than 20% of the time. Furthermore, the US market has now outperformed international and emerging markets for over a decade. Ironically, the cooling off of the US market may start with positive news outside our country, rather than bad news here domestically. For example, some form of trade resolution could be construed by investors as more favorable for China and perhaps signal an all clear to re-enter emerging markets. An amicable conclusion to Brexit may stimulate economic growth in Europe and make those equities more attractive given how inexpensive they are today. In each of these scenarios, investors would then reconsider their allocation and weightings to US markets, potentially pulling money from the US to fund trades abroad. Rest assured, at Westshore, we are considering those possibilities and adjusting our bets

accordingly. We have structured our portfolios with a conservative orientation, inserted many shock absorbers to protect against downside scenarios should they occur, and populated instruments that take advantage of sudden shifts in reallocation in that eventuality.

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