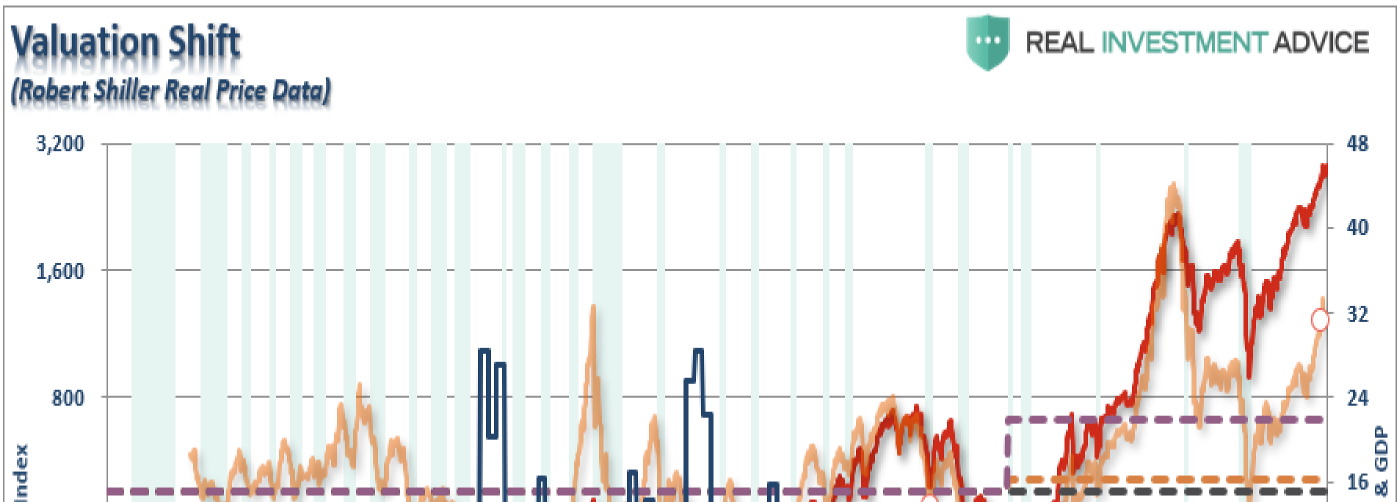
RIA Advice

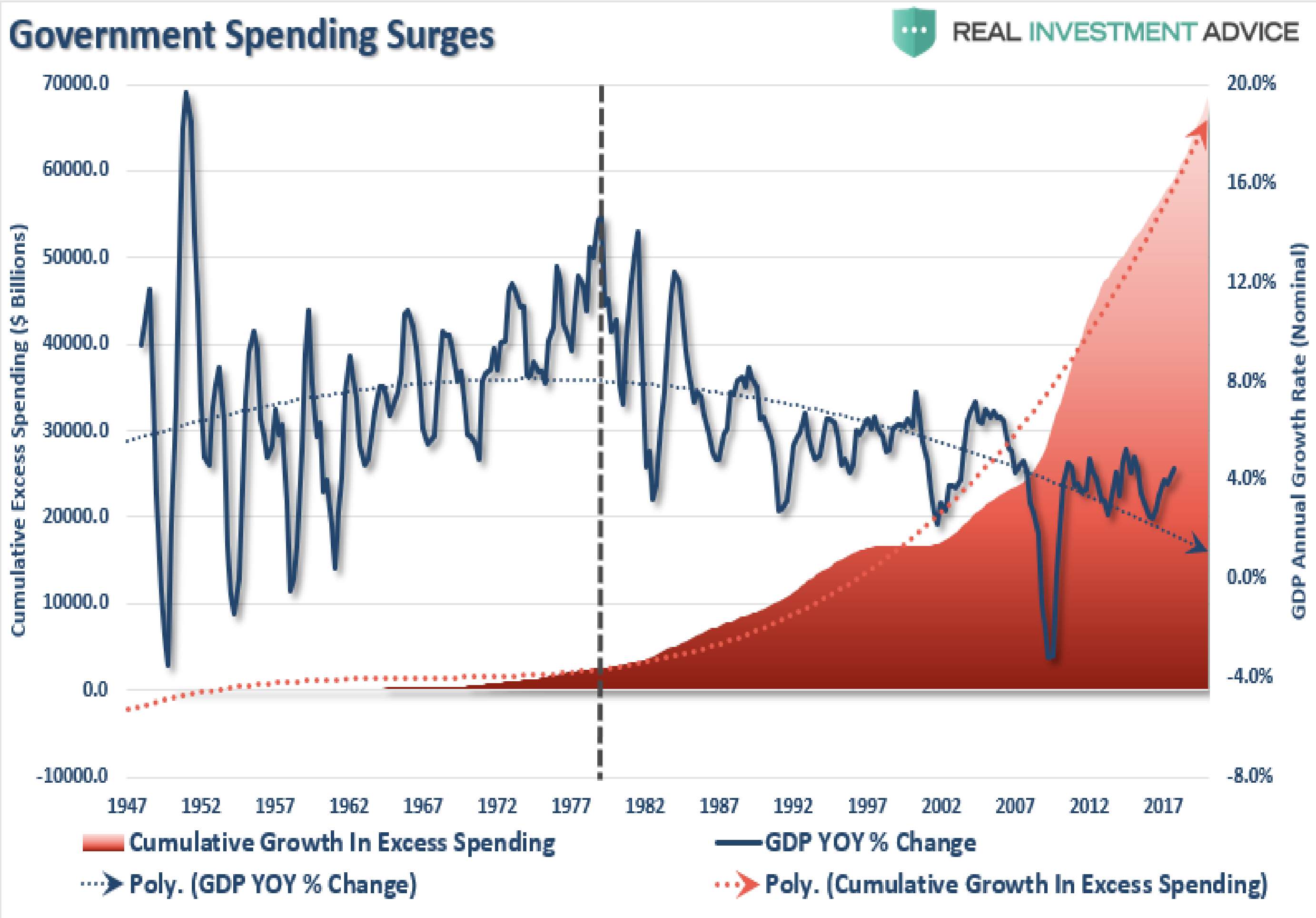
One of the ongoing thesis behind a continuation of a bull market from current valuation levels is that there has been a permanent shift higher in valuations due to changes in accounting rules, propensity for share buybacks, and a greater adoption by the public of investing (aka ETF's). This apparent shift to valuations is shown in the chart below.



There are two important things to consider with respect to the chart above.

1. *The shift higher in MEDIAN valuations was a function of falling economic growth and inflationary pressures.*
2. *Higher prices were facilitated by increasing levels of leverage and debt, which eroded economic growth.•*

The chart below tracks the cumulative increase in*•excess?•*Government spending above revenue collections. Notice the point at which nominal GDP growth stopped rising. It is also the point that valuations shifted higher.



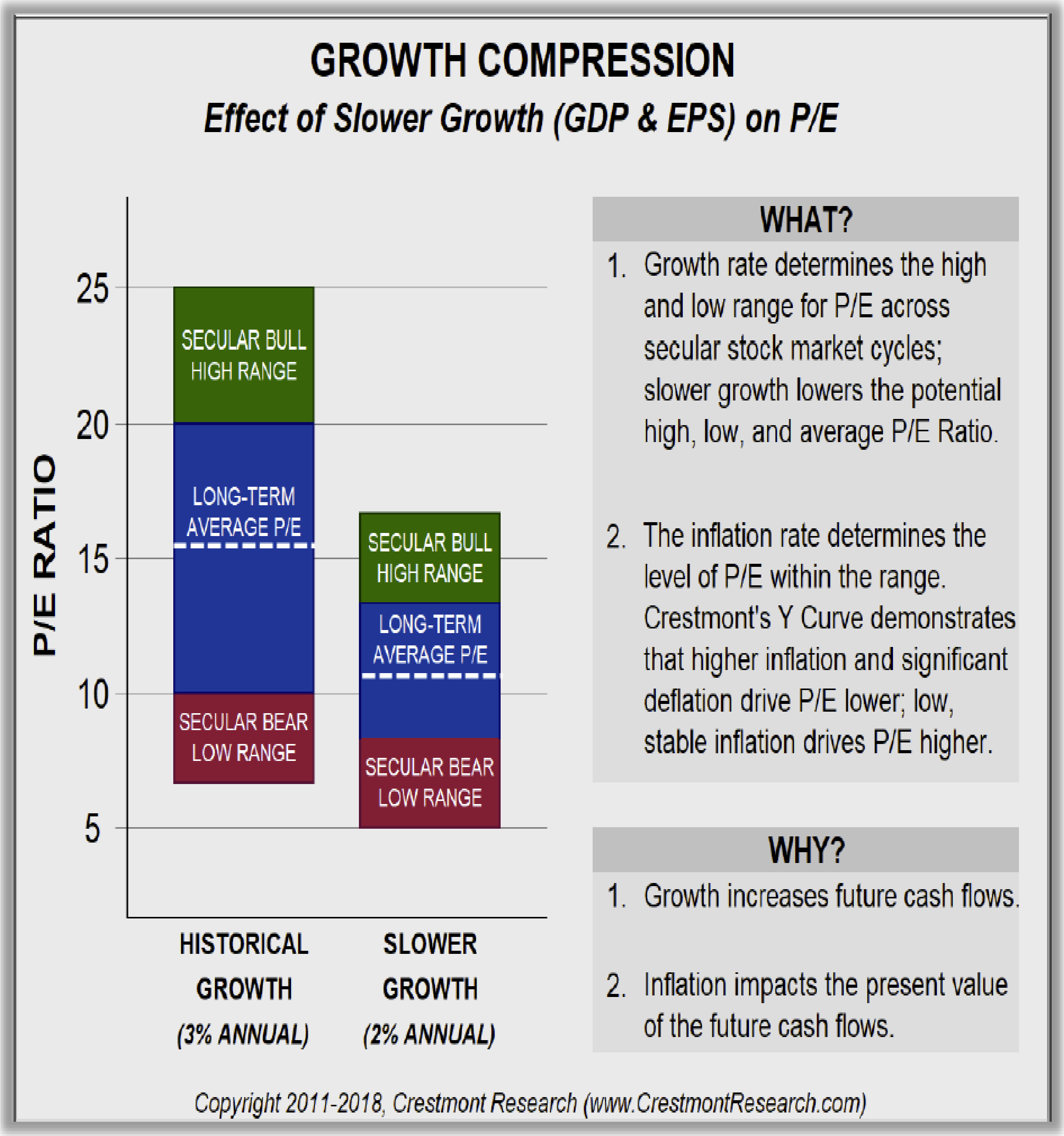
Given that economic leverage *(corporate, consumer, financial, and Government debt)* is at all-time records, and rising, the ability to create stronger, sustainable, economic growth *(which would lead to higher rates of inflation)*•remains little more than a hopeful goal. The issue with the idea that valuations have had a permanent shift upward is that the assumption is based on a market anomaly form 1990-2000 which temporarily skewed valuations above the long-term medians. However,•economic growth set to remain near 2% over the long-term,**the average valuation ranges will most likely trend lower in the future.** Ed Easterling at [Crestmont Research] made a great point recently in this regard:

> ***"However, as real economic growth significantly declined over the past two decades, it•triggered a series of adjustments that represent the forces behind The Big Shift.*** *Most•importantly, the downshift in real economic growth disrupted the financial relationship of•profits, future growth, and market value.* ***Slower growth drives P/E downward for similar reasons that it drives EPS•upward."***

Of course, much of the shift upward to EPS has been a function of wage suppression, buybacks and tax cuts more than actual top-line revenue growth as [I discussed just recently]. Ed continues.

"Therefore, since future economic growth is expected to be slower, *it is only consistent•that the future average for the market P/E will be lower.* ***The new normal growth rate•(i.e., slower) for the economy will drive slower overall earnings growth.*** *Such slower•growth will drive market P/E lower, just as previously higher growth supported the•market?s P/E at a higher level.The inflation rate also drives the level of market P/E, but it occurs within the range•driven by the growth-rate environment.* ***Higher inflation drives P/E lower; deflation drives•P/E lower. The level of P/E peaks when the inflation rate is low and stable.•Thus, while the growth rate drives the level of the P/E range, the inflation rate drives the•relative position of P/E within the range.•*** *Figure 6 illustrates these effects. The bar on the left•illustrates the range for P/E under a historically average level of growth. The bar to its•right illustrates the range for P/E under slower growth. Not only does the range•downshift, the expected long-term average P/E also downshifts. This has major•implications for analyzing the stock market."*

Figure 6. Game Changer: Effect of Slower Growth on P/E



> *"Going forward, we should expect a new paradigm.* ***Slower growth drives the ranges for•P/E lower, which will affect future assessments of fair value.****Keep in mind that, had real•economic growth averaged 2% instead of 3.3% over the past century, the historical•average for P/E would have been near 11?not 15 or 16.****In the future, the fair value for P/E when the inflation rate is low will be 13 to 15. With•average inflation, expect P/E to be near 11.*** *During periods of high inflation and•significant deflation, expect the low range for P/E to be 5 to 8."*

With the markets still currently trading near 30x earnings, a revaluation of markets will likely be just as painful to investors in the future as they have in the past. While this time may indeed appear to be different, it will most likely end the same as every other period in history. Just something to think about as you catch up on your weekend reading list.

Economy, 2008 & Fed

- **Overlooked Cause Of The Financial Crisis**by Caroline Baum via MarketWatch
- **I Just Don't Understand**by Scott Sumner via The Money Illusion
- **Further Tax Cuts, Further Fiscal Irresponsibility**by Committee For A Responsible Federal Budget
- **The Real Cost Of The 2008 Financial Crisis**by John Cassidy via The New Yorker
- **The Recovery Threw The Middle Class Under The Bus**by Nelson Schwartz via NYT
- **6-Signs We're Closer To A Recession Than You Think**by Sean Williams via Motley Fool
- **Secular Stagnation**by Roger Farmer via Project Syndicate
- **10-Years Later, What's Changed**by John Stepek via MoneyWeek
- **Economic Bump Due To Stimulus** by James Macintosh via The New Yorker
- **A Misunderstood Case Of Poverty**by Kevin Williamson via National Review
- **Who Really Creates Value In An Economy**by Mariana Mazzucato via Project Syndicate
- **A Decade Later, Is The Global System Safer**by Knowledge@Wharton

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Markets

- **Edwards: We Are Destined To Repeat Our Mistakes**by Tyler Durden via Zerohedge
- **GS: Warns Of Bear Market Approaching**by Lu Wang via FA Mag
- **Don't Look At This Chart**by Shawn Langlois via MarketWatch
- **It's Hard To Be A Contrarian These Days**by Joe Calhoun via Alhambra Partners
- **Tepper Has Been Cutting Stock Holdings**by Mark DeCambre via MarketWatch
- **Trends Being Tested**by Dana Lyons via The Lyons Share
- **What IS Market Breadth?**by Simon Constable via WSJ
- **Horrid Facts, Stubborn Facts**by Robert Seawright via Above The Market
- **Analyst Makes Rare Call To Buy Gold**by Ryan Vlastelica via MarketWatch
- **Ominous Pattern In The S&P 500**by Michael Harris via Price Action Lab
- **Gundlach: Stocks And Bonds Could Be Burnt Out**by Robert Heubscher via Advisor Perspectives

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Most Read On RIA

- **3000 Or Bust**by Lance Roberts
- **We The People**by Michael Lebowitz

- **Employment: The Trend Matters** by Lance Roberts
- **8-Steps To Fiscal Fitness** by Richard Rosso
- **The Bullish Bias Resounds** by Doug Kass
- **The Money Game & The Human Brain** by Lance Roberts

Research / Interesting Reads

- **It's The Fed, Not Investors To Blame For Bubbles** by Frank Shostak via The Mises Institute
- **How Long Until "All Hell" Breaks Loose"** by Tyler Durden via ZeroHedge
- **End Offshore Corporate Tax Havens** by Patrick Hill via The Progressive Ensign
- **A Great Opportunity To Lose Money Is Coming** by James Mackintosh via WSJ
- **The Result Of Jack Asset Monetary Policy** by Global Macro Monitor
- **Are Americans Ready For The Next Recession** by James Koren via LA Times
- **The Next Recession Could Be In 2019** by Upfina
- **BLS' Job Rejiggering Doesn't Compute** by John Crudele via NY Post
- **Yes, It Could Happen Again** by Steven Pearlstein via Washington Post
- **Feds Haven't Fixed The Main Problem** by Charles Gasparino via New York Post
- **The Will Be The Mother Of All Minsky Moments** by John Mauldin via Mauldin Economics
- **The Real Goldfinger: The Banker Who Broke The World** by Oliver Bullough via The Guardian

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> ***"Most people get interested in stocks when everyone else is. The time to get interested is when no one else is. You can?t buy what is popular and do well.?*** **-**
> Warren Buffett

Questions, comments, suggestions ? please email me.