In this past weekend's newsletter, I laid out the bull and bear case for the [S&P 500 rising to 3300.](#) In summary, the basic driver of the *"bull market thesis"* essentially boils down to Central Bank policy, as noted by the WSJ yesterday:

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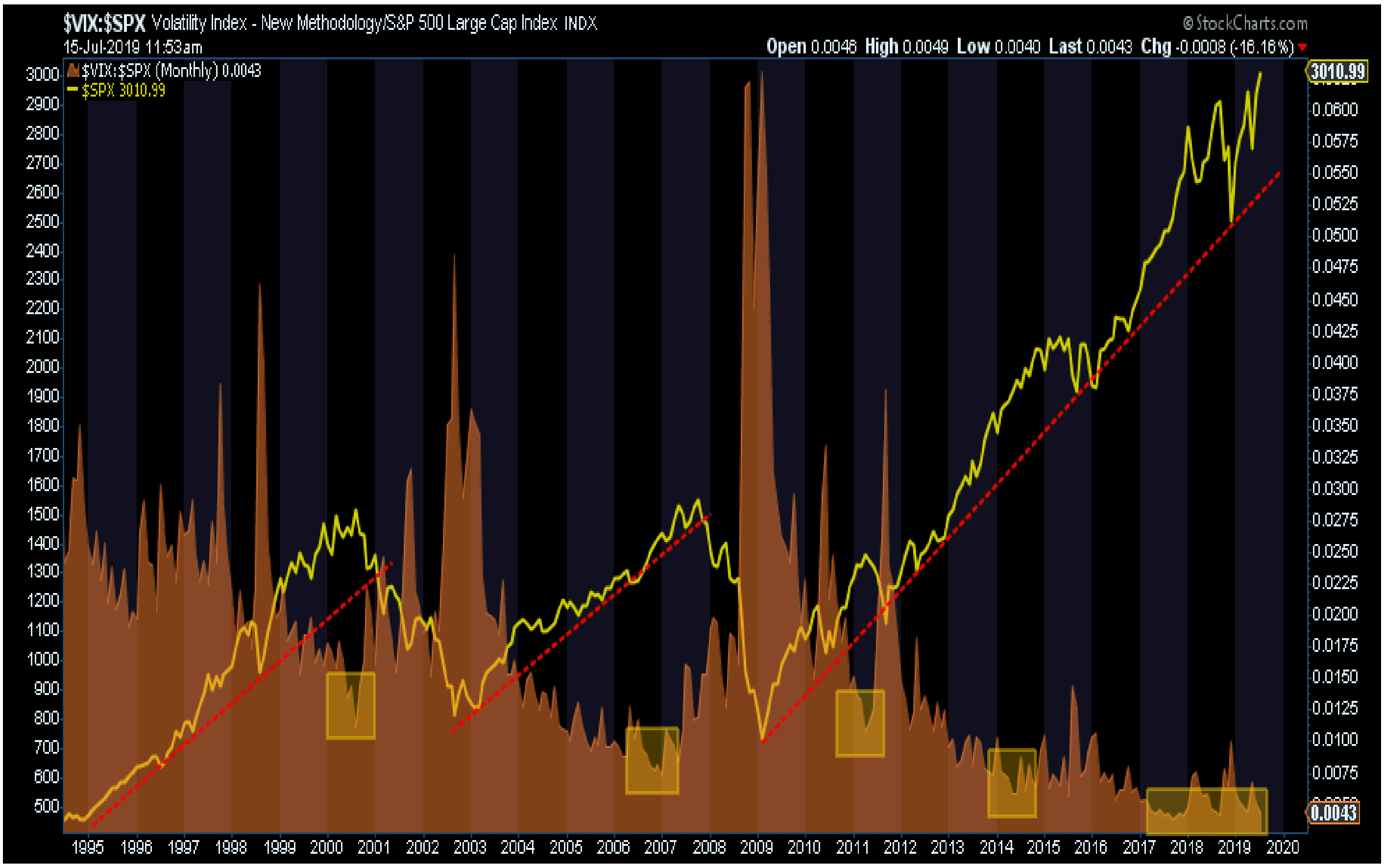
In other words, it is all about *"rate cuts."* This reliance on the Fed has led to a marked rise in *"complacency"* by investors in recent weeks despite a burgeoning list of issues. **As shown in the chart below, the ratio of the *"volatility index"* as compared to the S&P 500 index is near it's lowest level on record going back to 1995.**

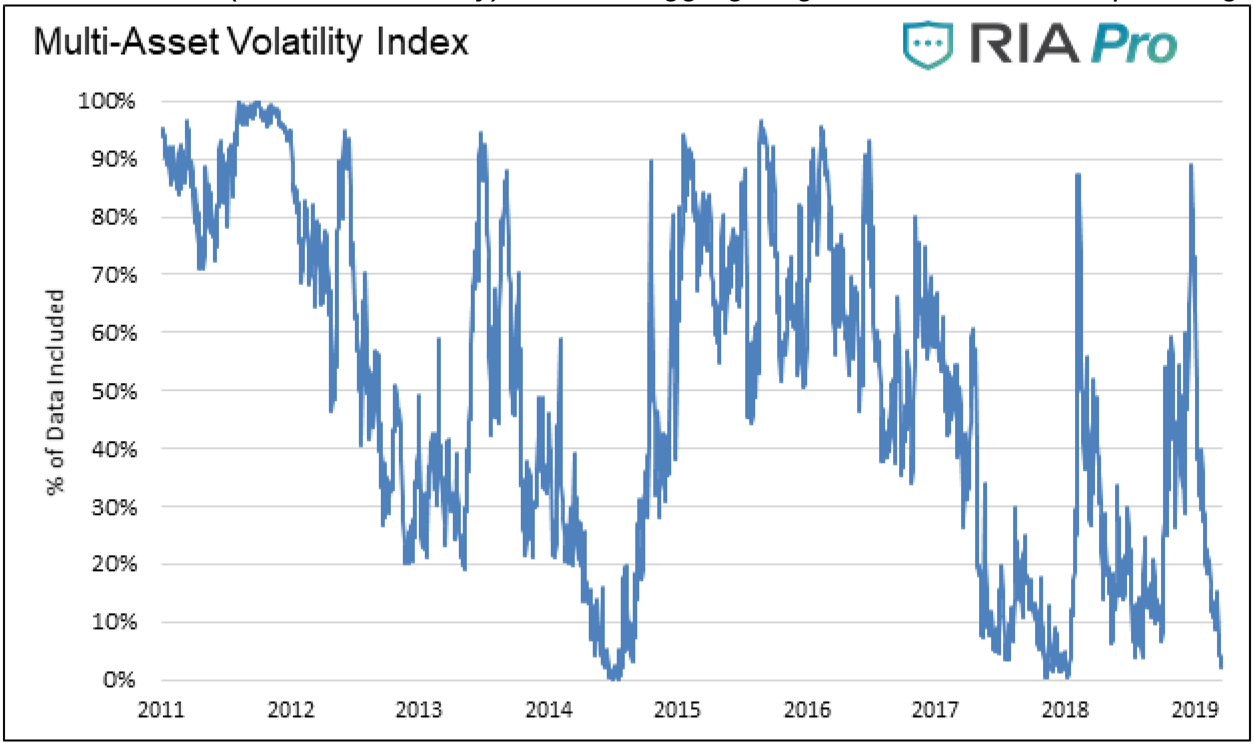


(Of course, exceedingly low levels of volatility relative to the S&P 500 have historically denoted periods of price corrections or worse.) The following considerations fly in the face of the high level of complacency ruling the financial markets:

- *The global economy is slowing.*
- *Growth in European economies is slowing dramatically, including Germany where 10-year bond yields dropped below zero for the first time since 2016. (There is currently a record level of nearly $13 Trillion in negative yielding debt globally.)*
- *China, representing 30% of global GDP growth, is weakening rapidly.*
- *Domestic GDP is expected to rise by only 1.50% in the second quarter, which is a sharp reversal from last year.*
- *The trade war with China, and to a lesser degree Europe, has not been resolved and could accelerate on a Tweet.*
- *Despite being ten years into an expansion, markets at record highs, and unemployment near 50-year lows, the Fed is talking about cutting rates at the end of the month. What does the Fed know that we do not?*
- *The potential for a hard BREXIT is still prevalent.*
- *Earnings expectations have fallen markedly along with actual earnings and revenues.*

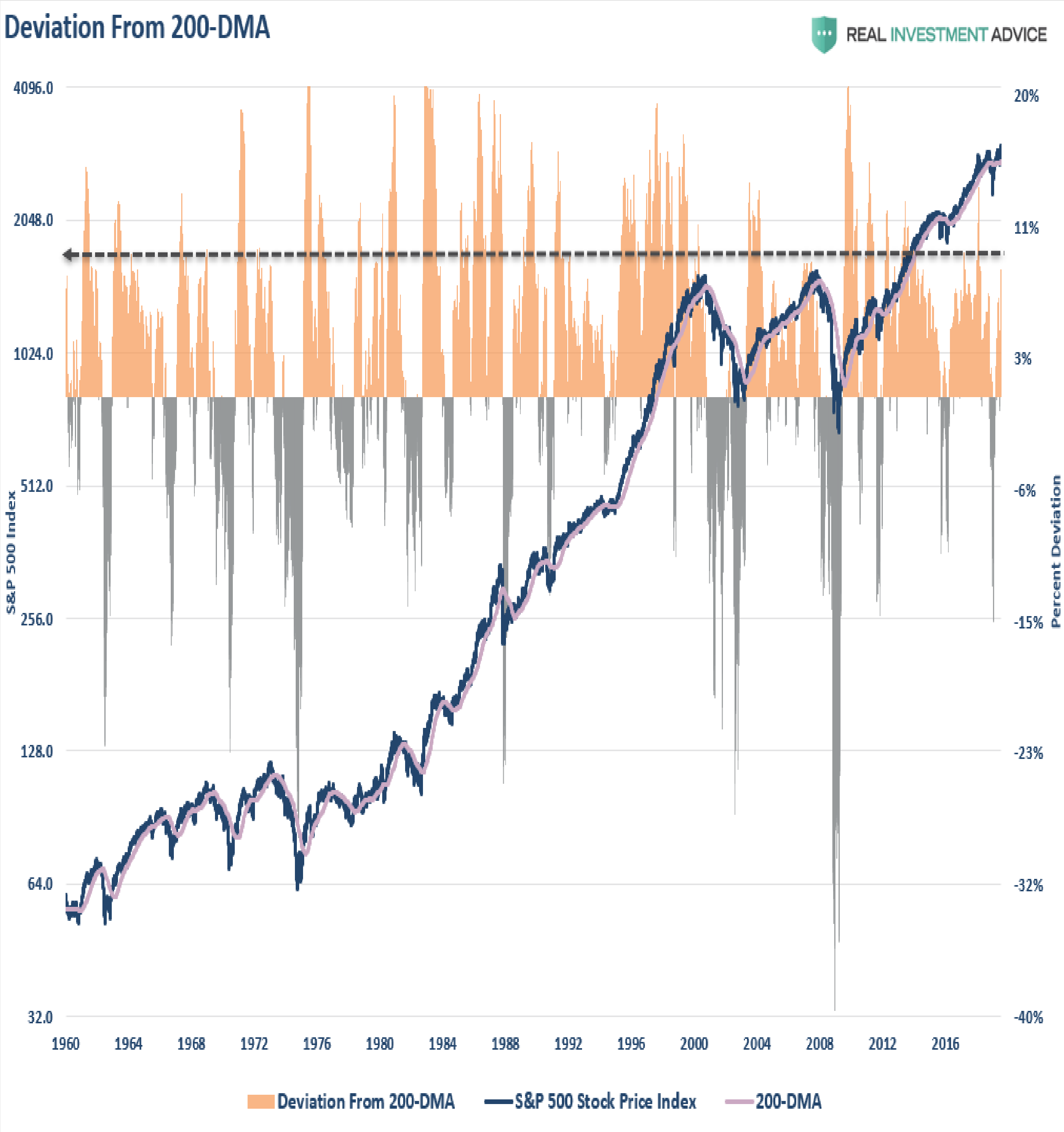
There is much more, but you get the idea. As we previously wrote for our ***RIA PRO Subscribers: (Get A 30-day FREE Trial)***

> ***"Based solely on today?s levels of implied volatility, the media, central bankers and uninformed cocktail chatter would have us conclude that there is little to worry about.*** *We see things quite differently and believe current indicators offer far more reason for fear than when implied volatility is high and fear is more acute. The graph below is constructed by normalizing VIX (equity volatility), MOVE (bond volatility) and CVIX (US dollar volatility) and then aggregating the results into an equal-weighted*



What

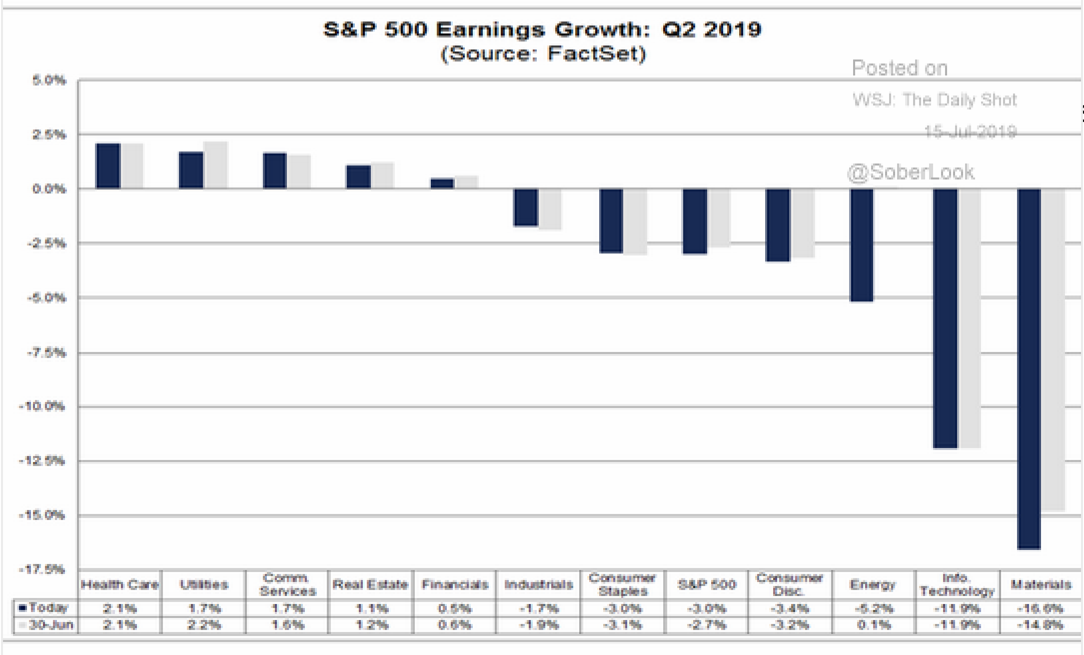
both charts above show is that when these complacency has previously reached such low levels, a surge occurred soon thereafter. This does not mean the index will bounce higher immediately, but it does suggest we should expect higher volatility over the next few months. Furthermore, prices are ultimately constrained by longer-term moving averages. At the beginning of May, I wrote *"A Warning About Chasing This Bull Market,"* and in particular noted the deviations above long-term means which were at 8% at that time. Of course, that preceded the May slide which knocked about 5% off of stock prices at the time. **Currently, prices are almost 10% above the long-term mean.**



As I stated back in May, this doesn't mean the market will begin a mean reversion process tomorrow; but, it is suggestive of a market that is certainly at risk of a reversal.

Millennial Soccer

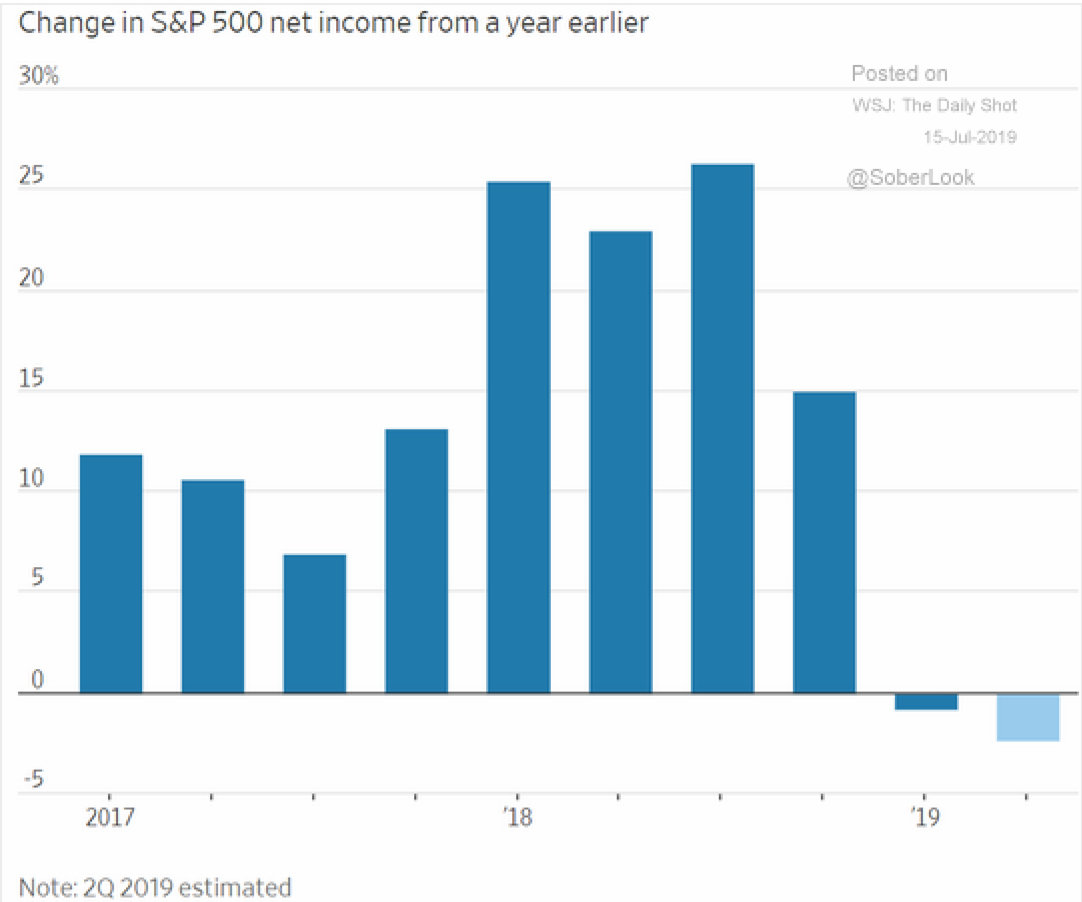
There is one thing the Fed can't fix by lowering rates - corporate earnings. Next week, the markets will begin to face the quarterly barrage of reports. **Don't worry, as always, we will see a high percentage of companies *"beating estimates."*** As I discussed previously, such shouldn't be a



season.

This is why I call it

?Millennial Soccer.?



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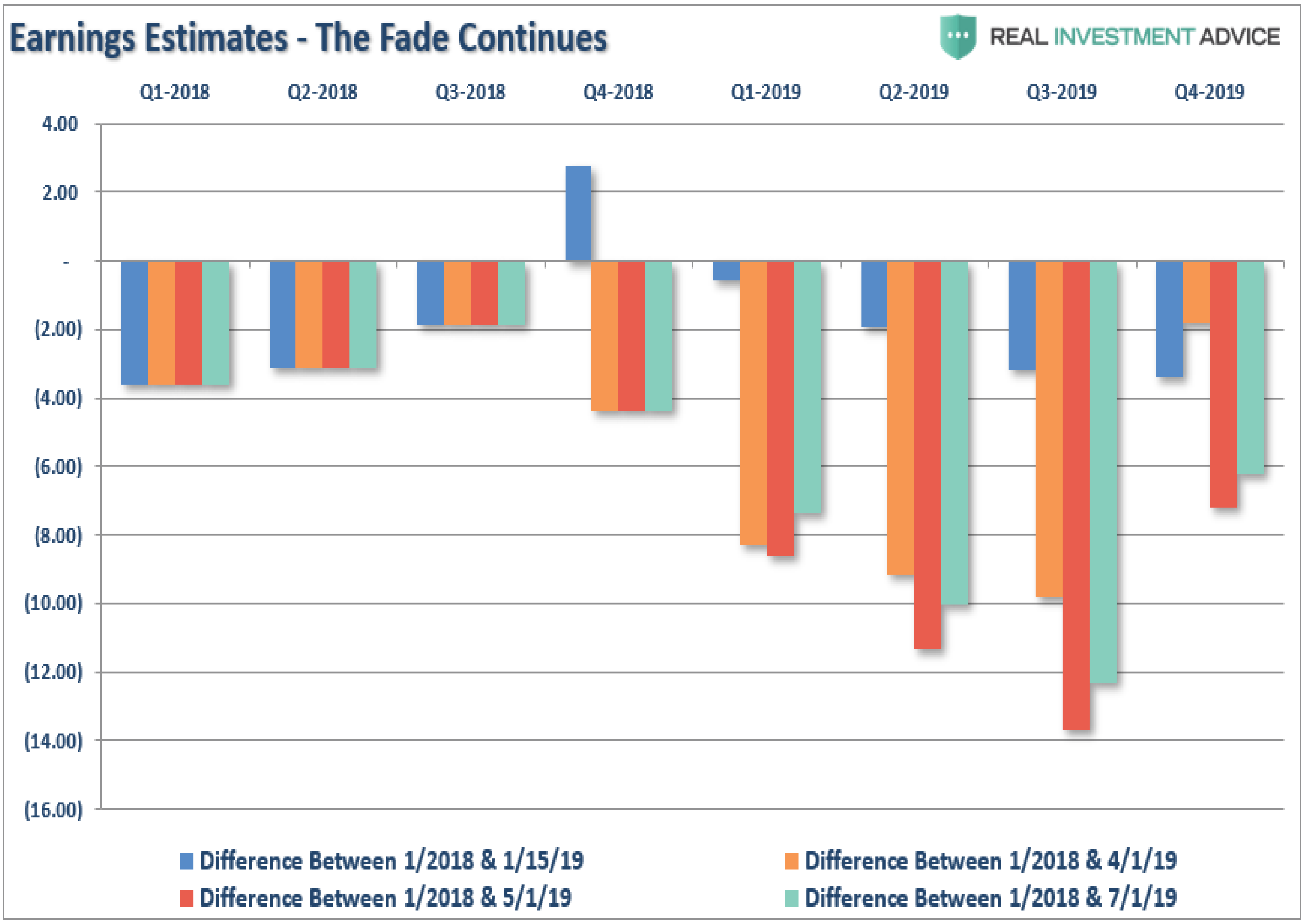
While it is currently

expected the slowdown in earnings this quarter is a temporary anomaly, the reality is it may not be. The ongoing trade war with China, potential for additional tariffs, and slower economic growth suggest earnings weakness may be with us longer than many suspect.

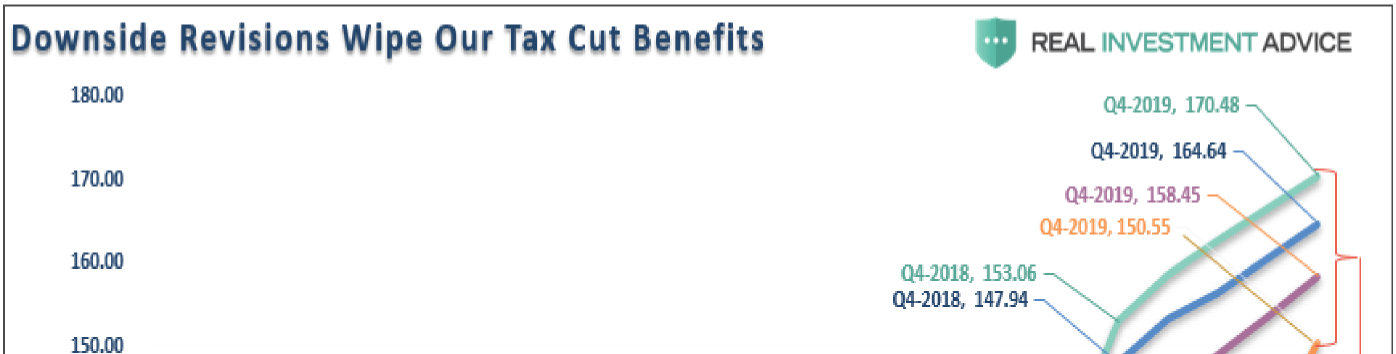
The chart below shows the changes in estimates a bit more clearly. It compares where estimates were on January 1st, 2018 versus April, May, and July of 2019. You can see the massive downward revisions to estimates over the last year.



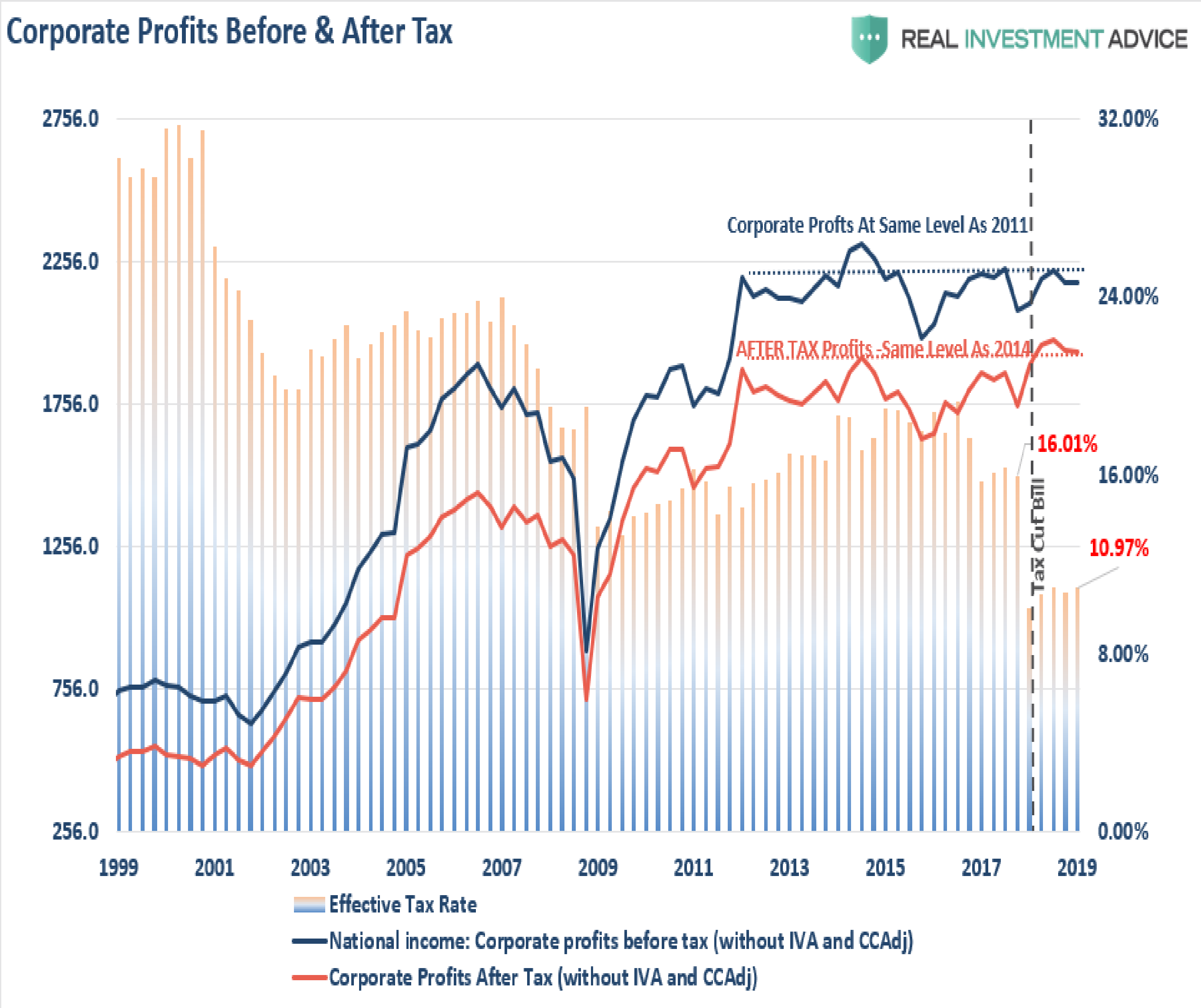
As I stated above, this is why a high percentage of companies ALWAYS beat their estimates. Had analysts been required to stick with their original estimates, the beat rate would be close to zero. Here is another way to look at it. In June of 2017, I wrote [?The Drums Of Trade War?] stating:

> *?Wall Street is ignoring the impact of tariffs on the companies which comprise the stock market. Between May 1st and June 1st of this year, the estimated reported earnings for the S&P 500 have already started to be revised lower (so we can play the ?beat the estimate game?). For the end of 2019, forward reported estimates have declined by roughly $6.00 per share.* ***However, the red dashed line denotes an 11% reduction to those estimates due to a ?trade war?*** *where an across-the-board tariff of 10% on all US imports and exports would lower 2018 EPS for S&P 500 companies* ***and, thus, completely offset the positive fiscal stimulus from tax reform.?***

As of the end of the Q1-2019 reporting period, guess where we are? **Exactly 11% lower than where we started which, as stated then, has effectively wiped out all the benefit from the tax cuts.**



However, note that analysts are still widely optimistic of a sharp *"hockey stick"* rebound in earnings by year-end. These estimates, and the ones into 2020, still need to be revised sharply lower. Since we are playing ***?Millennial Soccer,?*** let?s look at data which is devoid of much of the manipulation. Corporate profits, rather than earnings, is what is reported to the Internal Revenue Service for taxation purposes. It strips out the accounting gimmicks found in operating earnings, share buybacks, and other obscuring factors. **As noted previously, corporate profits have declined over the last two quarters and are at the same level as in 2014 with the stock market higher by almost 60%.**



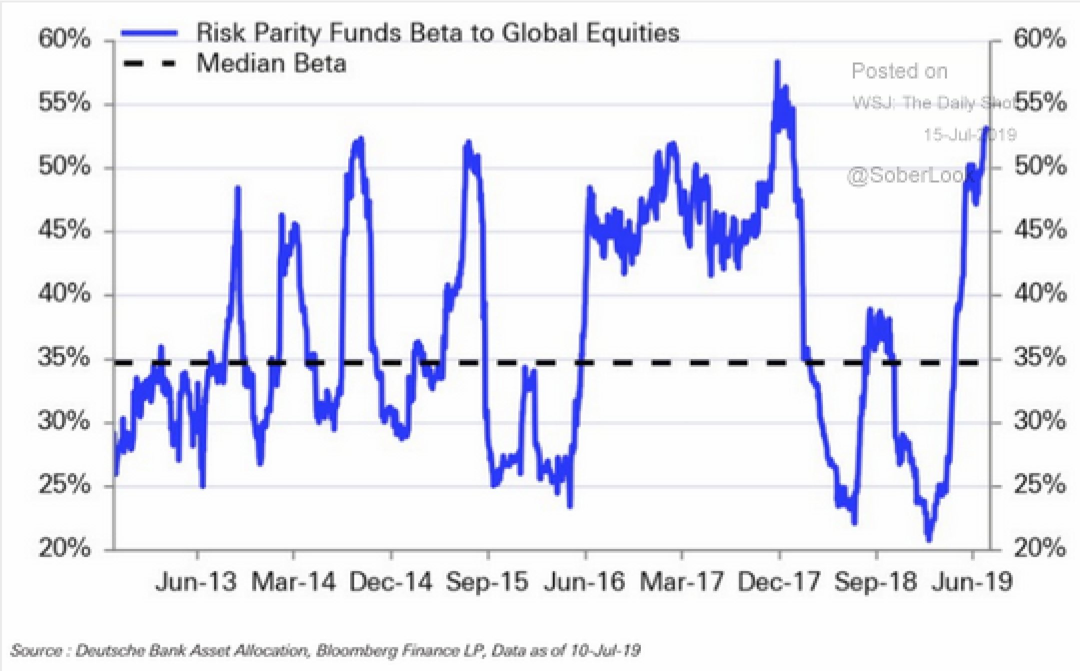
In other words, investors are paying a very high price for ownership currently. In fact, it is not just price-to-corporate profits which is elevated, but rather the majority of measures of valuation are at historic extremes. As noted by [Zerohedge] yesterday:

Table 1: S&P 500 Valuations -- borders denote metrics trading above their historical average (as of 6/30/19)

Metric	Current	Average	Avg. ex. Tech Bubble	Min	Max	% Above (below) avg	Z-Score	History
Trailing PE	18.1	16.2	15.5	6.7	30.5	11%	0.4	1960-present
Trailing GAAP PE	21.3	19.2	18.4	6.7	122.4	11%	0.2	1960-present
Forward Consensus PE	16.7	15.3	14.4	9.8	25.1	9%	0.4	1986-present
Trailing Normalized PE	21.2	19.1	17.7	9.2	33.9	11%	0.5	9/1987-present
Median Forward P/E	16.9	15.1	14.9	10.0	20.5	11%	0.8	1986-present
Shiller PE	29.7	17.0	16.3	4.8	44.2	75%	1.9	1881-present

While valuations may not seem to matter at the moment, they eventually will. **In fact, the lack of concern about valuations is simply another byproduct of extreme complacency.**

The End Of Complacency



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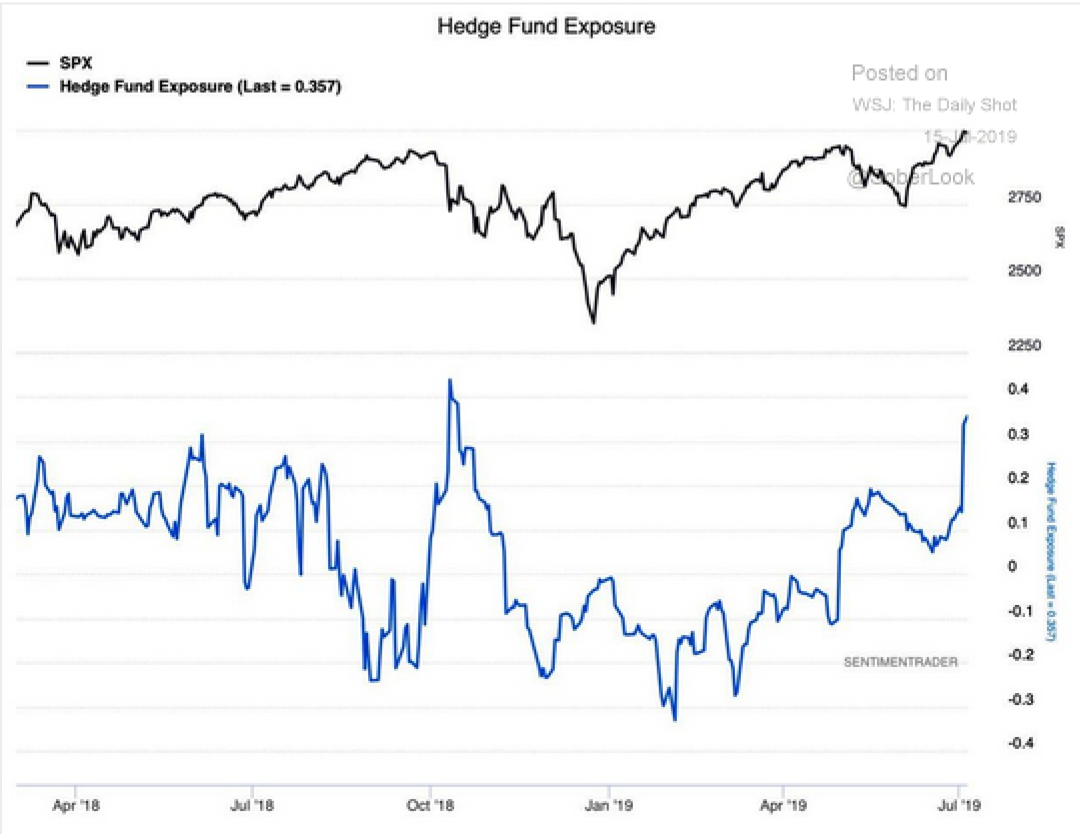

. (It is worth noting or in the past.)

This rush back into

equities should not be surprising. **The one thing about bullish sentiment is that it begets more bullish sentiment.** The more the market rises, the more ingrained the belief comes that it can only go higher. In a *?Pavlovian?* manner, as each *?dip?* is bought, the *?fear?* of loss is eliminated repeatedly teaching investors they should *?only buy?* and *?never sell.?* This is why, as I noted over the weekend, we remain bullishly biased in portfolios for now.

> *?**We are well aware of the present risk.** Stop loss levels have been moved up to recent lows and we continue to monitor developments on a daily basis. **With the trend of the market positive, we want to continue to participate to book in performance now for a ?rainy day? later.?***

That *?rainy day?* is coming. As noted above, while market participants are *?giddy?* about the prospects for the markets based on the Fed cutting rates, there is a laundry list of things issuing warning signals. We can add to the list above:

- *Growing divergences between the U.S. and abroad*
- *Peak autos, peak housing, peak GDP.*
- *Political instability and a crucial Presidential election.*
- *The failure of fiscal policy to ?trickle down.?*
- *An important pivot towards restraint in global monetary policy.*
- *An unprecedented lack of coordination between super-powers.*
- *Short-term note yields now eclipse the S&P dividend yield.*
- *A record levels of private and public debt.*
- *Near $3 trillion of covenant light and/or sub-prime corporate debt. (eerily reminiscent of the size of the subprime mortgages outstanding in 2007)*
- *Narrowing leadership in the market.*

But, for now, this *?wall of worry?* has yielded little concern. The more the market rises, the more reinforced the belief *?this time is different?* becomes. As I wrote previously:

> *?This is why we have been saying for the last two weeks ? the market is rising and you need to be invested?FOR NOW. **However, this is not the next great leg of a bull market so this will be a good rally to liquidate positions into and begin setting your portfolio up for more protectionary investments going into [next year].?***

That was on December 7, 2007. Are we complacent? Absolutely not.