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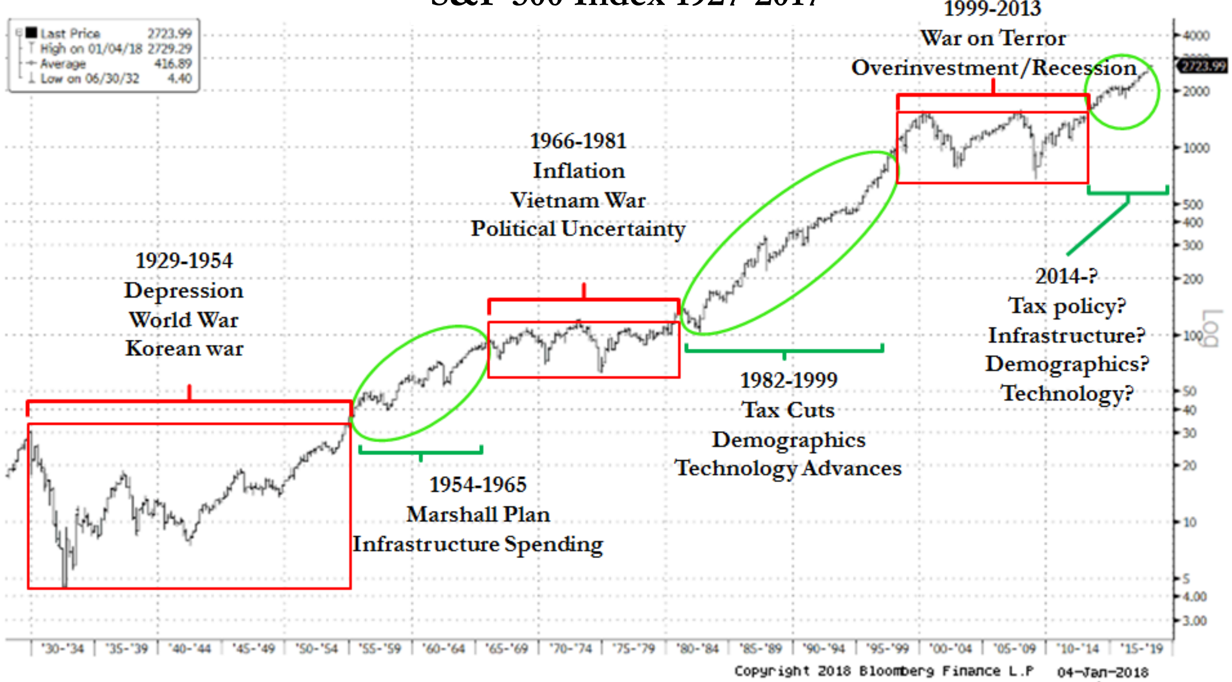
The Case for the S&P Doubling and a Global Bull Market
"You're gonna need a bigger boat!"

In a memorable scene from *Jaws*, a surly Roy Scheider was chumming from a boat for the killer shark when the Great White surfaced and he realized the size of the fish he was dealing with. Stunned, he stumbled to the cabin and told Captain Quint "You're gonna need a bigger boat!" As we watch this unloved domestic market advance expand into a Global Bull Market, the same phrase comes to mind. This secular bull market, which was confirmed in 2013 for the US by the new market highs, has been expanding globally more recently. With the economic excesses that triggered the great recession being largely addressed, we believe this global bull market has some time to run and should be supported by solid global economic growth.

In 2013, we wrote "The case for S&P 2500." At that point, the S&P 500 was trading at about 1800 and had recently broken out of a fourteen year sideways pattern. Historically, when the index does that, it generally heralded a 10 year run that provided annual returns of 11% to 12% on price and mid-teens on total return. Truthfully, we wanted to call that article the case for 4000, but figured our audience would assume we were crazy and dismiss the thesis. Now that we were proven correct and are over our initial 2500 target, we believe that worldwide equity markets remain in a secular bull run that probably allows them to double or better over the next 5 years. Investors are warming to this market and the path probably leads to over 5000 on the S&P by 2023. Upside for international markets is likely greater than for the US, because they are earlier in their economic expansions and just starting to break out to new highs. Simply put, if this market were a great white shark, we'd need a bigger boat.

S&P 500 Index 1927-2017



Why Should This Bull Continue and Go Global?

Several trends are contributing to this Global Bull Market, including:

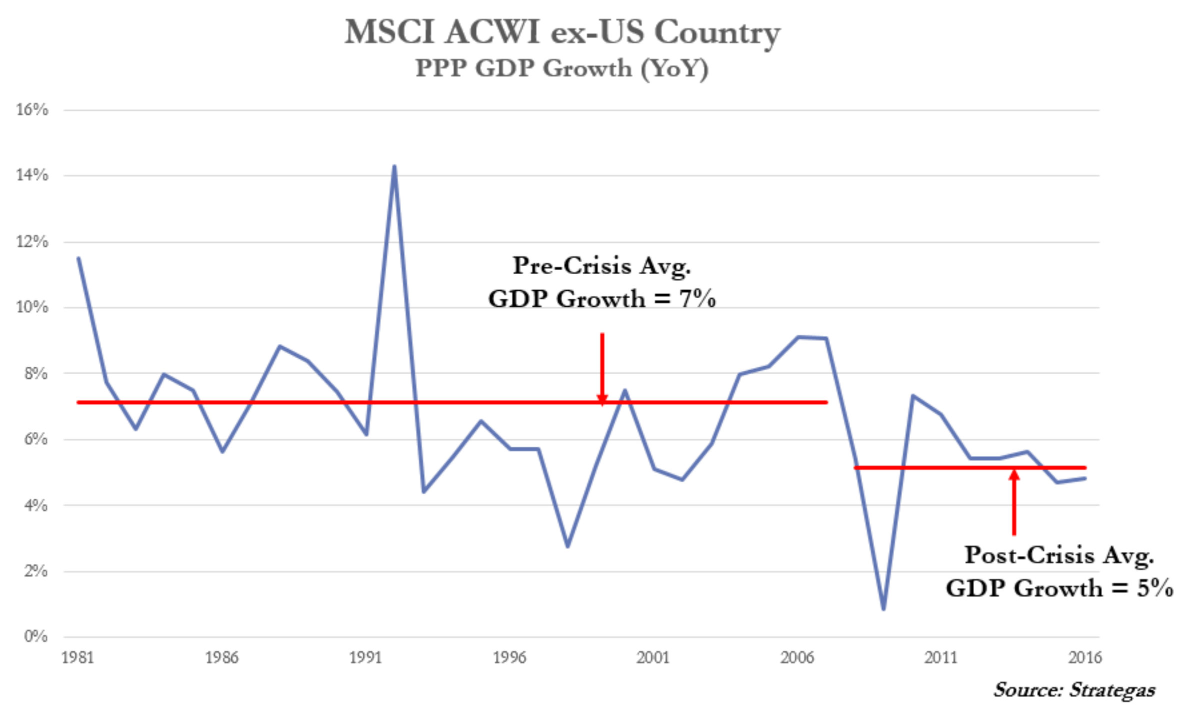
1) Politically inspired pro-growth policies are likely for the US, Europe and Emerging Markets that should allow for a consumer led, productivity enhanced expansion. Emerging market consumers are likely a major driver of this expansion.

2) Economically, we are finishing a 10 year period that reset economies from many excesses that built up prior to the Great Recession. This should allow for better organic growth.

3) Gauging Investor Sentiment, it appears few investors expect further stock gains.

4) Historical market actions suggest it. Market breakouts from long term trading ranges are followed by long secular bull markets.

Pro-growth policies are starting to appear worldwide. Voters have struggled with slower economic growth over the past 10 years. The chart below illustrates that growth has been about a third less than seen prior to 2009. That amounts to 200 basis points less annually of wage increases, consumable income, job growth and prosperity. It may not sound like a lot, but when you cut growth by roughly a third, populations suffer and overall confidence deteriorates. College graduates find it more difficult to gain meaningful employment and voter anger rises. That is the situation we find ourselves in today, where the political class has open rebellion brewing in the US, Germany, the UK, Spain, Italy, Brazil, Argentina and South Korea among others. Populist candidates have been elected, political separations have been voted for,

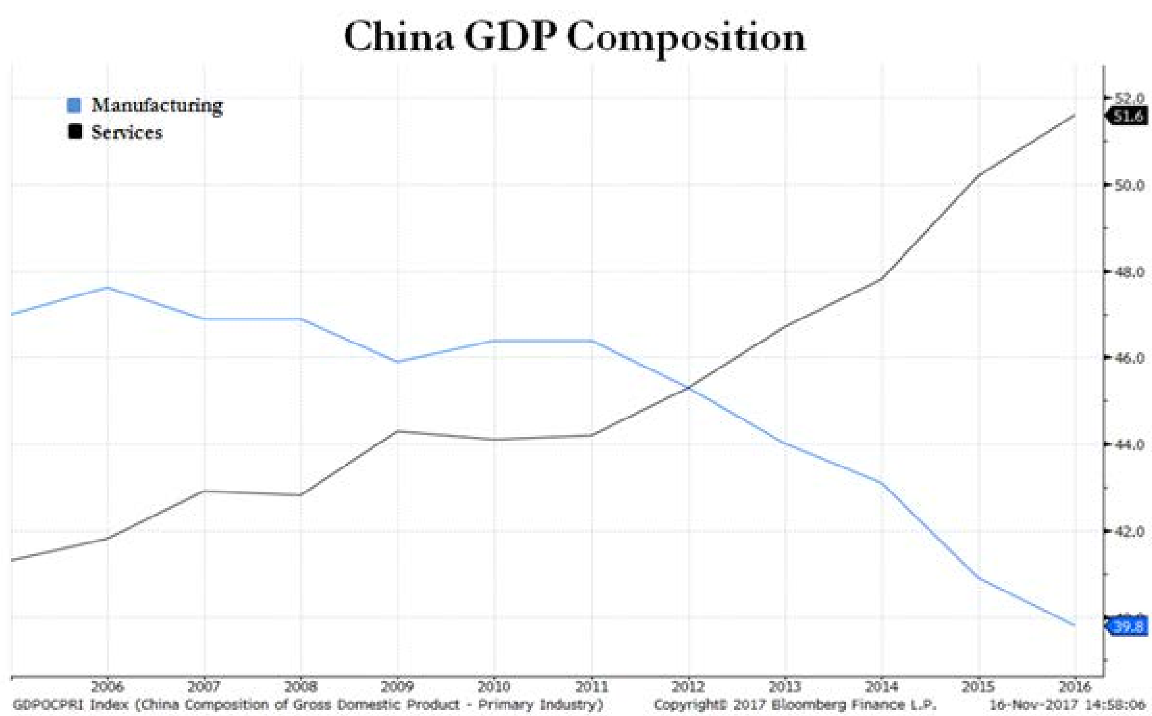


impeachment's have occurred and the natives are restless. An additional 2 percent annual growth over the past 10 years probably would have stemmed that tide and the current crop of populist politicians recognize this phenomenon.

Politicians want to get re-elected. Angry, unemployed (and underemployed) populations tend not to vote for the status quo. This is not rocket science and leads to somewhat predictable behavior. The path politicians can take runs one of two varieties. The first favors more socialist type policies where the state can answer the needs of the populations with some form of aid. The second variety is the group that favors more pro-growth policies. **We believe the current political reformers lean towards pro-growth.** Examples we would point to would include the US tax reform and deregulation to allow businesses to grow faster. Europe is pursuing labor market reforms to allow easier hiring and firing of workers in France and Southern Europe to allow businesses to manage more nimbly, and ultimately grow faster. Britain "voted themselves off the island" with Brexit because they did not want to cede control of their borders or their financial firms to regulations they did not control. Argentina elected a former businessman who is promoting supply side policies. China is pursuing infrastructure building, better efficiencies in the State Owned Enterprises (SOEs) and working to eliminate corruption to allow them a clearer path toward growth. Saudi Arabia is pursuing reforms to diversify the economy away from oil and provide opportunity for their large group of unemployed citizens that are under 30 years old. India has unified their tax structure to a federal system from a state system and altered the regulation of business to promote faster growth. Even Japan is showing signs of life after being moribund for almost a generation. Politicians worldwide have gotten the message that the status quo, i.e. slower growth, is unacceptable and needs to change. They say you need to break some eggs to make an omelet, and from our vantage point, this looks like a thousand egg omelet.

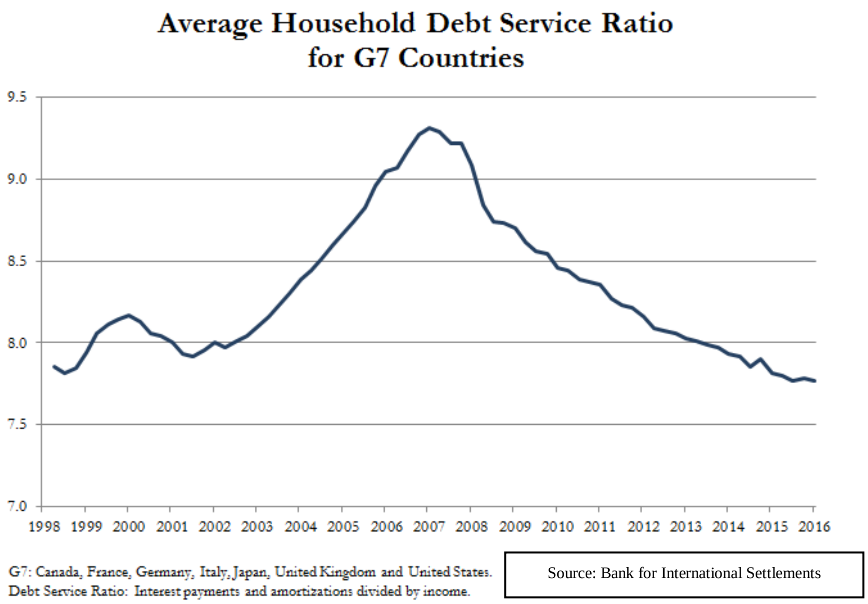
Economically, the period leading up to "The Great Recession" was characterized by some significant excesses and imbalances. China's entry as a full-fledged member of the World Trade Organization ushered in a great period of growth for them as they dominated worldwide outsourced manufacturing. They were able to do this because incentives for capital investment were in place and cheap labor was plentiful. As workers moved from rural provinces to cities, prosperity followed and economic growth ensued. In Europe, the monetary union occurred in 1999 and Germany pursued a similar path to grow exports to nearly a third of their economy. The target for those goods was the rest of Europe. The monetary union gave Germany a cheaper currency than they would have had under the Deutschemark, promoting their exports. The deal the rest of Europe got out of the EU was access to cheap financing. That cheap financing was used in many instances to fund unsustainable government spending. China's ascension led to other imbalances. Commodities soared, and many Latin American countries splurged their newfound wealth by promoting socialist policies. In the US, excess worldwide savings allowed access to cheap financing and promoted a speculative real estate bubble. Worldwide, banks levered up to carry debt loads that were as much as 30 or 40 times the equity on their balance sheets to promote new, financially engineered products that promised great returns with little risk. With leverage high at the banks, and unsustainable investments being made in commodity production, US Real Estate, Chinese Manufacturing and European Government spending, something had to give; thus the Great Recession.

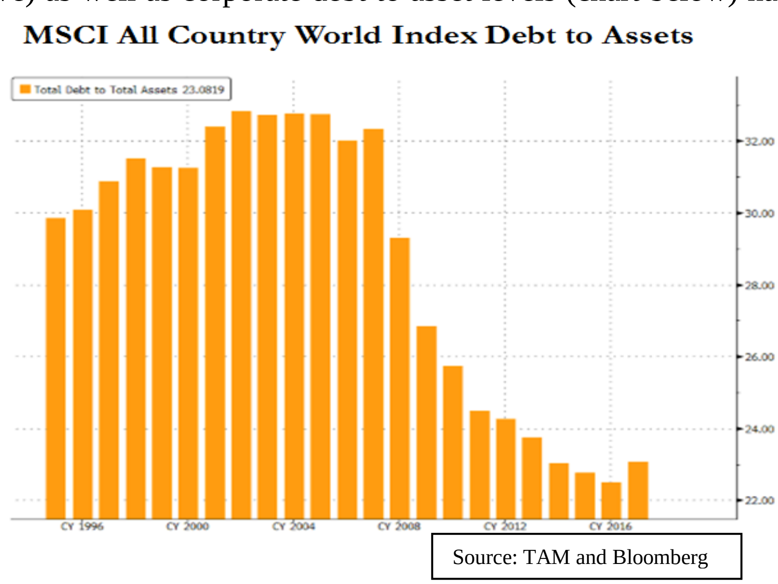
The good news is that the world has not been sitting idly by since Lehman failed and triggered a worldwide financial crisis. **In the past ten years, many of these imbalances have been addressed through "The Great Reset".** China reset their economy by pursuing more balanced economic growth. They have been emphasizing services over manufacturing, as seen in the chart below. That might be a lower growth path, but in the end it is likely more sustainable and one that should promote job growth for their population.



Source: Bloomberg

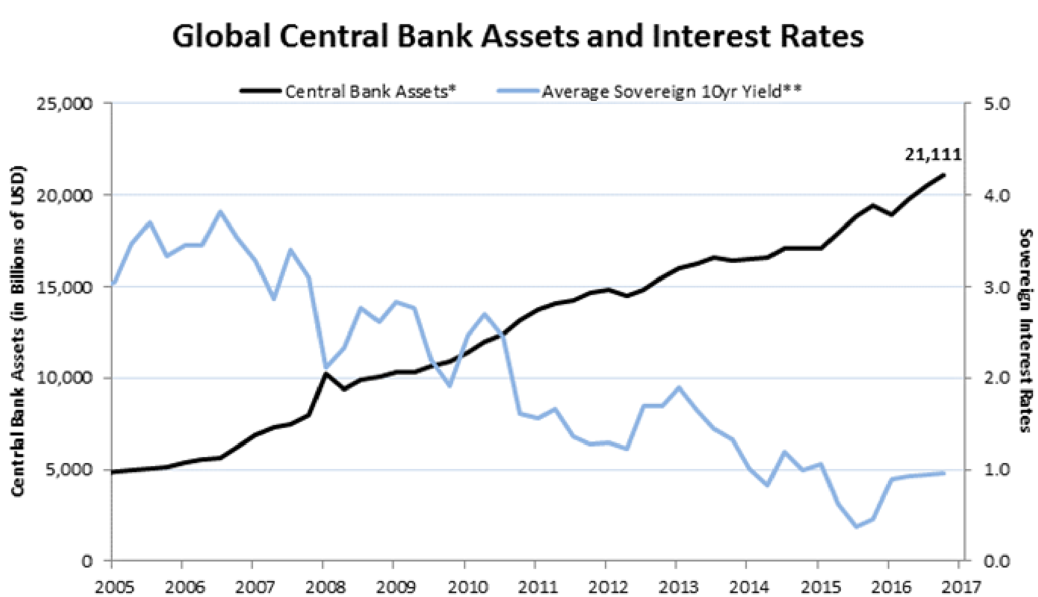
Turning to the continent of Europe, the Great Recession prompted International Monetary Fund bailouts or ECB assistance for Spain, Ireland, Portugal, Italy and Greece and Cyprus. The unfortunate moniker they were saddled with was the "PIIGS". The reset associated with these bailouts were economic and labor reforms to allow their local businesses to compete more freely with less red tape. As a result, Spain, Ireland and Portugal are among the fastest growing economies in Europe, and Spain produced one quarter of the new jobs in Europe over the past year. These areas still suffer from high unemployment and other lingering effects of the crisis. In the US, the reset was characterized by consumers and corporations shrinking the debt on their balance sheets. Measures like the consumer debt service to income ratio (chart above) as well as corporate debt to asset levels (chart below) have been reset lower to levels last seen in the 1990's or earlier. Banks worldwide have cut debt by more than half compared to the equity that backs them up. Central banks were instrumental in allowing the cleanup of financial leverage, as they purchased large amount of bonds and still hold them on their balance sheets. This reset resulted in low and sometimes negative interest rates for sovereign debt since the crisis.





These resets came at a price, specifically, about a third of GDP growth worldwide had to be foregone as private sector debts needed to be repaid and excess manufacturing capacity in finished goods and commodities needed to be absorbed. Theoretically, if a consumer or corporation is paying off debt, they are not consuming as much. If overcapacity is being absorbed, companies are selling products for less than when capacity is tight. If banks need to recapitalize, they are likely shrinking their balance sheets and not offering as many loans. Sound familiar? It should, because these have all been occurring and allowed deflation to become a concern as inflation levels plummeted. That is where many developed markets are right now. We think we are at the inflection point, where inflation probably firms up and could actually increase. In the US, we currently have full employment, and wage inflation is starting to tick up. In China, their producer price indexes showed DEFLATION FOR 5 YEARS, between 2012 and 2017. They are now firmly in positive territory suggesting that excess capacity has been absorbed. Commodity prices also suggest that the deflationary pressures are weakening, as oil, gas, iron ore and copper prices have all moved up significantly from bottoms in 2016. All of these point to "The Great Reset" wrapping up and economic growth having fewer headwinds. We are likely to get the extra 2% in worldwide GDP growth back after ten years of doing without.

Investors are not buying into expectations of a recovery. Worldwide interest rates remain low and even negative in Europe as central banks continue buying bonds as seen by their expansion in assets illustrated in the chart below. Investor flows have continued to favor bonds over stocks. The only reasonable explanations for money flowing into bonds when rates are at an all-time low is that either investors think deflation is coming or they are counting on a central bank to continue buying bonds at low rates. We think investors still worry that a repeat of 2008 is in the works. **That, my friends, is our opportunity**.

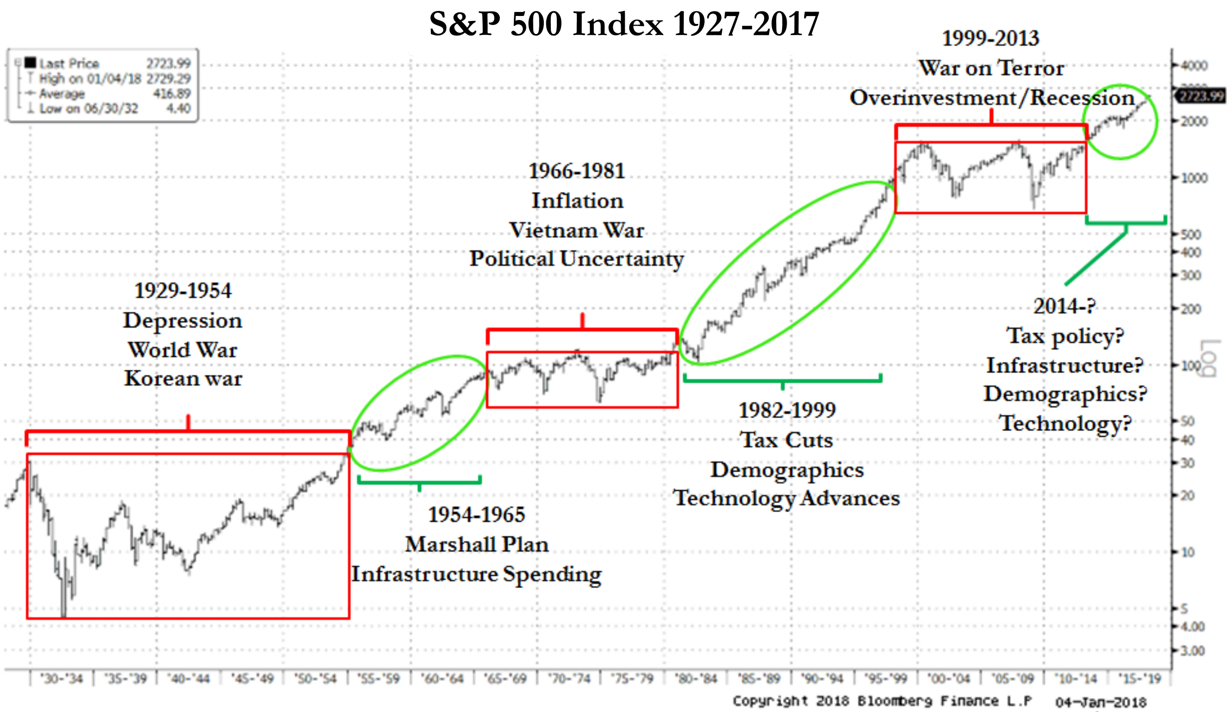


*Aggregate Assets of the US Fed, Bank of Canada, ECB, BOE, BOJ, SNB, People's Bank of China and Reserve Bank of Australia
BOE stopped reporting Total Assets in September of 2014. We have kept the BOE Total Asset figure static from that point on.
**Average 10yr yield of the US, Japan and Germany.
Data as of 9/30/2017

Source: TAM, MSCI and Bloomberg

While there may be some form of financial crisis in the future, two things need to be remembered. First, whatever occurs, it won't be another 2008. Since 2008, central banks worldwide have taken control of banks in developed markets. The ways they did this varied, but the underlying message to the banks was the same: clean up the bad debts, recapitalize and lower the amount of leverage you employ. All of these led to slower bank lending growth than prior to 2008, and that has been one of the headwinds to growth we spoke of earlier. **The second item to remember is that financial crises generally occur after overinvestment in an asset class and irrational exuberance.** Historically, this was seen in bank loans to sovereign countries (early 1980s) Commercial real estate development (1991- Resolution Trust), Emerging Market debt (1998- Long Term Capital Management, Asian Contagion), capital spending (2000- internet boom) and residential real estate (2007- the Great Recession.) Banks and brokers were complicit in all of these busts, and overleverage contributed to most of these problems. The big four US banks have spent ten years increasing equity to assets at the instruction of the Fed. In 2007, the largest four banks in the US had equity to assets in the neighborhood of 7%. Think of that as lending $14 for every $1 in equity ownership you could show. In 2016, equity to assets more than doubled to over 14% or $7 in loans for every $1 in equity. Also, with more stringent loan requirements, the quality of the lending outstanding is undoubtedly better now than in 2007. **A deflationary bust does not happen without excesses building up, an unlikely occurrence when developed market bank lending is as tight as it is currently.**

History suggests we are in the early innings of what is likely to be a long secular bull market. We examined prior periods where markets broke out from long term trading ranges and found that post breakout the markets generally had at least ten years to run. If you examine the S&P 500, we've identified three periods since 1929 where the market tracked sideways for extended periods. Those were 1929 to 1954, 1966 to 1981, and 1999 to 2013. We have denoted those periods on the chart below and given a synopsis of issues that caused the long trading ranges. During each of these periods, sentiment deteriorates, and investors lose faith in the potential for stock markets to provide good returns. Importantly, after the S&P moved to a new high, it was followed by at least 10 years where returns were 11-12% on a price basis and 14-17% on a total return basis. The breakout in 1954 ushered in 11 years where US industries rebuilt the shattered world economies, and the US government pursued infrastructure spending. The breakout in 1982 ushered in an 18 year period where a combination of tax cuts, demographics and technological advances allowed the economy and markets to perform well. In 2013, the S&P broke out of a fourteen year trading range. During that period, we suffered two dramatic bear markets and an economic situation that was as close to the great depression as we wish to come in our lifetimes. **Constructive actions by the Federal Reserve and the balancing of excesses through the Great Reset are what the market foresaw when it broke out in 2013.** Economically, we are seeing better growth currently as animal spirits reawaken in the economy. Pro-growth tax policies have been enacted, productive infrastructure spending is promised and continuing advances in technology are being introduced. **History suggests this market should continue to march higher.**



If this bull continues like the average of the 1954 and 1982 markets, then we would mathematically be roughly 4.5 years into a bull market that should last 14.5 years. During the prior bull markets, price gains average about 11.5% annually, with dividends in addition to that. ***Since the breakout in 2013, the average price gain of the market is 11.4% annualized, EXACTLY IN LINE WITH WHAT YOU WOULD EXPECT.*** The remarkable thing about history is how frequently it repeats itself.

Importantly, the US experience has been shared by international markets, and they are showing similar breakouts. *The good news about that is that historically, they have shown better returns than the S&P 500 when breakouts of this nature occur.* In recent years, the German DAX index and the UK's FTSE 100 index have broken out of long term trading ranges. In the 1980s and 1990s, when the DAX broke out of the prior trading range, it went on to have price return of over 15% annually through that bull market. We have included a synopsis of what that looked like in the chart below.

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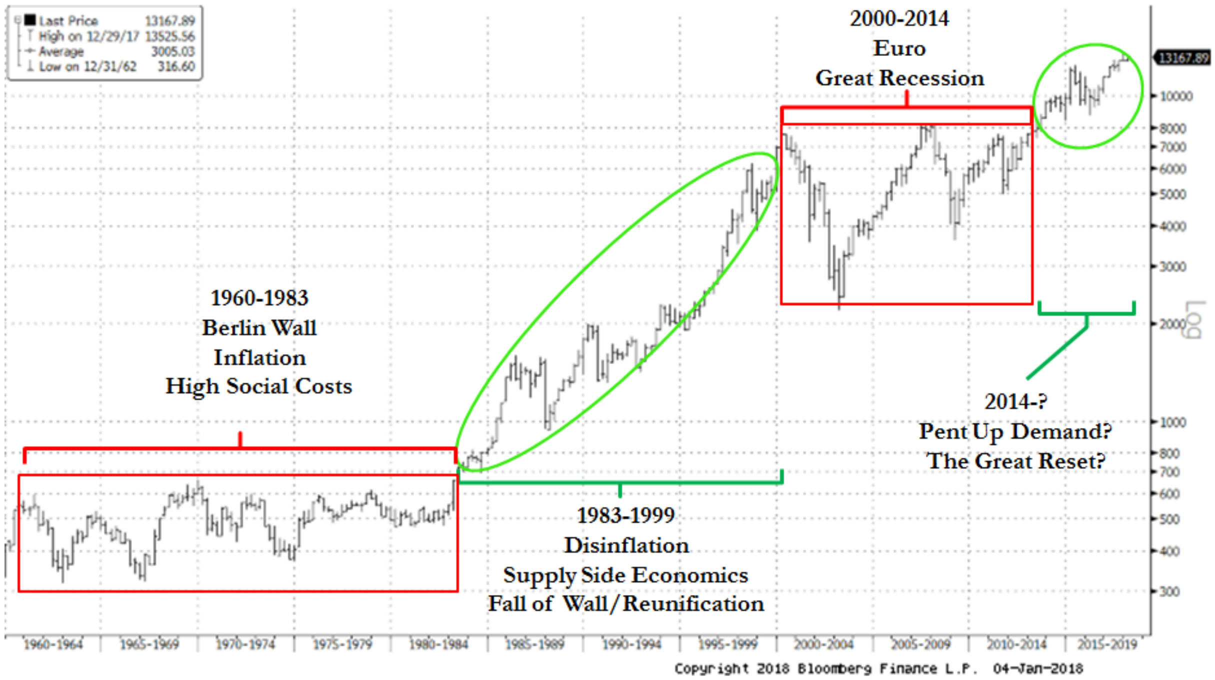
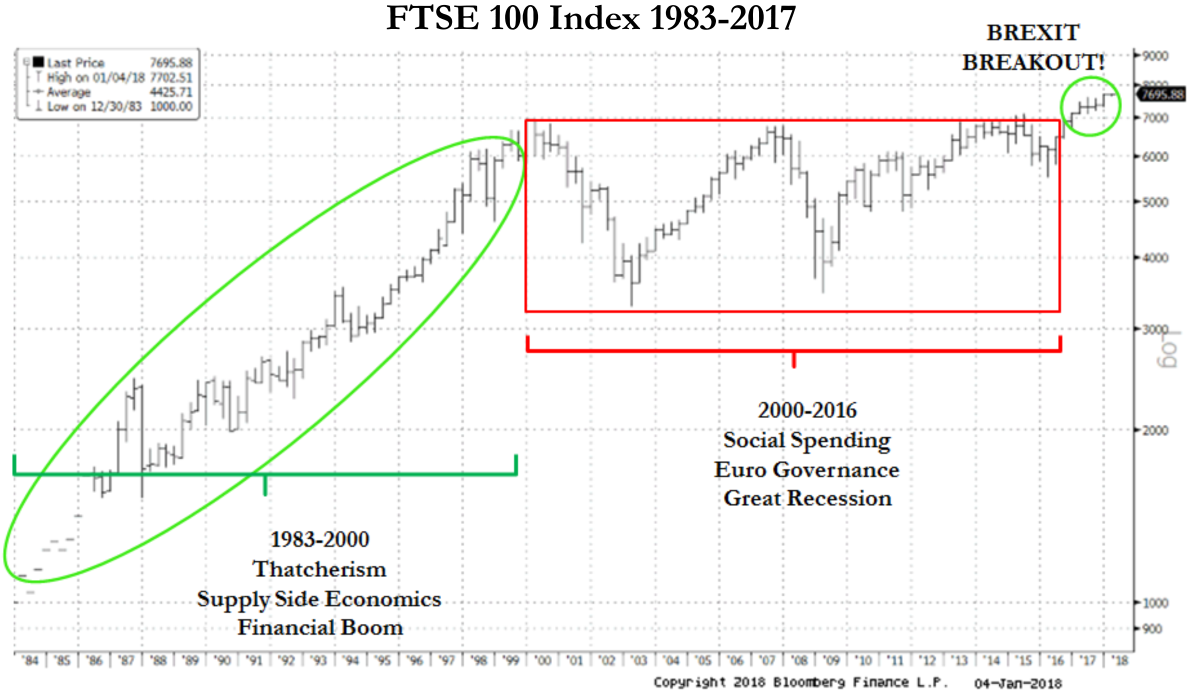
DAX Index 1961-2017



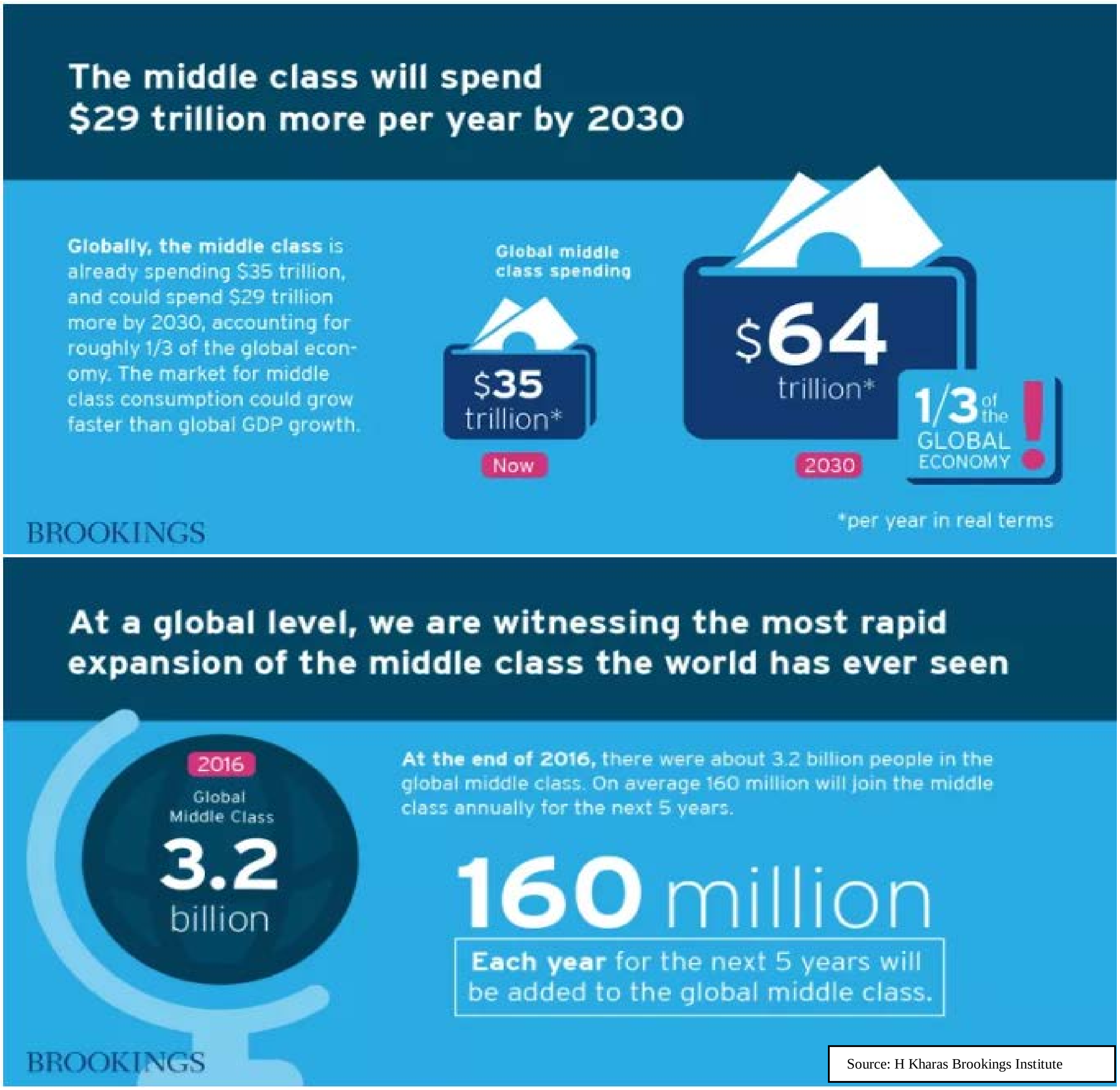
The UK market has also recently broken out of a longer term trading range, and it has only done so after the Brexit was voted on and announced! Since the FTSE 100 index was only introduced in 1984, we have a truncated history of performance. During the 1980s and 1990s bull market, the index provided price gains of over 12% annually.

FTSE 100 Index 1983-2017



Emerging Market Consumer is the largest contributor to the global growth we foresee.

According to the illustration below from the Brookings Institute, the global middle class should grow by 160 Million people or 5% of the base over each of the next five years. Much of this growth is driven by Emerging Markets in Asia. They expect 88% of the next billion entrants to the middle class will come from Asia and overall middle class spending should rise to $64 Trillion in 2030 from $35 Trillion currently.



Source: H Kharas Brookings Institute

The growth in the middle class will drive demand for infrastructure, technology, health care, financial services and consumer durables among other things. This should benefit companies worldwide and provide a strong base for growth going forward.

In summary, equity markets worldwide are anticipating a better future than will be predicted on CNBC or from most strategists. We believe the US, Europe and the Rest of the World is in an economic recovery after the great reset, which should last for years to come. The markets appear to anticipate this as well. During prior periods where a secular bull was in place, price gains averaged between 11% for the US to up to 15% for some European markets annually. The length of these bull markets was 11 to 18 years after making new highs. If we use simple averages of these, then the current bull market may have up to another 10 years to run, since we are 4 years post the US breakout right now. International markets may have longer to run, since many of them are only starting to break out now. If this market were to advance like prior bull markets, the S&P 500 would stand over 5000 by 2023. Bear markets will undoubtedly occur between now and then as they did in the 1950s and 1980s secular bulls. If history is a guide, markets should prove resilient and continue moving to new highs for the next decade or more.

As always, we are here to assist you. If you need any additional information, please feel free to contact any of us.

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