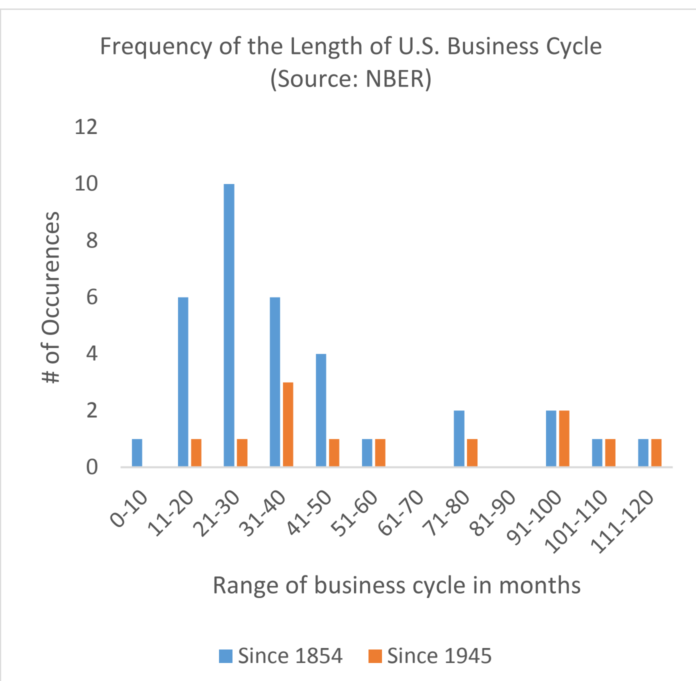
Economic & Investment Perspectives

The U.S. economy is days away from approaching a milestone reached only three other times in over 162 years and barring a major turn of events will end the month of March achieving a milestone reached only two other times during that same period. The National Bureau of Economic Research (NBER), the official arbiter of U.S. recessions has traced U.S. economic cycles back to December 1854. Since then the U.S. economy has experienced 33 cycles (excluding the present one) with average lengths of roughly 39 months. Since the end of World War II we have experienced 11 cycles (again excluding the present one) averaging slightly over 58 months (see Chart of the Week).

Chart of the Week



However, only three cycles managed to complete their 92nd month successfully and only two lived to exceed it. The 1961-1969 cycle lasted 106 months, the cycle of 1982-1990 lasted 92 months and the 1991-2001 which was the longest cycle on record lasted exactly 120 months. At the end of February our present cycle will have completed its 92nd month and given our present view, is likely to successfully complete at least its 93rd month at the end of March as well.

Quantifying that from an economic cycle view; entering the month of March we will have passed the 98th percentile of times since 1854, the 95th percentile of times since 1945, and the 93rd percentile of times since 1982. Our present cycle is old by any stretch of the imagination. And while we appreciate Fed Chairman Janet Yellen's point that "*…[expansions] don't die of old age*.", we are mindful of the fact that no living creature that we know of actually does die of old age. They die of symptoms that have a much greater chance of being fatal at an older age than they do at a younger age. Business cycles are no different, especially when the symptom is confidence. A shift in confidence will have a far smaller impact on the economy early in the cycle than the exact same shift late in the cycle. The "leverage in confidence" we are observing today, especially in the U.S. equity markets, is what most concerns us about this leverage. We have seen time and again in the past; the unwind of this confidence negatively impacts consumer and business behaviors to such degrees as to cause economic cycle turn-arounds. The deflating of that leverage will be far more impactful today than say five years ago when the cycle was under three years of age. A negative shift in confidence will most certainly impact the general economy to such a degree as to cause the next contraction.

An important sign of that leverage is what investors are willing to pay for future after-tax corporate earnings. According to a recent study by Goldman Sachs (and consistent with our observations above), the median S&P 500 stock is now trading at levels higher than the 95th percentile since 1982 on five different valuation

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metrics. Only the technology bubble of the 90's surpasses this cycle from that perspective.

A bull market ends when the very last buyer decides that the offer price being shown is simply too high relative to future earnings prospects and decides not to transact. The bull market of the 1961-1969 cycle reached that point in the 93rd month of the expansion when prices had risen by another roughly 5% from the close of the prior month. Exactly a year and a half later the S&P 500 had dropped by 33% relative to the closing price of the 92nd month. The peak in equities during the 1982-90 cycle was actually reached in the middle of the 92nd month and by the end of that month equities had dropped by 3.6% with an additional 17% drop during the following two and a half months. The equity market bubble of the 1991-2001 cycle actually saw prices rise by 33.5% for another thirteen months beyond the end of the 92nd month. But during the ensuing bear market (ending October 2002) prices dropped 33.25% relative to the close of the 92nd month.

Whether today resembles the 1961-1969 and 1982-1990 cycles where at this point in time we were either within a month of the peak or had already observed it, or resembles the 1991-2001 cycle with plenty of upside remaining to the bull market nobody knows. One thing we are confident about is the strong possibility of significant volatility ahead of us in the coming year or so as the odds of an economic contraction grow by the month.

While we remain open to and believe there needs to be consideration given to the possibility of something unique about this cycle, we are very mindful of the legendary investor Sir John Templeton's thoughts:

"The four most dangerous words in investing are, this time it's different."

As always, stay tuned;

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