An Odd Bull Market

Louis-Vincent Gave
lgave@gavekal.com

A good friend of Gavekal recently remarked to us that he had his Joe Kennedy "shoeshine boy" moment when he heard a checkout clerk at his local supermarket expounding on the merits of leveraged S&P 500 ETFs. And to be sure, signs are indeed accumulating that this bull-market is getting long in the tooth.

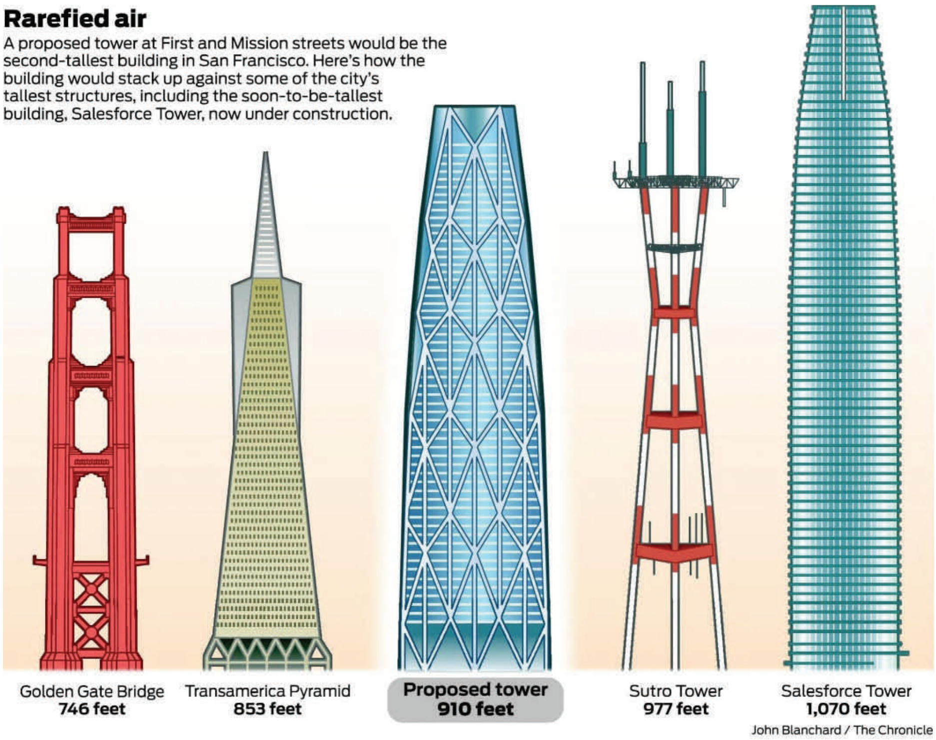
When concerns evaporate, it's usually time to get worried...

From the evolution of magazine covers over the last six years:

To the breakout in architects' fees, whether on the new Apple campus, the Salesforce Tower, or even on the US$250mn that the loss-making Uber is planning to spend on its new headquarters:

...and when people begin to construct grandiose new headquarters buildings

Towering vanity is seldom a good sign...



To the fact that seven out of the world's top ten companies by market cap are essentially in the same field. In the past, such concentrations on a single theme have seldom been a harbinger of good things to come:

...nor is heavy market concentration on a single theme

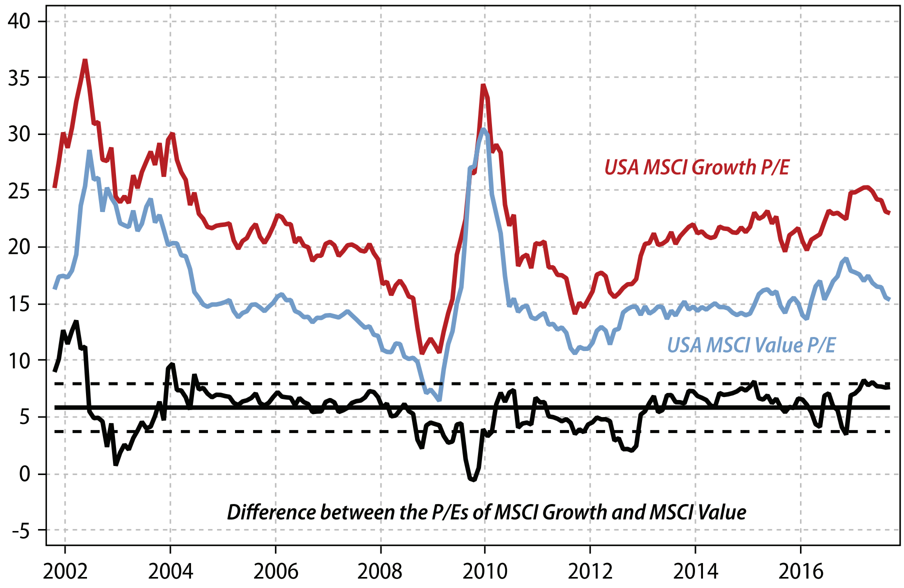
The world's biggest stocks by market cap down the ages

1980	1990	2000	2010	2017
IBM	NTT	Microsoft	Exxon Mobil	Apple Inc.
AT&T	Bank of Tokyo-Mitsubishi	General Electric	PetroChina	Alphabet (Google)
Exxon	Industrial Bank of Japan	NTT DoCoMo	Apple Inc.	Microsoft
Standard Oil	Sumitomo Mitsui Banking	Cisco Systems	BHP Billiton	Amazon.com
Shlumberger	Toyota Motors	Wal-Mart	Microsoft	Facebook
Shell	Fuji Bank	Intel	ICBC	Exxon Mobil
Mobil	Dai ilchi Kangyo Bank	NTT	Petrobras	Tencent Holdings
Atlantic Richfield	IBM	Exxon Mobil	China Construction Bank	Johnson & Johnson
General Electric	UFJ Bank	Lucent Technologies	Royal Dutch Shell	JP Morgan Chase
Eastman Kodak	Exxon	Deutsche Telekom	Nestlé	Ali Baba Group

Prominent beliefs: peak oil, US businesses are just better run	Prominent beliefs: Japan will take over the world	Prominent beliefs: this time it's different; US is a big TMT boom winner	Prominent beliefs: peak oil, China taking over the world	*Hey, it's not yet the end of the decade & we may still have time to dance?*
Underweight the US, underweight energy	*Underweight Japan, underweight banks*	*Underweight the US, underweight TMT*	*Underweight China, commodities*	***Good thing there is no common thread among the above names…***

To the valuation difference between growth stocks and value stocks, which, as the chart overleaf shows, has now firmly now firmly settled at one standard deviation above its long term average.

The valuation premium of growth over value



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It would all smell very "end of cycle"...

One could easily conclude that US growth stocks, and especially technology stocks, are now cruising for a bruising: stretched valuations, massive overweighting in domestic indexes, high retail participation, construction of skyscrapers and trophy buildings, angering policymakers, transgressing the boundaries of common decency (Uber, SoFi, etc.). It all smells very "end of cycle".

IPO drought

Except for one thing: at this stage of the bull market, one would expect to be receiving calls every hour from friendly investment bankers pitching the latest IPO. Yet this bull market has been amazingly devoid of such activity. Sure, the past year witnessed the Snapchat and Blue Apron IPOs (which most participants would rather forget). But these were hardly blockbuster deals.

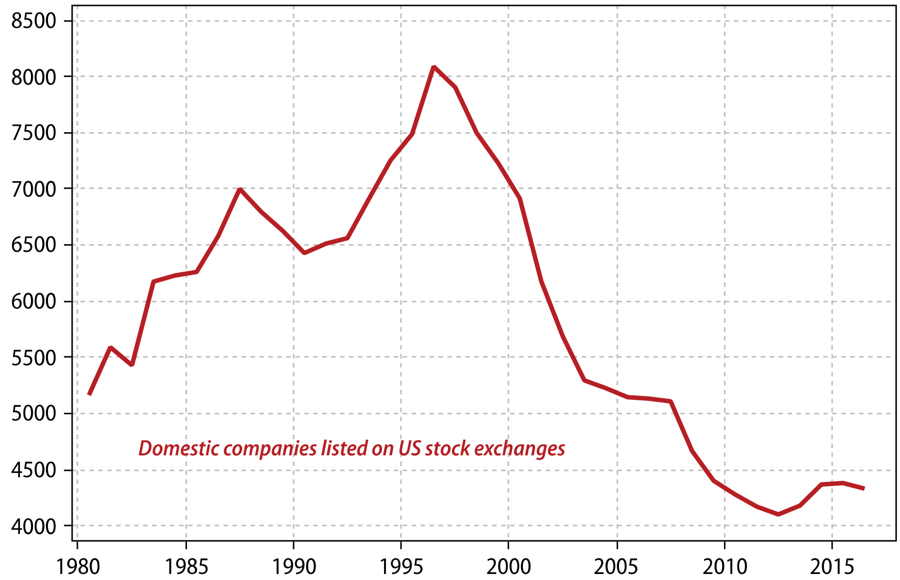
This brings us to our trick question of the day: **how many stocks are there in the Wilshire 5000?** Sounds like wondering who is buried in Grant's Tomb, right?

...except that IPOs have dried up and the number of US listed companies is falling

Wrong! When it was launched in 1974, the Wilshire did indeed have 5000 companies. But at the end of 2016, the index was down to 3,618 names. Why? For the simple reason that, because of mergers and acquisitions, private equity activity, or management buyouts, the number of companies listed in the US has been on a steady downward spiral (since Sarbanes-Oxley?).

As the chart overleaf shows, the number of domestic companies listed on US exchanges has slumped from 8,060 in 1997, to 4,331 companies today. So, even if it relaxed all its inclusion standards, Wilshire would be hard pressed to find 5,000 companies to put in its index.

The number of listed companies in the US is in decline



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All of which brings us to the greatest paradox about today's bull market: the fact that, in spite of punchy valuations, **the IPO market remains as dead as a dodo**.

The cost of equity remains high relative to the cost of debt

There are several explanations for the demise of the new issue market:

- Even though the cost of equity is low today, the cost of debt is much lower still. What CFO in his right mind would choose to fund growth through equity rather than debt?
- Private equity funds remain flush with cash and are therefore willing and able buyers of businesses looking for capital to expand.
- With punchy valuations, companies like Google, Amazon, Facebook and others can use their share prices to purchase smaller companies and see the purchases be immediately earnings accretive.
- In a services-driven economy, companies need less and less capital to fund their growth (a topic we first discussed in our 2005 book, ***Our Brave New World***).

Given all these factors, how much scope is there for a genuine pull-back? With the cost of debt so far below the cost of equity, and with CFOs keen to buy back their stock on any dip, can we really expect a crash in valuations?

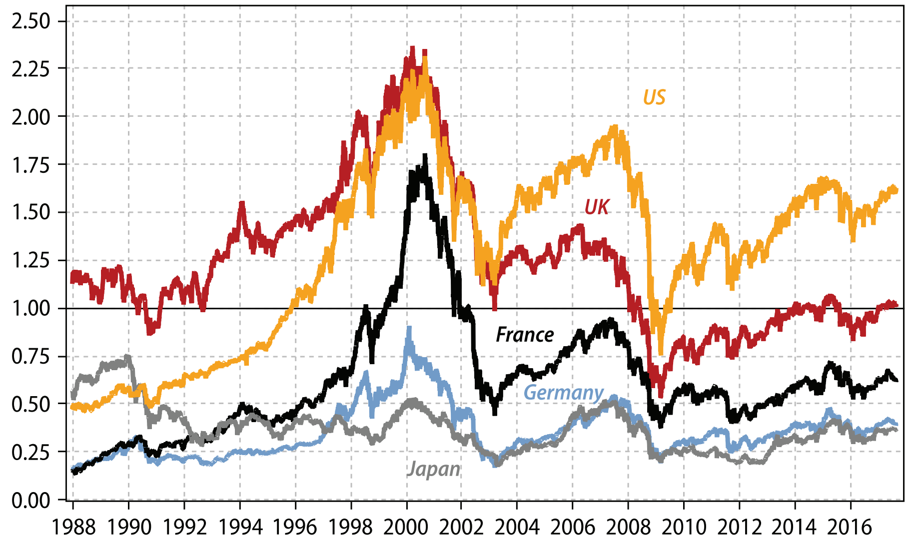
Today is there more money than fools?

To answer these questions, we return to the wise words of our first ever client, Beat Notz. When we first got started, Beat told us: **"Remember, this is an easy game. When there is more money than fools, you buy stocks. And when there are more fools than money, you buy bonds."**

Taking these words to heart, we devised a simple measure of the "fools to money ratio" by looking at the total market capitalization of any given country, relative to that country's broad money supply (M2).

Measuring the "fools to money ratio"

Market capitalization relative to M2



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The aim of this ratio is not to achieve a high level of certainty. Instead, like Lord Keynes, we find that "it is better to be approximately right rather than precisely wrong". So the chart above should be taken with a healthy pinch of salt, as a handy if imprecise measure of the fools to money ratio.

A couple of things immediately jump out:

Relative to money, in most markets the number of fools is low...

- Most major markets currently have a "fools to money ratio" of below 1x. This is relatively low by historical standards, and would tend to argue for higher equity prices going forward, especially if central banks (the Bank of Japan? European Central Bank? Swiss National Bank?) continue to print.
- The US stands out as an outlier, with a fools to money ratio of 1.6x. This ratio does not foreshadow immediate doom. The 1.6x level was first breached in 1998, and the market continued to rip higher into 2000 (when our ratio reached 2.25x). The ratio again broke 1.6x in 2004, on its way to 2x in 2007 and the subsequent collapse.

...but the US fools to money ratio could take a hit next year

So, nothing to worry about then? The answer to that question could well depend on your time horizon. True, over the next few months there is unlikely to be much of concern. But as we head into 2018, the fools to money ratio could easily take a nasty hit if any of the following events come to pass (ranked from most to least likely):

1) **The Federal Reserve starts to shrink its balance sheet**. This seems a likely proposition which, all else being equal, should reduce the amount of "money" in the system without automatically reducing the number of fools.
2) **The US budget deficit and debt expand**. Could it be that Donald Trump proposes a big increase in infrastructure spending just before the US congressional election, so allowing US Congressmen to go back to their districts and brag about the pork they are bringing home?

Obviously, if the Fed doesn't monetize this expansion in US debt, then either foreign central banks or the private sector will have to fund it (but what if the ECB tapers at the same time?). Of course, a big increase in US debt could be paid for through an increase in US bank lending and faster banking multiplier activity in the US; i.e.: more money being created (this time by commercial banks rather than the Fed). But failing that, a big increase in government debt could suck excess liquidity out of the system and leave us with a deterioration in our fools to money ratio.

An upsurge in IPO activity could be an ominous sign

3) **The IPO market kicks off in earnest**. The coming year is supposed to see a few bellwether IPOs. The big one is the Saudi Aramco deal (assuming it happens—the valuation gap between the hopes of the Saudi royal family and the market's expectations is wide enough to drive a bus through). Perhaps IPOs could follow for Uber? AirBnB? Pinterest?

Any one of these developments could push our US fools to money ratio into dangerous territory—and could therefore help to form a top for what feels like a very extended bull market. At the same time, however, I have to acknowledge that in a number of other markets, not least Japan, the money printing continues in earnest. Maybe that could that help to provide a floor in any pullback?