



The Volatile Path Back to “Old Normal”

After 2 weeks of absorbing the U.S. election results, watching the financial markets and reading countless market and economic commentaries, we offer the following condensed thoughts.

What was Expected?

While the election was thought to be close, the odds makers and thus the financial markets were clearly expecting a Clinton victory. That meant continued heavy entitlements, higher taxes, very low GDP growth, low inflation and a decent chance of a recession in 2017. All of this led to ultra-low interest rates and a relatively high stock market based on no real alternatives for positive risk based returns.

What Happened?

But Trump won. Now if, and a big if, Trump’s Republican-led houses get their way, we will see lower taxes (lower personal and corporate taxes and no 3.8% Obamacare tax), less regulation and all manner of fiscal stimulus that has so far been absent in our weak recovery over the last eight years. This would lead to higher GDP, higher wages, no recession and eventually higher inflation. The new premise is that we are headed back to the “old normal” of 3-4% GDP, 3%+ 10 year government bonds and higher corporate growth rates. Therefore, valuations multiples would also “normalize” with lower P/E ratios and higher cap rates for real estate.

Initial Market Reactions

Based on the above, money quickly moved out of medium to long-term bonds and fixed yield investments (utilities, REITs, preferreds) and into growth vehicles, mainly US stocks. Small caps, banks and energy are seen as having the most near-term potential benefit. The move out of bonds was particularly large. In about 2 weeks, we saw a three-fourths of one percent rise on 10-year bonds which equates to an increase of about 25% in the cost of borrowing. The consequence for this has raised havoc in the commercial real estate pending sales. Lenders backed out of loans and properties are falling out of escrow or re-traded at lower prices to reflect the higher cost of borrowing.

What is Likely to Happen Next?

Valuations, based on a multiple of earnings (P/E ratios and cap rates,) are affected by two big factors: 1) interest rates, as they represent known returns, and 2) expected growth in earnings (corporate profits or real estate rents). In a reversion to the mean “old normal”, these two factors will work against each other in determining valuations. In the decade of the 1970s, earnings grew at an average of 7%, doubling over 10 years, but the P/E ratios halved from 15 to 7. Double the earnings and half the multiple meant the Dow Jones started and ended the decade at about 1,000 with an inconvenient 50% drop in the middle.

We believe that a less dramatic version of the 1970s is likely. Valuations will alternately focus on interest rates (negative factor) and growth rates (positive factor). Initially, the markets have bid up stocks based on growth and dropped prices on real estate based on interest rates. At some point in the future, stock growth will be mitigated by higher interest rates and real estate will rise based on increasing rents.

Underlying Economic Steps

While the markets are anticipating these factors in the future, the real economy has to start taking steps to fulfill these premises. Fiscal stimulus policies have to be designed, negotiated and approved. Corporations have to believe in a better future and spend money on capital improvements and hiring. Current slack in factory over capacity and abundances of commodities must be absorbed. Profits should grow, leading to wage growth and eventually inflation.

The recent rise in interest rates assumes this is already happening; therefore, rates can only rise so far before getting too far ahead of the actual economy.

Investing Strategies Going Forward

While we have a likely path forward, the financial markets will be volatile as they focus on growth rates vs. cost of capital and actual vs. anticipated. Index funds, based on large sectors of the market like “Large Cap Stocks” have worked in the last few years as stock correlations were very high. Now, there are clear winners and losers. While the S&P 500 is up about 3% since the election, this is comprised of many up 20% and down 15% in different stock performances.

Below are near-term winners and losers based on current thinking:

Winners

Small Cap (Domestic) Stocks
Biotech
Pharmaceuticals
Financials
Energy
Floating Rate Bonds
Life Settlements
Private Equity
TIPS

Losers or Laggards

Bonds (US and Europe)
Commodities
Emerging Markets / Europe
REITs
Preferred Stocks

Longer term, we see the most opportunities by buying the following on dips:

- Emerging Markets
- Commodities
- Real Estate
- Small Cap
- Preferred Stock

Commercial Real Estate

Current real estate valuations are based on current sales (which are and will be lower) caused by the sharp rise in interest rates and the lowering of expected returns with now higher initial capital costs. However, existing commercial real estate with low cost loans financed over the last few years should make their expected, underwritten rates of return from higher than anticipated rent growth, offset by a higher final cap rate. Current purchases, based on higher borrowing costs and re-negotiated lower prices should also work fine. The real losers are properties needing to sell into this environment and taking unexpected discounts to do so.

Summary

The road back to normalized/historic average P/Es, GDP, interest rates, cap rates and inflation will be bumpy. It is a good and needed path for our country but none-the-less difficult to navigate. We look forward to discussing these economic and market changes with you and our individual strategies for your portfolio, risk level and tax situation.

Until next time,

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