How About Something Different
Don's Blog 2017.11.27

Forget that by all recognized historical measures, the financial markets have never been more overvalued.

Forget that since 2009, institutions have been sellers of equities as well as households (on a cumulative basis).

Forget that the rest of the world (foreigners)—and most importantly non-financial U.S. corporations—have been by far the largest buyers of equities.

Forget that corporate profits have not increased since 2014.

Forget that the inequality of incomes is the greatest since the roaring 20's.

Forget that the homeless numbers are greater now than during both the Great Depression and the Great Recession.

Forget that our nation—as well as the world—has never been more divided.

Forget that faith in established institutions is at an all-time low.

Forget, forget, and forget ad nauseum. There is absolutely no question but what we are not in Kansas anymore. Despite all the above, we have yet a much larger problem which I will get to in a little bit. I have mentioned it before, but it gets worse and worse every day; and the only possible solution is extremely destructive to our financial well-being.

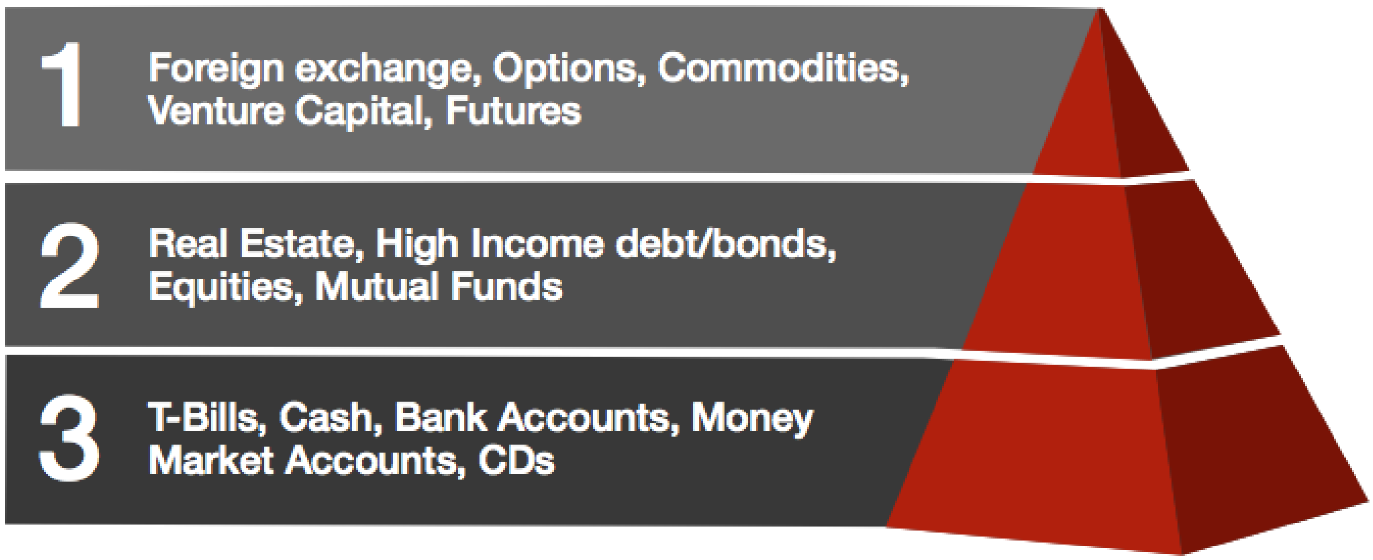
I saw something the other day which is absolutely right, but goes against all that we have studied and learned in our classrooms, textbooks, and business experience. Please pay attention to the following:

AS ALL MARKETS ARE EXTREMELY OVERVALUED, TO BUY AT THESE LEVELS MOST SURELY GUARANTEES FUTURE LOSSES. WHY NOT BUY A MORE “RISKY” ASSET WHICH HAS EXTRAODINARY POTENTIAL RETURNS?

Please note I put “risky” in quotes. Also note the chart below which depicts the well-known risk pyramid we have been taught since kindergarten. We know the base is the same, however, in the long-run one cannot really obtain a return in excess of inflation. Also, if we know the middle tier is extremely overvalued, thereby assuring probably future negative returns, why not go dumbbell? Build a portfolio something like 50/50 in tier 1 (venture capital) and tier 3 (short-term fixed income). Now, you can’t sell that approach to box believers, however to those that can think outside the box it makes a lot of sense; and is, in my mind, not as risky. Less risk, more reward, isn’t that what we all want? Think about it!

Now, to the larger problem. This dumbbell idea makes all the more sense when you think about the current structure of the stock market (and to some extent the bond market). Trillions have moved from the managed funds to passive funds as I have mentioned many times before. This has created an extremely malformed market. For example, we have recently been seeing what is called Hindenburg Omen type patterns. A pattern of new highs and new lows at the same time. It’s technically more than that, but that’s good enough for government work. It’s a fractured market. As everyone goes to passive index funds, they sell other stocks. Result: the S&P 500 stocks go to new highs and the non-index stocks go to new lows. What happens when this reverses? Katie, bar the door.

Again, overvalued financial markets plus markets that are in a structure made for disaster requires a different approach, in my opinion. But you know me. I’m not sure I will be around long enough to be proven right. However, the longer it continues in this same unhealthy direction, the more certain I am that the call will be correct.



Adapted from mahifx.com