



## Commerce Trust Company: Economic Breakfast St. Louis, Missouri, November 6, 2019

- Scott Colbert: So we're going to talk about the economy, and where we're headed, and what it probably means for stocks and bonds. They say people can only take away about three things from anything, but I can tell this is an exceptionally smart crowd. How do I know that? Because we're at the Ritz-Carlton, right? So we've got above average talent in the room.
- Scott Colbert: And so those four things I'd like you to try and leave with are, number one, the world is clearly cooling. It's slowing, there's no doubt about it. And the US is getting pulled into it. But number two, there's still a great deal of consternation on the will we or won't we go into a recession. And our bank is a little closer to the financial system than most of those commentators you see on TV. And we're here to tell you that we're going to avoid that recession, and we're going to make some more forward progress. That doesn't mean there are plenty of clouds on the horizon. It doesn't mean that we don't have elections, right? Elections coming up to worry us or at least to roil the markets. But we're going to make it through and we still think the economy can grow for a considerable amount of time.
- Scott Colbert: Now, that doesn't mean that asset prices aren't expensive. They are. Let's face it, stocks are at record levels. Bond yields are almost at record low levels, but because we think this economic expansion can continue for some time, we think they'd probably go to near record levels. And so since we don't have a football team anymore here, the Chiefs I guess is our adopted team. We're in hockey season, so we're going to overtime. Did the Blues win? They were winning one to nothing last night when I went to bed.
- Speaker 2: They won two-one.
- Scott Colbert: Two-one, good. Excellent. So let's take a look here at our charts and graphs. Now, the first thing to note is this is global growth and it peaked in 2016 at 3.8% worldwide. It fell a little bit in 2017 when we were still growing at a three plus percent pace. And in 2018, it fell further. And in 2019, we've got 3% growth. So it's a considerable downturn that we're facing here as we sit here today. And you can see this quite easily when you take a look at these global Purchasing Manager Indexes. Having peaked back in January '18, this is the service side of the economy. And all of these charts and graphs are at your table because I know you can't see all the writing here. So we're on chart two, I suppose, but this is the Global Service Index. As you can see, they've peaked, they've rolled over, but the world's a more service economy and it's not signaling a recession yet, but it's borderline on a contracting type of service side.



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- Scott Colbert: What's really been hit hard post 2018, probably because of the huge slow down in China and the trade wars, is the manufacturing side of the economy globally. And you can see that is in contractionary territory, but it's just beginning to hook up. And people want to know, they say, "Well, Colbert, when is this economy going to get better? Because we're clearly slowing." And the answer is simply what?
- Speaker 3: [inaudible 00:03:07].
- Scott Colbert: When those lines turn around, right? And what's going to make those lines turn around? Let's think about what's pushed them down. The biggest reason they've come down is the Chinese slow down. China's growth last quarter was 6%. It's hard to believe, but that's the slowest growth in China since 1989. And as they've slowed the world has slowed. The Federal Reserve last year raised rates four times, right? Four times. They've begun to take some of that back this year, but interest rate policy works with a lag, typically about 18 months, and so the world is still absorbing those higher interest rates as we sit here today.
- Scott Colbert: The dollar has been exceptionally strong. Why has the dollar been so gosh darn strong? Dollar's been so strong because our economy, on a relative basis for all the other developed economies, is doing better than anybody else, and we still have the highest interest rates of any developed nation practically on the planet. So when you're a German bond manager, and none of us are in this room I don't think, but when you wake up in Frankfurt and you have a chance to buy the German 10 year treasury at negative 50 basis points, or the US Treasury at positive one and three quarters, you say, "I'll take the extra two and a quarter percent and send it over to America," and that helps boost the dollar. But a strong dollar holds the world back. We'll talk a little bit about that. And then finally, we all know, gosh, we're in the middle of this trade war and nobody's really certain how this is going to end.
- Scott Colbert: Now, we have had, since World War II, 10 recessions, and we are in the middle of the 11th expansion. Here are eight of those expansions. And you can see that, basically, they've had the same upward slope and they've moved up to the right, and they've had about the same velocity. But the last three economic expansions, the longest one was back in 1960. That was a marvelous one where literally, the economy grew by 50% and it occurred over about a nine year period. The longest economic expansion we've ever had prior to the one that we're in was during the Clinton era and ended in the internet bubble. And that lasted for 10 years.
- Scott Colbert: And this is the one we're in today where we're 10 plus years, 10 years and essentially five months into an economic expansion. But note that the slope of the expansion, the magnitude of that expansion is about half, or maybe 60%, of the average other expansions. So why has this expansion,



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remember they used to worry it was going to be a V-shaped expansion, or an L-shaped expansion and it kind of turns out it's a lazy L, I guess. Why has this expansion been so slow? Well, the biggest reason are the three Ds, three Ds to take with you. And these three Ds are largely with us for most of our lifetime.

Scott Colbert: Number one, we've built up a heck of a lot of debt. And this is the debt chart. Aggregate debt peaked at about three and three quarters times the size of the economy. And you could think of this as a family that basically is making about \$100,000 a year pretax and owes 337 to \$375,000. Well as I'd say to commerce, that family that has a \$100,000, Amy will give them a loan, no problem, for \$200,000 on a house, right? Two to one income ratio. And we'll let them buy a Honda Accord and a Ford F-150 and give them a loan for that. Maybe that's another 50,000 that's \$250,000. And maybe we'll give them a credit card. That's another \$25,000, so it's \$275,000.

Scott Colbert: But what happens when you get here, Mark? What happens when you get to this level? And that's where our economy was in 2007 at the peak. Note that this is the only recovery in the history of the planet that has occurred while we are reducing our debt. And this is a perpetual headwind because the boomers, if you will, had so overborrowed that we're beginning to pay some of it back as we approach retirement.

Scott Colbert: So that's the D. The other D is the deficit and I don't bother with a chart here. You all know the deficits are large. In fact, the federal budget deficit was a 4% negative last year and it's going to be negative as far as the eye can see, so the ability to stimulate the economy with deficit spending is small.

Scott Colbert: And then the last D of course is demographics. And we know that the boomers are kind of a... We're working that that pig through the python, if you will, and there's a surplus of people between my age and say 80. And by surplus what I really mean is we've got to get rid of the surplus. How do you get rid of the surplus, Joe? We've got to go. The boomers got to go. I last night I was watching the talk shows and they got that "okay boomer" thing. It'll be "goodbye boomer" thing is what the kids are eventually going to wish upon us. But those three DS are holding us back and that's why we're not going to go back to those 3% growth rates that we've had historically. But that doesn't mean we still can't make good solid forward progress, much as we have in this recovery.

Scott Colbert: Now those are the bad things. The debt, the demographics and the deficits. The good thing is that we have never been wealthier as a country. Net-net, we are 61% wealthier today than we were when I did this deal back in 2009 or December of 2008. We are literally 61% wealthier today and our debts are down. Two thirds of the household debts are attached to a mortgage. I think we can all understand that. The biggest burden here is the student



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loan debt for people that are starting out. I don't doubt that as the policies heat up next year and they talk about, you know, what folks are going to do post the election, that working on the student loan debt is something that you're going to see front and center. But on the other hand, it really is modest to the relative size of the economy and we really have \$115 trillion of wealth, a \$20 trillion economy. So it's about five and a half or five and three quarters times the size of the economy never been bigger.

Scott Colbert:

And there is a multiplier effect to this. Last year when we did this, the stock market was down, everything was down. In fact, the best returning asset class other than cash was what? My lonely bond fund and what did my bond fund return last year, my lonely five-star bond fund? One basis point. That's how bad things were that last year. But this year, we're talking about booming results and there is a positive wealth multiplier effect and it's probably good for literally three tenths of a percent GDP this year in terms of a tailwind that we're going to go into.

Scott Colbert:

Now you can never have a recession if we're making forward progress on employment. And I mean that. If you guys collectively will promise me, we'll just hire one more person next year, this is not a country that goes back unless we're losing jobs. This is the historic employment growth. The bad news was is, during our last recession, we really got whacked. We lost 9 million jobs. How many jobs are there? How many jobs are there in the country? There's 155 million jobs, so we lost 9 million of them. But we've created now, in this recovery, over 20 million jobs and we're still growing jobs at about a 1.3% pace. So we've got 1.3% more people working this year than we had last year and we're paying them about 3% more, plus or minus a little bit. So that's 4.3% more money this year that we have than we had last year. Take out inflation. Four three minus 2% inflation. And what do you get? You get 2.3% economic growth and that's exactly where we're going to come in this year. I just gave you the dirty little secret of every economist, and now you're all closet economists for the rest of your life.

Scott Colbert:

Job growth plus whatever we're getting paid and raises gives you the total amount of money. Subtract out inflation and you get growth. Now notice though, if we start to lose jobs, that equation starts to get uglier. And of course if we stop giving raises, and in fact during the recession, a lot of people had a 0% salary budget. So you can see how quickly that can turn on you.

Scott Colbert:

Now, it doesn't mean that we haven't already peaked. We certainly are through the mid point of the cycle, and the economic cycle has peaked. And the two easiest ways to look at this are in terms of auto sales and home sales. On average, cars tend to be very cyclical. They're about three and a half percent, 3.2%, of the economy and you can see that they peaked about two years ago. And already you're looking at annualized sales now that are sub 17 million and probably approaching 16 million. But car sales never got



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back to the contributor that they were because this was a weaker recovery, but they had already peaked several years ago and they're rolling over.

Scott Colbert:

Housing's the exact same way, only it took a little further lag to get you there. Now housing is a bigger contributor to the economy, but it never got back to exactly where it was either because the last recession, of course, was we built too much housing for too many people or for too few people essentially. And you can see that housing's rolled over even last year. Even with these lower interest rates, it's rebounding a little, but it's not accelerating. So we're clearly on the other half of the cycle. Now the big thing that's holding us back probably from a psychological point of view is this Chinese trade war. And I just put up the headline there. The China trade deficit is two percent of GDP. What does that mean? It means that whatever we import from China is two percent of GDP and two percent of GDP, GDP is \$20 trillion, two percent of that is \$400 billion. Because we import about \$550 billion worth of Chinese goods and services and we export only about 150, the difference between those two, of course, is about 400.

Scott Colbert:

Shannon B is here today. She made that little arrow do that little swirly thing. Let me go back and do that again. This is high tech. Look at that. So, so the trade deficit with China is significant, but it's still only 2% of GDP. When you look at total exports and imports in this country, we tend to import about 15 to 16% of the economy. A lot of people think it's 25, 30, even 50% of our economy comes from China. No. Worldwide, we only import about 16% of our goods and services, and we export 13 so we have a total of 3% trade deficit, but two of it's right there with China. So that's why the focus is on China because two thirds of our trade deficit is there.

Scott Colbert:

Now, how have the tariffs affected trade? Let me tell ya, they're impacting them. We talked to a lot of middle market businesses, and to the extent that they're buying things from China that have now been tariffed, to a person, they've said they've managed to work about half of the purchases out. And you can see that now because basically once the tariffs were implemented, Chinese imports have declined by 14% in aggregate. If it had a 10% tariff on it, they've declined by 35%, and if it has that big 25% tariff on it, and we are tariffing, right now, about half of the goods and services that we buy from China, it's literally down just what those businesses told us, but almost by half. So you can see that the Chinese would be worried if we really do, in December, implement a full 25% tariff across the board because it will mean, and we will import, half as much stuff from China as we used to.

Scott Colbert:

And we are China's biggest customer. We are four and a half percent of their GDP. China to us is much less than one percent. It's a little more than a half a percent of our GDP. So the Chinese have already stopped buying our stuff. They're mad at us, right? And we're mad at them. But it's a much bigger hit to them than it is to us. And this is why I think you're starting to



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see folks come to the table. We would imagine that there's going to be some type of phase one agreement, but I'm guessing that phase two and three, if there is one ever coming, is going to be post the election because I think the Chinese, they've all become political experts and they're almost 99% certain they're going to be dealing with somebody else post the election. I don't know whether that's true or not, but, but they're pretty certain it is.

Scott Colbert: Now, we talked about the dangers of a strong dollar and why our dollar has been so strong because, and I hate that analogy, that we're the cleanest shirt in the laundry basket, but we were talking about college over here and that's when you go to that college analogy, don't you? And we've been more than a clean shirt. We've been spectacularly well-off in this recovery, well ahead of the rest of the planet in terms of what we've done. But 63% of all global trade occurs in dollars. When India trades with Pakistan, they don't do it in rupees. They do it in US dollars. Now when they're trading amongst the European nations, those tend to be in Euros. But short of that, almost everything else is dollar-denominated. 40% of all the debt in the world is dollar-denominated. We only have about 20% of it. So that means these other countries, even China borrows in US dollars.

Scott Colbert: And so when the dollar is strong, it's tough. China does not have a printing press. Well, they probably do, don't they? We know they probably do have a printing press somewhere, but nonetheless, it's tougher for them to come up with those US dollars. Almost all the emerging markets tie their currencies to the US dollar. And so when our dollar strengthens, so does all the other emerging market currencies, and then it's tougher for them to export. And then finally, for you energy experts in there, well you know that energy trades in the US dollar. So a US dollar that's strong holds global growth back. We're hoping that after the cut in interest rates, after we've reduced them here and the world begins to pick back up, we'll start to see some softening in the dollar, which ought to also help global growth.

Scott Colbert: It also will be the signal for you folks to think about international investing because you do know that has lagged so much, but it's lagged primarily for the two reasons, slower growth overseas and weaker currencies. Now, how much further can we go before we have a recession? We're pretty clear about it, that we're not going to have a recession right now and I would tell you the reason for that is largely that there's been so much stimulus put on the pipeline here. But otherwise, our financial system's such great health and of course stocks are at record levels and stocks tend to predict a stock market downturn. They don't usually do that when they're at record levels.

Scott Colbert: And one way you can look and see how much longer we have to go is, these are our leading economic indicators. Now these leading economic indicators have slowed their growth. That's that top of the line. They've certainly slowed their growth, but we are still making forward progress.



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They peak about 11 months prior to recession and then they start to fall. Once they fall, and during the recession they fully recover, and then on average we have about six more years of growth. The leading economic indicators got back to where they were back in March of 2017, so six years from March of 2017 is February of 2023. It's actually 71 months. I'm going to be very exact. In fact February 2023, that's the next recession. Now that's a wide... But there's a wide range of outcomes here, right? I'm pretty specific though. Feb two 23 I'm about to get more specific.

Scott Colbert: The yield curve. We've all heard about the yield curve and the yield curve is basically where interest rates are on the short end versus interest rates are on the long end. To the extent that we have a positively sloped yield curve as measured by the two year treasury versus the 10 year treasury. And today the two year treasury is about 1.6 something percent, and the 10 year treasury is about 1.8 Percent. So there's about a 15 to 20 basis point positive slope between two year treasuries and 10 year treasuries. And this yield curve did invert just a while ago, but now it's back to being positively sloped. You get almost exactly 1.2 years of growth for every year that you have a positively sloped yield curve. And this is very highly correlated.

Scott Colbert: The other statistic I just showed you had a wide range of outcomes where we could be in a recession a year from now or five years from now. This one is almost exactly 1.19 for every year of a positively sloped yield curve. Which also happens to take you, and mind you, I built these charts and graphs, and I've tortured these statistics Robin to give me exactly the answer I was looking for. You're shocked, aren't you? Just shocked. February, 2023. And to get specific, let's make it on Valentine's Day, right? That way we can remember it.

Scott Colbert: Now, the Federal Reserve does not think even that flat yield curve or that inverted yield curve that we got really signals a recession, although it is nine for nine in calling a recession. So this is taking us a little out of the box to tell you that we still think we can grow because it's nine for nine. So you have a perfect indicator that, when it inverts, tells you are about to have a recession. But the reason that it's inverting is because these overseas interest rates are so ungodly low. Just five days ago, the next six largest government borrowers on the planet are only paying 19 basis points to borrow monies for 10 years. This is when we talked about the German bond manager. His rates are negative. They're negative 41 right now in Germany.

Scott Colbert: And so the rest of the world has ultra low interest rates driven by the ECB and the bank of Japan, and those overseas interest rates are pulling on us like gravity because of their quantitative easing. Our interest rates are down because our central bank has quantitatively eased. How much? If you can read those statistics in your chart there, you'll see that basically the central banks have purchased up about a fifth or more of all US and foreign



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government securities driving those rates down. And so the Federal Reserve thinks, if it hadn't been for QE and these ultra low interest rates overseas, our 10 year treasury would be 1.1% higher than it is today or something closer to 3% instead of the 1.8%. So this is why they're willing to ignore this recessionary signal, and it's why I'm suggesting to you that we think we can look past it and that we still have quite a bit of economic expansion still to go.

Scott Colbert:

Now, if you still don't believe me that we're not going to have a recession, I want you to think about what it has taken historically to brake the economy and push us into a recession. Most of us in here have lived through nine recessions. You had the Arab oil embargo where the energy prices were spiking and the fed had to press on the brake to push back on inflation. We had the wage price spiral in 1979, 1981, where Paul Volcker had to raise interest rates to press on that inflationary button. We had the Iraq war in 1990. Energy prices were rising and once again, the fed was braking to push back. In 2000, we had the internet bubble and the fed was braking because they saw that Stamps.com was worth more than Commerce Bank, and it just didn't make a heck of a lot of sense did it? It still doesn't make much sense, does it? And of course in 2007 we had our housing bubble and they were pressing back on that.

Scott Colbert:

In fact, when you look at the last three recessions, on average, it took the Federal Reserve to break the economy by three and three-eighths percent. They had to put fed funds rates  $3\frac{3}{8}\%$ , almost  $3\frac{1}{2}\%$  over trailing inflation. And I think we can all agree that inflation is somewhere around two, which would tell you that the fed would have to be having pushing short term rates to exactly what all the savers in the country want. 5%. They want that 5% cigar, don't they? They want that 5% yield on their savings account. And the Federal Reserve, while it got rates 50 basis points with a two and a half percent short term rate, it didn't get anywhere near to its average braking ability and they've already taken their foot off the brake now and have probably just barely tapped the gas again to continue the economic expansion along.

Scott Colbert:

Now the biggest reason that they're able to give us back some accommodation and reduced rates three quick times is because inflation has been so benign. Inflation's been coming down most of our adult lifetimes. So this is the average inflation that occurred post the 21% short term rate hike and the Paul Volcker squeeze on the economy when we had such high inflation. But even during that recovery, from 1982 to 1990, inflation only averaged... Most people remember inflation as being double digits or high. No. There really was never any double digit inflation. That's just a long memory, a fond memory that most of you have for that 17 and three quarter percent money market yield you used to get for those couple years. But inflation only averaged 4.1% during the 1980 to 1990 recovery. The next recovery, of course during the Clinton era, the 91 to 00, we



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averaged inflation rate of 2%, 2.1%. And this last one before the housing crisis, it was one nine. And the one we're in today, notice a pattern here, four, two, one, nine, has only been 1.6% the way the fed likes to measure inflation.

Scott Colbert: So this is why the fed, with a 2% inflation target, can be accommodative here late in an economic cycle, when historically they've had to press on the brake to fight against inflation. Because they made great progress on inflation, they don't want to let that genie out of the bag. I don't think there's a genie in the bag anymore. Why is there such little inflation globally? In Europe it's less than 1%. In Japan it's been negative. It's largely demographics. The negative population growth in Japan and in Italy. Almost no population growth in Europe except for immigration. Population growth here in this country is slow, materially. And even in the emerging market economies like Thailand, the birth rate is now less than 2%, and so we see them shrinking as well.

Scott Colbert: So I think it's largely demographics and we're going to have to fight that demographic bubble for, largely, the rest of the boomers' lives. Secondly, of course, it's technology. Technology, whether it's businesses... Commerce Bank is a good example of this. We had 4,800 employees, maybe 4,900 employees, when I started here and we were a \$6 billion bank. We still have 4,900 employees and we're a 25 plus billion dollar bank. We're almost four times bigger with the same amount of input of labor. That's productivity. Companies are keen to keep their costs in line. We know that technology has allowed the consumer to shop, price, the Amazon-ation of the world. And then finally, it's probably underrated, but the cargo container ship has been one beast of a product that has literally doubled in size in my lifetime. And with the technology that lets those cargo container carriers get on and off quickly is the technology that affords us, probably, to give you a, I'll assume it's at least \$5, a \$5 speaker here on your table. It's, it had to be more like 25 didn't? Didn't it? But nonetheless, this would've cost us 100 bucks 10 years ago. And you can see it's the, the access to unlimited amounts of foreign labor plus the cargo container ship and cheap energy prices that affords us this deflationary environment.

Scott Colbert: Now only two things are going to happen. We're either going to soft land, like we say we are, or we're going to hard land, and a hard land is a recession. A stock manager has a tougher bet to make here because if in fact we have a recession, within a year, stock prices typically are down about 20%. If we don't have a recession, once the fed starts cutting rates, stock prices are up about 20%. And this is why the stock managers get paid so much more than us bond managers. That was hard. That's a hard... Now we are up 2.7% so far, actually almost three now because I put this chart together, I didn't put the chart together. Shannon put the charts together. Where are you, Shannon? Where are you? You and Dan, are you both here? Between the two of them, they do all this stuff.



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Scott Colbert: This is technology. It worked. When I first started at the bank 30 years ago, we used to have to make all this stuff by hand. Heck, we had slides and ViewMasters and overheads. In fact, I remember the first one of these events, the guy that did it was doing it with a ViewMaster, right? The old ViewMaster on the thing? But the stock market's already up 2.7%, hinting that there really isn't any hard landing coming. But the bonds, when you start cutting interest rates, they fall. They're, on average, down about 60 basis points one year after the fed starts cutting rates, whether it's a hard landing or a soft landing.

Scott Colbert: So if any of you are out there hoping for a lot higher rate environment over the next 12 months, it's never happened. Once the fed cuts rates, those rates are coming down. They're not going back up. Now eventually this curve ought to steepen. Eventually the recovery ought to take hold. Eventually, hopefully, we get some lift, but we can't get any lift until we get those foreign rates up, and those foreign economies have to make forward progress basically to allow us to have a higher interest rate environment. How long has the 10 year treasury stayed below 2% like it is? Well, it's dipped down one, two, three, four times in this recovery already and on average it stays below 2% for seven and a half months. My feeling is that it will be at least seven and a half months before it gets back to north of 2%. and it's at 180 right now, so 20 basis points is just a chip shot. But on average, maybe in another four or five months we might see the 10 year treasury perk up just a little bit.

Scott Colbert: Now, what has that done to stocks and bonds for the year? I think we all know that domestic stocks have had a heck of a year. They're up 20 plus percent so far this year. S&P 500, mid-cap stocks have done just as well as large-cap stocks. Small-cap stocks are chilling a little bit. Yesterday there was a headline story on the Bloomberg. It said, and I wouldn't have known this if there had been a story, but there's been seven times where the stock market's been up 20% through the end of October, and in all seven of those time periods, the stock market has ended further positive for the rest of the year. And on average, the return is 6%. So imagine if I told you here that the average expected return right now is 28% for the stock market.

Scott Colbert: But I did just show you a chart that says if we soft land, stock prices tend to go up. So it's not out of the question that we won't still have a considerable rally. I might add that we are also now in the highest seasonal part of the economy, the November one to April 30 time period. Those six months are the strongest seasonals for the equity market. Now, international stocks have lagged, but they haven't lagged tremendously. And that's largely because the dollar's peaked. It's begun to roll over. And in fact, in just the last month, emerging market stocks and international stocks have actually started to barely outperform the US market. And this is the first time this has happened because basically over the last five years, emerging market



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and international stocks haven't given us half the return, even a third of the return, of the US stock market for the emerging market side.

Scott Colbert: So basically they've been left in the dust while the US has made forward progress. And even my lowly bond fund, my lowly CFBNX bond fund. And by the way, the folks that really manage the bond fund are back here. You want to thank Ryan Craig and Brent Showy and Brian Musialek back there. But we've even returned 8.85% in fixed income securities. And so when I talk about the wealth effect next year, some of this, a very modest amount of it, will get spent. But that modest amount of \$120 trillion net worth is a huge positive for the economy.

Scott Colbert: Now that doesn't mean stocks aren't expensive. This is the longest bull market we've ever had by time. And it's the second highest-returning bull market, up over 340%/ In fact since the bottom, the S&P 500 has averaged returns a 17 and a half percent per year compared to its long run average of 9.8. So for us to sit here and tell you that this is going to continue would be frankly a little bit crazy because we have to ask for valuations to really, really get stretched. But we don't think it would be abnormal for stocks to do better than bonds because interest rates are so low and the yield on my bond fund is now down to about 3%. And so that's about all fixed income would give you is about 3%, and we think that stocks can still do better than that. And you can see that basically based on the PE, they're about average valuations.

Scott Colbert: Here are five different metrics, though, that show you that, in general, stocks, no matter how you want to measure them, are a little bit above their averages. But maybe not one standard deviation rich. But what is it that makes stocks look cheap today? Someone said at my table, it's the acronym TINA: there is no alternative. Because the 10 year treasury of course is so low, the earnings yield on the stock market is essentially one standard deviation higher than what it typically is, which means the inverse of the PE, or the US stock market, has an earnings yield of about 6%, cash on cash. They give it 2% dividends. Company gives about a third of its earnings back in dividends. It buys back 2% of its stock, and it invests about 2% in the company. That's what the S&P 500 does. But it gives you 6% gross earnings. Compared to the bond, the triple B corporate bond market, which is sub 4%. So on a relative basis, this is what makes stocks seem cheap.

Scott Colbert: Now that doesn't mean, though, that these things can go to the sky forever, and this is why we talk about the economy because ultimately it's the size of the economy that keeps asset values in check. Twice in our lifetime, we've seen asset values get really, really stretched. The first time was back during the internet bubble. And on average you can buy up the stock market for about one times the size of the economy. So if you had \$20 trillion in your pocket, who does have 20 trillion? Anybody have 20 trillion



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yet? I know who has it. Jeff Bezos's wife has \$20 trillion, doesn't she? So she might be able to buy up the stock market. But you can see that, during the internet bubble, when stocks were extremely expensive, 1.7 times the size of the economy, we got peaks and the total of all the house that you could buy plus all the stocks you could buy totaled 2.8 times GDP and we had a huge correction. Down 50%.

Scott Colbert: Now we saw this again during the housing bubble when houses got so gosh darn expensive, but stocks were of average price. Still though, the combination of our homes and our stocks, which is almost where all of our net worth is, peaked at again, 2.8 to 2.9 times GDP. Now, here's where we are today and notice that last year about this time it was 2.8 times GDP. We've had a correction, the economy has grown, but we're still pushing on that 2.8 times ratio that historically has been what's pushed us back and brought valuations back down. But neither stocks nor bonds are as egregiously overvalued, either one, but both are becoming more than averagely valued. Why? What's different today than what happened back then?

Scott Colbert: It's that nickel cigar, it's that 5% US ten year treasury. We had a 5% 10 year treasury during the internet bubble. We had a 5% 10 year treasury during the housing bubble. And today, you've got a 2% 10 year treasury, which makes these even more attractive. And so if we're correct about the length of the economic expansion being a lot longer than the average economics forecast for recession, we really don't see that there's going to be much to hold these valuations back and we're likely to, having gone through the full 10 plus years and the longest recovery, we're likely to go into overtime. And it's probably like to stretch valuations, even higher.

Scott Colbert: If there is a bubble, where is the bubble? It's probably in the bond market, right? And it's something that would eventually prick it and inflation that comes back. But boy it's been so dormant and you don't see it around the globe. And we really don't see this as a bubble-like environment. Perhaps in levered credit that's a bubble, meaning all the private equity that's been taken private and all the leverage that's been put on that because interest rates are so low.

Scott Colbert: It's rather obvious, and a home builder was talking to me before we came up here, that any higher interest rates bite harder and faster than they ever have because we are so levered as a society. So any uptake in interest rates does slow us down. But nonetheless, earnings are projected to grow next year. And if we don't have a recession, it sure looks like stock valuations can probably even, and home valuations by the way, can even sneak higher. But we're playing for record territory. We're playing for overtime. And what? We could be wrong. And if that recession is around the corner, the last two times we had a recession, you turn your 401k into a



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201K licky-split because the market was down 50% in 2000 and the S&P 500 was down 55% during the last recession.

**Scott Colbert:** So we think it's an appropriate time to maybe start thinking about taking some risk off your table. Our bond funds have outperformed, our stock funds have outperformed and our balanced funds have outperformed their peers this year because we've been full risk-on in a sense. We haven't taken anything back because we were positive on this economic outlook while a lot of people backed off. But now clearly we are playing for those extra innings or overtime situation. And I would only caution you: the one thing none of you own in this entire environment is what?

**Scott Colbert:** A 30 year treasury bond. And it's the one thing. It's not gold, it's not cash. Cash can go negative during the next recession. But it's those long-dated fixed coupons that nobody wants to buy because who wants to own a 30 year treasury yielding 2.3%? Absolutely nobody. But that is your new insurance policy against a disaster because the next time that rates go down, they're going to go down again to even lower record lows. Now, that's not a downbeat final thing to conclude on, but just to recognize that, to the extent we do approach a recession, you need to start to batten up the ship. We don't think you need to do it yet. We think it's still quite a ways away. In fact, we think it's so much further away than the average economist, I would call that a grossly out-of-consensus-like forecast, but nonetheless, you've got to know that eventually, the cycle will turn.

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