

Market Outlook:

**Transition**

I've been writing for quite some time that the stock markets are being propelled by a lack of suitable alternatives in fixed income, more so than by simple fundamentals alone. As we discussed last week, the more "good news" we hear about the economy (housing starts, earnings, employment data), the greater the risk that "bad things" (price erosion, momentum dissipation) might happen to financial markets. For sure, the fear that the Fed might abruptly reverse course and start to tighten money rates had a major impact upon stock trading last week.

While no one wants to see another recession, neither do we welcome the thought of a major downside capitulation in market valuation. And if the market continues on a pattern of uninterrupted new highs, the latter is likely to occur. Quite simply, valuation expansion is nearing a point of exhaustion.

Gauging the strength and sustainability of the economic recovery is, after all, at the heart of each investor's monetary gamble.

Is all the short-term posturing really of any significance? To be honest, no. It is the stuff of interesting conversation by television "talking heads", and too often the focus of traders and speculators. It is far more important to recognize that interest rate trends *will* redirect upwards, equity performance *will* ultimately revert to historical norms, and long term demographics *demand* allocation into: aging infrastructure; healthcare for citizens (biotech, pharmaceuticals, life sciences); depleting energy and natural resources; technology; and civil defense. In the end, objective intelligence and intuition will own the lion's share of future capital gains opportunity.

**Response**

A concern about inflation is nothing new. The previous five years' unbridled digestion of equities as a surrogate for just about any other investment is as much a psychological compulsion as a fundamental one. As economic data improves, it would only be logical for "price creep" to manifest as well. Inflation is a secular/generational phenomenon. While we may find it difficult to quantify at its inception, we obviously know it when it happens. And once its roots take hold, it spreads into the market in more prolific ways, such as higher energy costs, food costs, wage spikes, and other cost-of-living data.

Whatever the talking points might be, the permanence of the trend could last for years.

The legacy of inflation further permeates into corporate profitability and, thus, market sustainability. In that scenario, **unless top line demand were to expand, commensurate with or in excess of cost pressures, the global equity markets would be held hostage by a consumer that is "stuck in neutral" and lacking confidence.**

When looking to create above average portfolio alpha with diminished volatility it is imperative to build asset allocation models that limit concentrated risk positions and which correlate earnings acceleration patterns with long-term price performance.

Whereas the first three quarters of this year have been more than sufficient for our investment objectives, they are prototypically way above average in expanding risk tolerance levels. Prices versus earnings are too expensive, as measured by RSI (relative strength) valuations. It would be difficult to propose an "all-in" strategy at this juncture as we enter the final quarter of the year.

As alluded to earlier, it is highly more likely that the S&P begins a "distribution" phase as a result of price fatigue than it begins a new period of accumulation and price mark-up. This is not to suggest a new bear, simply the beginning of a cycle reboot.

That having been said, it appears as if fundamentals don't really matter...just our perception of them!!

Full steam ahead. Keep your powder dry.

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