This commentary is not intended as investment advice or an investment recommendation. Past performance is not a guarantee of future results. Price and yield are subject to daily change and as of the specified date. Information provided is solely the opinion of the author at the time of writing. Nothing in the commentary should be construed as a solicitation to buy or sell securities. Information provided has been prepared from sources deemed to be reliable, but is not a complete summary or statement of all available data necessary for making an investment decision. Liquid securities can fall in value.

March 6th, 2018

“Eye of storm” themes

(Trade weighted US$: 86.25; US 10-yr: 2.90%; S&P 500: 2,721; Oil: $63.15; Gold: $1,328; Silver: $16.63)

- Outsized stock returns: it’s about multiple expansion (what we’ve had in “teens”), not EPS growth!
- Est. S&P 500 NPV: realistic EPS growth & apt discount rates (higher insolvency & inflation risks)
- Bonds and stocks “travel together!”
- ROI: strategic returns depend materially on acquisition P/E
- Reversion beyond the mean; from valuation boom to valuation bust is what’s next!
- Valuation reset triggers: bonds and stocks priced for perfection juxtaposed against financial/economic/political storm (we appear to be in eye of storm; false sense of confidence?)

Long term nominal equity returns examined

- Long-term nominal equity returns p.a., whether in the US or other OECD nations, typically mirror nominal GDP growth p.a.

- As such, S&P 500 *bull market* decades were not GDP growth or earnings growth driven, rather they resulted principally from P/E (multiple) expansions in the '50s, '80s, and '90s -- the ‘80s and ‘90s valuation “bubble” was deflated in the ‘00 years:

Decade	Nominal Gross Domestic Product	S&P 500 EPS	Inflation (Deflation)	S&P 500 Total Return
1930-1940	-1.4%	-5.0%	-1.9%	0.0%
1940-1950	11.2%	7.7%	5.0%	8.9%
1950-1960	6.3%	5.4%	2.1%	19.3%
1960-1970	6.6%	5.6%	1.9%	7.8%
1970-1980	9.7%	7.9%	6.3%	5.8%
1980-1990	8.3%	5.5%	6.3%	17.3%
1990-2000	5.6%	7.1%	3.4%	18.0%
2000-2010	4.0%	4.5%	2.4%	1.4%

All table statistics are nominal p.a. growth rates

Sources: S&P, Bureau of Labor Statistics, Ibbotson, Crestmont Research

S&P 500 NPV using 4%, 5% & 7% discount rates, resp., over 3 decades
Est. EPS CAGR of 2.6%, 2.4% & 2.0%, resp., over 3 decades:

S&P 500's est. NPV per share*:		
NPV yrs 17 - 26 (decade):	816	
NPV yrs 27 - 36 (decade):	658	
NPV yrs 37 - 46 (decade):	616	
sum of above:	2090	
less net debt per most recent data*:	414	
= est. intrinsic value:	1676	or 15.3x "puffy" 17 EPS (avg P/E over 147 yrs: 15.7)
share price:	2721	3/5/2018
loss potential:	38.4%	

*- Assumes adequate and affordable dense energy availability with which to generate leveraged output/high ROIs

Please note: S&P GAAP EPS grew from 2006 cycle high of $81.51 to $109.46 by 2017, up 34.3% or 2.7% p.a. (CAGR)

Sources: S&P senior index analyst Harvey Silverblatt, author EPS assumptions, author NPV calculations, and https://dkanalytics.com/dk-analytics-post-25-interest-rate-impact-sp-500-valuation-energy-disconnect/

S&P 500 NPV using 6%, 7% & 9% discount rates, resp., over 3 decades Est. EPS CAGR of 2.6%, 2.4% & 2.0%, resp., over 3 decades:

S&P 500's est. NPV per share*:		
NPV yrs 17 - 26 (decade):	732	
NPV yrs 27 - 36 (decade):	491	
NPV yrs 37 - 46 (decade):	353	
sum of above:	1577	
less net debt per most recent data*:	414	
= est. intrinsic value:	1163	or 10.6 “puffy" 17 EPS (avg P/E over 147 yrs: 15.7)
share price:	2721	3/5/2018
loss potential:	57.3%	

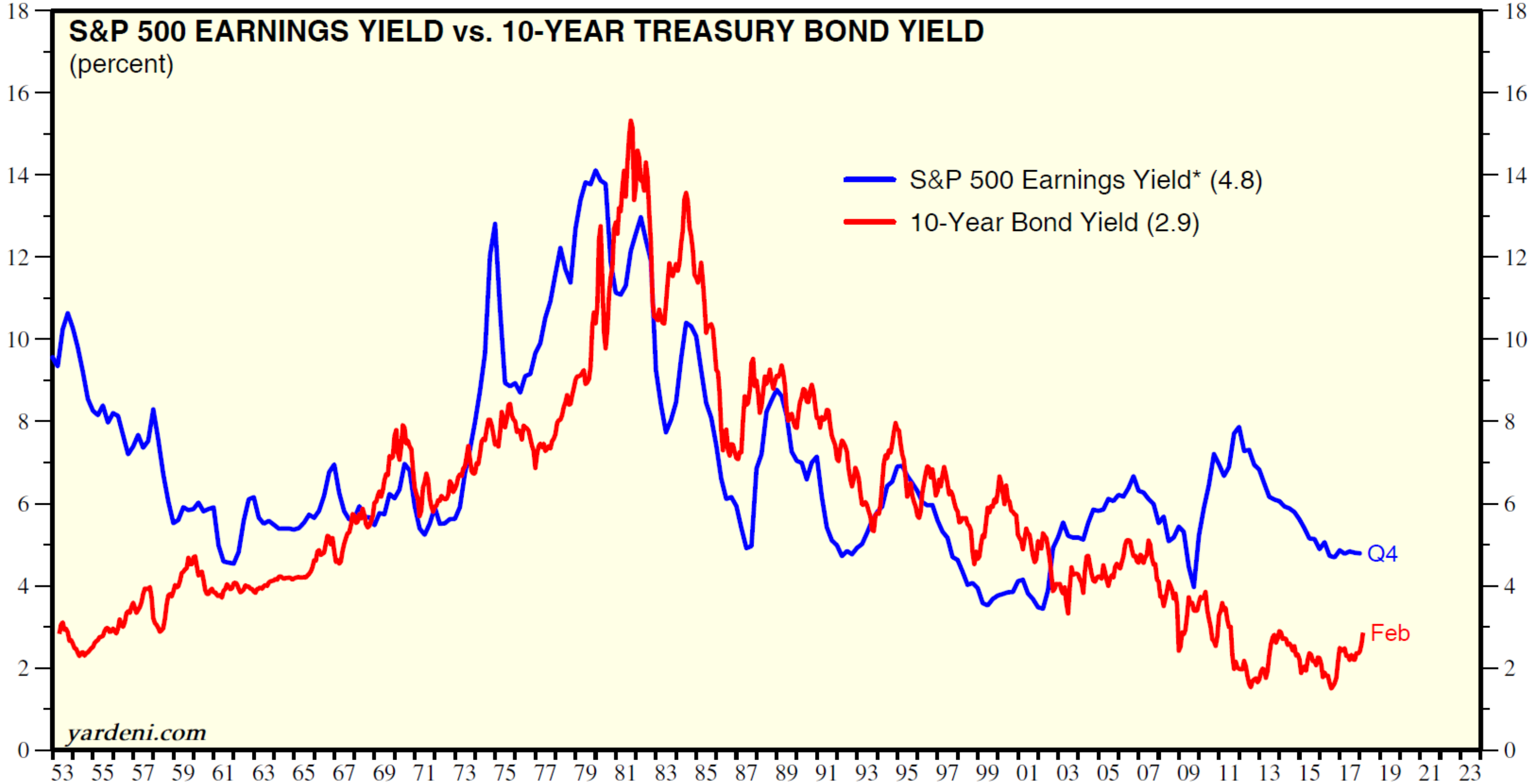
*- Assumes adequate and affordable dense energy availability with which to generate leveraged output/high ROIs!

Please note: if 8%, 9%, and 11% discount rates were used, estimated S&P NPV would be 858, 68% below current level

Sources: S&P senior index analyst Harvey Silverblatt, author EPS assumptions, author NPV calculations, and
https://dkanalytics.com/dk-analytics-post-25-interest-rate-impact-sp-500-valuation-energy-disconnect/

Bonds and stocks "travel together"

Bull markets in bonds and stocks are ignited off high bond and earnings yields!



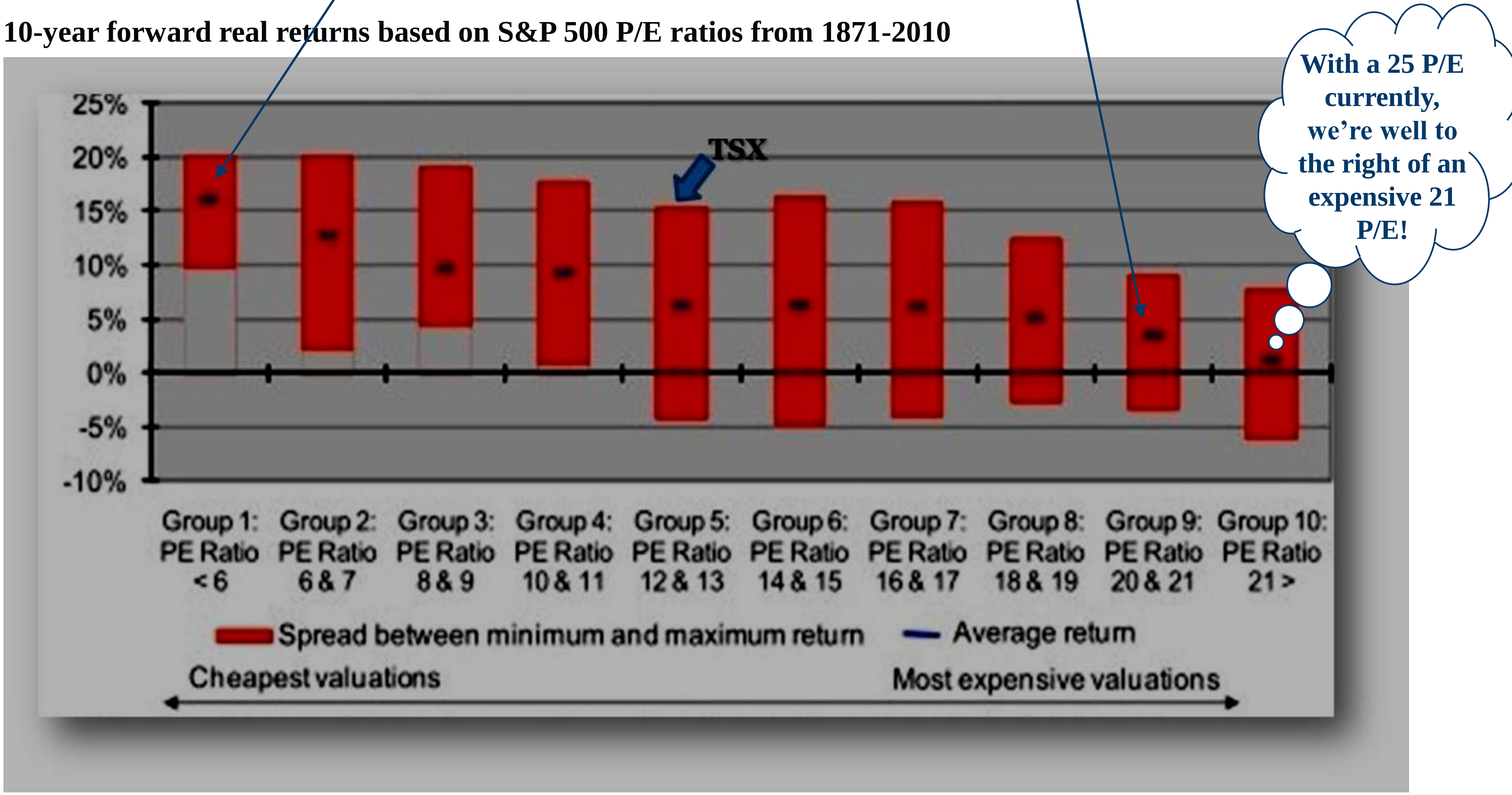
Please note: if GAAP EPS were used after Q3:1988, the current S&P 500 earnings yield would be 3.9% currently

Sources: www.yardeni.com/pub/sp500trailpe.pdf & https://dkanalytics.com/dk-analytics-post-24-stocks-bond-markets-reversion-beyond-mean-machines/

Strategic stock returns depend on acquisition P/E (valuation)

P/E of 6 or E/P of 16.7% (P/E expansion!); P/E of 20 or E/P of 5% (no P/E expansion)

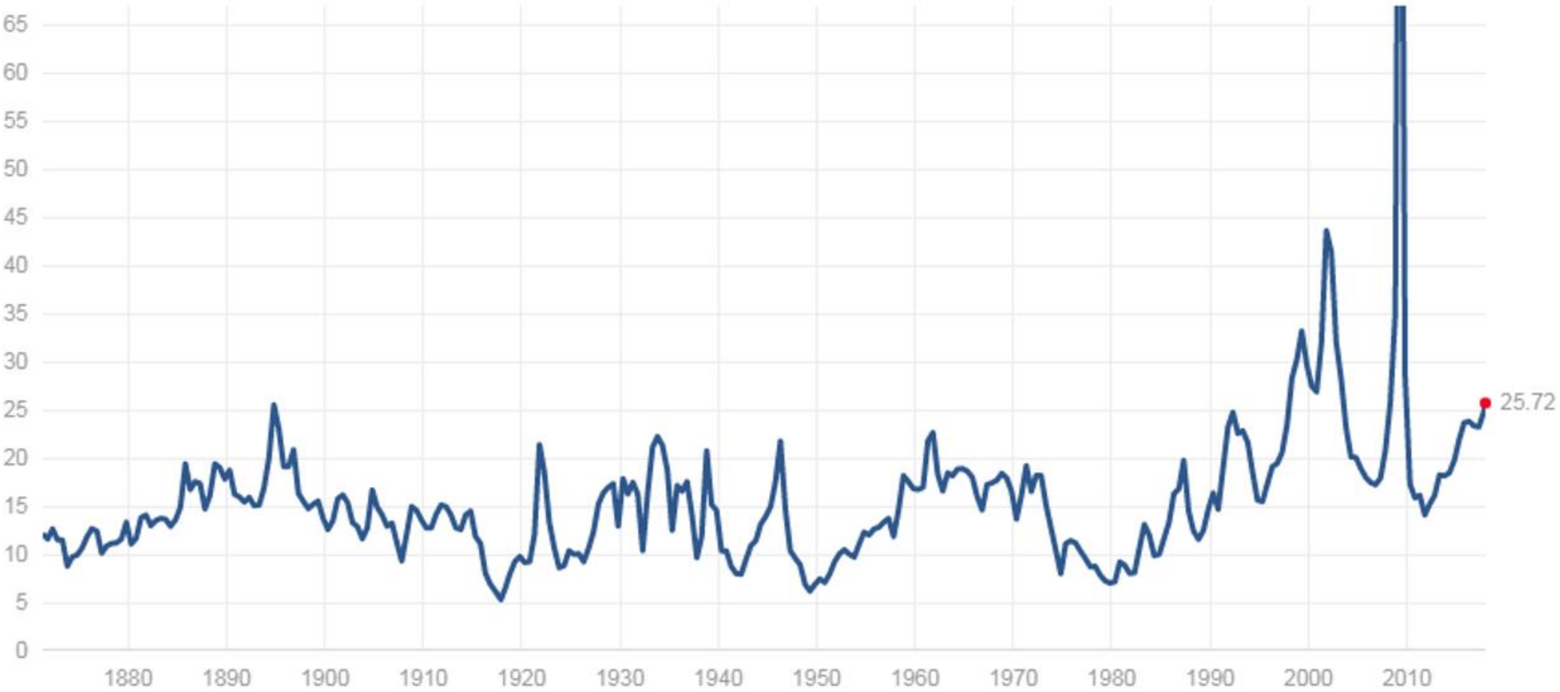
10-year forward real returns based on S&P 500 P/E ratios from 1871-2010



Sources: Plexus Asset Management (based on data from Prof Robert Shiller and I-Net Bridge per 9/30/2011)

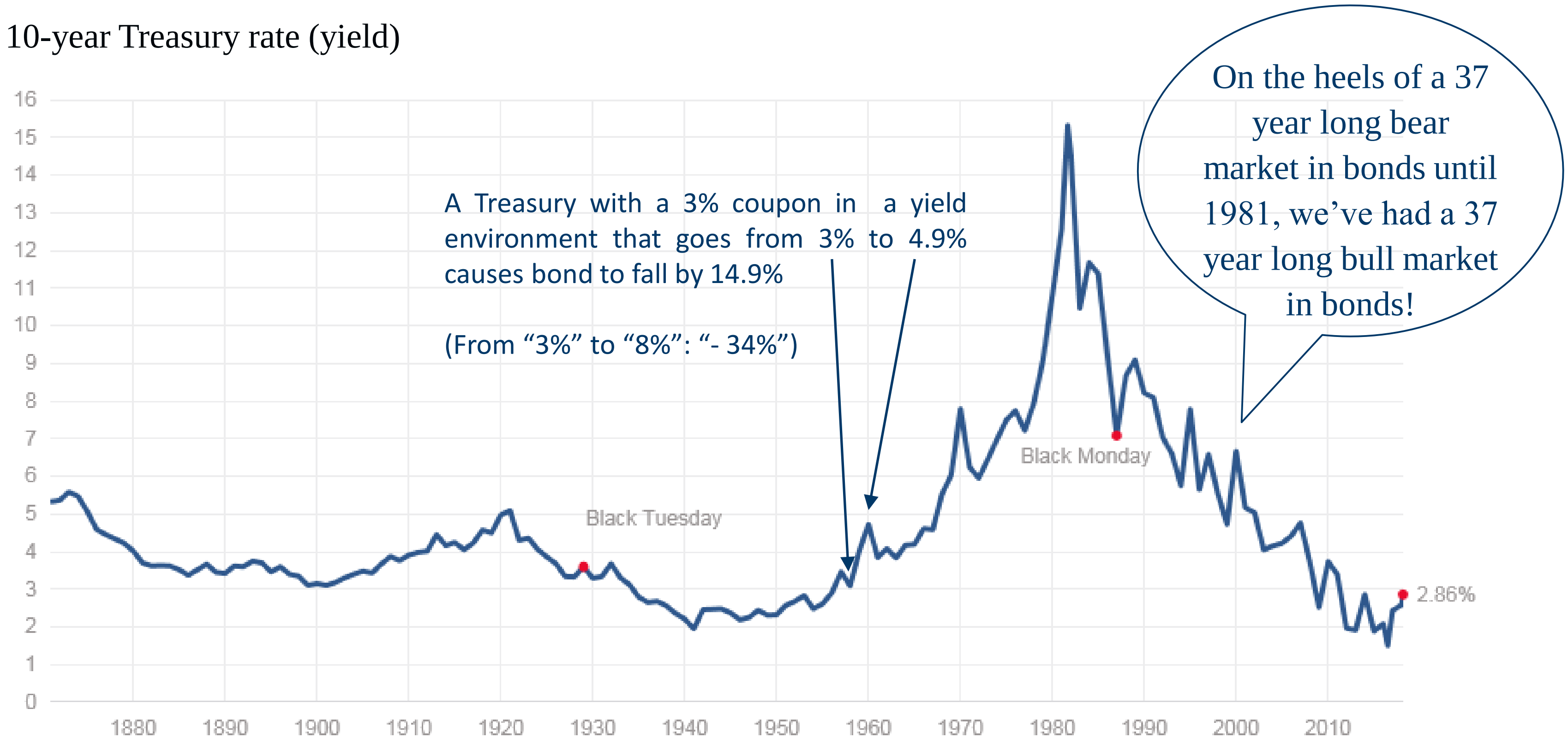
Reversion beyond the mean (we spend hardly any time "there!")
Analysts often talk erroneously about "mean reversion"

S&P 500 P/E ratio



Source: www.multpl.com Mean P/E: 15.68 Median P/E: 14.68 Min P/E: 5.31 (Dec 1917) Max P/E: 123.73 (May 2009)
Definition: P/E, or Price to earnings ratio, based on trailing twelve month "as reported" (GAAP) earnings.

Reversion beyond the mean (we spend hardly any time "there!")
Analysts often talk erroneously about "mean reversion"



Source: www.multpl.com/10-year-treasury-rate; mean yield 4.57%; median 3.86%; min yield 1.40%, July 2016; max yield 15.32%, Sept 1981

Valuation reset triggers: bonds & stocks priced for perfection, …

juxtaposed against financial/economic/political storm (in eye of storm; false confidence?)

- Financial
  - Unprecedented global QE-enabled debt (over $15trn "printed) of $233trn; nearly $68trn debt in US!
  - Hugely interest rate sensitive global & domestic economy: i-rate up 1% pt, + $680bn US interest exp.
  - Over $400trn in OTC/off-balance sheet interest rate derivative exposure (banks bet on low i-rates)
  - Expanding US trade deficit of $600bn; US federal budget deficit to eclipse $1trn; Fed wants to sell $600bn worth of bonds. Over $2trn of USD bonds to hit market! At what price?
- Economic
  - Sharply declining global and domestic productivity growth thanks to "financial repression" and the facilitated/enabled misallocations and cronyism
  - Weak nominal US GDP growth led to lacking organic EPS growth worsened by corporate focus on debt-financed share buybacks (corp. debt Q1:08 $3.5trn, Q3:17 $6.1trn) vs. on robust cap ex & R&D (p.15)
  - An overdue recession will likely "clock" peak EPS by 70% to 80%, as in 2008 -- a fair bet
- Political
  - Loss of rule of law/constitutional fidelity and assaulted property right protections from sound money to redistributionism (Obamacare) to de facto transfers of US (& OECD) taxpayer wealth to Wall Street, K Street, & illegal aliens/refugees -- cronyism and third world amnesty in place of representative gov't
- Lots of thunderclouds, rain to come, & so will "valuation reset lightening." Risks & opportunities!