

Why the U.S. Bull Market Still Has Room to Run

**With Chris Hyzy, Chief Investment Officer,
Merrill Lynch and U.S. Trust**

And

**Michael Hartnett, Chief Investment Strategist,
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MR. CHRIS HYZY: Hi, I'm Chris Hyzy, Chief Investment Officer for Merrill Lynch and U.S. Trust, and with me here today is Michael Hartnett, Chief Investment Strategist for BofA Merrill Lynch Global Research.

MR. MICHAEL HARTNETT: Hey, Chris.

MR. HYZY: Hey, Michael. We've been trying to work through this crazy world we're living in over the past, well, you could say decade plus. I would argue it was crazy before that. But we are clearly getting long in the tooth here in this bull market, and there's a lot of inputs that are coming at us in a lot of different ways, some positive, some negative. You've got the geopolitical equation that is hard to come to grips with, not to mention the trade and tariffs situation.

You've got liquidity, you've got terms like balance sheets coming down or normalization. So I just wanted to put things into perspective. You recently wrote a report in the "Thundering Word: The Long View." And in there you talk about a lot of the components that drove the last ten years and where we are. You mention a lot about different cycle components and how things are beginning to look tired, and there was one phrase that you used which was, you can go a number of different ways, the great bull market is dead. Do you want to just explain what you mean by that?

MR. HARTNETT: Yeah, it was a pun on the Grateful Dead, but even though I don't know a lot about the Grateful Dead. But yeah, the Great Bull Dead was the title. And I think we should preface this, and you've been around long enough to know this as well, is that troughs in markets are a moment. Tops in markets are a process. Greed is much harder to kill than fear. It's just human nature. And so what we're not trying to say is that's it, it was over last Wednesday. What we're trying to say is that the tail wind that has driven this bull market, and boy has it been one heck of a bull market, both in terms of length but also the magnitude of it.

MR. HYZY: Predominantly in the States.

MR. HARTNETT: Predominantly in the States, that's absolutely right. There's a lot of places out there and indeed sectors that have got left behind; but has been pretty forceful. And the big driver, as far as I'm concerned, is the central banks, and the central banks have cut rates I think 700 or so times in the past ten years, they bought 12, 13 trillion dollars of financial assets and pushed interest rates all the way down to zero and they're just not doing that anymore.

And I think that's why outside of the U.S. this year it's been a little bit more of a struggle, particularly in equity markets. I think credit markets have struggled a little bit this year. But the U.S. still has one thing going for it, which is the great earnings story and particularly an earnings story in a sector which is 25% of the equity market, which is technology.

MR. HYZY: So when you step back and you look at the drivers, the primary drivers over the last ten years, what components of those drivers or those drivers in and over themselves are you the most concerned about in the next three to five years?

MR. HARTNETT: I would say number 1 that you don't have the ability of central banks to ride to the rescue as aggressively as they could in the past. That, I think, is something that were there to be a surprise shock, a surprise negative shock in the world, you don't have the monetary--you can't lean on monetary policy just as aggressively as you could in the past. Obviously the Fed has got some room to cut rates, but clearly the Europeans and the Japanese don't. So that's one thing that I think is different.

I think the second thing that potentially is different is the politicians today may react to a recession in a very different way than they did 10 or 20 years ago when globalization, free trade, free movement of people, liberalization, deregulation, all of those things were thought to be much more of a smarter way to address problems, whereas I think now there is a little hint of protectionism in the air, there's a little hint of redistribution in the air. So again, I think the policy reaction, less monetary, perhaps going forward a little bit more populist.

The good news, I think, is the household sector, and indeed I think the financial center, the banking sector are in a lot better place today than they were ten years ago. I think the sector that perhaps has a few more issues that it'll have to deal with is the corporate sector, but I think there are these two big sectors, the financials and the consumer that look in much greater shape.

MR. HYZY: One of the things that you and I, as people who have followed markets for almost three decades now, getting close to that anyway, you hear this term the wall of worry, and you could argue that a good portion over the last ten years, we've had four or five episodes, maybe a little bit more than that, where markets have actually been, or at least have looked like it was over and you had moves, peak to trough 15, 16, in some cases 19½ percent. And we had one literally February and March.

MR. HARTNETT: That's right.

MR. HYZY: And then you see this big divergence between emerging markets and non-U.S. and U.S. since the tariff talk. So my question is could we possibly still be in that wall of worry method where the Fed knows they can't go too far, earnings hang in there, growth comes down because you can't grow at 25% every year, you get some international equities, emerging market equity catch-up, closes the gap, maybe value closes the gap with growth a little bit.

And then the question becomes at what level of interest rates and at what level of earnings growth and at what level does the bull actually get very tired. What are your thoughts on that?

MR. HARTNETT: Yeah, I think firstly, inflation is a make or break for the market going forward. I think that you hit the nail on the head. If the Fed can remain

relatively accommodative, I think that that's a plus so far as markets are concerned, all other things being equal, because critically what that does is that it keeps the glue in place. The glue is the corporate bond market. That's the thing that keeps this--the overall conditions on Wall Street reasonable.

Again, I'm going to repeat, I don't think they're going to be as great, as fantastic as they have been, but I do think that so long as the corporate bond market hangs on in there, the potential for low but positive returns is still pretty reasonable. I think in terms of the other factor that you point to, which is sentiment, positioning, the wall of worry as you call it. Clearly for much of the past ten years people are like, no, this is not for real. This can't be right. We can't be coming back this quickly.

I think there's clearly a little bit more greed in certain parts of the market. I mean, you ought to see that in the price action. But there's no doubt that you and I, we see what our private clients do, we see the way that they allocate their money. I certainly have never felt that the private client world is hubristically long risk assets. You had a bear market in 2000, you had a bear market in 2008. It would be surprising if that was forgotten as quickly. So I think that from the private client side, it's still a fairly conservatively managed portfolio.

MR. HYZY: Our team in the Chief Investment Office, we obviously partner with you and your team quite extensively, and quite a few strategists and economists in BofA Merrill Lynch Global Research. One of the aspects that we are seeing is that when you come out of this big hole that was created from the global financial crisis, mathematics take over.

When you fall so far, and your base is low, and then you rise from that base, given everything that we've gone through, the returns on an annual basis are much larger, and we've seen that. So we are fully in the throes of that return expectation coming down, and that return expectation over the next ten years from a mathematics perspective, call it 40 or 50 percent lower than what we've seen.

MR. HARTNETT: Right, right, I see what you mean.

MR. HYZY: And right now we're at that pivot point, and that pivot point, like you said, could be--it could be two years, it could be three years, it could be four years, it could be five years of when you start to normalize. One of the things that we look at is the yield curve, three-month to ten-year. We look at earnings revisions, the level of earnings. We look at credit spreads, like you talked about. Portfolio flows, sentiment, valuation. A number of things like everyone looks at. So we're still overweight equities on the premise that earnings revisions in the States are still healthy.

The global wave, overall, which is a number of different components, as you know, has not fully rolled over, it's kind of staying static. But we have a healthy concern about all the things you mentioned. If you could point to one or two things

that we must watch in the next few years to give us a better clue as to the cycle being over, what would that be?

MR. HARTNETT: Well, I think you touch on one, the yield curve. I think if the Fed was to aggressively tighten policy because suddenly there was a cyclical burst of inflation and you were to see the yield curve invert, it's very difficult to believe that the market is just going to turn a blind eye to that. I think probably you would see the market turn a little bit more defensively, but it comes back again to that story of inflation. I think one of the reasons that you've managed to have a long bull market and a strong bull market is because we've been in this era of low and fairly benign inflation and interest rates. And as long as that lasts, that will be a good thing.

I think a second story will be the rest of the world, because again, I think that one of the reasons that the Fed funds is at 2%, the ten-year treasury is at 3%, not 4 and 5, is because Japan, Europe, China, their economies haven't got--so I think that you--and of course that's something that is causing the divergence that you call about. If you're going to see the rest of the world catch up with the U.S. in a good way, that is because the rest of the world starts getting better and stops being left behind by all this tremendous economic growth that we're seeing in the U.S.

And then perhaps a third thing would be the dollar and just whether as we saw in the mid-80s, whether there was a dramatic overshoot in the dollar, because currencies never lie. They're very--when they get volatile, currencies, they tell you that something is going wrong. And again, that hasn't happened--

MR. HYZY: Particularly in emerging markets.

MR. HARTNETT: Yeah. But look, I mean, again, if you saw productivity start to accelerate in the U.S., you can make the case that the imbalances, the excesses are nowhere near as great as they were 10 years ago or 20 years ago. It hasn't been that kind of recovery that you've created these tremendous imbalances, and generally that's something that can make it last a little longer.

MR. HYZY: One final thought, one final question, and then we'll wrap it up. From the perspective of what we see in terms of sentiment at the institutional level, the private client level, and the fundamentals, and even the fact that valuations, you can argue in many respects--Savita has written about this--are stretched, particularly in the States. We like to say that the bull is very tired. It's run a heck of a marathon. The question I have for you is, on a final thought basis, when the cycle is over, that doesn't necessarily mean it's 2008, '09 all over again.

It doesn't necessarily mean it's a hard reset to the economy, like we've seen in other times. It could be a smaller reset like we saw in the 1990s a few times. It will have to be determined by the three components you mentioned before. And it also doesn't mean that another cycle cannot build, right. So from the standpoint of what you see in the demographics and what's going on all around the world, in automation, in AI, predictive analytics, and machine learning and X, Y and Zed, over

the next 50+ years, is it likely we could have a restructuring in the global economy which sends us back up in a four- or five-decade further long-term bull market?

MR. HARTNETT: Oh, for sure. I mean, I think that--firstly, I don't think the next recession is going to be a big recession in terms of the real economy. I worry a little bit more the recession on Wall Street could be greater because I think we've done better than Main Street over the past ten years and you can see that reflected in the way the asset prices have risen relative to wages. So I think that --I could see at some point in the next two or three years, a Wall Street recession which is probably greater than a Main Street recession.

But I think, as you say, there's always change, and there's always sort of structural change. I think the obvious three areas to look at, at least in the next sort of 10 to 15 years, one is inequality and how that is, how we find a solution to that. The second is innovation, which we're all very, very au fait with, but it's moving at such speed in so many different directions, whether it's Fintech, whether it's the military, whether it's security, privacy, all of these things. So it's a very rich field in terms of investment opportunities, and threats, to be honest with you as well.

And then I think a big one that we're really just getting to grips with is immortality, is the idea that we're all going to be around for a lot longer. You are in the perfect position because your clients will live longer, they'll have to save more, they'll need investment advice as to how they save, and you're the guy that's going to give it to them. So stick around, because there's going to be plenty for you to do in the next 20, 30 years.

MR. HYZY: I appreciate that. Michael, thank you for your time.

MR. HARTNETT: Pleasure.

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