January 20th, 2015

What, me worry?

Central bank actions around the globe continue to grab headlines – be it from the U.S. Federal Reserve to the BOJ, ECB, and the latest move by the SNB (Swiss National Bank) to remove its exchange rate cap of 1.20 with the euro, which had been in place for the last three years. Last week's surprise move by the SNB sent the Swiss Franc surging almost 20% to a record high versus the euro while the Swiss equity market slumped as much as 12% for its biggest decline in 27 years. The pressure to maintain the 1.20 peg was becoming too much to bear as the Swiss National Bank balance sheet was becoming excessively bloated. The decision by the SNB to abandon its peg to the euro is perhaps a precursor of sorts that the ECB will finally move forward with full-fledged QE following its meeting on Thursday – whisper numbers expect the ECB to announce a €550 billion bond purchase program.

Volatility and choppy trading continued with what has become the theme for the start of 2015, but a Friday rally in equity markets (after five straight days of declines) helped limit the erosion in the major market averages by week's end. The Dow Jones Industrial Average gave up 226 points, or 1.3% while the S&P 500, likewise, declined 1.3% losing 25 points on the week. Gold has been catching a bid with the pick-up in volatility, after all gold is an asset that thrives on uncertainty and has rallied for six straight days to a three month high.

Treasuries moved higher as yields declined with the yield on the 30-year Treasury bond falling to an all-time low last week before ending the week at 2.43%. The 10-year note's yield reached lows not seen since May 2013 and ended the week at 1.81%. Supporting the move lower in yields was a weaker than expected retail sales report, a higher than expected increase in jobless claims, and a cut by the World Bank to its global growth forecast. Corporations are not letting the gift that is lower interest rates go to waste as they have lengthened their average term to maturity on corporate debt to 16.4 years from the historical average of 10.7 years – as an example AIG recently issued a 40-year bond only to be outdone by FedEx who issued 50-year paper.

The housing market is benefitting as well with mortgage rates plunging to 14-month lows of 3.7% and applications soaring (up 30% from year ago levels) in the first week of January. The low absolute interest rate levels coupled with declining energy prices will likely help keep corporate profit margins near all-time highs and pose a significant offset to further tightening in the labor market, if and when wage inflation picks up. However, even though corporate profit margins are anticipated to remain near record highs, lower oil prices and a stronger dollar are forcing analysts to slash S&P earnings estimates for 2015 with year-over-year EPS growth expectations moderating to a range of 2 – 4%.

Crude oil prices found some support last week although in a rare occurrence Brent crude traded below WTI as global production attempts to find its new equilibrium. Where the floor in crude prices lies is anyone's guess, but my belief is that it won't be reached until we have a clearer indication on what ultimately closes the two million barrel per day gap that exists between supply and demand. Furthermore, it takes time for production to be taken off line and right now production almost everywhere is still going up as producers fight to retain market share and maximize whatever profit they can get out of already producing wells. The break-even price levels are significantly lower for projects that have already written the check for the initial capex outlay to get a project to the operational stage. In many cases it is still profitable for these projects to continue to pump – it's the economics on new projects and the reduced net-present- value or IRR that accompany them which will delay and ultimately reduce future supply.

The rig count in the oil patch continues its decent with the total number of oil-directed rigs having now fallen 15% from its recent October peak of 1,609. The total number of oil rigs working in the Williston basin, which includes the Bakken shale of North Dakota, has dropped by 34, or 17%, since October, while the number in the Eagle Ford shale of south Texas has dropped by 32, or 16%. The number in the Permian basin of West Texas is down 81 rigs, or 14%. The decline appears to be accelerating: the North American oil rig count has dropped by 170 in the past four weeks, compared to a decline of 38 in the preceding four weeks. Every bottom – 1986, 1992, 1999, 2002, and 2009 – eventually witnessed the rig count being at least cut in half. So far, the decline has reached 15% which suggests that more is yet to come.

The costs and benefits of lower oil prices disproportionately impact the net results on economic output (GDP) relative to corporate earnings. You see, energy carries only a modest weight in U.S. GDP compared to consumption which makes up nearly 70%. As it relates to GDP the benefit to the consumer from lower energy costs (gasoline in particular) generally outweighs the headwinds of lower energy profits and investment.

But the impact of lower oil prices on S&P 500 EPS is quite the opposite – the direct hit from lower earnings and capex from the energy sector significantly outweighs the positive contribution from increased consumption and lower energy costs. The energy, materials, and industrials sectors (which are most affected by the decline in energy prices) represent over 25% of S&P 500 earnings compared to the consumer discretionary and consumer staples sectors (which only benefit marginally to the energy price slide as consumers are not likely to consume all of their savings from lower energy costs) constitute approximately 18% of S&P 500 profits.

From an earnings standpoint the biggest beneficiaries are likely to be companies that have higher energy costs (these costs decline as oil prices slide) without pass-through agreements/surcharges (i.e. airlines) or retailers focused on low-end consumers, for whom gasoline makes up a higher percentage of disposable income. The companies that make up this segment of the overall market represent a very small portion of overall S&P 500 earnings.

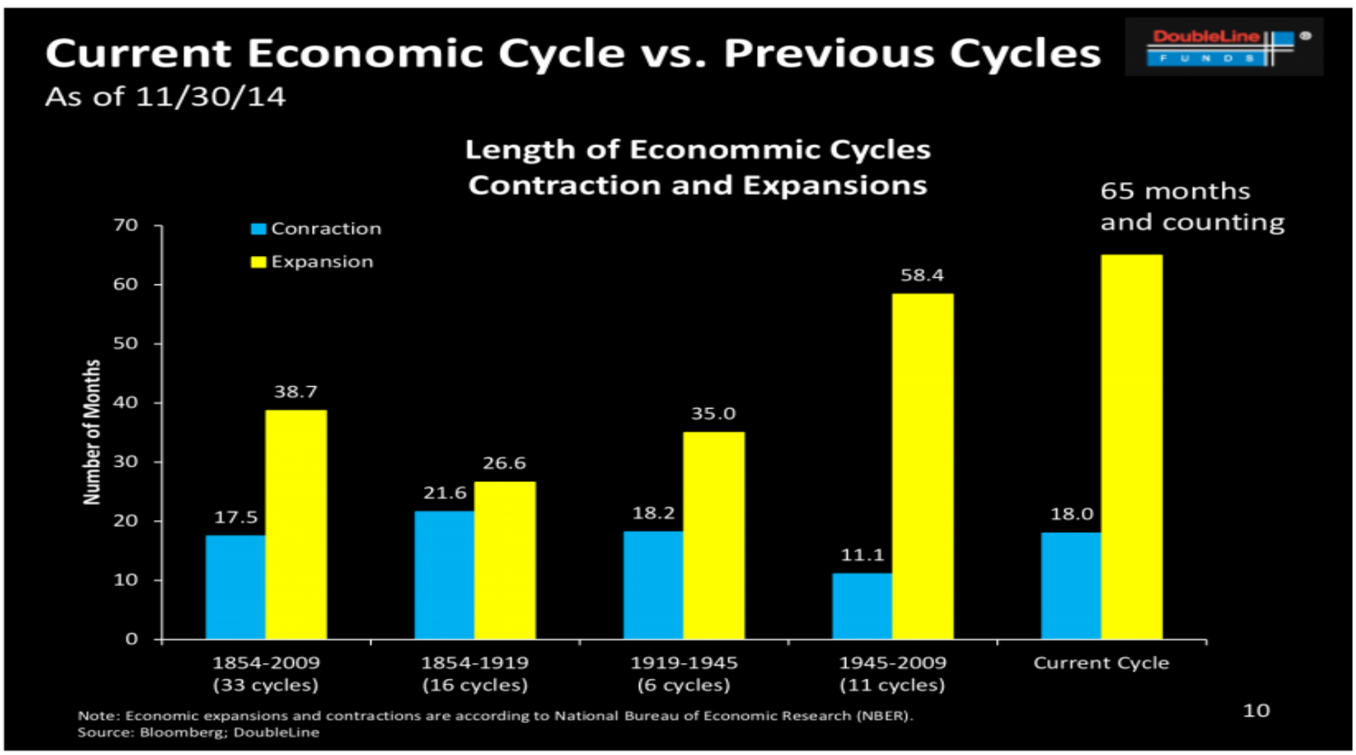
As for the equity market it is currently in the midst of its 15th corrective phase since the bull market began in March 2009 – so the current bout of volatility should not come as much of a surprise as these episodes are part and parcel to stock ownership. The S&P 500 peaked at 2093 on December 29th and at it low of 1988 on Tuesday (January 14th) it has corrected 5% - which isn't to dissimilar to the 4% slide in the S&P 500 last January (on its way to a 6% peak-to-trough decline by mid-February).

According to data from Gluskin Sheff's David Rosenberg – over the course of this 6 year bull market the Dow Jones Industrial Average has amassed a total of 55,962 down points on the down days and a total of 67,029 up points on the up days. So, the price an investor has had to pay to profit from what is the fourth longest and the fourth strongest bull market in history has been to stay the course during the 55,962 cumulative down points – which given the results has been a price well worth paying.

However, the contours of the variables supporting such a move in stock prices over this bull market have evolved to a point where any expectations of a repeat performance over the next six years are, in my opinion, unrealistic. The economic cycle has moved into its mature stage which historically has coincided with the following characteristics:

- Robust, but moderating GDP growth
- Slow return of inflation (talking about Core inflation which excludes volatile food and energy which is compressing the headline readings)
- A Federal Reserve looking to normalize interest rate policy (the initiation of a rate hiking cycle is expected in the second half of 2015)
- Steep but flattening yield curve (last year at this time the 10s/2s curve – 10-year Treasury yield minus the 2-year Treasury yield – was 244 basis points (2.84 – 0.40) and today this measure is a much flatter 134 basis points (1.83 – 0.49).
- Double digit gains in equities (stocks have appreciated by double digits for the last three years)
- Increasing volatility

Now to be sure, economic recoveries do not die of old age: they die of excesses, systematic asset bubbles, overexpansion of cyclical sectors, and/or over-tightening of monetary policy which restricts the flow of credit through the economy. But the following chart from a presentation by Jeffrey Gundlach of DoubleLine shows the average length of economic expansions and contractions throughout time.



As you can see in the post-WWII era (1945 – 2009) the average length of expansions is just shy of five years or 60 months which compares to the current expansion being in month 67 (the data in the chart is through November 2014 of which I added 2 months on to the tally).

So, while the current pace of this economic expansion has definitely grabbed another gear over the last several quarters the thought of this economic cycle beginning to peak-out is starting to enter into my mind. This isn't to suggest that the expansion is over, it's more of the viewpoint that we may be plateauing and how long we can maintain this peak level of output is what is in question. Job gains are at their most robust pace of the recovery, unemployment is at cycle lows, but jobless claims (a leading indicator of employment) have started to increase and last week came in at their highest level since September.

The ISM manufacturing survey results peaked at 59.4 in October and have been on a steady decline ever since (55.5 in December), albeit still firmly above the 50 level that is associated with expansion. Same goes for the ISM non-manufacturing results which peaked at 65 in August, but have declined each month since to 56.2 as of December. Last week the Preliminary University of Michigan Consumer Sentiment for January came in at 98.1, up from last month's level of 93.6 and the highest level of sentiment in eleven years. To put this latest sentiment reading into context - the average level of this index since its inception in 1978 is 85.1 and 87.4 during non-recessionary years – which puts the January reading 15% and 12%, respectively, above average levels.

And it's not just the University of Michigan Sentiment Index that is carving out cycle highs. The Conference Board's Consumer Confidence index for December was at its third highest reading since November 2007. Additionally, the NFIB Small Business Optimism Index for December reached its highest level since October 2006.

These numbers are not an indication that investors should run for the hills and that the tide's about to turn because they are set to rollover tomorrow. What they are an indication of is that the economic recovery and bull market in stocks is no longer a secret – it's well known, and that a lot of the good news is priced in, period. What matters to asset prices going forward is the rate of change in these fundamental variables, but it's safe to assume that we are at a point where a high bar has been set.

I've said many times before that stock market corrections and pullbacks don't concern me much, as they are normal occurrences within a well-functioning financial system. What is worrisome and problematic for me as a steward of other people's capital are recessions. In the normal run-of-the-mill recession earnings decline approximately 22% and the stock market declines about 35%. The chart below from BofA Merrill Lynch summarizes the peak-to-trough decline in GDP, the S&P 500, and corporate earnings during the eleven recessions since 1929.

Table 2: Bear markets since 1929

	1929-32	1937-38	1946-49	1956-57	1961-62	1969-70	1973-74	1980-82	1987	1990-91	2000-02	2007-09	Avg. (1929-2009)	Avg. (1929-2002)	Avg. (1960-2009)	Avg. (1960-2002)
Quarter of GDP trough	1933	4Q38	2Q49	1Q58	4Q60	4Q70	1Q75	3Q82		1Q91	1Q01	2Q09				
Peak to trough Real GDP (%, chg)	-26.7%	-3.4%	-1.7%	-3.7%	-1.6%	-1.1%	-3.2%	-2.7%		-1.4%	-0.3%	-4.1%	-4.5%	-4.6%	-2.3%	-1.7%
S&P price at peak	31.86	18.67	19.25	49.74	72.64	108.37	120.24	140.52	336.77	368.95	1527.46	1562.47				
S&P price at trough	4.4	8.5	13.55	38.98	52.34	69.29	62.28	102.42	223.92	295.46	776.76	676.53				
Peak to trough % decline	-86%	-54%	-30%	-22%	-28%	-36%	-48%	-27%	-34%	-20%	-49%	-57%	-41%	-39%	-37%	-35%
Quarter of S&P peak	3Q29	1Q37	2Q46	3Q56	4Q61	4Q68	1Q73	4Q80	3Q87	3Q90	1Q00	4Q07				
Quarter of S&P trough	2Q32	1Q38	2Q49	4Q57	2Q62	2Q70	4Q74	3Q82	4Q87	4Q90	4Q02	1Q09				
Quarter of S&P trailing 4-qtr EPS trough	1932	3Q38	3Q52	3Q58	2Q61	4Q70	4Q75	1Q83		4Q91	1Q02	3Q09				
Trough EPS ($/sh)	0.41	0.62	2.34	2.88	3.03	5.13	7.76	12.42		18.48	44.19	50.84				
Peak to trough EPS (%, chg)	-75%	-49%	-18%	-22%	-12%	-13%	-15%	-19%		-28%	-23%	-45%	-29%	-27%	-22%	-18%

Note: Bear Market defined as greater than 20% decline in peak to trough EPS.

Source: BofA Merrill Lynch US Equity and US Quant Strategy

This is a part of the business cycle that investors hope to sidestep and navigate as best they can so as to dampen the downside contraction in a portfolio's capital levels.

The current footprint of the economic data is far from indicative that the Great Recession "part deux" is about to commence (I'd go as far as to peg the odds of recession occurring this year as a sub 15% probability), but the possibility exists that economic fundamentals may be nearing a cyclical peak which does enter into the allocation of capital decision each investor must make for their investment portfolio. With the S&P 500 trading at 17.3x trailing 12 month profits and 16.5x forward 12 month estimates (both at a slight premium to historical averages) it's a reasonable assumption to believe that a lot of good news is already reflected in stock prices.

Dartmouth professor Kenneth French dug a little deeper into the underlying valuation level of the S&P 500 and came away with the conclusion that valuations are much more stretched than the headline P/E levels suggest. Using data going back to 1926 the Noble Prize winner found that according to data through June of 2014 the median U.S. stock price stood at a post-WWII high of over 20x earnings. This compares to the median P/E trading around 12x at the depth of the Great Recession in 2009. The median price-to-cash-flow ratio, at 15, was also at a postwar high. Analyzing valuation levels under this method provides a more thorough evaluation of the overall market because most indices are market cap weighted (the Dow Jones and S&P 500 are two examples) which allow the fundamentals of large companies (i.e. Apple, Microsoft, Exxon Mobil, Berkshire Hathaway, Chevron…) to dominate (or in this case mask) the fundamentals of the market as a whole.

From our vantage point, now is not a time to panic nor abandon a prudent long-term investment strategy that is constructed to weather the vicissitudes of a volatile capital market backdrop. However, the list of worries in the global market place are mounting and the divergences showing up in U.S. economic data are consistent with what occurs at inflection points. This doesn't mean the cycle is over, but it is worth monitoring for further confirmation.

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