February 17th, 2015

Stealing from the future…

News of a truce between Russia and Ukraine coupled with rumors of a possible deal being reached between Greece and the Eurozone sent stocks to new all-time highs last week. The S&P 500 rose 2% on the week and took out the previous high reached on December 29th. The equity rally that began in mid-January has been broad based with small caps outperforming mega-caps and international markets outperforming U.S. markets as a confluence of constructive geopolitical and fundamental factors support risk assets. However, over the long holiday weekend we were reminded of how fragile and fluid the execution of these deals can be as the Greek leadership has pushed back against the terms of last week's negotiations and the supposed ceasefire agreement in Ukraine hasn't stopped the bullets from flying.

Last week's economic data was a mixed bag as retail sales plunged 0.8% month-over-month in January (consensus expectations were for a decline of 0.4%) with the decline in oil prices acting as key contributor, pushing gas station sales down 9.3% (the largest decline since December 2008). Core control sales were also soft, increasing only 0.1% month-over-month versus expectations for a gain of 0.4%. Looking at the details: Auto sales declined 0.5%, furniture dropped 0.7%, spending on food was down 0.3%, and clothing sales dropped 0.8%. Where consumers are spending is at restaurants, with this category up 13.1%

year-over-year and the strongest component among other major categories.

The retail sales numbers have been soft for the last two months leaving many economists scratching their heads as there are many signs suggesting we should have a robust consumer on our hands: job growth has accelerated with an average of 336,000 jobs created per month over the prior three months, gasoline prices have plunged, and interest rates have declined. These constructive elements have pushed sentiment measures higher with the University of Michigan consumer sentiment survey reaching levels last seen in January 2004 (the last time we had a booming economy on our hands). The natural outcome should be for consumers to splurge, hitting the malls and going out to restaurants, but the data suggests otherwise. Much of the windfall is being saved as the personal savings rate increased to 4.9%

in December, but this isn’t a bad thing for consumers to continue to improve upon their personal finances, which have been strengthening since the credit crisis.

Also coming in on the weak side of the ledger last week was the NFIB (National Federation of Independent Business) small business optimism index, which slipped to 97.9 in January from 100.4 in December. Expectations were for a slight improvement to 101.0, but the January print remains above the 6-month moving average of 97.3. However, the job front continues to look rock solid as last week’s JOLTS data showed job openings increased to a post-recession high of 5.03mn in December from 4.85mn in November. As a result, the job opening rate increased to 3.5% from 3.3%, the hiring rate saw a small bounce, rising to 3.7% from 3.6% while the separations rate picked up to 3.5% from 3.4% and the quit rate (a Yellen favorite as it indicates the confidence level within the workforce) was unchanged at 1.9%.

All in all, the economic data continues to paint a picture of an expanding economy – albeit at a decelerating rate – as it looks as though Q4 GDP growth will be revised lower to sub 2.0% from the initial 2.6% read. This is a sizable downshift in growth from the 4.6% and 5.0% GDP prints in Q2 and Q3 of last year. Furthermore, the chart below of the Citigroup Economic Surprise Index (which measures how the economic data is coming in compared to economist's expectations) illustrates the deterioration in recent economic data.

Now to be sure, equity markets have done little more than flinch at the worse than expected results, but it is the rate of change that in the end matters most for markets and this data point is one worth watching. Although, given the lack of reaction from the markets, this may in and of itself be an indication that the bar is being lowered for future expectations to surprise to the upside.

A similar story is playing out on the earnings front with 390 companies in the S&P 500 having reported for Q4, with 70% of companies beating EPS estimates and 58% beating on revenues. However, 63 companies have issued negative EPS guidance for Q1 2015 compared to just 11 issuing positive guidance. This is consistent with the 3-month S&P 500 earnings revision ratio (ERR) declining in January for the sixth straight month to 0.61 from 0.63 (this is below its long-term average of 0.85 and at the lowest level since mid-2012), suggesting analysts are increasing their rate of estimate cuts. Equity markets have remained very resilient in the face of these cuts, so, like the economic data, perhaps it's just a lowering of the bar for future beats and that's why the market is looking through this downbeat guidance.

The earnings tally for the S&P 500 for 2014 is a bit muddled as the steep slide in oil prices caused a plunge in earnings in the energy sector (almost a 10% weight in the S&P 500) and companies with pensions have taken a large hit due to the decline in interest rates which have increased discounted liabilities causing a 4% reduction in Q4 '14 earnings per share. Most analysts assume this arithmetic will be reversed in the future when/if oil prices recover and interest rates rise creating the opposite effect and becoming incrementally accretive to earnings (best to smooth out this volatility, but this also plays into the theory of making numbers say whatever you want them to).

Taking the current operating earnings numbers at face value puts trailing four quarters earnings for the S&P 500 at $113.04. With the S&P 500 closing at 2096.99 on Friday, it is trading at a P/E of 18.5 on trailing earnings – a high for this bull market cycle. Looking at the first half of 2015, analysts are now projecting year-over-year declines in both earnings and revenues for both Q1 and Q2 and full year 2015 EPS estimates are for the S&P to earn $118 which puts the S&P trading at a forward P/E multiple of 17.7 (also a high for the cycle).

The elevated valuation levels are one of the biggest constraints curtailing another leg higher in the broad averages. Cliff Asness, co-founder of the global investment management firm AQR, published an analysis on forward equity returns from various valuation levels. His valuation metric of choice was the Shiller PE (also known as the CAPE ratio) which calibrates the markets price relative to the trailing 10 years of earnings to smooth out the normal cycle variability of corporate earnings.

In his analysis he looked at the monthly Shiller PE multiple from 1926-2012 (1,032 data points), broke them down into deciles and then tabulated the subsequent 10-year return by decile based on the starting Shiller PE level. The results are as one would expect – the highest forward 10-year returns are garnered from the lowest starting valuation levels and the lowest returns from the highest valuation levels. In an investment world where the current Shiller PE level is around 25x, these results are worthy of attention.

Results For S&P 500 From Different Starting Shiller P/Es 1926-2012

Starting P/E Low	Starting P/E High	Avg. Real 10 Yr Return	Worst Real 10 Yr Return	Best Real 10 Yr Return	Standard Deviation
5.2	9.6	10.3%	4.8%	17.5%	2.5%
9.6	10.8	10.4%	3.8%	17.0%	3.5%
10.8	11.9	10.4%	2.8%	15.1%	3.3%
11.9	13.8	9.1%	1.2%	14.3%	3.8%
13.8	15.7	8.0%	-0.9%	15.1%	4.6%
15.7	17.3	5.6%	-2.3%	15.1%	5.0%
17.3	18.9	5.3%	-3.9%	13.8%	5.1%
18.9	21.1	3.9%	-3.2%	9.9%	3.9%
21.1	**25.1**	**0.9%**	**-4.4%**	**8.3%**	**3.8%**
25.1	46.1	0.5%	-6.1%	6.3%	3.6%

Source: Cliff Asness, PhD (AQR)

While 10 years is a long time where many things could happen – including even higher levels for this current bull market cycle – the reality is that unless almost a century's worth of market history has for some reason become irrelevant, forward looking return expectations should be moderated.

As a steward of other people's capital, the current valuation backdrop is at the top of the list of items that keeps me up at night. However, the economic backdrop in the U.S. is solid, Europe is improving, China is treading water as it transitions its economy to a more consumption based society, global central banks continue to keep capital markets awash with liquidity, inflation is tame, interest rates are low, and sentiment measures exude confidence among consumers. These are just a short list of items that suggest the seeds are sowed for this cyclical bull market to sprout into a secular bull. But unless we start to see earnings catch back up with stock prices (as has been the case up until mid-2013), thus moderating the valuation disconnect that is being created in stocks, it's difficult to not think that prior year returns have stolen future year returns from present day investors.

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