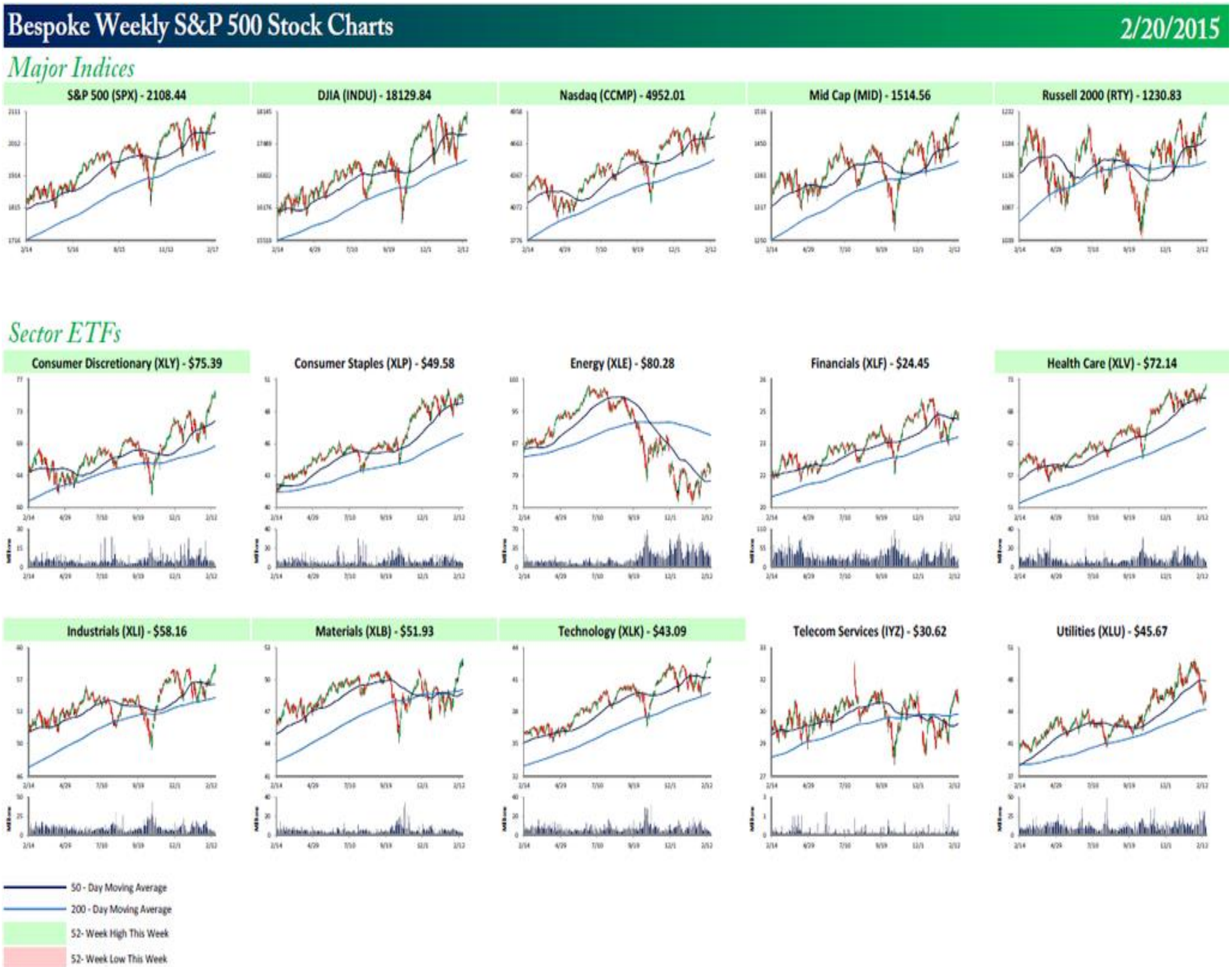
February 23rd, 2015

More often than not, the hardest thing to do is the right thing to do…

As has become customary in the Eurozone, Greece and European finance ministers agreed to 'kick the can down the road' once again as news hit mid-day on Friday that a four month extension of the current bailout agreement was reached. The file is far from closed on this chapter as newly elected Prime Minister Alexis Tsipras is required to submit a plan to the Eurogroup on Monday laying out reforms that Greece will adhere to in order to get their finances on a long-term sustainable path. It's yet another episode of 'extend and pretend' in the Eurozone that will resurrect itself in the not too distant future. What might perhaps be most interesting to monitor is how long Tsipras remains at his newly elected post given he vowed during his election campaign to not only reject the current bailout, but also radically alter the terms and conditions of the existing bailout.

The fact of the matter is that Greece has very little leverage in this negotiation given the fact that the Eurozone financial system has ring-fenced its banks from any cataclysmic fallout as a result of Greece exiting the Eurozone (in stark contrast to 2010 and 2012, the majority of Greek debt is owned by the ECB, EC, and IMF). According to data from BIS, global banking exposure to Greek debt has plunged to less than $80billion from $250billion over the last five years. The Germans hold all the cards and remain unwilling to put the strength of their financial resources behind what is inevitably an insolvent country. However, the Germans are very much aware that it is in their best interest to keep the weak periphery economies in the Eurozone as it affords them a weak currency with which to transact trade across the globe (an extremely valuable stimulus to an economy that is highly dependent on exports).

The news of Greece getting a reprieve set off a risk-on rally in stocks across the globe and sent U.S. equities into the black on the week. The below chart from Bespoke Investment Group illustrates the breadth of new highs hit across various broad market indices. Half the sectors in the S&P 500 are at all-time highs, led for the most part by the cyclicals (Materials, Healthcare, Consumer Discretionary, Technology, and Industrials). The Utilities sector is starting to lose some its shine as interest rates stage a comeback from their January swoon and push up against some key technical levels. It's been an interesting start to the year with practically everything that occurred in January (weakness in equities, a rally in bonds, continued plunge in oil and a strong U.S. dollar) reversing in February. The one constant throughout 2015 has been the outperformance of equity markets outside the U.S. which is especially the case for European stocks which are up almost double the S&P 500's 13% return since the lows of the pullback we had in October.



As for interest rates, last week they continued to retrace the January plunge with the yield on the 10-year Treasury note climbing to 2.14% by week's end after closing at 1.98% the week prior. The FOMC released the minutes from the January policy meeting where heightened debate continues among policy officials about how to best communicate its forward guidance for the eventual normalization of policy rates. Officials continued to highlight the strength in the dollar and weak economic growth overseas as headwinds for further improvement in U.S. growth, and concern over how the market will interpret them dropping the term “patient” from the statement. The overall view on the committee was that the risks to the U.S. outlook were “nearly balanced”, and “several saw those [global growth] risks as having diminished over the intermeeting period.” “Many” worried that the markets might see dropping “patient” as, in effect, constraining the Fed to hike sooner rather than later and thus risking unduly tight financial conditions.

The minutes were sufficiently muddled that a June rate hike still remains on the table, although the odds of a September liftoff have increased. Keep in mind that the minutes are now more than a month old and somewhat stale, making this week's semiannual testimony by Fed Chair Yellen in front of Congress on Tuesday and Wednesday much more relevant.

It's fascinating to have witnessed the increased focus by the capital markets on the evolution of monetary policy since the credit crisis. In my opinion, if the yield on the 10-year T-note was left solely to the forces of the domestic economy, its yield would be much closer to 3.5% than its current 2.14% yield. Yet, with global central banks around the world attempting to stimulate growth through lower interest rates or outright QE, it is little wonder why yields in many parts of the world are at or near all-time lows. Here in the U.S. we continue to have a fed funds rate set at 0% for its sixth year and counting, yet the economic backdrop now compared to when the Fed first took rates to the zero-bound in December 2008 is so much stronger and more stable that it begs the question of why such fear exists by Fed officials to come off the ZIRP floor.

Understandably, they don't want to prematurely hike and ignite a relapse similar to the contraction that occurred in 1937 following the Great Depression, but have they set themselves up for a no-win situation where asset prices have been pushed to artificial levels by unprecedented monetary policy accommodation? Whereby, a rate hike will spook investors out of financial assets of all kinds causing a ripple to matriculate through the economy in the form of lower asset prices, therefore unwinding the wealth effect which was targeted by this form of monetary policy to boost confidence and increase spending. The degree to which capital markets have become enthralled by central bank policy and clinging to every word coming out of the Fed in the interest of ascertaining when a change may be afoot is fascinating. Monitoring how Chair

Yellen threads this needle of normalizing interest rate policy has the potential to be Oscar worthy, if she can pull it off.

The price of crude continues to jump around and in my opinion is showing signs that a bottoming process is underway. Oil prices experienced their first weekly decline in a month with crude oil in storage jumping to the highest levels in 80 years as the U.S. pumps oil at its fastest pace since 1972. Last week's larger than expected build in crude inventories (API numbers showed a 3.1 million barrel build and the EIA data showed U.S. crude stockpiles rose further to a record 425.6 million barrels) caused crude price to plunge, but this weakness was quickly met with buyers moderating the decline. This data was clearly bearish for the black gold yet the price action suggested otherwise, which suggests to me that the worst of this seven month bear market may be in the rearview mirror.

Furthermore, the latest rig count data from oil driller Baker Hughes released on Friday, showed that the number of oil rigs in use fell by 37 last week to 1,019 – the lowest since July 2011 – with combined oil and gas rigs falling by 48. Since hitting a peak of 1,609 in October, the number of oil rigs in use is down by 37%, and in its earnings announcement last month Baker Hughes said that during the last three oil downturns the rig count has declined by 40%-60%.

So, here we are at the lower end of the rig count decline range that historically coincided with a cycle low in oil prices, signs are percolating that capitulation is setting in when we have the likes of major Wall St. research outfits calling for $20/barrel, yet gasoline consumption is likely set to increase – all supportive that a price floor is nearing. According to data from the Commerce Department, over the past six months, 53% of vehicle purchases in the U.S. were light trucks or sport-utility vehicles (vehicles that tend to consume more gas than cars), which was the highest share in a decade and up from 51% last June, when oil prices peaked for the year. Additionally, the Transportation Department estimates Americans drove more than three trillion miles in the 12 months through November, the most since mid-2008 and the biggest annual increase—38 billion miles—in a decade. Now to be sure, it's likely that we will have to retest the late January lows in the mid $40/barrel, but if this level holds it will a pretty strong confirmation that this bear market is over.

As for the economy, the data continue to come in at solid levels, but are indicative of an expansion that is in its mature stage of the business cycle. Both the Philly Fed Index and the Empire Manufacturing survey came in below expectations, with the internals for the former coming in stronger than the headline suggests, but the internals of the Empire manufacturing coming in weaker than the headline. The headline Philly Fed index fell to 5.2 in February from 6.3 in January and is at the lowest level since February 2014 with the new orders index declining, but this weakness was offset by a pickup in shipments, a build in inventories, a jump in delivery time, and an increase in both the workweek and employees index. The Empire manufacturing index dropped to 7.78 from 9.95 in January with the new orders index stumbling to 1.2 from 6.1, but the shipments index jumped to 14.1 from 9.6. The employment index decreased to a still strong 10.1 from 13.7, while the average workweek improved to -1.1 from -8.4.

The jobs recovery is in full swing with the labor market averaging gains of 282k over the past six months, and jobless claims at historically low levels. Initial claims for unemployment insurance declined by 21k last week to 283k (consensus was for a reading of 290k) from 304k the prior week pushing the four-week moving average to 283.5k from 289.75. Last week's jobless claims survey coincides with the BLS monthly employment report survey week and the level of 283.5k on the four week moving average is handily below the 307k four-week moving average level that prevailed during the January payroll survey week, 299k in the December survey week, and 288k in the November survey week – last week's reading was the best survey week reading since October. This augurs that we are in store for another solid employment report when the February data is released at the beginning of March; a print of +200k is a reasonable assumption which would make it 12 months in a row of +200k in job gains.

Producer prices plunged 0.8% month-over-month in January, coming in well below consensus expectations for a 0.4% decline. Energy was once again the main driver, down 10.3% month-over-month, but core prices were also weak, down 0.1% month-over-month. On an annual basis the headline index decelerated to no change from 1.1% year-over-year in December, and will likely head into negative territory next month. The inflation data juxtaposed against the strong labor market complicates life for a Fed that would like to start the rate normalization process, but continues to be conflicted by the diverging paths of its dual objective of price stability and full employment.

Fourth quarter earnings season is winding down and according to the S&P's tally through February 19th, 439 companies have reported with Q4'14 EPS at $26.56, down $0.22 (0.8%) from the previous week and 6% YoY. Trailing four quarter EPS for the S&P 500 is now $112.82, down 1.5% from its level after Q3. This will represent the first YoY decline in EPS since the fourth quarter 2012 which turned out to only be a blip, as EPS growth quickly resumed in the first quarter of 2013 and hasn't looked back since.

However, this current bout of EPS weakness is very likely to persist over the next several quarters due in large part to the stronger U.S. dollar, weak energy prices, and a pickup in wages which are sure to crimp record profit margins (case and point was Walmart's – the country's largest private employer – surprising announcement to give a pay raise to more than half a million employees). Analysts forward EPS estimates for Q1'15 have been revised lower to $26.80 (a 1.9% YoY decline) and estimates for Q2'15 EPS of $29.13 (a YoY decline of 0.7%) bringing trailing EPS to $112.92 after Q2. In effect, trailing EPS peaked at $114.51 in the third quarter of 2014 and in a glaring illustration of how prices can diverge from fundamentals, while earnings growth has contracted in the most recent quarter, the S&P 500 has appreciated by 7% since the end of September 2014.

This is a trend that warrants increased attention and serves as a cautionary signpost that the margin of safety to buffer any downside volatility in equity markets is razor thin. It's becoming increasingly difficult for anyone to argue that the equity market is not richly priced with the value of the U.S. stock market relative to U.S. GDP trading at a ratio of 155% – above the 150% level on this metric at the stock market peak in 2007, but below the 180% level during the tech bubble in 2000. This isn't the only valuation metric registering highs for this bull market cycle, however history has proven that valuation alone is a lousy timing indicator for the stock market, and bear markets are rare outside of an economic recession. According to the models we track, the probability of a recession occurring in the next twelve months remains very low – that is a story that may find an author sometime in late 2016 or 2017.

As would be expected with new all-time highs in a broad array of equity market indices, investor sentiment according to AAII moved up in the latest survey week with bullish sentiment increasing 7.0 percentage points to 47.0%. This is the largest amount of optimism since January 1, 2015 (51.7%), and is firmly above the historical average of 39.0%. Neutral sentiment fell 4.6 percentage points to 35.1%, remaining above its historical average of 30.5% for the seventh consecutive week. Bearish sentiment declined 2.4 percentage points to 17.9% with pessimism at its lowest level since November 6, 2014 (15.1%) and significantly below its historical average of 30.5%.

I've often argued in this missive that there are many elements in the myriad of information that go into making an informed investment decision that an investor simply has no control over. Certain things can't be quantified with numbers nor defined with descriptive words, hence why all investing is accompanied with a relative level of risk – compensation for the unknown. In essence it's a leap of faith, a belief that the future will be more prosperous and bountiful than the past and reward investors for accepting the risk that accompanies said investment. I've long lamented that one of the key variables every investor has complete control over is the discipline they adhere to when managing their capital.

The mosaic of information that feeds through our models and assists us in analyzing the opportunity set of investment possibilities has justified our decision to overweight our equity exposure in client portfolios throughout this bull market cycle. Our analysis of the global investment universe continues to suggest that the equity market offers a more favorable risk/reward trade off relative to other asset classes. However, the conclusiveness of this analysis is becoming more clouded and the risk/reward scale for U.S. equities at today's valuation levels are tipping the way of increased risk per unit of return.

With the S&P 500 having appreciated more than 215% since its March 2009 lows – still in the midst of the fourth largest and longest bull market in stock market history, making new highs as this goes to print, and economic activity at its most secure state of this expansion – I find myself, as a steward of other peoples capital, confronted with the dilemma facing most investors: Do you continue to ride the tide of this bull market with the same level of equity exposure that has been in your portfolio, with the belief that you can get out at a later date and at a higher price? Or, do you reallocate your portfolio by selling stocks when the horizon looks so bright and stocks are at their all-time highs?

Knowing that the stock market is a discounting mechanism for future expectations and equity valuations are pushing up against the lofty levels reached in prior bull market peaks, it's difficult not to surmise that a lot of good news is already priced into this market. Therefore, we believe the prudent course of action at this time is to be disciplined, and we are reducing our client’s exposure to stocks. The Prudent Man Rule posits:

> “to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested."

It’s our opinion that given the current fundamental backdrop, “the probable safety of the capital to be invested” carries more risk than at any other time during this bull market cycle. Hence, our responsibility to our clients dictates we execute the prudence and discipline they expect us to exercise on their behalf.

This isn’t to suggest that we are exiting the equity market in totality, as that would likewise be imprudent, but I'm finding it more difficult to justify maintaining the overweight equity exposure we've held in equities up to this point. This isn't a market call that the bull market is over – I know I'm not smart enough to make that prediction, nor do I believe anyone else is either – but I do respect the more than one century worth of data that suggests future gains on stocks from current valuation levels have been muted.

Therefore, at the current juncture I believe U.S. equities offer suboptimal compensation for the risk one is taking on from this point going forward. If the fundamentals change in a manner that would close the gap that has opened up between fundamentals and price then I am open minded to reversing this decision, but this would require a reacceleration in earnings and revenue growth and no further expansion to an already expensive valuation multiple. Our aim with this allocation shift is to moderate risk exposure to a more neutral position as this business cycle evolves.

It's important for all investors – including those managing capital on the behalf of others – to be honest with themselves and the return objectives that are necessary for them to reach their long-term investment goals. For investors who have had money in U.S. equities over the last six years, you have been rewarded with an average annual return exceeding 15%, and that is likely much higher than your long-term investment goals and objectives. Moreover, it is highly unlikely that this level of returns will be repeated over the next 6 years. So, while it is always hard to execute discipline by reducing exposure to an asset class that has rewarded you so handsomely for so long, it is my opinion that this is now the right thing to do. Investors who have had a higher exposure to stocks than is appropriate for their risk tolerance or financial needs will no longer have the benefit of a capital market setup that fundamentally justified such a position in the past.

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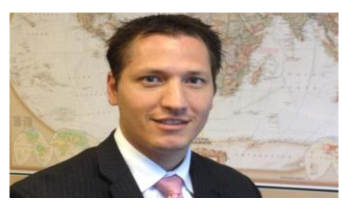

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