January 26th, 2015

Broaden your scope…

Following the lead of the Federal Reserve, the Bank of England (BOE), and Bank of Japan (BOJ), last week the European Central Bank (ECB) announced plans to initiate its own quantitative easing, vowing to purchase 60 billion euros ($67.2 billion) of securities per month beginning in March. The program is set to run through September 2016, totaling €1.14 trillion which would roughly reverse the shrinkage of the ECB's balance sheet over the past couple of years. Between the BOJ and now the ECB the collective total of balance sheet expansion will amount to $1.5 trillion this year – by way of comparison the balance sheet expansion on the part of the Fed in 2014 was roughly $500 billion.

Unlike the Fed and BOJ, the ECB's allocation method is quite different as they have to deal with the sovereign debts of different countries, each with different levels of creditworthiness – ranging from junk-bond status in Greece to the highest-grade status in Germany and Finland. Interest rates for the debt of the very highest-grade sovereigns are already next to zero in the Eurozone. The same is true for nearby sovereigns like Sweden and Switzerland.

The low sovereign yields won't deter the ECB from buying such paper, as suggested in Mr. Draghi's comments that the ECB will acquire sovereign debt even if the yield is negative. Think about that – the central bank will be creating money in order to pay the various sovereign governments for the privilege of buying their debt. That is how a negative interest rate works.

In all of Europe, interest rates on longer-term sovereign debt are remarkably low and mostly lower than in the U.S. The 10-year German Bund yield is just 0.36% (all German maturities under 5 years are trading at negative yields), French 10-year bonds yield 0.54%, the Spanish 10-year reached 1.37%, and Italy's 10-year benchmark sovereign debt touched 1.52% on Friday, compared to the U.S. 10-year Treasury closing out the week at 1.79%. Illustrating just how dire the financial repression is around the globe and the extent to which savers are being penalized, it’s shocking to know that the average government bond yield globally is an infinitesimal 1.14%.

So it goes without saying that the ECB's expectation is not to lower interest rates further – they are already at rock bottom levels near zero – but its likely objective is to further weaken the euro which seems to be on a crash course to parity with the dollar. Following the announcement, the euro traded down to an 11-year low to $1.12 from $1.24 in December and $1.40 a year ago. And the ECB isn't alone in this race to the bottom as last week Denmark lowered its key policy rate further below zero in an attempt to stave off an appreciation in the krone. Our neighbor to the north surprised markets with a cut to its key rate to offset the weakness in its oil-dependent economy. All of this follows the Swiss National Bank's surprising move two weeks ago to unpeg the franc to the euro.

Also weighing on the minds of ECB officials and Eurozone leaders was the outcome of the

Greek elections, which we found out Sunday that voters elected the anti-austerity Syriza party into office – although the party fell two votes short of procuring a majority in parliament. The goal of newly elected Greek Prime Minister Alexis Tsipras will be to form a coalition government in the interest of pushing forward his agenda. High on his list of items to tackle is negotiating a workout plan on Greek debt which will not be an easy task as the brass in Berlin and Brussels are staunchly against granting a haircut on the €240 billion in aid provided by the Troika since May 2010. With Greece projected to run out of money by July, election results which put into power a leader to pushback against austerity policies that have driven unemployment rates in Greece to some of the highest in the world, and the threat of Greece exiting the Eurozone – something's gotta give. My guess is that any negotiation that stands to gain traction will include some form of debt relief for more pro-growth reforms.

How this Greek drama unravels is sure to garner attention from radical parties in many key Eurozone economies, as Portugal, Italy, and even France could see similar political uprisings if they don't do more to break their unsustainable welfare-state models and adopt supply-side economic reforms. The lesson to be learned from this is that the volatility of politics increases without economic growth.

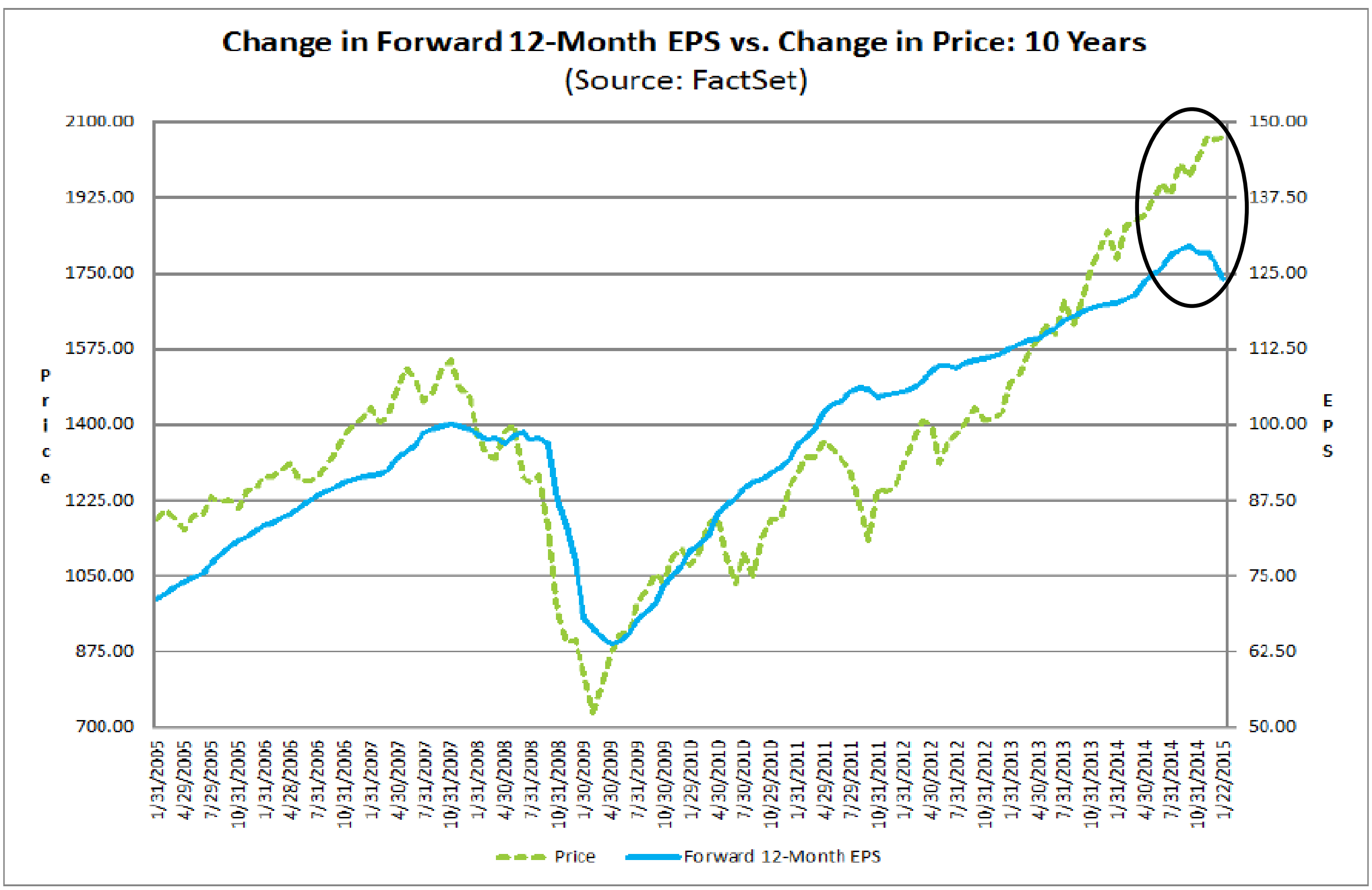
We now have virtually every central bank in a fight against deflation with interest rates near or in some cases below zero, setting off a currency war as countries look to acquire or retain a bigger share of a global demand pie that just is not expanding fast enough to prevent prices from falling. Last week the IMF cut its global growth estimate to 3.5% from 3.8% (this followed a similar cut two weeks ago by the World Bank who cuts its growth estimate to 3%), but at the same time the IMF upgraded the U.S. to 4.0% from 3.3% for this year – citing cheap oil, low interest rates, and supportive fiscal policy factors. The downgrades to growth came from the Euro area, Japan, and China (to 6.8% from 7.1%).

One thing is for sure, the world is not short on monetary accommodation and asset prices love money printing – it's like candy to a child – which was well illustrated with the Dow Jones Industrial Average surging 260 points following the ECB decision. However, what was unnerving was seeing the lack of follow through in Friday's trading as the Dow gave up over half of Thursday's gains. Makes you wonder whether capital markets around the globe are experiencing a bit of QE exhaustion, or better yet investor's acknowledgment that money printing alone won't be enough going forward to move the needle for asset prices. Markets likely are going to need to see some real fundamental improvements in growth and inflation to validate the high valuation levels already in place for debt and equity markets.

Investor interest in gold surely has been revived, and why not given one of the perceived values for owning the yellow metal is its allure as an alternative currency. In a world awash with money and central banks fostering an environment for currency depreciation, as six of the G-10 countries have negative interest rates (either in the money market or up to the front of the bond curve), gold has resurfaced as a quasi-safe haven.

The technical set-up for gold is becoming much more constructive as the 50-day moving average is trending higher and the 100-day has stopped falling. We are not too far away from the 50-day crossing above the 200-day which would confirm that this move is not just a technical, but a fundamental story as well. The bottom line is that the gold bull market that was all but left for dead three years ago is alive and well. Especially in an investment world hankering for an asset as a hedge against a central bank misstep and monetary dysfunction as there is no opportunity cost in holding gold when interest rates are below zero.

Corporate earnings season is off and running with 90 S&P 500 companies having reported Q4 2014 thus far, and according to Factset Senior Earnings Analyst John Butters, 79% of companies have reported earnings above estimates (54% beat rate on sales). However, as result of a poor showing from the financial sector (the earnings results from the large money center banks came in much lower than expectations) and lower oil prices compressing energy company results, EPS growth for Q4 has moderated to sub 1%. At this point investors have reacted to the slowing EPS growth trajectory with a yawn as the S&P 500 has traded sideways since late November. But the chart below depicts the disconnect being created between earnings and price.



The current forward P/E on the S&P 500 is 16.6 which is well above its 5-year (13.6), 10-year (14.1), and 15-year (16.1) historical average. This variable in and of itself suggests caution, but it is completely disingenuous to evaluate equity market valuations in a vacuum given every asset class in financial markets is ultimately priced off of interest rates, which we know are hovering around all-time lows across the globe. Keeping all other variables constant in a time value of money or valuation equation – as interest rates (which is a denominator entry in these equations) fall, they have the effect of increasing the net present value of virtually all asset classes. The toughest variable to handicap in today's global landscape is the appropriate risk premium to assign to assets in an era of unprecedented monetary policy by central banks around the world.

I'll leave the appropriate risk premium debate for another day, as I'd like to focus more on valuations at this time. There is no argument on my part that we are in the more mature stage of this bull market which doesn't mean the run is over, but it does warrant an evaluation on potential levels where the bull market could ultimately peak. What is important for investors to analyze today is the return potential that exists from current levels relative to the potential for loss.

Looking at valuation levels at previous bull market peaks, the historical archives suggest that the peak multiple is some 2 – 3 points above current levels (that's equivalent to about 200 points on the S&P 500). Furthermore, I came across a report from RBC Capital Markets that looked at the last 35 years of data and the subsequent return achieved by investors over various time horizons when buying the

S&P 500 at certain forward P/E valuation levels. At a forward P/E range of 13x - 16x, investor returns over the subsequent 6-months, 1-year, 5-years, and 10-years ranged from 8% - 10% with the 10-year return averaging 8.9%. When the forward P/E level got to the 16x – 19x range the results changed significantly as the 6-month return was 18%, the 1-year return was 16%, but the 5-year and 10-year average returns fell to 3.1% and 5.4%, respectively. When forward P/E levels traded between 19x – 22x the subsequent returns fell substantially to 3% over the following 6-months, 2% 1-year, 0.5% 5-years, and 1.8% over the subsequent 10-years.

The take away from this data is that the easy money from P/E multiple expansion in this bull-run has for the most part run its course. Future price appreciation in the major averages will be on the back of continued economic and earnings growth. From an investment perspective, in my opinion, the time to be aggressive has passed and the time to moderate return expectations, begin the migration in portfolio positioning to a more balanced profile, and refine your investment plan is upon us.

As much as the U.S. is looked at as the bastion of safety in an uncertain world – asset prices here state-side fully reflect this perception – investors are waking up to the idea that there is an entire investable universe out there where valuations are far more compelling at the current time. Per Bloomberg's database, Asia trades at forward P/E of 13.5x followed by Europe at 14.8x and the U.S. at 16.6x. Thus far in the early innings of 2015 investors are recognizing this opportunity, with international equity markets outperforming the U.S. YTD: Emerging Markets +4%, India up double digits, Europe up more than 3%, Hong Kong +5%, Japan +3%, and the list goes on.

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