February 9th, 2015

Separating the wheat from the chaff…

The literal translation of this expression is the process by which the dry husk surrounding the grain is removed to separate that which is useful (grain) from that which is no longer useful (chaff) at the time of harvest. My usage of this expression is more for its metaphorical interpretation (Psalm 1:4 “Not so the wicked! They are like chaff that the wind blows away”) to delineate the persisting disconnect between fundamentally strong economic data with a range bound stock market.

Last week, stocks surged higher moving the major averages back into the black on the year with the Dow Jones Industrial Average jumping by 659 points, or 3.8%, while the S&P 500 tacked on 61 points for a 3% gain. As nice as these gains were, last week's action was just a continuation of a trend that has been persisting since December where the S&P 500 has lost 5%, gained 6%, lost 5%, gained 4%, lost 4%, and now gained nearly 5%.

It's been nearly three years since we've witnessed this level of indecision on the part of investors. This type of market action in the past has been indicative of either a change in market trend or that a long period of consolidation is upon us (my hope is for the latter, but I fear it may be the former). It's still too early to tell what this heightened level of volatility will ultimately imply, although it's not is if it's unprecedented – we've seen similar 10%

trading range patterns in ’94, ’96, ’97, and ’99 – but the fact that the NYSE Composite Index (one of the broadest measures for equity markets) peaked on July 3rd last year and investors haven’t been able to overtake this level (failed in September and again in November) is somewhat troubling.

Furthermore, the market action following Friday’s whopper of a jobs report was additional confirmation that a lot of good news is already priced into equity markets. On the oil front the price of crude closed out last week with its biggest two-week rally in nearly 17 years, even with Saudi Arabia deepening its price discount to Asia and U.S. crude stockpiles hitting fresh three decade highs. The oil rig count continued to decline for the ninth straight week and has decreased by 342 rigs since the start of the year. It was almost two weeks ago when OPEC oil minister Abdalla El-Badri spoke at a conference in London, saying "maybe prices have reached a bottom". Time will tell whether he is right, but by looking at the price action in oil stocks which hit a trough in mid-January he just may be on to something.

It was difficult to find even a morsel of bad news in the January employment report. The headline payroll print showed the U.S. economy created 257k jobs (handily above the 230k consensus expectations), but the revisions to prior months were jaw-dropping – December revised up to 329k from 252k and November increased to 423k from 353k (all-told the revisions tallied +147k). In a sign that job growth is clearly gaining momentum, payrolls have averaged a gain of 336k over the last three months and job creation in 2014 was the strongest since 1999.

Moreover, average hourly earnings surged 0.5% month-over-month, more than reversing the weakness in December and pushing the year-over-year rate up to 2.2%. Revisions to average hourly earnings also indicated a better trajectory for wage growth over the last year and the work week remained at cycle highs of 34.6 hours. In an attempt to negate the overall strength of this report some bears may point out that the minimum wage was hiked in 21 states at or after the turn of the year (Florida, New York, and New Jersey were some of the bigger ones), but wages are wages in no matter what form they come to you.

While the path for wages is higher, wage growth does remain at a sluggish pace with wage inflation suggesting there is still considerable slack in the labor market which is only being worked through gradually. However, some workers are taking it upon themselves to instigate a raise as the United Steelworkers strike continues, encompassing over 5,000 workers at 11 refineries across the country and then there is the contentious labor dispute disrupting activity at the Port of Los Angeles – both are indications that the bargaining power of labor is gaining some leverage.

The Household survey validated the strength in the establishment survey as employment surged by 759k following a soft 111k gain in December, with most of these gains coming in the full-time jobs variety (777k). In a sign that the unemployed are gaining confidence in the jobs market, the labor force expanded by 1.05mn, pushing up the participation rate to 62.9% from 62.7%, bringing it back to November 2014 levels. This caused the unemployment rate to tick higher to 5.7% from 5.6% and the broader U-6 measure ticked up to

11.3% from 11.2%, but those out there with a college degree have steadily seen their unemployment level fall from 3.2% in November to 2.9% in December to a six-year low of 2.8% in January.

Employment in the 25 – 34 year age cohort rose by 188k and is running at 3.5% year-over-year rate which is a very solid data point for the housing market, as this demographic is gaining confidence with their new found jobs and finally coming off mom and dad's payroll and moving out of the basement. Over the last 12 months, the number of new households being created has risen by 1.96mn – which is the most since 2005 when housing starts were running closer to two million units per year from today's one million units – the housing market looks to be taking the growth baton from capex which is set to slow as a result of the slide in oil prices.

The reaction in the bond pits to the employment report sent yields surging as the yield on the 10-year Treasury shot up to 1.94% from 1.81% in its largest one-day gain since November 2013. The late Friday afternoon announcement from Standard and Poor's rating cut to Greece's sovereign debt did little to shift the sell-off that was already well entrenched.

The strong jobs report put a June rate hike by the Fed back on the table as the yield on the 2-year T-note surged almost 13 basis points to 0.65% – its highest level in a month. Additionally, the probability of the fed-funds rate reaching 0.5% by the September 16-17th meeting shot up to a 63% probability from less than 50% a week ago – so all eyes will shift to the March FOMC meeting which is accompanied by a press conference for further clues on how Chair Yellen will verbally brace markets for an eventual hike.

I'm not sure how much to read into the sluggish nature in which stocks traded Friday, with the Dow giving back 60 points following such a blowout employment report. Perhaps it was just catching its breath following the 715 points it added during the week going into Friday's trading, but the volatility being exhibited not only in stocks but also in currencies, commodities and bonds suggests that change is afoot.

Undoubtedly the U.S. economy is the envy of the global world at this time, but at some point this gets priced in. The stock market is not the economy and vice versa, hence why we can witness the U.S. economy expanding at its most robust pace since this recovery started back in 2009, yet the stock market has been unable to find its footing for the last six months as it does little more than tread water.

The equity markets may in fact be sniffing out a subtle moderation in segments of the economic data which have the reputation of being leading indicators, rather than employment and wage data which are lagging economic indicators that are still on the incline. The January ISM manufacturing survey slowed to 53.5 (a 12 month low) from 55.1 in December, 57.6 in November and 57.9 in October, suggesting that the pace of manufacturing activity is cooling off, but far from contracting. Now to be fair the 53.5 reading is still a very solid level that is historically consistent with GDP growth above 3%, but the fact that four of the five main subcomponents declined is something worth monitoring. Additionally, U.S. auto sales for January came in at 16.6 million units at an annual rate – up 9% from a year ago, but below the 16.8 million sales pace in December.

You see, the stock market has been and always will be a mechanism that discounts future expectations back to a present value figure. The fact that the economy is picking up is old news to equity investors, hence the rally in stocks of 15% in 2012, 30% in '13 and 11% last year. Since the March 2009 lows, the S&P 500 has surged 200%, the Euro Stoxx 600 by roughly 130%, and the MSCI Asia index is up almost 100%, but these markets all trade at distinctively different valuations today – S&P 500 forward P/E of 17x, Stoxx 600 is 15.5x, and Asia is at 13.5x.

These markets outside the U.S. are not only trading at a valuation discount (some of them for good reason), but they are also going to be the beneficiaries of increased monetary policy support and/or cheaper currencies that bolster their competitiveness with foreign trading partners. Monetary policy in the U.S. is transitioning from a tailwind to a headwind and the 15% appreciation of the dollar over the last eight months is a de facto tightening of financial conditions which is also inhibiting EPS growth as has been clearly pointed out in Q4 earnings season. On this front the GDP data suggest that profits may no longer be slowing but actually contracting, which will create a challenge for U.S. equities unless investors are willing to push valuation multiples that are already at historical averages to even more expensive levels.

This isn't to say that investors should go out and sell all their U.S. based investments and reallocate their equity exposure to foreign markets. While Europe has been putting up some better economic numbers of late (composite manufacturing & services index for December came in at 52.6 from 51.3 in December and sentiment in the Eurozone has improved to its best levels in four months) but they still have to deal with the latest Greek drama and what the potential domino effect this will have on the rest of Eurozone.

At the current time the Greek government and European authorities are engulfed in a classic game of chicken, as each is holding firm on positions at opposite ends of the spectrum. The Greeks remain adamant that they will not ask for an extension to the bailout mechanism with both Tsipras and Varoufakis confirming that a bridge agreement is required for Greece to work-out a long-term solution. The Eurozone, led by Germany, wants Greece to continue to commit to honoring its financial agreements following the funding that was provided to bail them out when they were on the brink of insolvency during the European debt crisis in 2011.

As rancorous as the talks are right now, (the move by the ECB to terminate access to one of the sources of liquidity for Greek banks, forcing it to tap a higher cost alternative was a clear indication to Greece that their options are becoming limited) compromise is still the logical bet to make. From the European perspective it is important that a message is sent to any other government or any other anti-austerity movement in the rest of the periphery (Spain, Portugal, and Italy) that confrontational tactics entail a cost and if Greece has to be the example, so be it. At last check the Greek population is about 11 million people and its footprint on the Eurozone is approximately 2% of GDP. Furthermore, European banks have significantly reduced their exposure to Greek debt and a Greek default or a Grexit, while negative in the short-run, will not have long-standing ramifications on the European financial system. It would definitely sap growth out of the system, but likely would not create a calamity rivaling the ’08 credit crisis.

Those that have been reading this missive over the last couple of months have a sense of the lack of conviction I have towards the capital markets at this time. I’m having a difficult time squaring how to feel about the fact that roughly 75% of the world economy is now anchored by zero or negative short-term interest rates, Sweden and Austria have negative yields out as far as five-years, German debt has a negative yield out to the six-year part of the bund curve, negative yields in Switzerland go out 13 years (oy vey), central banks around the globe have cut rates 542 times since the failure of Lehman Brothers, global central bank assets total $22.5 trillion (a sum larger than the U.S. and Japanese

GDP), and central banks alone now own 25% of the global sovereign bond market.

Using the last four years as a guide, since the initial launch of QE in the U.S., this form of monetary policy has been supportive of risk assets. However, given that the jury is still out on the efficacy this form of policy support provides to foster a pickup in economic growth, one must wonder what it symbolizes that fixed income investors are willing to trade off a negative return on their money for the security of getting less back. Even in the corporate bond sector you have the likes of Nestle and Shell bonds recently trade at a negative yield – Apple just last week issued $6.5 billion in bonds, including a 30-year bond at a yield of 3.5% (it's dividend yield is roughly half that level and the company already has $178 billion on its balance sheet).

On the surface this suggests to me that there remains an extreme level of risk aversion in the investment world today. When you see investors willing to get paid less at a later date for the certainty of payment it puts a whole new meaning into the tradeoff all investors face on whether they prefer a “return on capital or a return of capital”.

I continue to be of the opinion that investors should be moderating risk exposure in their portfolios – not abandoning it, but running a more balanced risk allocation than the last couple of years. So to say, “separating the wheat from the chaff” as the unfortunate reality for investors today is that the investment environment is one that does not offer very compelling future expected returns – cash pays next to nothing (negative returns in some segments), bond yields are near all-time lows in many regions across the globe, real estate values have been bid up as a result of cheap money, commodity markets are over supplied with low global growth unable to sap up the excess to bring prices into equilibrium, and equity valuations are fully priced.

As I've said before, have a plan, stay the course, make adjustments along the way, and don't lose sight of your long-term objectives due to intermittent noise which will always be present.

> *"I will not abandon a previous approach whose logic I understand even though it may mean forgoing large, and apparently easy, profits to embrace an approach which I don't fully understand, have not practiced successfully and which, possibly, could lead to substantial permanent loss of capital."*
> – Warren Buffett

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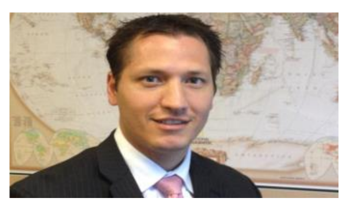

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