April 13th, 2015

When did Noah build the ark?

Equities rallied for a second straight week last week as the Dow Jones Industrial Average pushed back above the 18,000 level and the S&P 500 reclaimed 2,100 (only a couple points shy of its 2,114 all-time high reached on March 23rd). The real fireworks are being set off in international markets with both Europe and emerging markets gaining nearly 4% on the week, with emerging markets having logged a 10-day winning streak. Hong Kong shares have increased for seven straight days launching the index higher by almost 13% over that time. The buying in Asian markets has become so frenetic that the Shanghai stock market is up almost 100% over the last year. According to data from Bloomberg the total value of equities listed in Hong Kong have surged to $4.9 trillion, putting it just a whisker below Japan's total stock market value of $5 trillion dollars (the U.S. is the largest stock market by value at just under $25 trillion with mainland China a distant second at $7 trillion).

Economic momentum has really improved in Europe, to the point where whisper numbers are that economic growth in the region could be stronger than the weak Q1 GDP reading expected for the U.S., which has pushed the Euro Stoxx 600 beyond its March 2000 peak. The outperformance of European equities this year relative to U.S. equities is not smoke and mirrors, and is justified on many metrics:

- Earnings momentum is stronger across the Atlantic, as is seen in the earnings revision ratios.
- Economic growth and investor expectations were far lower coming into the year than they were for the U.S. As a result, more than $50 billion in fund flows has found its way into euro area equities so far this year while almost $60 billion has been taken out of U.S. equities.
- Monetary policy by the ECB is where the Fed was in 2010, with QE just being initiated in March – like it or not this has proven to be a rewarding proposition for risk assets in today's capital markets.
- The income compensation investors can procure from dividends by owning stocks in Europe outstrips the interest income they can receive from bonds by a factor of three.
- The tailwind from a more than 20% decline in the euro has greatly buttressed economic growth in the region.

One item that should foster some cautionary thinking going forward is the fact that the trailing P/E multiple on the Stoxx 600 has risen from approximately 14.5x a year ago to over 19x today – versus an increase from around 16.5x to just over 17x for the S&P 500.

Undeniably the economic data to kick off the year has been a bit squishy (similar to the start of last year), but expectations (mine included) are for the Spring to bring a thaw that reinvigorates an economic recovery that is now moving into its 70th month (ranking in the top ten of the longest expansionary cycles since the 1850s). The start to this year has had to contend with the fifth coldest March in recorded history, a significant and quick appreciation of the U.S. dollar, and a West Coast port strike that crippled shipping, manufacturing, and inventory channels for several weeks. Keep in mind that it is not uncommon for the economy to experience a quarterly hiccup with a sub 2% GDP print in a non-recessionary period, as has historically happened roughly one-third of the time (in most cases it is the result of transitory headwinds).

Last week's strong ISM-nonmanufacturing reading (keep in mind that the U.S. economy is dominated by the service sector and this report is much more relevant than its brethren ISM-manufacturing index) and solid initial jobless claims data confirm that the U.S. economy hasn't fallen off the wagon. Furthermore, The Job Opening & Labor Turnover Survey (JOLTS) increased by 168k in February to a new cycle high of 5.133 million job openings (this is the second highest reading on record since the data started being collected at the end of 2000).

In the overall scheme of things, the worse than expected March payroll report was only an outlier relative to the strong string of payroll gains we've experienced over the last twelve months. Relative to other expansionary cycles, the 126k in payroll gains we had in March is actually par for the course. In 2004 (the year the Fed set out on its rate hiking cycle during the '02-'07 expansion) the U.S. economy generated four such employment reports, but that didn't stop the Fed nor the economy from expanding for another three years.

While I do believe it would be imprudent to completely dismiss the recent soft patch, I don't think it's worthy of significantly augmenting a portfolio's composition until a more discernible trend is apparent. At the current time the soft patch in the economic data looks to me like mere noise, as the broader fundamental constructive elements of this recovery remain in place:

- Housing continues to heal with home prices (according S&P/Case-Schiller) rising at a more sustainable level of 4.6% in the past twelve months.
- Households are wealthier than they've ever been with debt service ratios falling to their lowest levels in the 25 year history of the data.
- The more than 2 million in job gains over the last twelve months coupled with the savings rate moving up near 6% (the highest level in several years) is kindling for pent-up demand.
- Banks are more than sufficiently capitalized.
- Inflation remains low, but is showing some verve in the right places – namely wage growth is picking up.
- Stock prices are 10% higher over the last 12 months.
- Both the Michigan and Conference Board measures of consumer confidence are back to pre-crisis levels and have surged 16% and 21% respectively in the last 12 months.
- Oil prices appear to have bottomed, but continue to remain low which should bolster consumer spending as households start to believe that lower gas prices will be sticky at these lower levels for some time to come.

In a nutshell, the economy has operated in fits and starts throughout the duration of this expansion and has earned the benefit of the doubt. None of the economic indicators we monitor are flashing red from a recessionary standpoint, so I believe it behooves investors to not get too caught up with what appears to be yet another minor setback for what is otherwise a continuation of this almost six year old economic expansion.

Corporate activism has ignited a spark under the equity markets with several large scale deals or restructurings announced last week: FedEx looked to bolster its presence in a recovering European region by launching a $4.8billion dollar acquisition of TNT Express, Royal Dutch Shell made a move to take advantage of the value opportunity being created with the bear market in oil prices as it announced a $70 billion acquisition of BG Group, and General Electric inked a deal to further separate itself from its financial division – selling almost $30 billion in real estate assets while announcing a plan to return almost $90 billion to shareholders over the next several years (GE stock ended the day up more than 10% and over 14% on the week).

It’s nice to see that animal spirits are alive and well as corporations move to fulfill their objective of creating value for their shareholders, but it begs the question of how much of this activity has to do with the dearth of organic growth opportunities companies can wring out of an underinvested corporate infrastructure and how much has to do with low interest rates around the globe. After all, German Bunds (10-year German bonds) yield a miniscule 16 basis points and five-year bonds in Germany now yield a negative 13 basis points – these bonds join the ranks of Belgium, the Netherlands, Finland, Sweden, Denmark, and Switzerland who all have negative yields out to the belly of the curve. One additional factoid on German debt is that roughly 20% of German bonds no longer qualify to be purchased by the ECB under the terms of their QE purchases as they are no longer eligible because they trade below the minimum -20 basis points acceptance level.

In yet another example of how unique this period is from a yield perspective, the Swiss government managed to issue 10-year bonds last week with a negative interest rate (yes, as an investor you have to pay them to loan money for 10 years). Wait, there is more: also last week Mexico floated a 100-year (yes, a one-hundred year bond… that is not a typo) euro-denominated bond with a coupon of 4.2%. Let’s put this into perspective – the 30-year Treasury bond (mind you Uncle Sam carries a AAA rated balance sheet) yielded 2.58% last week, and Mexico is barely an investment grade credit at BBB+, yet it was able to issue a 100-year piece of paper for less than a 200 basis point spread to Treasuries with a maturity spanning 70 years longer (WOW). Those arguing that a bubble is percolating in an equity market that is trading at a modest premium to average historic multiples need to redirect their attention to global sovereign debt.

I’m not alone in attempting to decipher some of the anomalies taking shape in the debt markets and how they should be interpreted for capital allocation decisions. Over the weekend I reviewed a transcript of a speech given last week by legendary hedge fund manager Stanley Druckenmiller to the Lone Tree Club. In this presentation he pointed out that in 2006 and 2007 (a time when speculation in credit markets was reaching fever pitch status) corporations issued $700 billion in debt compared to $1.1 trillion in debt issuance in 2013 and 2014. Furthermore, 28% of the debt in ’06 -’07 was B rated (junk bonds or below investment grade) compared to 71% of the debt in the last two years being B rated.

One of the key things I took away from the transcript of Mr. Druckenmiller’s speech and a view I wholeheartedly share is that as an investor you must refrain from focusing too much of your investment thesis on the present and focus more so on visualizing through scenario analysis what things may look like 18 months from now. That is where the investment opportunity and the risk lie. A strong economy that is humming along on all cylinders in the present is already discounted into prices across the spectrum of capital market securities. It is how the future evolves relative to expectations that cause security prices to adjust to the eventual future reality.

Mind you, it is an impossible task to predict the future and these comments are in no way suggestive that we at this firm are able to do so. But what any investor can do is understand how prices for various assets are derived and what could happen that would significantly alter the prevailing price. Since the depths of the credit crisis, the Federal Reserve had to take unprecedented monetary action to rescue the financial markets from devastation and provide support to stimulate a sustainable economic recovery. I am one who believes the actions taken by the Fed were both necessary and heroic as they instituted policies that were only ever concepts in the most advanced monetary policy textbooks.

Now we find ourselves six years removed from the most severe economic contraction since the Great Depression, yet Fed officials (and some of the smartest economists in the world) continue to find it necessary to maintain ultra-aggressive monetary policies. The Federal Reserve was founded in 1913 and in the first 96 years of its existence two things had never happened: 1) the Fed never implemented QE (bought bonds) and 2) they never reduced the fed funds rate to zero (let alone keeping it at this level for 6 years and counting). Over this 6+

year period other central banks have witnessed the success of the Federal Reserve's policies and climbed aboard this freight train, instituting their own versions of QE and interest rate cuts.

Where I'm going with this is the fact that asset prices around the globe have become addicted to aggressive monetary policy. Monetary policy around the globe has reduced interest rates to such low levels that it has forced many unsuspecting investors into corners of the capital markets where they are unfamiliar with the potential risks once a utopian state is not present.

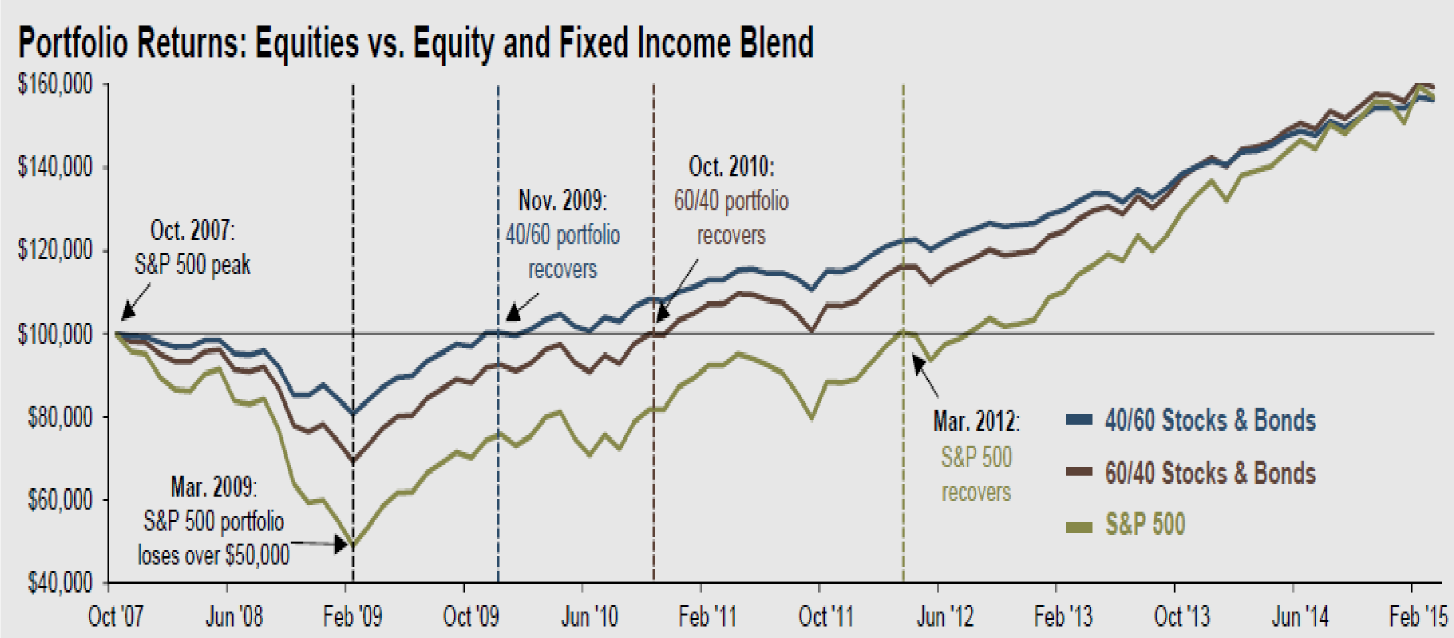
And now we have a Federal Reserve that is on the doorstep of attempting to brace the capital markets for a lift off in the fed funds rate in an effort to gradually normalize interest rates. Bernanke attempted to do this in the summer of 2013 which caused what is now known as the taper tantrum which sent stocks on a quick 6% slide and interest rates spiked higher. I would expect a similar type of reaction when/if we do get the initial volley in this rate hiking cycle, but keep in mind that this level of reaction isn't atypical. There has never been a bull market or an economic expansion that has ended on the first rate hike by the Fed, so this is not an event that I think is worthwhile for investors to get overly concerned about. Prepared, yes, as it will likely cause some increased volatility, but downright bearish that the bull market and expansion are over, no.

But, when I ask myself the question of "what does the investment landscape look like in 18 months' time?" I don't have a clear or confident view of two things:

1. How strong / sustainable this economic expansion is to be able to handle a measured rate hiking cycle and if it is not strong enough, what else does the Fed have in its bag of tricks to reinvigorate a turndown in the economy and/or a loss of confidence in its ability to support growth?
2. How do financial markets and investor sentiment cope with a central bank moving towards restrictive monetary policy?

In my mind these are two very material questions that I don't believe anyone has the answers to. That isn't to say that they are something that requires action to be taken today, as it could very well be that the Fed doesn't hike rates at all this year. Or if they do, it's a token hike in September or October then a couple additional hikes in 2016. The Fed could very well thread this needle and the two boom/bust cycles experienced since 2000 could be a thing of the past. I believe it is appropriate for investors today to ask themselves the following question: What am I giving up by keeping some powder dry, adding risk management hedges, and/or further broadening out my portfolio exposure with low/non-correlated investments? In my opinion, not very much when you consider that this bull market has appreciated almost 215%, is the fourth longest and fourth best in history, valuations are at their highest level of this cycle, profit margins remain near all-time highs, bond yields are at or near all-time lows, and households weighting to equities as a percentage of their net worth is at its second highest reading in history (below only the level it reached at the height of the dot-com bubble.

Take a look at the chart below from JP Morgan's latest Quarterly Guide to the Markets chart book. It compares the path of three separate portfolio allocations (100% equity, 60% equity / 40% bond, and 40% equity / 60% bond) from October 2007 through the credit crisis and up until the end of Q1 2015.



Two things stand out: 1) the much lower draw down of the two portfolios that had some fixed income exposure relative to 100% equities during the bear market, and 2) all of these portfolios are very close in portfolio value as of today. Furthermore, it only took a little more than two years for the 40/60 portfolio to recover from its drawdown, almost three years for the 60/40 portfolio to regain the $100k starting level, and 5 ½ years for the all equity portfolio to fully recover what it gave back.

I titled this commentary with a question: When did Noah build the ark? The answer: before the rain. I don't know when another bear market will begin nor do I believe it is right around the corner, and I'm okay with that because I do know I feel a lot more comfortable taking some steps to fortify our clients' position before it shows up. As the above chart shows, you will not be giving up much in the long-run by taking cautionary steps to mitigate risk and all-time highs in stock prices is not a bad place to take some profits.

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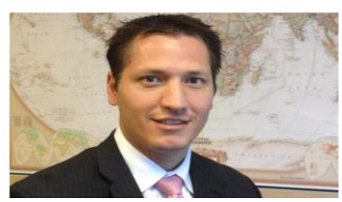

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