July 13th, 2015

Rinse, wash, repeat…

As an investor you have to respect the price action exhibited by stocks last week as there was a plethora of excuses for stocks to sell-off, and sell-off in a significant manner: continued back-and-forth on the negotiations between Greece and the Troika where for a time the possibility of a Grexit seemed likely, a continued relentless meltdown in the Chinese equity market, and a technology glitch on the NYSE that halted trading for almost four hours (this followed news of a network failure at United Airlines which grounded planes and the Wall St. Journal's homepage going off-line for a short stint). Let's face it, the stage was set for the S&P 500 to perhaps finally experience that 10% correction so many market prognosticators have been calling for, after all it's now four years and counting since this last occurred.

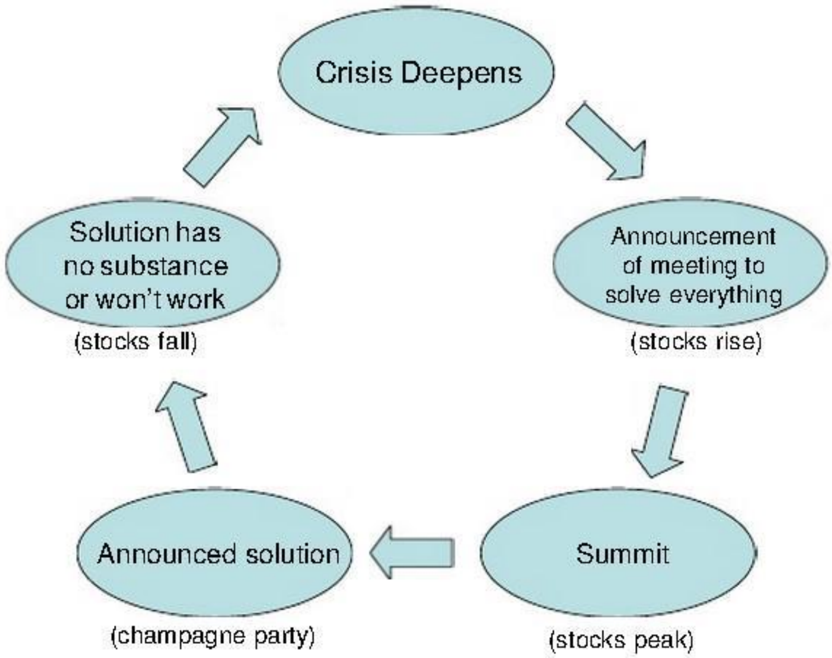
However, by week's end when all the dust settled the Dow Jones Industrial Average ended the week 30 points higher than where it was at the start of the week. Although it did experience its fair share of volatility, as the Dow moved a total of 1,231 points (up and down) throughout the week. In the end, investor's nerves were calmed by signs of a resolution being worked out on Greece, Chinese equity markets finding stability (albeit with a heavy dose of government intervention), and information that the halt on NYSE trading activity was the result of a botched software update.

As for Greece, the foundation of a deal has been established after an 18-hour marathon negotiation. The conditions that Tsipras swallowed comprised a laundry list of unfinished business from Greece's two previous bailouts and a new demand for the government to transfer 50 billion euros of state assets to a holding company that will seek to either sell or generate cash from them. The terms of the deal are significantly tougher than those Tsipras previously labeled "blackmail" when he persuaded Greek voters to reject them in a referendum just a week ago.

In this deal, Tsipras has once again failed to procure outright debt restructuring, although he does appear to be getting the French and Italians to come around to his and the IMF's view (their estimates indicate that 1/3rd of this debt needs to be restructured) that debt restructuring is a necessity for long-term economic sustainability in Greece. After all, we're talking about a $390 billion debt burden for a $225 billion economy- the math just doesn't add up! However, I don't view Tsipras as a significant loser in the ultimate result of this process; he's gained considerable political power at home and his popularity has surged for having stood up to the German 'bully'.

On the flip side of Greece's tough financial position are the Germans and the rest of the Eurozone members recognizing that real reform is necessary given that government spending in Greece accounts for 50% of GDP with pension benefits alone comprising a 15% chunk, and tax enforcement in the country is a joke as government revenues have contracted 20% over the last five years while currency in circulation has increased an estimated 35%.

It's been a long rollercoaster ride getting to this point with its share of ups, downs, and sudden turns, but it looks as though this story will soon be moving from page one news to page ten while understanding that there still remains some legislative roadblocks ahead. The stakes are too high to turn back now and the credibility of the Eurozone experiment will truly be in question on the global stage (reserve currency status and all) if this deal doesn't get finalized. As for the moral hazard issue relating to other debt strapped nations in the Eurozone attempting to approach the same watering trough – I don't think it is anything to get too concerned about given the misery the Greek citizens have gone through as this process has played out. Furthermore, Greece has provided a valuable lesson to anyone thinking that a divorce from the Eurozone will not carry with it some messy and costly ramifications. The following chart from a presentation by David Einhorn from several years ago aptly depicts the crisis management process in Europe and the typical accompanying reaction in equity markets – rinse, wash, repeat.



After registering loses in 8 of 10 days leading up to last Wednesday, the Shanghai Composite index is on a three day winning streak as the bear market in China's various equity indices managed to supplant Greece as numero uno on investor's biggest concerns list last week.

Here was a market that went parabolic since November of last year to mid-June as it surged nearly 130%, and so far the bursting of this bubble has seen almost $3.5trillion in paper wealth disappear. However, it is my opinion that the global fallout (like Greece) will be marginal over the intermediate term as it's estimated that fewer than 90 million Chinese citizens are engaged in the stock market, and this is a civilization that comprises over 1 billion. Furthermore, total market cap to GDP only got to 30% in China whereby it is closer to 100% in most industrialized countries and Chinese bank exposure is relatively muted with margin debt at 1.5% of industry assets.

Stemming the tide in the unrelenting bear market was the latest policy mandates from Beijing which suspended trading in 1,300 companies (roughly 50% of the equity market) and China's securities regulator banning major shareholders, corporate executives and directors from selling stakes in listed companies for six months. These actions came after other previously implemented policy measures failed, such as: PBOC cash injections into financial markets, PBOC interest rate cuts and reduced lending restrictions, allowing real assets to be posted as collateral to buy stocks, investigations of stock manipulation, and a suspension of all new IPO's.

While the latest measures may have steadied the boat in the near term the radical interventions taken by China's leaders to artificially prop up their stock market will likely come with some adverse costs in the global capital markets as they have severely tarnished Beijing's reputation for being able to manage their economy and capital markets.

While there is plenty to write about on the global stage – I haven't even mentioned President Obama's nuclear deal with Iran missing two deadlines in the past week as the ban on shipments of conventional arms into and out of Iran is proving to be a key sticking point – I'd like to shift focus onto some items taking shape within the capital markets, starting with oil prices.

The price of crude oil had its worst week since March – down 7.5% even after Friday's rally – as excess supply concerns continue to loom large over the energy market. The slowing in China is exerting pressure on demand while OPEC production continues to come in above their 30 million barrel per day target (Saudi Arabia pumped 10.564 million barrels per day in June which exceeded a previous record set in 1980), and the possible flood of supply that could enter the market if an Iran deal gets inked are all weighing on the price – Iran reportedly has 40 million barrels of oil stored in offshore tankers.

The price backdrop continues to weigh on the share prices of companies in the energy sector, and while many U.S. producers have focused on cost cuts and lowering their breakeven production expenses for this new lower oil price range it hasn't been enough to shore up the cash crunch they are falling subject to. Even with Q2 earnings for the sector penciled by analysts to decline by -62.7% and revenues to fall -36.7%, investment capital continues to flow into the space as energy companies have been able to raise $15billion in equity and $20billion in debt financing so far this year.

What will be interesting to see is if we revisit the March lows of $43 in crude given that we've crossed below both the 50-day and 200-day moving average in the price of crude. Ultimately we will see some defaults from the weaker balance sheet players that are over leveraged and will be unable to roll-over their debt in the high yield market. That just may be the time when this space becomes really interesting and the baby gets thrown out with the bath water, but we aren't there yet.

As for the bond market, it was interesting to see how the 10-year Treasury yield moved last week with all the white-knuckle volatility in the equity market and the risk-off trade in full bloom, but its yield could only muster a move down to 2.18%. By week's end it was right back to the 2.4% level in what has become the new higher interest rate range we've settled into ever since we got that strong wage data in the employment cost index (ECI) at the end of April.

The broad fixed income indices have generated negative returns so far through the first six-months of the year and this is a trend that is likely to continue as the probability of lift-off in a Fed interest rate hiking cycle looks to commence in the second half. Chair Yellen echoed these sentiments in a speech last week and we're likely to hear more detail from her this week as she conducts her semi-annual congressional testimony on Wednesday and Thursday. Recently, there has been a growing chorus of Federal Reserve Board members to raise rates not just once, but twice before year end.

Beyond higher interest rates, a bigger concern circulating around the fixed income markets is the unstable trading activity and lack of liquidity in the bond market as a result of increased regulation coming out of the credit crisis on the dealer market. I've got news for you – any fixed income investor hiding out in bonds hopeful for returns similar to what they earned over the last decade needs a healthy dose of perspective.

The 30-plus year bull market in bonds that started in the early 80's – when the 10-year Treasury yield was around 15% – is over. Bond prices and interest rates move inversely with each other and that is how long-term government bonds were able to generate annualized returns of 12.6%, 8.8%, 7.7%, and 8.9% in the decades of the 80's, 90's, 00's, and so far in this decade respectively. With a starting yield in the low 2's (where we are today), investors should look back to the decades of the 50's and 60's (when annualized returns were 1.0% and 1.7% respectively) as a reference point for future return expectations from this asset class. Outside of the diversification benefits, due to their low correlation relationship with other asset classes and capital preservation characteristics, there is little value in the fixed income market at this time.

This isn't to suggest you should abandon the asset class as it is still a necessity in a prudently allocated portfolio, but an investor should be ultra-selective. Our preference is for individual bonds – which provide permanence and definition given they carry a defined maturity date and we can be selective in regards to the credit quality we're comfortable with – as opposed to a bond fund which lacks a defined maturity element.

For those wondering what is wrong with the stock market, the answer is nothing. Yes, it's been a choppy start to the year and it's had some significant global macro hurdles to overcome through the first six months (Greece, Q1 GDP contraction, Fed rate hike jitters…), but the resiliency it's shown through the first half has been a surprise even to me. Don't get me wrong, I'm not a screaming bull at this time given my belief that valuations are too full to justify a weighting in equities that is above an investor's risk-profile and return objectives. Furthermore, if the S&P 500 is able to make a new all-time high this month (it's only a percent or two below, depending on the day), it will mark the 75th month in this bull market cycle – already the third longest bull market in history and far surpassing the post WWII average of 59 months.

This is a year of catch-up in the broad equity averages, as price gains have outpaced earnings growth by a factor of 3 to 1 over the last three years and equity investors have rightfully taken a pause before valuation levels got too stretched. This week will begin the onslaught of Q2 earnings which will give investors the latest look under the hood to assess how corporations are doing, and on this front the bar has been set pretty low.

According to Factset data (Thomson data is tracking similarly) Q2 earnings are expected to decline -4.4%. If this is the final earnings decline for the quarter, it will mark the first year-over-year decrease in earnings since Q3 2012 (-1.0%), and the largest year-over-year decline in earnings since Q3 2009 (-15.5%). Seven sectors are projected to report year-over-year growth in earnings, led by the Health Care sector. Three sectors are predicted to report a year-over-year decline in earnings, led by the Energy sector. However, if the Energy sector is excluded, the estimated earnings growth rate for the S&P 500 would jump to 2.0% from -4.4%.

The estimated revenue decline for Q2 2015 is -4.2%. If this is the final revenue decline for the quarter, it will mark the first time the index has seen two consecutive quarters of year-over-year revenue declines since Q2 2009 and Q3 2009. It will also mark the largest year over-year decline in revenue since Q3 2009 (-11.5%). Once again, seven sectors are projected to report year-over-year growth in revenue, led by the Health Care sector while three sectors are predicted to report a year-over-year decline in revenue, led by the Energy sector. If the Energy sector is excluded, the estimated revenue growth rate for the S&P 500 would jump to 1.6% from -4.2%.

Pulling out the energy sector isn't intended to cherry pick the data, it's intended to gain a better insight into how the rest of the market is performing outside of a sector that we know has been crimped by a collapse in the price of its key commodity. The other parts of the earnings composite indicate that growth is good – not surging, but solid – with little that would suggest investors should be nervous about the rug being pulled out from under them.

Beyond the earnings backdrop, which will become clearer over the next six weeks, the equity income theme is alive and well. In the second quarter S&P 500 dividend payments were up 9.5% from a year earlier to $94.6 billion. At this point equities are on track for an unprecedented fifth straight year of double-digit dividend growth as the dividend payout ratio has moved up to 37% and is getting closer to its historical norm of 50%.

The point I'm trying to make to investors is that the fundamental underpinnings of the economy and stock market are solid and in a position to be a tailwind for investors in the second half of the year. There are several indicators that do confirm this economic cycle and bull market cycle are maturing as some of the late cycle indicators are plateauing and in some cases the rate of change is contracting, but at this time there is nothing suggesting that a recession is on the near-term horizon. So now is not the time to load up on risk and get too far out over your skies, but some risk is warranted and necessary to generate a rate of return in a world where return generation is harder to come by.

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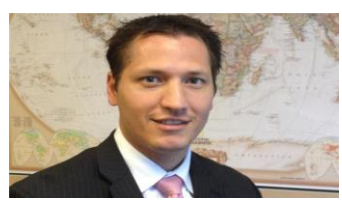

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