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Earnings have some catching up to do…
Historically it's been the case that when governments start panicking, it's generally time for investors to start buying. That line of thinking definitely rang true over the last week and a half as some resolution was found in the stand-off between Greece and the Troika while aggressive action on the part of the Chinese government rescued its stock market from a four week collapse which wiped out nearly $4 trillion in paper wealth during the route. Prior to stabilization in Greece, European bourses were in official correction mode while China was in the throes of an outright bear market. However with Greece reluctantly grabbing hold of the latest lifeline tossed its way, European equity markets have rallied nearly 10% from their recent lows while closing higher in seven of the last eight trading days. China's "throw it at the wall and see what sticks" intervention policy has achieved its objectives in the near term as China's Shanghai Composite index has now rallied 13% from its July 8th low after gaining 2% last week.

Here at home, earnings season is underway and the early results (only 60 companies have reported thus far) suggest things in corporate America are not as bad as expected. Banks dominated last week's docket by besting analyst's expectations on both the earnings and revenue front: Citigroup reported 11% growth in its retail bank while Wells Fargo reported that credit card balances were up 15%, both are indicators that all is well at U.S. households and a constructive sign for the 70% of the economy that is driven by consumption. Reports from GE and Honeywell – two large conglomerates with businesses that touch almost every crevasse of the U.S. economy – each reported better than expected results and boosted their full year outlooks.

However, taking the cake when measured by share price performance post-earnings announcement was Google, which saw its shares rally 16% and added $65 billion to its market cap as investors celebrated a more disciplined spending strategy going forward. As for the major averages, the Dow gained 2%, the S&P 500 added 2.4%, and the Tech heavy Nasdaq surged 4.3% on the week as it notched a new record high. On the surface it would appear that all is well in the equity market with the S&P 500 within 10 points of its all-time high, but one indicator that is floundering and not substantiating the move is the breakdown in market breadth with fewer companies pulling the average higher – not something to stew over, but worthy of monitoring as this latest push higher progresses.

There is some evidence that this latest rally in the equity market is a rush by investors to get back in after the uncertainty surrounding Greece and China was too much for them to bear. The net speculative position on the CME showed traders with their largest negative bet on U.S. equities since July 24th, 2012 as net short positions on the S&P 500 rose to 25,175 contracts in the July 7th week from 863 net long contracts as of June 2nd. Suffice to say, many of these traders have been forced to buy and cover these positions over the last ten trading days.

Furthermore, bullish investor sentiment in the Investors Intelligence poll dipped to 43.7% in the past week from 44.8%, the lowest level since October last year. This coincides with the results of the most recent Global Fund Manager survey conducted by Merrill Lynch (a survey that comprises money managers that oversee a combined $600 billion in assets) where cash ratios were raised to 5.5% – a level that hasn't been seen since the height of the panic in late 2008. Sentiment surveys like Investors Intelligence, AAII, or Merrill Lynch's Global Fund Manager Survey should be viewed with a contrarian perspective where optimism implies that a lot of good news is priced into markets as investors are positioned in that matter and pessimism implies that a lot of bad news is priced into markets.

Nearly one-third of the S&P 500 will report Q2 earnings this week in the busiest week of the reporting season, so we will have a much more comprehensive view of how companies have been navigating some significant global economic headwinds: uncertainty in Europe, a transitioning Chinese economy, choppy U.S. economic growth, Fed policy uncertainty, a bump up in interest rates, and a stronger U.S. dollar.

As for the dollar, it has regained its mojo and is on the rise which will result in a net drag on GDP growth. According to a recent report by economists Mary Amiti and Tyler Bodine-Smith, a 10% appreciation in the dollar over the course of a three-month period slices half a percentage point off of the year's total growth rate. If the rise in the dollar is maintained, it will take another 0.2 percentage points off growth the following year. With the Fed estimating the economy's long-run growth trend at around 2% to 2.3%, headwinds such as those described in this research can have a significant impact. There are other benefits to a strong currency that offset some of the negative growth impacts, such as attracting capital flows from around the world, crimping inflationary forces, and reinforcing the dollar's reserve currency status. With the Fed set to begin normalizing interest rates this headwind is not going away, so it would behoove investors to accept this reality as it relates to economic growth and corporate earnings expectations.

Over the past three years the S&P 500 has gained 15% on average while earnings have grown at a rate of 5% per annum. With the S&P 500 up roughly 3.5% a little over half way through 2015 the thought was that this was going to be a year of catch up, where price appreciation would take a pause while earnings caught up. However, this is yet to be the case with Q1 earnings growth for the S&P 500 coming in at 1.5% and Q2 expectations for EPS to decline by 3.5%. Yes, as we get into the second half of the year earnings growth will pick-up as the drags from the precipitous decline in oil prices (which started in June of last year) and the surge in the U.S. dollar will dissipate making, year-over-year comparisons look better.

But with revenue growth running in the low single digits, U.S. GDP growth settling into a 2 – 3% range, and interest rates methodically inching their way higher, it's hard to see how equity valuations do not continue to be a rather large headwind for investors. BofA Merrill Lynch's US Equity & Quant Strategy team recently updated a detailed analysis of current valuation levels for the S&P 500 compared to historical data. The net take away is that stocks are trading at or above historical averages on virtually every metric (see table below).

Table 2: : S&P 500 Valuations (as of 6/30/15) -- borders denote metrics trading above their historical average

	Current	Average	Avg. ex. Tech Bubble	Min	Max	% Above (below) avg	Z-Score	History
Trailing PE	17.4	16.0	15.3	6.7	30.5	8%	0.3	1960-present
Forward Consensus PE	16.3	15.1	14.0	9.7	25.1	8%	0.4	1986-present
Trailing Normalized PE	18.6	19.0	17.4	9.2	33.9	-2%	-0.1	9/1987-present
Median Forward P/E	17.3	14.6	14.3	9.8	19.6	18%	1.3	1986-present
Shiller PE	26.7	16.6	16.0	4.8	44.2	61%	1.5	1881-present
P/BV	2.94	2.87	2.57	1.65	5.87	3%	0.1	1986-present
EV/EBITDA	10.5	9.9	9.5	6.3	15.1	6%	0.3	1986-present
Trailing PEG	1.57	1.55	1.55	1.07	2.42	2%	0.1	2001-present
Forward PEG	1.48	1.32	1.32	0.98	1.82	12%	1.0	2001-present
P/OCF	12.3	10.5	9.6	5.5	19.6	17%	0.6	1986-present
P/FCF	23.8	28.4	24.8	13.1	65.8	-16%	-0.4	1986-present
EV/Sales	2.10	1.80	1.69	0.86	2.92	17%	0.6	1986-present
ERP (Market-Based)	711	452	466	136	880	57%*	1.5	11/1980-present
Normalized ERP	481	277	323	-96	947	74%*	1.0	1987-present
S&P 500 in WTI terms	34.5	22.6	19.6	2.7	109.0	53%	0.8	1960-present
S&P 500 in Gold terms	1.75	1.52	1.19	0.17	5.53	15%	0.2	1975-present
S&P 500 vs. R2000 Fwd. P/E	0.86	0.93	0.89	0.73	1.35	-7%	-0.5	1986-present
S&P 500 Market Cap/GDP	1.03	0.57	0.52	0.22	1.29	81%	1.8	1964-present

*ERP above average implied equities are attractive relative to bonds. Note: Trailing P/E based on GAAP EPS from 1960-77, Operating EPS from 1978-87, Pro forma EPS 1988-now. Market-baed ERP based on DDM-implied S&P 500 return less AAA corp bond yield. Normalized ERP based on normalized EPS yield less normalized real firks-free rate.

Source: S&P, Compustat, Bloomberg, FactSet/First Call, BofA Merrill Lynch US Equity & US Quant Strategy

A couple things come to mind when analyzing this data and valuations as a variable that goes into the capital allocation decision for investment portfolios. First and foremost, valuation is a very poor market timing metric as stocks can stay or move further into over or under valued territory for an extended period of time during market cycles. Therefore, it would be premature to conclude that this bull market cycle is over just because we are trading marginally above historical average valuation levels. This type of naïve conclusion does not account for prevailing interest rates and inflation levels, corporate profit margins, or differences in tax policy and geographic revenue recognition throughout eras.

Bull markets end and a recession ensues when the Federal Reserve hikes interest rates to a level that causes the economic growth engine to seize up and the yield curve to invert. On this front the Fed hasn't even begun the process of hiking rates and the slope of the yield curve (as measured by the difference between the 10-year T-note and the 2-year T-bill) at 170 basis points is near its historical average. I will acknowledge that several economic metrics (in particular, late cycle variables like employment, manufacturing, and capacity utilization…) are showing signs of plateauing and the rate of change is declining which is a portentous sign that this economic cycle is maturing. But the transition from the mature stage of an economic cycle (where there remains some benefit to owning stocks) to the late stage of an economic cycle (where stock ownership becomes more dangerous) can take years – and years, my friends, is a long-time with the potential for material portfolio returns.

Another thing that comes to mind is the challenge of building a thesis with the expectation that stocks will churn out double digit annualized gains in the years to come without a similar level of EPS growth. There is a case to be made that the multiple stocks trade at today is fair and that they can maintain this level for years to come – said another way, they are not overvalued nor are they undervalued – they are fairly valued. Although, under this line of thinking it is a reasonable conclusion to surmise that future expected returns on stocks will be dependent on earnings growth and dividends, where a lack of EPS growth (which is the case through the first half of 2015) will be accompanied with a stock market that basically treads water.

The last observation that comes to mind regarding the stock market's current valuation is the risk/reward trade-off. Undoubtedly luck can play a part in succeeding in the stock market from time to time, but long-term investment success requires discipline, which applies to controlling ones emotions as much as it does to rigorous accurate analysis. When the risk/reward pendulum is heavily shifted towards the reward side of the scale (as is usually the case in the darkest days of a bear market) investors can plug their nose and buy virtually anything in the equity market and make money. When the pendulum swings the other way and the risk outweighs the reward, it behooves investors to tread a bit more cautiously. I don't believe the pendulum is unbalanced to the risk side of the scale today, but I do believe it is balanced and as such an investor's portfolio should be reflective of such a view.

Outside of the housing data and jobless claims, the recent slate of economic data has not been that constructive. The most recent retail sales report was a real stinker where instead of eking out a 0.3% month-over-month gain as was expected, sales fell 0.3% in June and May was taken down to 1.0% from 1.2%. The control group (excludes building materials, gas, and autos) which feeds into GDP declined 0.1% month-over-month (consensus was expecting +0.3%) and has now fallen in two of the past three months and five of the past seven.

On the inflation front, headline and core CPI came in as expected in June, growing 0.3% month-over-month and 0.2%, respectively. This moved the year-over-year rate to 0.1% on the headline and 1.8% for the core – still below the Fed's 2% target. Industrial production topped expectations adding 0.3% month-over-month in June (expectations were for a gain of 0.2%), up from a 0.2% decline in May as capacity utilization increased to 78.4% from 78.2 % in May. This suggests that ample idle capacity remains in the manufacturing economy as is the case in the labor market with 8.3 million people still unemployed, both of which should keep inflation at bay.

We got two sub-par readings on manufacturing activity last week as both the New York Fed Empire Index (49.9) and the Philly Fed (49.2) dropped below the 50 level (a reading above 50 connotes expansion while a reading below 50 connotes contraction). Historically when both are below 50 in the same month the national ISM index does the same 70% of the time. While these economic metrics are survey data (considered soft data by many economists) it will be interesting to see how this plays into the data dependent Fed's mindset. The archives of history shows that on average the ISM is sitting around 56 the month before the Fed begins hiking rates and it's been the case that a sub-50 reading is usually 6-7 months in the rear-view mirror before the Fed has embarked on its first rate hike.

At the current time the Atlanta Fed model, which accurately pegged the first quarter contraction in GDP, is indicating 2.4% real growth at an annual rate for Q2. If this proves to be true and we couple it with -0.2% growth in Q1 it means the U.S. economy grew at 1% in the first half of the year. Not exactly the growth backdrop one would like to see with a Fed fixated on hiking rates by year end. To be fair this is rearview mirror data and what really matters is what transpires in the months ahead, but these sub-par readings on the economic landscape are likely in large part why the fed funds futures market is discounting just 31% odds of a September hike and 69% chance that the Fed moves in December.

Market expectations versus Fed speak is where I see the biggest gap in capital market views at the current time. Esther George, Kansas City Fed Bank President, was the latest Fed member to come out in support of a rate hike sooner rather than later, joining the ranks of Williams, Mester, Bullard, Lacker, and even Chair Yellen leaned this way in her congressional testimony last week. Although as she is very aware of how over analyzed every word that comes her mouth is she continues to reiterate that the Fed continues to be data dependent and will only move if the data supports such action.

It’s very difficult at the current time to form a definitive opinion on what the commodities markets is telling investors:

- Brent crude oil peaked in June ’14 at roughly $108 per barrel and is now around $57
- Natural gas peaked at $8 per million BTU in 2014 and its now below $3
- Aluminum, Stainless Steel, Tin, Gold, and Platinum all peaked in 2011 and are down 40%, 46%, 55%, 39%, and 43% respectively
- Corn peaked in 2012 at $8 per bushel and is now $4

Is this significant decline in prices across the commodity market a prelude to much weaker global economic growth in the future, or is it just confirmation that the commodities super-cycle is over as China transforms its economy and growth in emerging markets is a shadow of its former self? My gut thinks it’s the latter, but the forecasting history of commodities prices reminds me that it’s a variable that should not be readily dismissed. As for investors interested in the space as a buying opportunity, I wish you luck, as I prefer instead to use this information as a variable in the mosaic of information that informs one’s investment view.

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