June 15th, 2015

A range-bound market – it's not as rare as you think…

The aimless meandering of U.S. equities aptly summarizes what investors have experienced almost six months into this calendar year. Last week was no different with the broad market averages (S&P 500 +0.06%, Dow Jones Industrial Average +0.28%, Nasdaq -0.34%, and Russell 2000 +0.32%) all closing within a third of a percent from where they ended the previous week. Over the past seven months the S&P 500 has traded within a range of about 7% (it hasn't closed higher or lower by more than 1% over the last seven trading weeks).

However, long periods of sideways range bound activity in the S&P 500 is not as rare an occurrence as some would think. I came across an analysis from market strategist Urban Carmel where he identified 15 similar situations over the past 35 years.

The last time we experienced a range this tight during the current bull market cycle was from January to August 2011, whereby the market ultimately broke out of the range by declining almost 20% in what was the largest correction investors have had to endure during this bull market. However, it's important to keep in mind that the global economic backdrop was on much weaker footing at that time, U.S. Treasury debt got downgraded, and the Eurozone sovereign debt crisis was in full bloom – so drawing parallels to today's environment does not have the same relevance, in my opinion.

In the 2004-2007 bull market there were three similar occurrences with all of them lasting almost a year:

From 1991 – 1995 the S&P 500 had five such range bound periods, with the S&P virtually unchanged from early 1993 until the end of 1994.

The bull market of the 1980's was no different, enduring long stretches (early '83 – early '85 and mid '89 – mid '90) of trendless action.

As you can see, we've been here before and this type of go-nowhere market is as much a part of the fabric of investing as raging bull markets and white-knuckle bear markets. This too shall pass as nothing moves in a straight line, up or down. The secular bull market that began in 2009 remains intact, albeit in a much more mature stage, with elevated risks, lower expected future returns, and a much more compressed investment opportunity set. So do not over react, don't try to do too much by charting into unknown and/or unfamiliar areas of the market, or abandon a prudent long-term investment strategy – raise some cash if that helps you sleep at night, and settle in because this could last for some time to come.

If one adheres to the philosophy that earnings drive stock prices, then the behavior of the stock market this year should not be a surprise. Yes, the S&P 500 is flat, but after yearly returns of 16%, 32%, and 13% in 2012, 2013, and 2014 while operating EPS growth averaged roughly 5% per annum over that span, it's too much of a stretch to expect a little consolidation to occur. After all, market prices outpaced EPS growth by a margin of three to one, and now investors find themselves in a position where the "E" needs to catch up to the "P" in the Price/Earnings ratio.

Unfortunately it looks as though investors will have to exhibit a little more patience on this front with EPS growth coming in at roughly 1.0% in Q1 and estimates for Q2 are not exactly ripping. According to data from Factset, year-over-year earnings are estimated to decline -4.6% in Q2, which is higher than the expected decline of -2.3% at the start of the quarter (March 31). Seven sectors have recorded a decline in expected earnings growth since the beginning of the second quarter due to downward revisions to earnings estimates, led by the Industrials and Consumer Discretionary sectors.

If the Energy sector is excluded, the estimated earnings growth rate for the S&P 500 would jump to 2.2% from -4.6%. The Industrials sector has witnessed the largest decrease in expected earnings growth (to -3.2% from 4.2%) since the start of the quarter. The Consumer Discretionary sector has recorded the second largest drop in expected earnings growth (to 4.2% from 9.0%) since the start of the quarter.

The estimated sales decline for Q1 2015 of -4.4% is higher than the estimated year-over-year revenue decline of -3.1% at the start of the quarter. Again, if the Energy sector is excluded the estimated revenue growth rate for the S&P 500 would jump to 1.7% from -4.4%. It's not just analysts that are lowering the bar for Q2 earnings, as companies have proactively revised down there guidance as well. Of the 104 companies that have issued EPS guidance, 76 have issued negative EPS guidance and 28 have issued positive EPS guidance. The percentage of companies issuing negative EPS guidance is 73%, which is above the 5-year average of 69%.

In addition to the sanguine earnings outlook, capital markets in the U.S. are confronted with the expectation that Fed policy will swing from easing to tightening (at some point this year). For sure the last three times when the Fed swung from easing to tightening (1987, 1994, and 2004) were challenging years for stock price appreciation, as the S&P 500 eked out an average gain of barely 2% in those years. But it's important to note that none of those years marked the end to the bull market. Similar to those periods, the pace of economic activity today is positive and picking up steam from the first quarter's growth sapping transitory factors.

Investors who remained patient in these previous episodes were rewarded with solid market gains once the initial jitters subsided – historically the economy endures the initial Fed volley as the expansion broadens. Keep in mind that in the annals of history, it is the last rate hike – not the first rate hike – that brings the bull market to an end. Corrections come and go, and on this front we may very well be in the midst of one at the current time – after all we have to go back to 2011 since we last endured one. But bear markets are a different animal altogether, as they tend to impair capital for a prolonged period of time and are something better to be avoided rather than endured. However, the fundamental underpinnings of the economy and capital markets – technical weakness, narrowing breadth, high valuations, and jovial corporate activity (think M&A and buybacks) notwithstanding – do not suggest that a recession nor bear market are on the near-term horizon.

It's interesting that the latest market angst is occurring at a time when the macro economic data is starting to firm. The latest data on employment, housing starts, auto sales, retail sales, and ISM crushed consensus expectations and in a boost to consumption (which makes up 2/3^{rds} of the GDP pie), wage gains are finally starting to pick up momentum. Perhaps the latest surge in interest rates is in part due to the improvement in the economic backdrop, as economists are ramping higher their Q2 GDP estimates to the 3% level.

The Energy Information Administration (EIA) has come around to the idea that the economic activity around the globe may be a bit firmer than the pessimistic main stream media would have you believe, as they recently lifted their world oil demand forecast by 1.1 million barrels per day to 93.6 mb/d (up 0.7 mb/d from 2014). Supporting this view was data in the retail sales report which showed that miles driven in the U.S. increased 3.9% year-over-year in Q1 and overall volume demand for gasoline was up 4.2%.

Judging by the latest Federal Reserve Flow of Funds report, why wouldn't the consumer be in a better spending mood going forward? Undoubtedly the 20% aggregate contraction in household net worth that evaporated during the credit crisis from 2007 to 2009 was traumatic, but this loss has been recovered and then some. In the most recent report, household net worth hit a new all-time high of $84.9 trillion at the end of Q1 – this figure also marked an all-time high on a per capita basis. Aggregate household assets are at a record high of $99 trillion in Q1, up nearly $30 trillion from the recessionary lows with financial assets and real estate assets setting new all-time highs.

However, the household balance sheet improvement is not solely rooted on the asset side of the ledger, as total credit outstanding still remains below its pre-recession peaks – the debt-to-income ratio is at its lowest level (101.7%) since Q3 2002, the debt-to-asset ratio (13.6%) is the lowest since Q4 2000, and household debt service ratios continue to hold at record lows dating back to the 1980's.

The evidence is mounting that we are no longer in an environment that requires the Fed keeping policy rates near zero in nominal terms or negative in real terms. In my opinion, the sooner the Fed removes the negative real yield (nominal yields less inflation) the better, and that would mean getting to 2% on the funds rate. On the surface this may seem like a large move given we are coming off a 0% floor level and there is no need for the Fed to become overly aggressive, but a move of this magnitude is a far cry from the 6% terminal level they took the funds rate to in '94, 6.5% in 2000, or 5.25% in 2006. Even baby steps start with putting one foot in front of the other no matter how long the stride – as I can attest having a little girl who just turned one and is in the process of getting a crash course.

This week brings with it an FOMC meeting where expectations are for the Fed to hold serve and make no move on raising rates. However, much attention will be paid to the movement in the Fed's dot plot as well as the language in both the Fed statement and Chair Yellen's press conference following the meeting. The FOMC meeting that is currently in play for the first interest rate hike is September and Fed watchers will be keyed in on the “"description of the economic situation and outlook, and of progress towards the Committee's goals" as this was the verbiage used in April's Fed statement to communicate when liftoff will likely occur. Additionally the Fed provided a checklist of data-dependent outcomes that would be needed for a rate hike in September: (1) continued improvement in the labor market; (2) above-trend growth in 2Q and beyond; and (3) underlying inflation steady but not falling.

The only item on this checklist that looks questionable with the data over the last couple weeks is underlying inflation. Fed officials are likely to once again dismiss various disinflationary forces, like the strong U.S. dollar as "transitory". The only inflation measure that has shown any recent upside has been core CPI, which continues to diverge from the Fed's preferred core PCE measure. Core PPI (excluding volatile trade services) and import prices of consumer goods fell in May. Earlier in the year, Chair Yellen said inflation need not rise to start the hiking cycle, it just cannot fall. When she spoke, core PCE inflation was 1.4%; the most recent reading is 1.2%. This may be a temporary dip, but the inflation outlook remains the biggest risk for plans to hike in September. The Wall St. Journal compiled a summary of what various policy makers have said during their recent speaking engagements:

- **Chairwoman Janet Yellen (voter)**, May 22 in Providence, R.I.: "I think it will be appropriate at some point this year to take the initial step to raise the federal-funds rate target and begin the process of normalizing monetary policy."

- **Vice Chairman Stanley Fischer (voter)**, May 25 in Herzliya, Israel: "We will wait and see what happens. If the economy is moving slow we'll wait. If fast, we'll do it earlier."

- **Gov. Lael Brainard (voter)**, June 2 in Washington, D.C.: "But while the case for liftoff may not be immediate, it is coming into clearer view. If continued labor market strengthening is confirmed and inflation readings continue to improve, liftoff could come before the end of the year."

- **Boston Fed President Eric Rosengren**, June 1 in Hartford, Conn.: Would like to raise rates "as soon as possible, but it has to be because the economic conditions are right. The economic conditions haven't been right to date."

- **New York Fed President William Dudley (voter)**, June 5 in Minneapolis: "If the labor market continues to improve and inflation expectations remain well-anchored, then I would expect–in the absence of some dark cloud gathering over the growth outlook–to support a decision to begin normalizing monetary policy later this year."

- **Cleveland Fed President Loretta Mester,** May 1 in Philadelphia: "I'm going to be data-dependent, I'm going to look at the data, and go into each meeting with an assessment of the data that comes in. So I'm not taking any of the meetings off the table."

- **Richmond Fed President Jeffrey Lacker (voter)**, May 26 in Baton Rouge, La.: "I haven't made up my mind yet about June…I am going to wait and see what the data reveals."
- **Atlanta Fed President Dennis Lockhart (voter)**, May 6 in Baton Rouge, La.: "Probabilities as reflected in forward markets, or futures markets for fed funds, seem to have moved from December toward September. I think that's a reasonable alignment with what I think to be the likely policy outlook" for short-term rates.

- **Chicago Fed President Charles Evans (voter)**, June 3 in Chicago: Favoring a 2016 rate rise, he said "the hurdle is pretty high for raising rates at the moment."

- **St. Louis Fed President James Bullard**, June 3 in St. Louis: "I would like to move on the back of good news, basically, and I think it's very difficult to say that you're trying to normalize interest rates just at the moment where the economy looks a little bit weaker."

- **Minneapolis Fed President Narayana Kocherlakota,** May 28 in Helena, Mont.: "Under my current outlook, I continue to believe that it would be a mistake to raise the target range for the fed funds rate in 2015."

- **San Francisco Fed President John Williams (voter),** May 28 in Singapore: "I've gotten myself into trouble there [on the likely timing of a rate increase]. I said at one point that we will do something in summer, and I found out that my definition of summer was not the right definition of summer….So, I've got to be very careful about these things. I would say sometime [in] the remainder of the year."

As for Europe, it continues to be jostled around like a piñata with the latest rumors coming out of the Greek debt negotiations. The latest posturing came at the hands of the IMF who decided enough was enough and walked away from the negotiating table putting the ball back in Syriza's court to come up with reforms that will be given serious consideration. The Europeans have perfected the art of kicking the can down the road – we've only been dealing with this Greek drama for four years and counting – and Greece has until the end of the month to produce a credible plan.

The truth of the matter is that the two sides are not that far apart, but neither wants to be seen in the public's eye as being soft: the IMF, ECB, and European Union (also known as the troika) are pandering to stave off any repeat occurrence of this issue with Italy, Spain, or Portugal. While recently elected PM Tsipras risks political suicide if he caves on his pledge to push back against reforms which his constituents believe pushed them into poverty and recession.

I found the following article by Anatole Kaletsky explaining the latest juncture in these negotiations to be spot on and worthy of sharing in its entirety (From Farce to Irrelevance):

> "*The good news is that a Greek default, which has become more likely after Prime Minister Alexis Tsipras' provocative rejection of what he described as the "absurd" bailout offer by Greece's creditors, no longer poses a serious threat to the rest of Europe. The bad news is that Tsipras does not seem to understand this. To*

judge by Tsipras' belligerence, he firmly believes that Europe needs Greece as desperately as Greece needs Europe. This is the true "absurdity" in the present negotiations, and Tsipras' misapprehension of his bargaining power now risks catastrophe for his country, humiliation for his Syriza party, or both.

The most likely outcome is that Tsipras will eat his words and submit to the conditions set by the "troika" (the European Commission, European Central Bank (ECB), and the International Monetary Fund) before the end of June. If not, the ECB will stop supporting the Greek banking system, and the government will run out of money to service foreign debts and, more dramatically, to pay Greek citizens their pensions and wages.

Cut off from all external finance, Greece will become an economic pariah—the Argentina of Europe—and public pressure will presumably oust Syriza from power. This outcome is all the more tragic, given that the analysis underlying Syriza's demand for an easing of austerity was broadly right. Instead of seeking a face-saving compromise on softening the troika program, Tsipras wasted six months on symbolic battles over economically irrelevant issues such as labor laws, privatizations, even the name of the troika. This provocative behavior lost Greece potential allies in France and Italy. Worse still, the time wasted on political grandstanding destroyed the primary budget surplus, which was Tsipras' trump card in the early negotiations.

Now Tsipras thinks he holds another trump card: Europe's fear of a Greek default. But *this is a delusion promoted by his finance minister, Yanis Varoufakis. A professor of game theory, Varoufakis recently boasted that "little Greece, in order to survive, [could] bring down the financial world." Apparently, Varoufakis believes that his "sophisticated grasp of game theory" gives Greece an advantage in "the complicated dynamics" of the negotiations. In fact, the game being played out in Europe is less like chess than like tic-tac-toe, where a draw is the normal outcome, but a wrong move means certain defeat.*

The rules of this game are much simpler than Varoufakis expected because of a momentous event that occurred in the same week as the Greek election. On January 22, the ECB took decisive action to protect the eurozone from a possible Greek default. By announcing a huge program of bond purchases, much bigger relative to the *eurozone bond market than the quantitative easing implemented in the United States, Britain, or Japan, ECB President Mario Draghi erected the impenetrable firewall that had long been needed to protect the monetary union from a Lehman-style financial meltdown.*

The ECB's newfound ability to print money, essentially without limit, to support both banks and governments has reduced Greek contagion to insignificance. That represents a profound change in Europe's financial environment, which Greek politicians, along with many economic analysts, still fail to understand.

Before the ECB's decision, contagion from Greece was a genuine threat. If the Greek government defaulted or tried to abandon the euro, Greece's banks would collapse, and Greeks who failed to get their money *out of the country would lose their savings, as occurred in Cyprus in 2013. When savers in other indebted euro countries such as Portugal and Spain observed this, they would fear similar losses and move their money to banks in Germany or Austria, as well as sell their holdings of Portuguese or Spanish government bonds.*

As a result, the debtor countries' bond prices would collapse, interest rates would soar, and banks would be threatened with collapse. If the contagion from Greece intensified, the next-weakest country, probably Portugal, would find itself unable to support its banking system or pay its debts. In extremis, it would abandon the euro, following the Greek example. Before January, this sequence of events was quite likely, but the ECB's bond-buying program put a firebreak at each point of the contagion process. If holders of Portuguese *bonds are alarmed by a future Greek default, the ECB will simply increase its bond buying; with no limit to its buying power, it will easily overwhelm any selling pressure.*

If savers in Portuguese banks start moving their money to Germany, the ECB will recycle these euros back to Portugal through interbank deposits. Again, there is no limit to how much money the ECB can recycle, provided Portuguese banks remain solvent— which they will, so long as the ECB continues to buy Portuguese government bonds.

In short, the ECB bond-buying program has transformed the ECB from a passive observer of the euro crisis, paralyzed by the outdated legalistic constraints of the Maastricht Treaty, into a proper lender of last resort. With powers to monetize *government debts similar to those exercised by the US Federal Reserve, the Bank of Japan, and the Bank of England, the ECB can now guarantee the eurozone against financial contagion.*

Unfortunately for Greece, this has been lost on the Tsipras government. Greek politicians who still see the threat of financial contagion as their trump card should note the coincidence of the Greek election and the ECB's bond-buying program and draw the obvious conclusion. The ECB's new policy was designed to protect the euro from the consequences of a Greek exit or default.

The latest Greek negotiating strategy is to demand a ransom to desist threatening suicide. Such blackmail might work for a suicide bomber. But Greece is just holding a gun to its own head—and Europe does not *need to care very much if it pulls the trigger."*

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