March 14th, 2016

Tough to square the math…
Stocks staged their fourth consecutive week of gains with the S&P 500 edging higher by 1.1% last week, the Dow Jones Industrial Average climbed 206 points (1.2%) while Gold slid nearly 1% and the 10-year Treasury bond yield rose 10bps to end the week at 1.98%. It was a more subdued 'risk-on' trading week with the bulk of the gains coming on Friday after investors had time to reassess the implications of the latest iteration of ECB President Mario Draghi's 'whatever it takes' monetary policy strategy.

It was a quiet week on the economic data front with jobless claims deserving of some noteworthy attention given they fell to 259k last week. This print is the third lowest level in the last 40 years, bested only by the reading of 255k in July and 256k in October of last year. These levels suggest that there is very little give back in what has been and continues to be a strong employment market. This bodes well for the roughly 70% of the economy that is driven by consumer spending and housing which more than offsets the roughly 15% of GDP that is comprised of manufacturing and mining, oil & gas.

With deflationary forces becoming pervasive in the Eurozone, economic growth stagnating, and comments from Draghi back in January that the ECB governing council would be reviewing its policy stance at the March confab, market expectations were high coming into Thursday. To which Mr. Draghi did not disappoint, reminding investors just how big of a 'bazooka' he has in his arsenal. In total the ECB increased its QE monthly asset purchase program to a pace of €80 billion per month from €60 billion (consensus expectations were for €70 billion), while expanding the list of securities eligible for purchase to include investment grade euro-denominated bonds issued by non-bank corporations established in the euro area. In addition to this, the ECB cut policy interest rates by 5bps to 0% and lowered the deposit facility further into negative territory (reducing it by 10bps to -0.40%), along with instituting a new series of four targeted longer-term refinancing operations (TLTRO).

In essence what the new TLTRO program does is backstop the financial stress that has been building up in Europe's largest banks by putting in place a substantial lending subsidy with the hope that it will stimulate demand by incentivizing banks to extend additional credit.

Capital markets initially reacted with a bout of confusion as the Dow traded up nearly 130 points to only reverse by close to 300 points before finishing virtually flat on the day of the announcement. This was likely the result of Draghi suggesting at his press conference that there likely would be no more rate cuts (meaning the extent to which the ECB will take rates further into negative territory appears to have reached its floor), but given the backlash by capital markets following the Bank of Japan's decision to institute NIRP and the lackluster results from the prevailing negative rate environment in the Eurozone, this rate floor may be a positive.

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Also, last week we learned that Chinese regulators are taking additional steps to speed up the ways it can help banks redress the nonperforming loan problems on their balance sheets, by encouraging Chinese companies to swap their debt for equity. Current banking rules generally forbid commercial banks from taking stakes in non-financial entities, but regulators (led by the powerful government commission overseeing state assets – State-owned Assets Supervision and Administration Commission – SASAC) are pushing for changes in the rules to help heavily indebted state companies cut debts. According to Standard and Poor's Ratings Services corporate debt in China now amounts to 160% of GDP – up from 98% in 2008 and compares with a current 70% level in the U.S.

We have indeed entered a new chapter in how policy makers are responding to what remains an enormous debt overhang fully eight years after the onset of the global financial crisis as the downside to this latest policy out of China is that it could potentially saddle banks with near worthless stock thereby further squeezing their liquidity. We'll have to wait and see whether this merely serves as a quick fix or a development that actually leads to a fundamental improvement in bank balance sheets. Although, this proposal should come as little surprise given China has a history of doling out money to paper over financial hardship.

Time will be the ultimate judge on the implications of what has become an era of monetary policy experimentation. Thus far it's been a losing bet to go against the creativity and vigor of government excursions into financial markets, but I am warming to the view that we are moving into the initial stages of a deterioration in central bank credibility by capital market participants. The latest action by the ECB is akin to throwing everything including the kitchen sink at the situation in the Eurozone which will better be judged over the course of weeks and months, not days. Central banks will be front and center once again this week as we'll hear from the BoJ, BoE, and the Fed as they conclude their two day meeting on Wednesday.

The Fed meeting will entail both an update of the Summary of Economic Projections and press conference by Chair Yellen. Investors are expecting a hawkish tone given further gradual improvements in the labor market and inflation metrics moving closer to the FOMC's 2% objective. Fed fund futures are only pricing in a 4% chance of a rate hike at this meeting with the probability of at least one hike occurring this year moving to over 70% – instead investors will be focused on the language and what this foreshadows for the April and June meetings.

It's worth noting that many of these unconventional monetary policy tools were once considered just theory and conjecture prior to the global financial crisis of 2008. Since then we've had more than 600 rate cuts globally and unconventional policy tools seem to have evolved into common practices. Which raises more questions than answers, for instance: Are we still in a crisis situation that requires such aggressive policy support? Is this the new normal, where central bank mandates should now include asset prices along with employment and inflation? What happens to global economic growth without central bank balance sheets at all-time highs and more than $7 trillion in sovereign bonds trading at negative rates?

These are very difficult questions to comprehend, measure, and confidently forecast; questions that would be reckless and irresponsible for stewards of other people's capital not to consider. One view I do hold on this regard is that at this juncture the risks for 'more of the same' are greater than the potential benefits. Moreover, should the efficacy of central bank policies around the world continue to wane, with the risk of unintended consequences outweighing the reward of higher growth, then I suspect the unwind could become very disorderly.

As for the stock market, we now have on our hands an equity market that has surged by 10.5% in four weeks while racing through several technical hurdles (it's now above its 50-dma at 1,932 and 100-dma at 1,998) to

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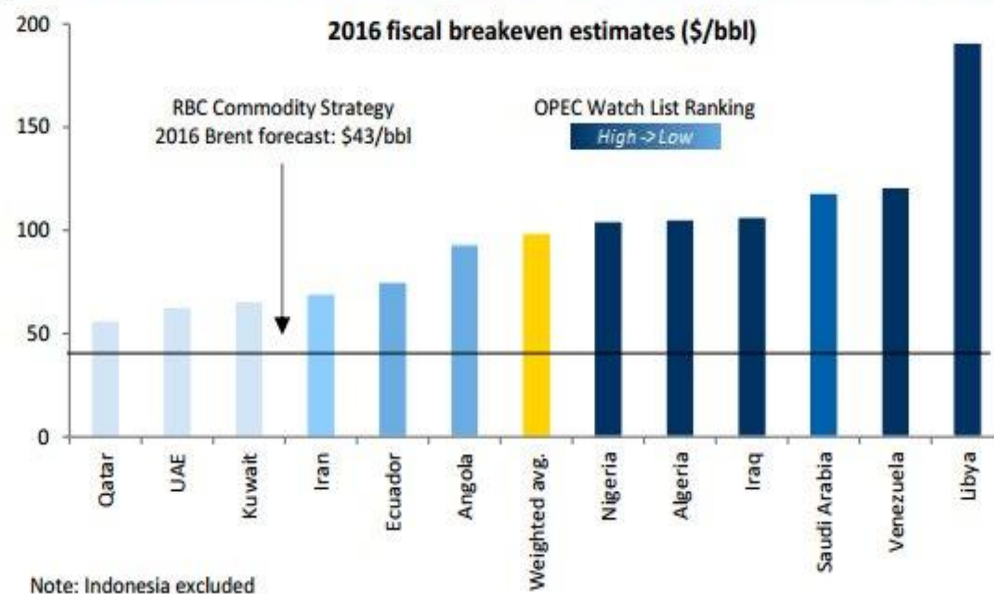
currently sit at its 200-dma of 2,020. On a short-term basis stocks have moved well into overbought conditions with 90% of the S&P 500 trading above their 10-dma, 95% above their 20-dma, and 89% above their 50-dma. Without question the speed and jubilance of this move has taken me by surprise, but Mr. Market doesn't much care what I think anyways. The next couple of weeks will decide if this move was/is a rebound from a correction which leads to an extension of this bull market that started in March 2009, or if this was just a bear market rally reminiscent of the ones experienced in Sep.-Nov. '01 and Mar.-May '08 before what ultimately ended up being significant drawdowns.

The 50% surge in oil prices from $26/bbl to a snick over $40/bbl last week has to be near the top of the list of catalysts driving this rally. Last week alone oil spiked more than 7% in part on a report by the EIA where they floated their view that the bottom is in for oil prices. Their data suggests that U.S. oil output will fall to 8.19 million barrels per day by 2017 – down from 8.67 this year and if 2017 estimates come to fruition it would mark a four year low. This shouldn't come to much of a surprise to anyone given the fact that the U.S. rig count has plunged by more than 2/3rds which by itself suggests that production has nowhere to go but down.

The possible floor being in for oil is without question a positive development for the entire globe as it would take a considerable period of time for the long-term consumption benefits to offset what would be material near-term financial repercussions if oil prices were to stay in the $20/bbl area. But please don't mistake this bump to $40/bbl as a coup de gras to heal all that ails the industry, as can be seen by the below chart where much higher prices are necessary to close the fiscal shortfall present in many regions. According to analysis from RBC on average OPEC producing nations need oil prices to rise to $98/bbl to break-even on their fiscal budgets. Assuredly many of these nations are taking steps – like many private companies have already done – to moderate the strain, but there remain many chapters to be written in this book.



Taking a step back and looking at the longer-term picture before returning to the present day, it's worth noting that last week marked the seventh anniversary of the equity market bottom following the epic global financial collapse (funny how clear hindsight looks). Since then, roughly $14 trillion of equity wealth has been created (more than recouping the $11trillion that was vanquished during the Great Recession) as the

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S&P 500 has tripled from the trough. And although it may not feel like we've experienced a vibrant economic recovery, the U.S. has generated over 13 million net new jobs over the last six years with 65 straight months of payroll gains (the longest period of sustained employment growth on record).

Not to pour cold water on this bull market anniversary party, but is it really fair to be suggesting that we are still in a bull market when the S&P 500 hasn't made a new high in 10 months and trades at levels it first reached 20 months ago? This isn't to say we are in a bear market just yet, as the S&P 500 is only 5% below its all-time high (although 212 stocks are still down more than 20% from their highs). So, investors who prefer definitive market descriptors will have to be patient because for now we remain in no-man's land at the top end of an 1,800-2,000 trading range that has gripped stocks for the last 10 months.

The emotional, fear-based sell-off in the first six weeks of the year has nearly reversed itself (S&P 500 down 1% year-to-date) as the recession mongers have been silenced (for now), but at the same time, ferreting out a catalyst that will drive the next leg of economic growth to perpetuate this 82 month old economic cycle is proving as difficult as finding the proverbial needle in a haystack. Furthermore, in my estimation, this catalyst is a must as we enter the second quarter where we will start to comp year-over-year growth estimates to what (as of now) looks to be where several parts of the economy peaked in Q2 last year (corporate earnings, GDP, personal consumption expenditures, and consumer confidence).

A couple additional headwinds the bull crowd will have to overcome to push the major averages higher are sentiment, earnings, and valuations. On the sentiment front – and this is one metric I underestimated the potential strength of several weeks ago – is the recovery in those carrying a bullish view. Keep in mind sentiment should be looked at with a contrarian bent where an elevated level of bulls vs. bears should be viewed as negative with the presumption that a lot of good news is already priced in at that point (and vice versa). With this in mind, the low levels of sentiment that prevailed several weeks ago can no longer be considered a tailwind for market upside:

- The latest AAII survey of retail investors shows bulls outnumbering bears to the tune of 32% vs. 29.25% – this compares to extremely pessimistic levels in mid-January where bears checked in at 45.5% compared to bulls at 17.9%.
- Market Vane Bullish Consensus Stock sentiment has moved up for three consecutive weeks to 51%, which marks its highest level since mid-January.
- The latest survey from Investors Intelligence shows the bull camp expanding to 39.4% from 36.4% last week, and the bear share at 35.4% from 34.3%. Back in mid-January the bull camp was at 26%, a full ten points lower than the bear share at 36%.

The sentiment levels that were reached near the lows in mid-January (S&P 500 got down to 1,812 on January 20th) merely required the news to stop being bad to elicit a snap back rally in stocks. However, at the current levels further upside will require actual 'good' news as 'less bad' is unlikely to move the needle.

As for earnings and the subsequent multiple investors are willing to pay for those earnings (a.k.a valuation), corporate profits are estimated to decline a rather large 8% in Q1. This will mark the third consecutive quarter of negative earnings growth and sets up a rather uncomfortable foundation for stock owners. What I mean by this is that the consensus view is to simply look past the sluggish set up for Q1 and Q2 2016 earnings as the outlook for the second half of the year (Q3 and Q4) is much more constructive given the decline in energy prices and the headwind from a strong dollar will have dissipated.

The risk with this view is that if it does not come to fruition – this same argument was being made at the start of 2015: earnings growth was loaded to the back of the year where EPS ended up declining in both quarters – then the margin of safety just doesn't exist to support a hiccup of any kind. This earnings degradation isn't

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unique to the U.S as consensus earnings per share growth views in Europe for 2016 have been sliced to +2.9% from +6.9% – same claim can be made for Japan and China as well.

Full year EPS estimates for the S&P 500 range from $110-$120 with the biggest challenge facing investors being what multiple to assign to these earnings. Let's be generous and use the top end of the earnings range ($120/share) and assign a slightly higher than average 16x forward multiple, which gets you to a fair value level of 1,920 on the S&P 500. Now one could definitely argue with assigning a slight premium valuation multiple to stocks at a time when decelerating economic data points outnumber accelerating ones by a ratio of 2:1. Beyond that we are in the throes of a business cycle that is almost two years longer than the average economic expansion dating back to 1930.

What I'm getting at is that the math just doesn't add up for a prudent investor that values the security of the return of his capital more than the possibility of the return on his capital. What investors need to do at the current time is take a deep breath and appreciate what has been a welcomed recovery from a severe overreaction by investors to a recession that had little chance of occurring in Q1, but I implore these same investors to not become overly complacent as many of the risks that existed a short four weeks ago have not gone away. Yes, there are areas in the capital markets where the risk/reward trade-off is skewed in the right direction, but they are not as wide spread as I believe many think they are.

That being said, over the last several weeks we have layered additional hedges into our client's portfolios. In hindsight these hedges have proven to be early (another way of saying wrong) which made last week especially challenging for me, but my attention continues to be focused on what our research suggests is the next potential big move in security markets and not trying to catch every wiggle in what has been a very choppy tape. I remain of the view that the next big move carries with it a higher probability of downside return outcomes than upside return outcomes. As such, I continue to assess the current investment backdrop with a high degree of skepticism and caution while acknowledging that it is very unlikely we have everything figured out. Which brings to mind the wise words of Jason Zweig: "Experience has taught me to have just enough self-confidence to be full of self-doubt".

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