CUMBERLAND

Like 1999- A Tale of Two Markets

I'm frustrated. Maybe it's due to the tough market environment but deep down I think it's probably because of a conflict between what my head is saying and what my gut is telling me.

Let me start with what my instinct's sense before taking a little more rational approach to the issues.

My gut has been saying: Look, this market has been on a roll since March, 2009 with only a bit of a shake in 2011. M&A activity is at an all-time high which correlates with market tops and I think there are probably some problems that will surface in emerging markets due to weak commodity prices and the soaring U.S. dollar. Otherwise the market has been straight up. It's overvalued and we're due for a correction, which we're now starting to get. That said, there is reason to believe that we're further into a setback than most recognize. Nonetheless, volatility and fear don't seem to be extreme enough to set a solid bottom and valuations still need to come down by about 10% just to get us to fair value, let alone cheap.

So, keep some cash on the sidelines and look for a better buying opportunity down the road.

On the other hand, my head says I should take a longer term view as the problems are all manageable.

So, let's go through a check list of the issues and drill down a little to see if the market is interpreting them correctly.

1. **<u>Market isn't acting well; breadth is unfavourable</u>**

Let's start by comparing the current market to the markets we experienced in the late 1990's. I went back to some of the quarterlies I had written then and pulled out a handful of quotes that should sound familiar.

"Value managers the world over are relieved to see the end of 1999 and to get behind them one of the toughest years of this decade. There's no lack of statistical evidence to support how narrow the market was nor how overvalued certain sectors are."

"1999 had two distinguishing features. No breadth and no earnings, which makes it tough on those of us who look for companies generating free cash flow."

"For the year only 31% of the companies listed on the New York Stock Exchange advanced while 60% of listings declined."

"For the S&P 500 the 50 largest capitalizations advanced an average of 11% while the remaining 450 declined between 16 and 44%."

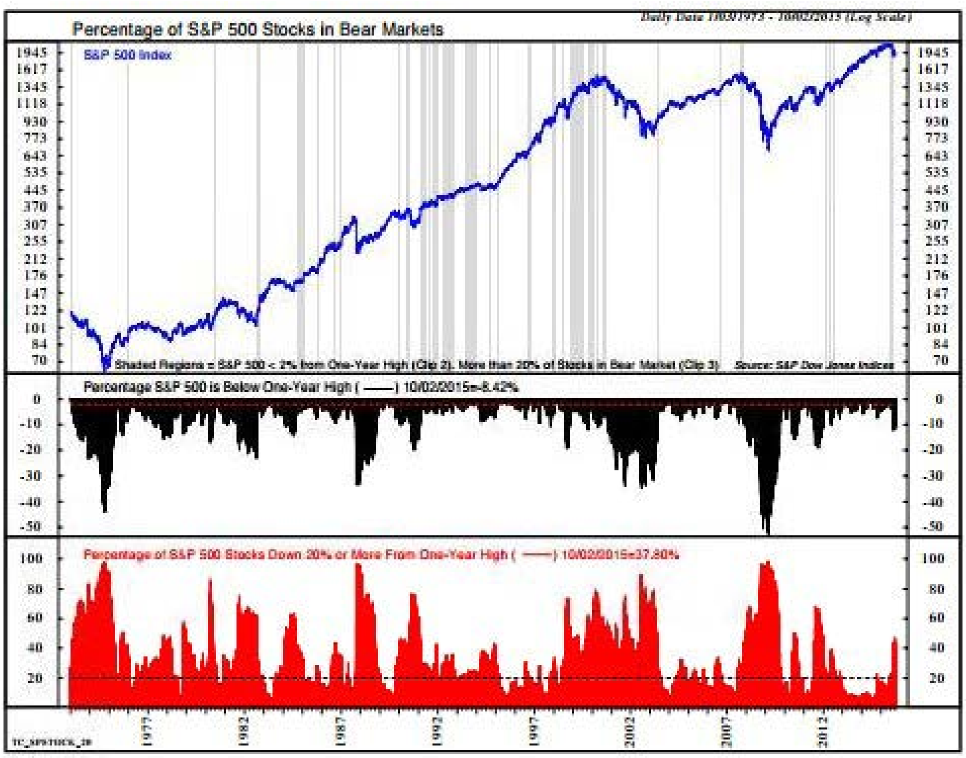
Some of the names from back then included:

	Internet Stocks			Old Standards	
	Mkt Cap	Revenues		Mkt Cap	Revenues
American Online	$70.8 bn	US$2.9 bn	Disney	$62.4 bn	$23.0 bn
Yahoo	$26.6	.15	Colgate	26.8	9.0
Amazon.com	$17.5	.42	J.P. Morgan	18.3	19.0
Ebay	$11.0	-	R.J.R. Nabisco	9.6	17.0

So the trademarks of the 1999 market included, no breadth, performance concentrated in a handful of overvalued stocks and no earnings growth.

2015 looked very similar. If we judge breadth by the number of issues advancing or declining, last year was pretty lopsided, with over 56% of the S&P 500 constituents declining.

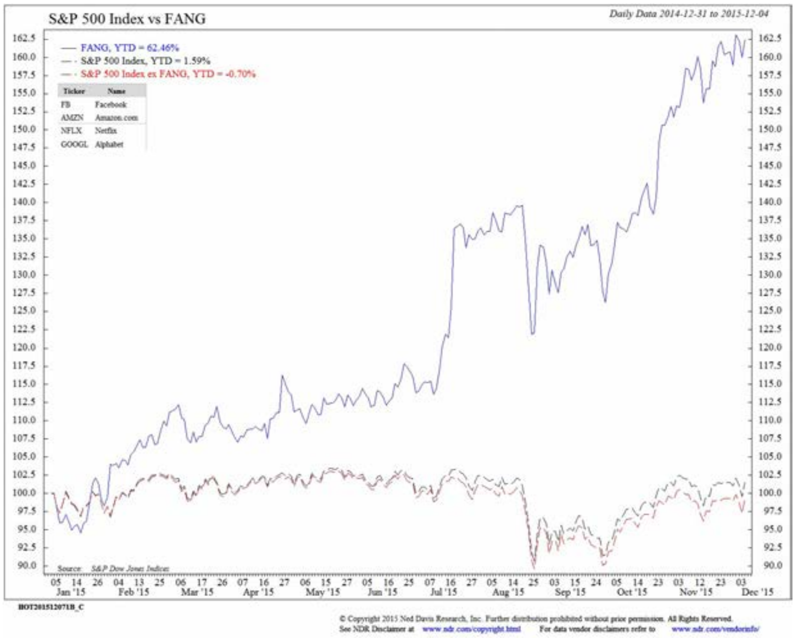
Not only were the majority of stocks down but the declines were significant.



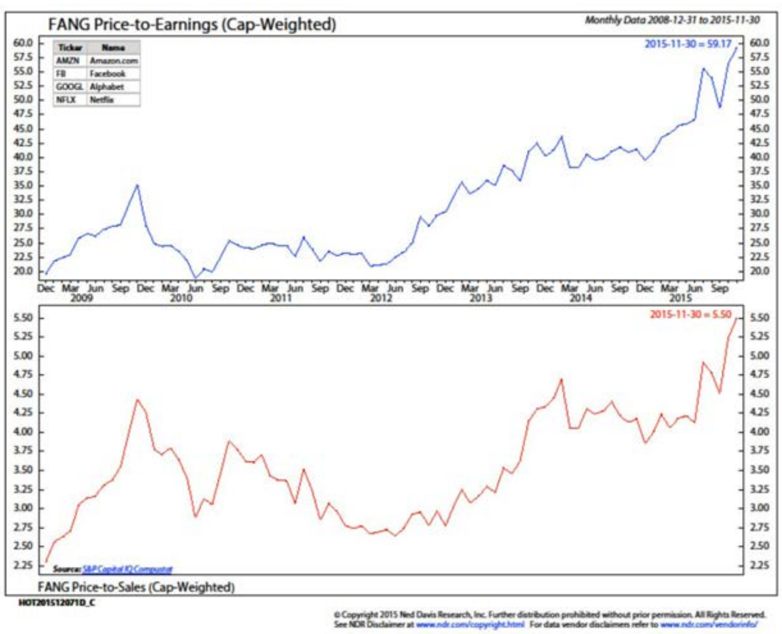
This chart measures the magnitude of the drops and suggests that through January 7th 2016, 42.2% of the S&P 500 companies were down 20% or more from their one year high, underlying how difficult it was to preserve capital and pick winners. In fact, the average stock in the Index was down over 24% while the S&P 500 index was only down 8.81% from its high.

Why such a divergence between the Index and the average stock? Well, it can be attributed to the same kind of concentration that we saw in the late 1990's.

Back then, they were known as the "New Economy Stocks"; this time they're known by the acronym "FANG" – Facebook, Amazon, Netflix and Google and worth a collective $831 billion.



This chart shows their collective performance which added roughly 48 points to the S&P 500 index.



There is no doubt they're good companies, but as seen in the top clip above, they collectively trade at almost 60x earnings. If you expand this exercise to the top ten companies, you will see they gained 71% last year while the other 490 companies lost 4.6%. The spread between S&P growth stocks and value stocks was a significant 9%.

Why do they attract such high valuations? I'd probably attribute it to a scarcity factor. In a market that isn't showing any earnings growth and in fact, may see three consecutive quarters of declining earnings, any company with above average growth is pretty rare and garners a premium.

So the odds of making money in the market last year were pretty low and in fact, a lot of stocks saw significant declines.

This is the third time I've seen a market like this other than the late 1990's period I discussed above. The first time was in 1974 when the "Nifty Fifty" dominated the market.

In each of the previous cases there was some catalyst that caused a change in the leadership and purchasing the out of favour investments proved to be very rewarding.

This may not happen broadly across the market this year but there is definitely the potential for certain groups to outperform as the perception of their future becomes clearer.

Bottom line, this market has been going through a fairly significant stealth bear market for a while, disguised by the averages being held up by a handful of growing but overvalued companies.

2. **China**

Of all the global economies, China seems to draw the most attention and has the biggest impact on North American markets. It's probably because news gets directly transmitted to our stock market through specific companies.

A weak economic statistic is immediately reflected in the price of oil or copper and as a result, the energy and material stocks react or Apple's sales in China get questioned. As the world's largest company by market capitalization, it has an impact on our markets.

A weak Yuan immediately suggests a currency war which will hurt the S&P 500 earnings.

The correlations are correct but the magnitude seems to be a little extreme.

Recently, the Chinese stock market took a dive and the immediate reaction was that it signaled a much weaker economy.

In fact, the market had a significant selloff last August and the government instituted new rules to mitigate the slide. One of the rules was a ban on the sale of shares by major stakeholders. This ban was set to expire on January 8th. Investors anticipating the end of the ban started to sell their shares and tripped market circuit breakers that are intended to maintain an orderly market. The circuit breakers require a trading halt for 15 minutes after a 5% decline and then the closure of the market for a day after a 7% decline.

Once the market reopened after the initial 5% decline everyone scrambled to sell before being locked out by the full day suspension.

The markets reopened the next day but the ban on major shareholders has been extended indefinitely. It has left the Shanghai-Shenzhen 300 index down 35.2% from last year's high on June 8th, but it's still 66.2% above the March 20, 2014 low.

There is also a lot of focus on their manufacturing PMI index. It edged up to 49.7 in December (anything under 50 suggests contraction) and has been below 50 for five consecutive months. Yet the output component of this index is at 52.2 and hasn't been below 50 since January, 2009. The weakest component of the index has been employment which has been below 50 since June, 2012 which could suggest that automation is being used to boost production while reducing demand for workers.

Furthermore, China's non-manufacturing PMI rose to 54.4 in December, a sixteen month high while retail sales have been growing at a double digit rate.

For sure there are problems. Their banking system is fairly leveraged and bad loans are rising. But the government would seem to have ample resources to deal with any issues and savings still exceed investment.

Economic growth is slowing as the country transitions from producing goods and capital investments to a consumption driven economy. But there are no signs that the pace of this slowdown is going to become dramatic.

3. **Oil**

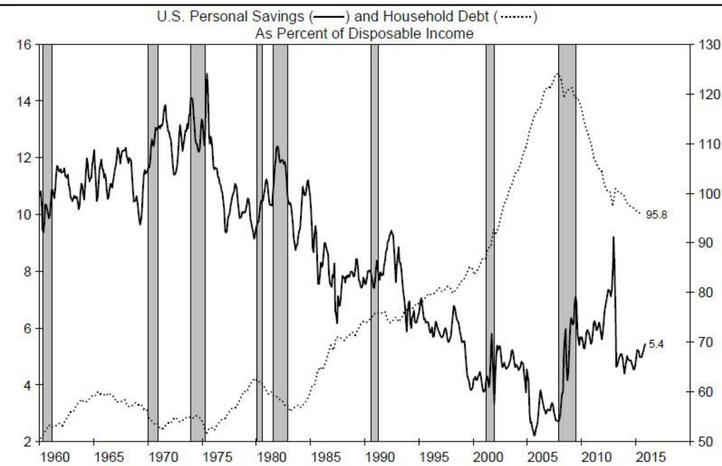
Is the price of oil another bad omen for the market? Well, if the decline in price was due to falling demand I might agree. But demand is up 2.4% year over year through November, the fastest rate of growth since July, 2011.

This time, it's a supply issue with Iran and Iraq increasing production suggesting over supply could now continue into 2017. It has resulted in price forecasts as low as $20 per barrel by Morgan Stanley and Goldman Sachs compared to its average price of $53.79 in 2015.

However, one must appreciate that negatives from oil are concentrated and immediate while the benefits are deferred and spread out. We saw a lot of the consequences in 2015 with cutbacks to capital spending in the oil patch.

The benefits could be enormous and could show up in 2016 considering that global oil revenues have plunged by $2.2 trillion from an annualized $3.8 trillion in June, 2014 to $1.6 trillion in November, 2015. OPEC is highly impacted with their revenues down by $770 billion. But for users of the commodity, this is a significant positive.

The decline in gasoline prices amounts to over $100 billion in additional buying power in the U.S. or about one thousand dollars per household.



This windfall hasn't been spent yet and this latent consumption can be found in the personal savings and household debt statistics where the consumer's balance sheet continues to improve as seen in this chart.

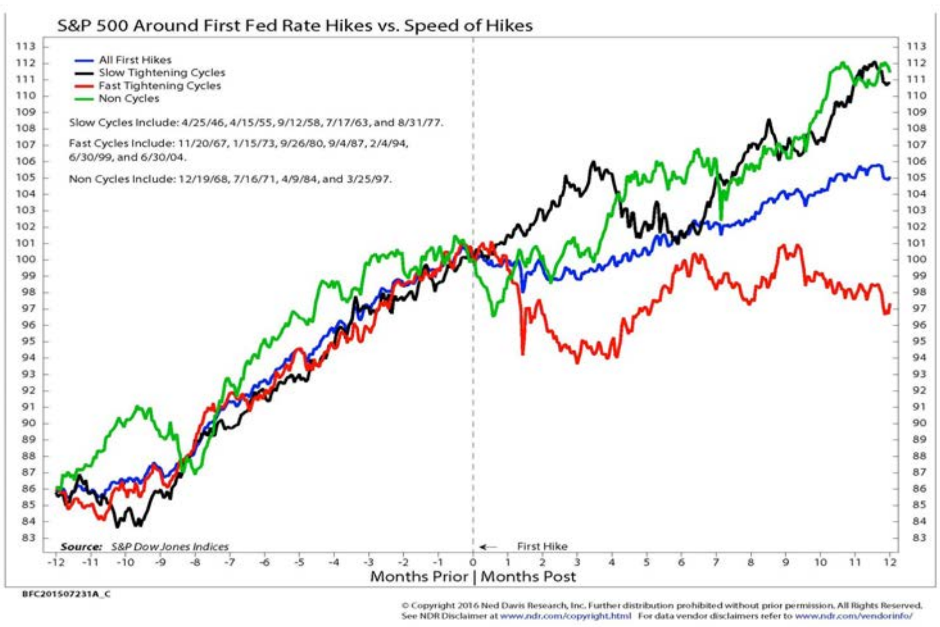
With further employment gains, 2016 may be the year when consumers start spending some of this oil dividend.

4. **<u>Federal Reserve Rate Increase</u>**

Well, the Federal Reserve finally got around to the most well-advertised interest rate hike in history this past December and the market has been stumbling ever since.

Market history will tell you that stocks generally decline leading up to and immediately after the first rate hike. So no one should have been surprised by the recent market reaction.

Where we go from here depends on the trajectory of future interest rate increases.



As this chart shows, slow rate increase cycles and non-cycles, (one or two hikes only), tend to be good for the market. In fact, non-cycle markets tend to initially underperform slow cycles immediately after the first hike but then catch up, which is consistent with what we are experiencing in the current market.

Essentially, the market has tended to shrug off one or two hikes but has struggled when long-term interest rates have risen by at least 100 basis points.

So, what's the prediction? Well, if you listen to some of the Fed governors, their tact seems to have changed. Until recently, they have responded to stock market weaknesses with dovish prospects for future policy.

Now in the face of a market decline, Fed Vice Chairman Stanley Fisher is projecting that the Fed will raise rates three to four times in 2016.

Markets expect maybe two rate hikes. Is the Fed tired of overpromising and under-delivering and now making sure they build in the worst case scenario? Or, are they concerned that any backing off in their stated direction would send a message that the economy is weaker than expected and result in a negative market reaction?

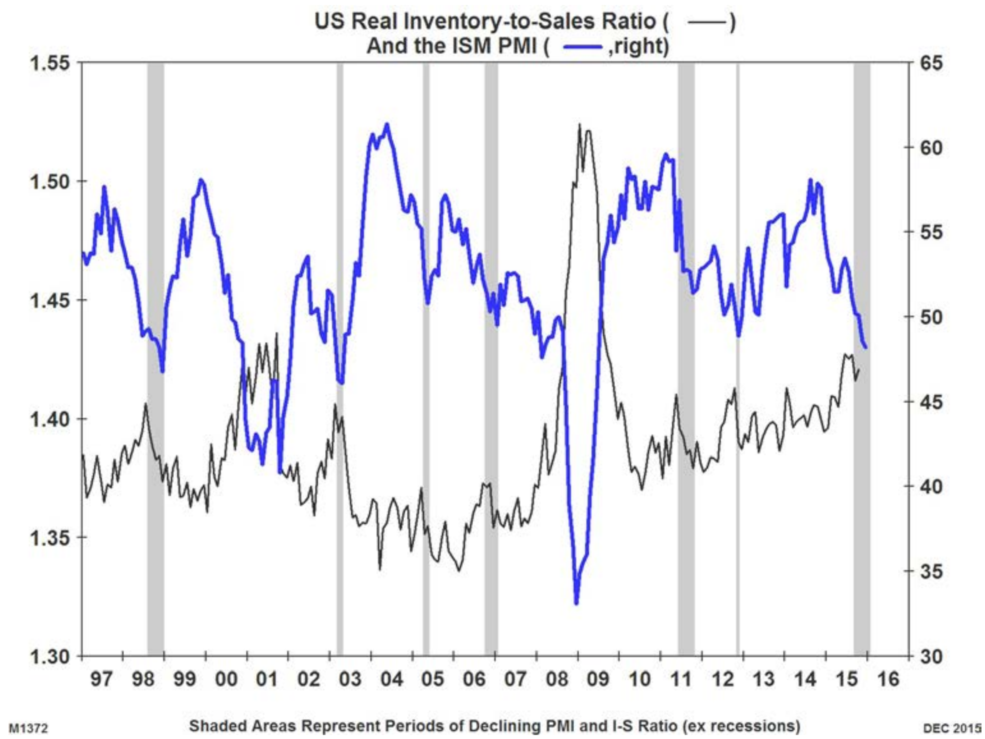
We know the December vote to increase rates was made with some reluctance, so my bet is that the Fed will remain data dependent and they won't be in a hurry to raise rates much further. Fourth quarter GDP forecasts are already being marked down, commodity prices are still declining and the dollar is still strong while equity markets are weak. If the Fed remains data dependent, this doesn't seem like an environment that calls for any additional monetary tightening.

5. **<u>US Economy</u>**

There is a concern that the US economy is struggling and could potentially slide into a recession.

Most of the concern is focused on manufacturing. For December, the Institute for Supply Management's (ISM) manufacturing index fell for the second month to 48.2 which is the lowest since June, 2009. There has certainly been a pronounced slowdown in manufacturing in the second half of last year as the plunge in oil prices depressed U.S. energy production. However, it generally requires an index reading below 43.0 to signal a recession and current readings are more consistent with 1.6% annual GDP growth.

Besides, manufacturing's share of GDP has declined to 12% from 27% in the 1950's and its share of employment has also declined to less than 9% from 30% over the same period.



What's accounting for part of the manufacturing slowdown is the unwanted accumulation of inventories as seen in this chart. Some of the accumulation can be attributed to the strong dollar and slower foreign sales but there is also unwanted inventory in retail as winter merchandise didn't sell well during the unseasonably warm Christmas selling season. The well-documented increase in oil inventories is also affecting the ratio.

Meanwhile, the nonmanufacturing ISM came in at 55.3, down slightly from the previous month's 55.8, but still a very healthy number especially since the new orders component of the index improved to 58.2 from 57.5.

On balance, the domestically oriented industries such as autos and housing continue to show strength while those affected by the strong dollar or commodities are underperforming.

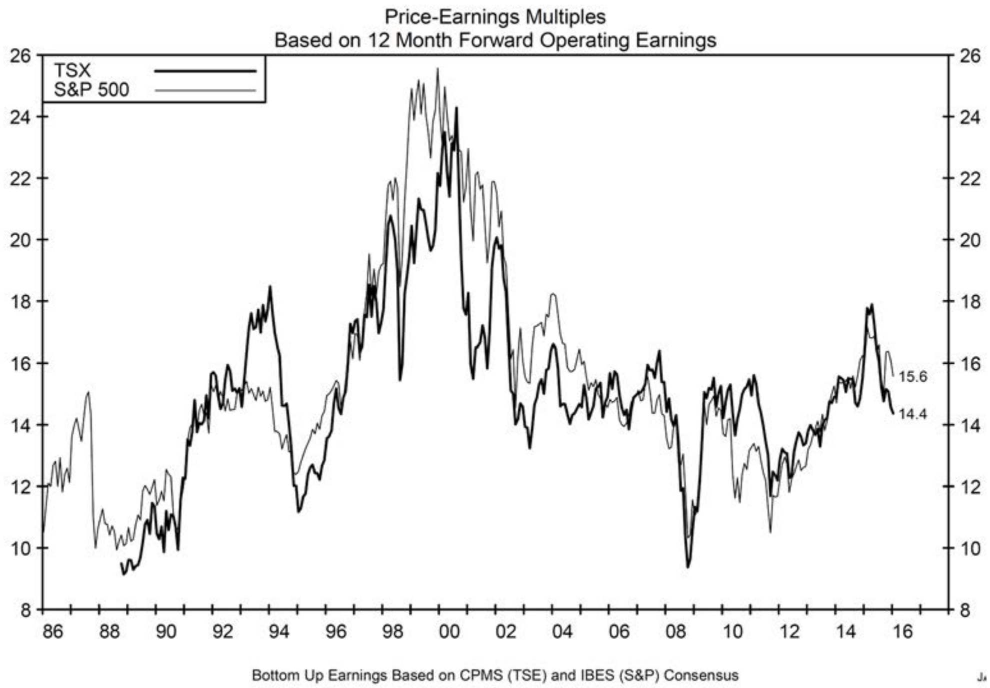
Nonetheless, employment continues to be strong and should support further consumer spending in 2016.

6. **<u>Valuation</u>**

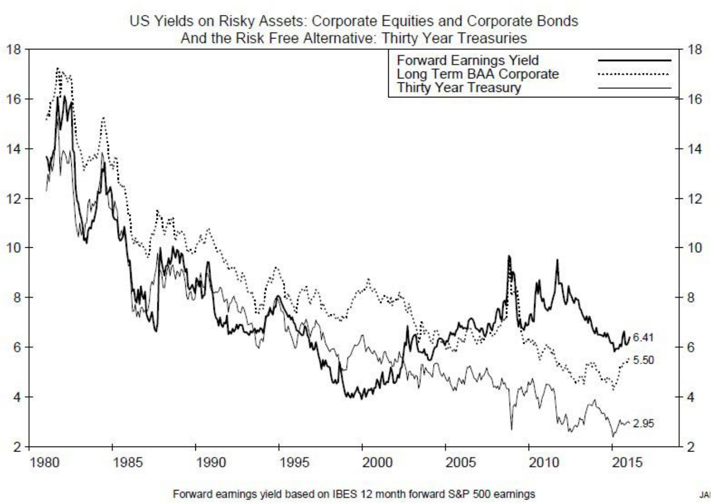
This is the one area that gives me the most concern and not only for the stock market. Real estate and fixed income are also overvalued and the signs of a correction are apparent in Real Estate Investment Trust prices and bond yield spreads. Commodities are one of the only areas in full retreat and could be approaching a bottom. However, commodity cycles are long and at best we're nine years into the oil price correction if you consider 2007 as the top and 2014 essentially a re-test of that peak.

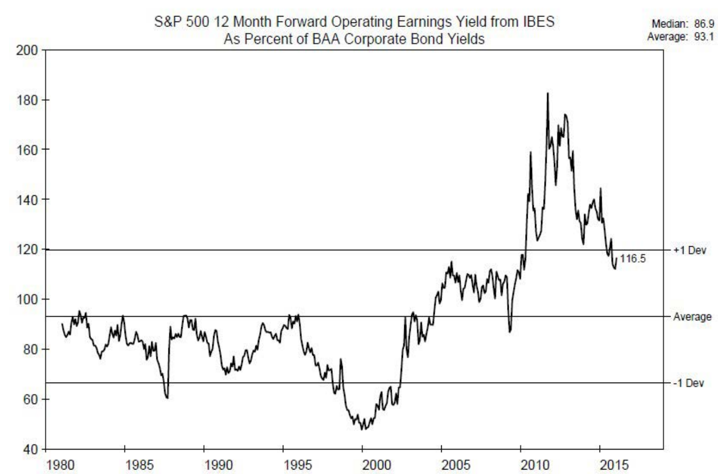
Here, my gut says to be a contrarian and look to the most out of favour asset class. This might surprise you but that asset class would be "cash". Nobody wants it and it doesn't earn anything. But it's liquid and won't lose value given the current inflation rates. On a relative basis, it's looking pretty good right now.

The stock markets, both the TSX and the S&P 500 are trading either side of 16x trailing earnings and 15x projected earnings as seen in this chart.



The valuations don't suggest that the market is overly expensive but it isn't cheap either, especially if the earnings estimates prove to be too high which I think is likely.





The only valuation metric that suggests the market is cheap is when you compare earnings yields to bond yields.

This spread has been a primary supporter of the market because it has allowed corporations to borrow cheaply in order to buy back their shares.

As you can see in the above chart, the earnings bond yield spread still supports the market, but the recent uptick in corporate rates makes it less favourable than it was earlier.

However, if you dig below the surface a little the picture appears a bit brighter.

In aggregate, earnings for the fourth quarter are forecast to decline for the third consecutive quarter by 3.9% and earnings are expected to reach $118 for the year. The two biggest detractors from earnings would be energy and the U.S. dollar. However, the S&P 500 earnings ex-energy would be at a record high. In the third quarter, S&P 500 earnings reportedly dropped 14.7% but rose 2.3% if energy was excluded.

This year, energy is unlikely to have as big impact on aggregate earnings, as its weight in the Index has dropped from last year's high of 12.1% in January to only 4.2% at the end of November.

The dollar has also contributed to the decline in S&P earnings. With its 20% appreciation since the summer of 2014, it has slashed about $93 billion or $10 per share from the S&P 500 earnings.

So there has been a lot of change below the surface for the major indices. As I said earlier in this piece, over 40% of the S&P companies are down over 20% from their highs while the averages have held up extremely well. Yet, six of the 10 market sectors had lower price earnings ratios at the end of last year than at the end of 2014.

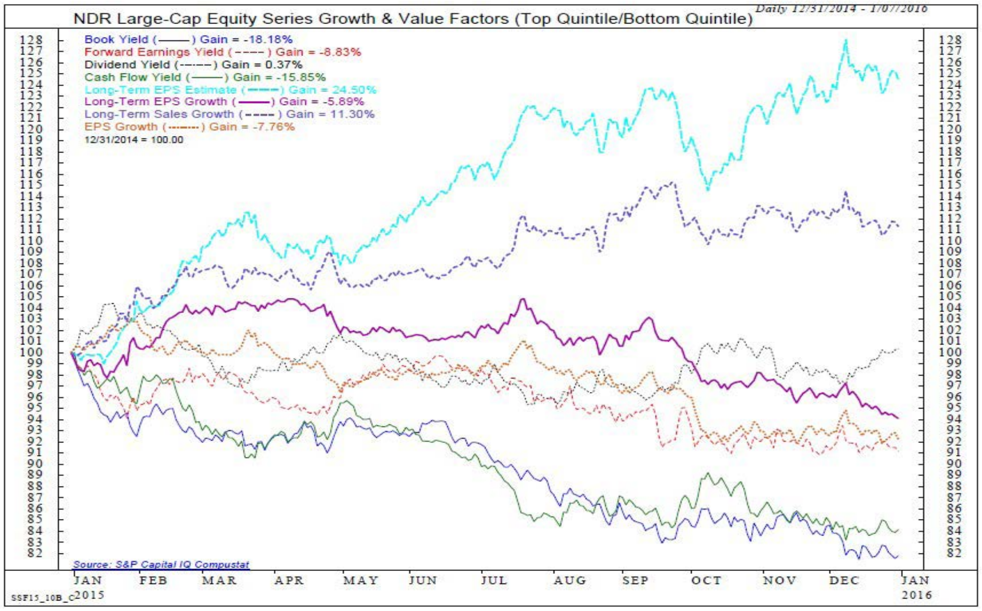
The only sectors to have major increases in valuation were Energy and Consumer Staples.

If we removed these two sectors from the S&P 500 index, the average would be trading at a more reasonable 15.6x earnings. If we eliminated only the "FANG" stocks, the market would be at 15.7x and if we eliminated both groups, the S&P 500 is trading at 14.7x. Pretty reasonable.

Conclusion

My gut says we have yet to see enough volatility or fear to set a solid bottom. The VIX (CBOE Volatility Index) recently reached 27 and is 60% higher than a year ago. However, between 1990 and 2014, the index spent one third of its time between 20 and 30. And, higher fear almost always equates to lower valuations.

That said, my head says that the market has already endured a fairly significant stealth bear market not only in breadth but by style. Value investing has been out of favour and individual companies are starting to look cheap.



This chart provides a good breakdown of performance by investment characteristics.

As you can see, long term earnings per share (EPS) estimates, a classic trait of a growth or momentum stock, led the performance pack last year. Meanwhile, value investors that focus on free cash flow yields saw their performance and the value of their companies underperform significantly.

Will it turn? In my experience, it always has in the past. Styles like most variables will regress to the mean as they come into or fall out of favour.

The catalyst for change this time will probably be the economy. Certainly a stable or weaker U.S. dollar would be good for earnings.

Maybe oil bounces which would be good for the resource sector but at only 4.2% of the Index, it won't be significant.

More likely, employment holds up and the savings from the gasoline pump start to get spent.

Overall, it may not result in an improvement in the aggregate averages but the internal dynamics of the market could be a mirror image of what we saw last year as value investing starts to pay off.

So, I'm reconciling my internal conflict by believing that my gut senses a correction while my head believes it will be in the context of an ongoing bull market.

GRC/amh
January 12, 2015

Credits:	Barrons	Ned Davis
	TD Securities	Yardeni