IT'S SUPPLY AND DEMAND – STUPID

We've put a twist on President Bill Clinton's campaign slogan "It's the Economy – Stupid", suggesting investors stay focused on what's driving this market: namely corporate buybacks and mergers and acquisition activity.

For sure, there are a lot of headlines to worry about especially regarding Greece and China's stock market.

I won't dismiss them, but Greece seems to be on a path to resolution even if it might only be temporary. All told, it's estimated that the country owes about $540 billion, spread among bond obligations, central bank's liquidity assistance and interbank balances. A default would require some of the institutions that have lent Greece money such as the European Stabilization Mechanism (ESM), which is a corporation, and the European Central Banks (ECB) to recapitalize themselves. Given that the ECB has been a buyer of bonds, this would probably be pretty disruptive to the European Monetary policy.

China is also a wild card. Their domestic stock markets have risen about 150% since last year. However, they've collapsed almost 30% since mid-June, wiping out an estimated $4 trillion of value. The cause of the decline is being blamed on forced liquidation from margin calls where loans to support equity purchases surged five-fold to $323 billion since last year.

The Chinese government has instituted a number of measures to stem the slide including:

- Cutting interest rates
- Back stopping margin loans for banks and brokers
- Suspending Initial Public Offers (IPOs)
- Pension funds and insurance companies are being pushed to allocate funds to Chinese equities
- Brokers have been ordered not to sell stocks and forced to set-up a $20 billion fund to buy blue-chip stocks
- Corporate executives, directors and insiders have been forbidden to sell their holdings for the next six months
- Short-selling is being discouraged
- Trading has been suspended in roughly half of the exchange listed companies

Seems as though they're taking this seriously.

However, a lot of experts don't think the market slide is anything to get too worried about.

It may be true that stocks only comprise about 15% of household assets and stock traders may only represent 7% of the Chinese population, or about 90 million people; however, they're probably the upper middle class that the government is counting on to develop a more consumer-oriented economy.

To the point, vehicle sales growth forecasts were recently cut from 7% to 3%.

Although Greece and China seem to be getting equal press coverage, the magnitude of the problem seems to be dramatically greater for China. A $4 trillion hit to a $10 trillion economy as compared to a $540 billion problem for Europe which has an economy almost the size of the United States.

Nonetheless, each problem is leaving its mark on the financial markets. China's in the commodity pits where we've seen a collapse in copper and iron ore, most likely due to margin call liquidation. And in the case of Greece in the currency and bond markets, investors worry about the contagion in the sovereign debt markets and run for the safety of the U.S. dollar.

It's resulted in some mixed signals for investors. Is commodity weakness due to a slowing global economy or loan collateral being liquidated? Is the strong dollar due to the Federal Reserve's impending interest rate increase or a flight to safety?

Will these problems jump up and bite us? We don't know, but we might borrow a line from Federal Reserve Chairwoman Janet Yellen at her last press conference when she said, "the situation in Greece remains unresolved" to which we would add China.

So, what do we know? Well, the market remains expensive but remarkably resilient to bad news.

It's still our belief that the secular bull market will continue until we get either a tighter monetary policy or a recession.

Neither seem to be on the horizon but each has a caveat that's worth examining. Let's start with monetary policy. The Fed has ended its accommodation phase and is now talking about raising interest rates. The only issue that is remaining is when. The consensus bet is this September, or it could get pushed off until December. So what's the hold-up? Well, monetary policy operates with a delay of about one year. If it starts too late you risk getting an overheated economy and overshooting the Fed's inflation target. Start too early and you could snuff out the recovery that has been building slowly.

At the June 17th press conference, Chairman Yellen stated, "The committee currently anticipates that, even after employment and inflation are near mandate – consistent levels, economic conditions may, for some time, warrant keeping the target Federal funds rate below levels that the committee views as normal in the longer term".

So it's apparent that if the Fed is to make a mistake, it would rather err on the side of too much inflation.

Besides, this cycle is different than previous cycles where rising rates reflected a tighter monetary policy. This time, the Fed will be taking rates from almost zero towards normal which is far from tightening. There is currently no motivation for the Fed to rein in an overheated economy. So this phase is probably better labelled "normalization" rather than "tightening" and represents a recognition that an abnormally stimulative monetary policy is no longer required, but it's not tightening in the traditional sense. It is however less favourable, maybe, than what we have experienced over the last 6 years.

This phase will certainly take the accent off of bonds and could cause some volatility and overreaction in the fixed income market as investors reconsider their options and sell bond funds into a very illiquid market. The question then becomes, what do they do with these funds? Perversely – rates will be higher making fixed income returns look better but equities could be the answer.

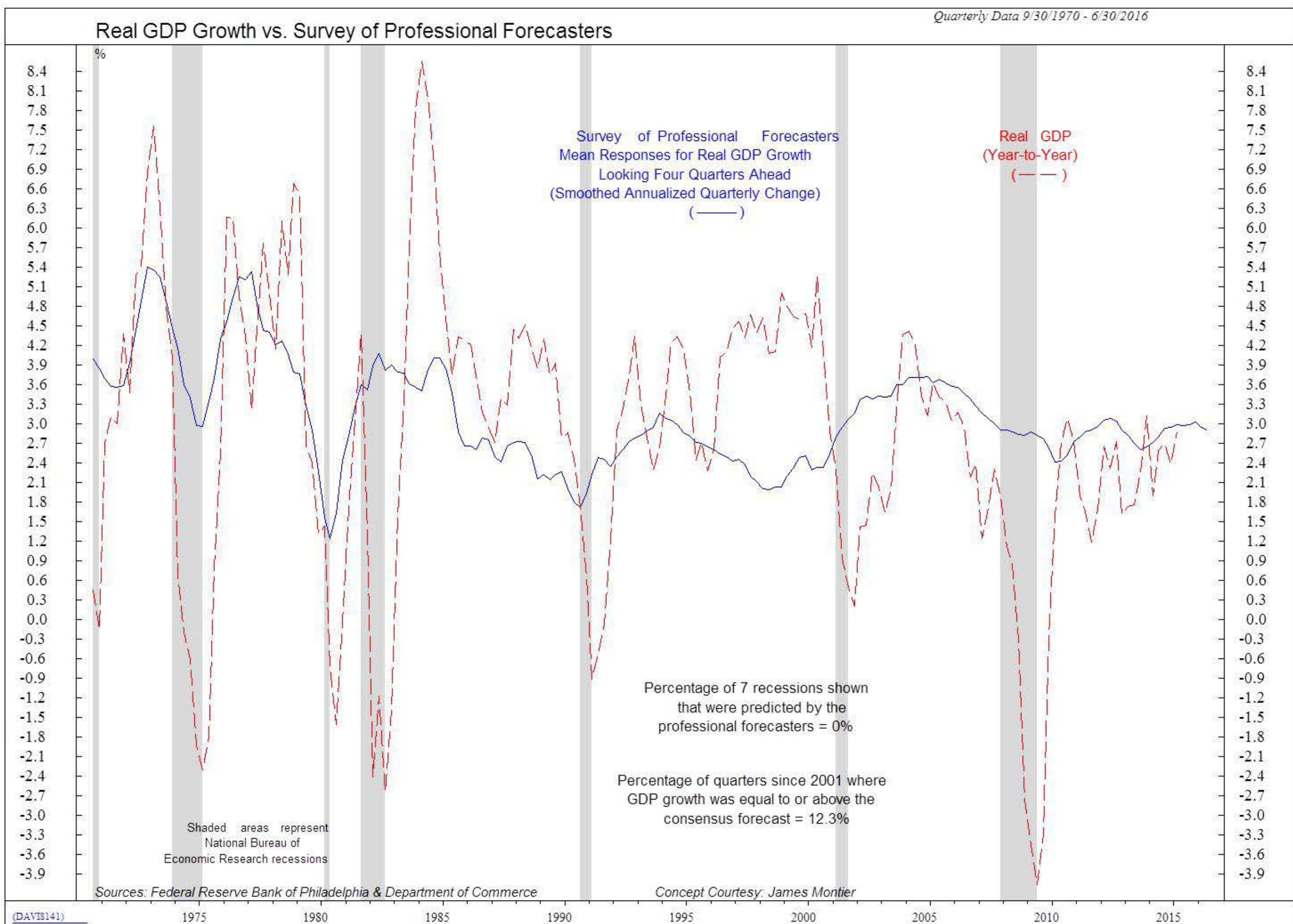
At the start of previous Fed rate hikes, the 10-year treasury yield was between 4.65% to as high as 10.3% with an average of 7.0% compared to 2.25% today.

Fed funds rates in the previous six rate hike cycles started at 5%. In other words there is room to raise rates before they bite on the economy. A Fed funds rate of 1% would still be historically low and is three hikes away.

Bottom line, the economy is not likely to be strong enough to support sustained or significant interest rate increases. The only challenge to monetary policy could come from inflation, especially in wages.

Consequently, we don't see monetary policy as a threat to the bull market.

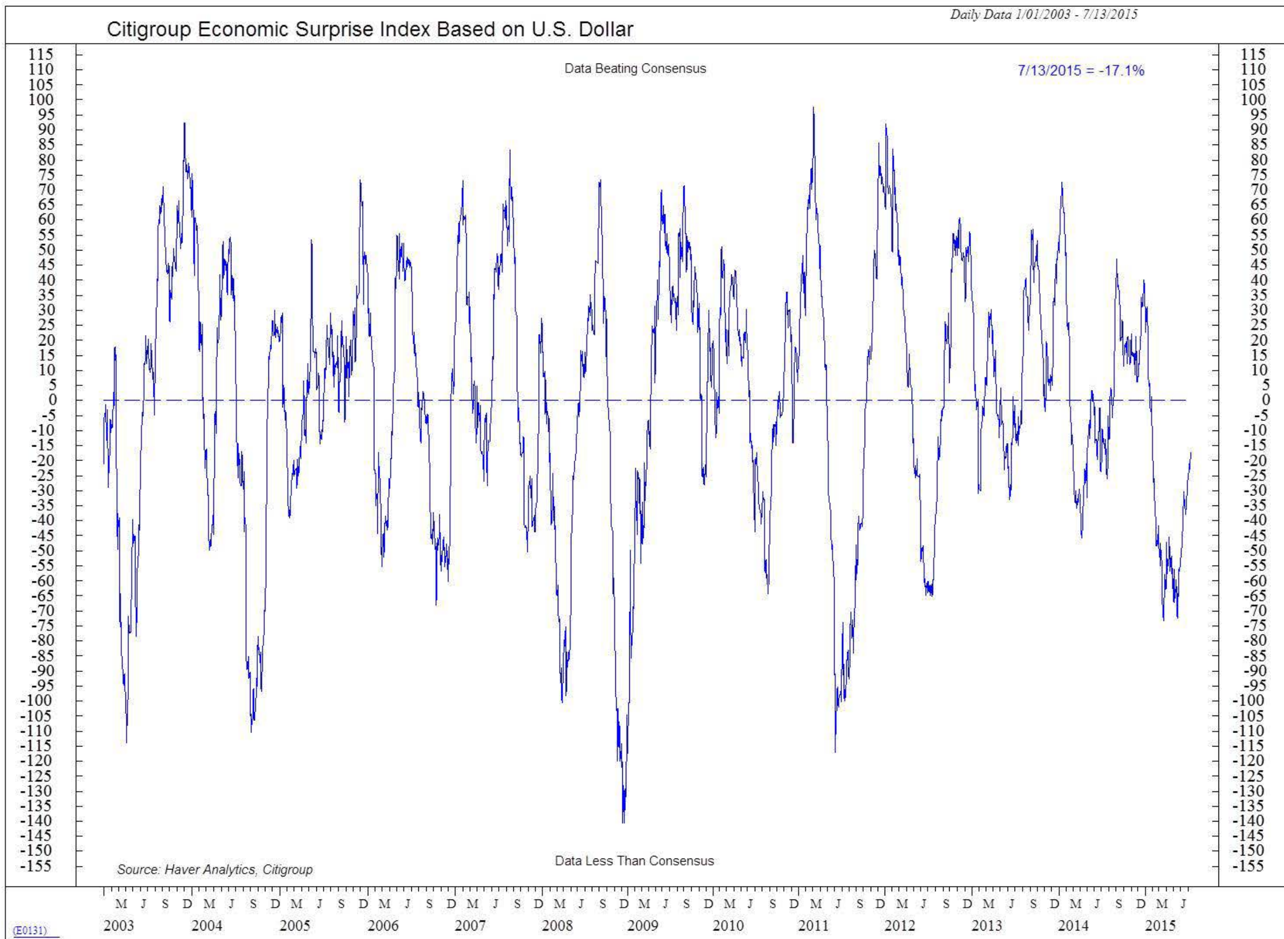
The other show stopper for this market would be a recession. Right now, no one is forecasting this and in fact the majority see a re-acceleration for the economy in the second half. The trouble with this is that the track record of the survey of professional forecasters is pretty poor. Since 1970, we've had seven recessions and the consensus forecast has predicted none of them. In fact, real GDP has only met or exceeded their forecasts 12.5% of the time as shown in this chart.



So they're not a very credible group to place confidence on. Yet market expectations are for an economic improvement in the second half of this year.

Let's hope they're right because the year hasn't started off too well. We had negative GDP in the first quarter which was blamed on weather and a West Coast port closure. However, even after these issues were resolved, the economy didn't bounce back.

More recent economic releases have improved. Probably the best overall gauge for how the economy is doing is represented by the Citigroup Economic Surprise Index.

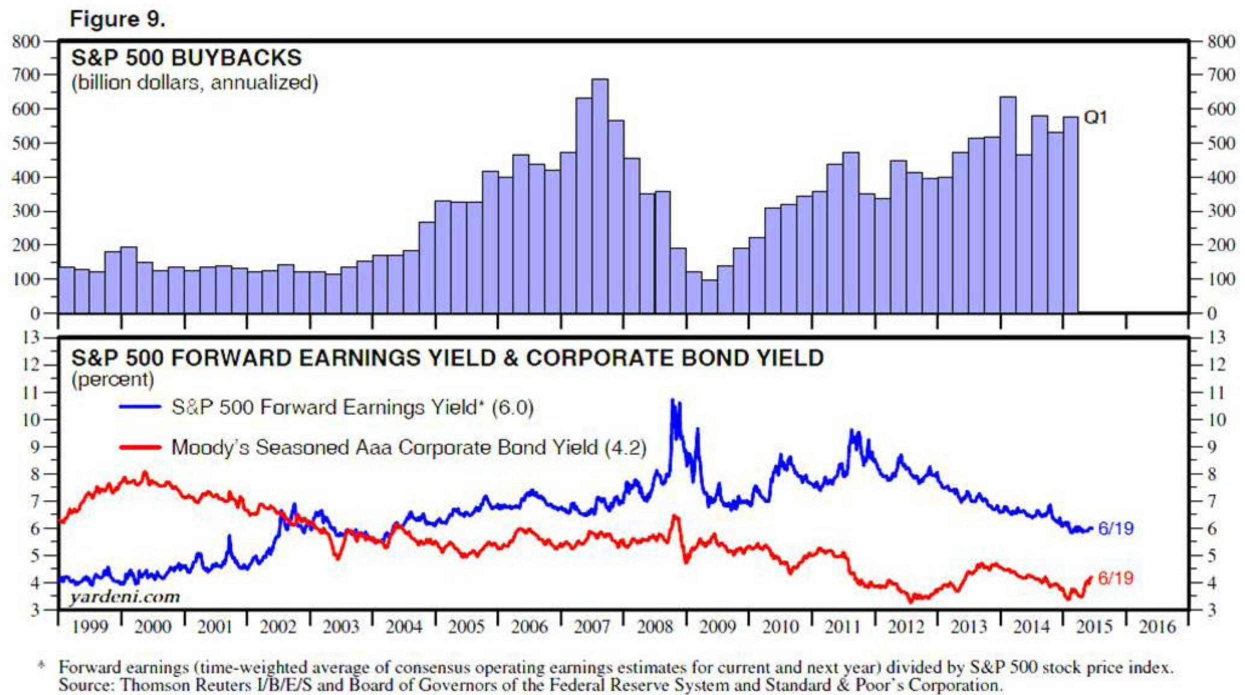


Here you can see the collapse in results versus expectations early in the year, and its recent improvement.

If things stay on track, we don't believe the economy will threaten this market either.

This status quo leaves us with a market that is overvalued in absolute terms but still cheap relative to interest rates, especially for valuation insensitive corporates intent on driving earnings per share higher when economic growth isn't providing much help. This is also the inspiration for our title because corporates are the 300 pound gorilla in this market.

Figure 9.



* Forward earnings (time-weighted average of consensus operating earnings estimates for current and next year) divided by S&P 500 stock price index.
Source: Thomson Reuters I/B/E/S and Board of Governors of the Federal Reserve System and Standard & Poor's Corporation.

We've shown this chart several times in the past. It indicates that the Standard and Poor's forward earnings yield at 6% exceeds their borrowing costs of 4.2% which makes it economic and accretive to borrow to buyback shares.

Stock retirements in the first quarter totaled $144 billion and $538 billion in the past four quarters. Dividends totaled an additional $93 billion in the quarter and $362 billion for the year. Since the start of the bull market, corporates have repurchased $2.4 trillion of stock and paid out $1.7 trillion in dividends.

More than a fifth of the companies in the S&P 500 reduced their shares outstanding by 4% or more during the quarter and nearly 300 companies reduced their share count to some extent.

Yet, cash held by all non-financial corporations remains near $2 trillion.

On top of this, mergers and acquisitions continue to heat up. Globally, there have been almost $2.15 trillion in 20,000 M&A deals done or offers made in the first half of the year. This puts 2015 on par to match the record $4.3 trillion in deals done in 2007.

Buybacks and M&A represents a large chunk of market capitalization.

So, failing a dramatic economic slowdown or significantly higher interest rates, this supply and demand balance should provide the foundation for this secular bull market.

Valuation

That said, we're still faced with a market that is verging on expensive, especially considering the lack of earnings growth.

Although analysts expected a 3.9% year over year decline in the first quarter earnings, they were relieved to get an actual 1.4% increase.

And, if you exclude energy, earnings rose 11.3% year over year which might be some justification for the market's valuation.

The second quarter's expectations are set at a similar 3% decline led again by a 63.1% drop in energy and if it is excluded, it would result in a modest 3% gain. For the year, earnings are only expected to grow 2.2% followed by a gain of 12.6% in 2016.

Nonetheless, it's been remarkable that the market has been able to hold up as well as it has in the face of declining earnings expectations and the resultant higher valuation.

In fact, the S&P 500 is close to the level it was at last November, when earnings revisions started in earnest. Last October, S&P 500 earnings were expected to come in at $136.14 for 2015 versus the current forecast of $119.38, a 12.3% drop with no adjustment in market values.

So maybe that's a good segway into what might be going on under the surface of this market.

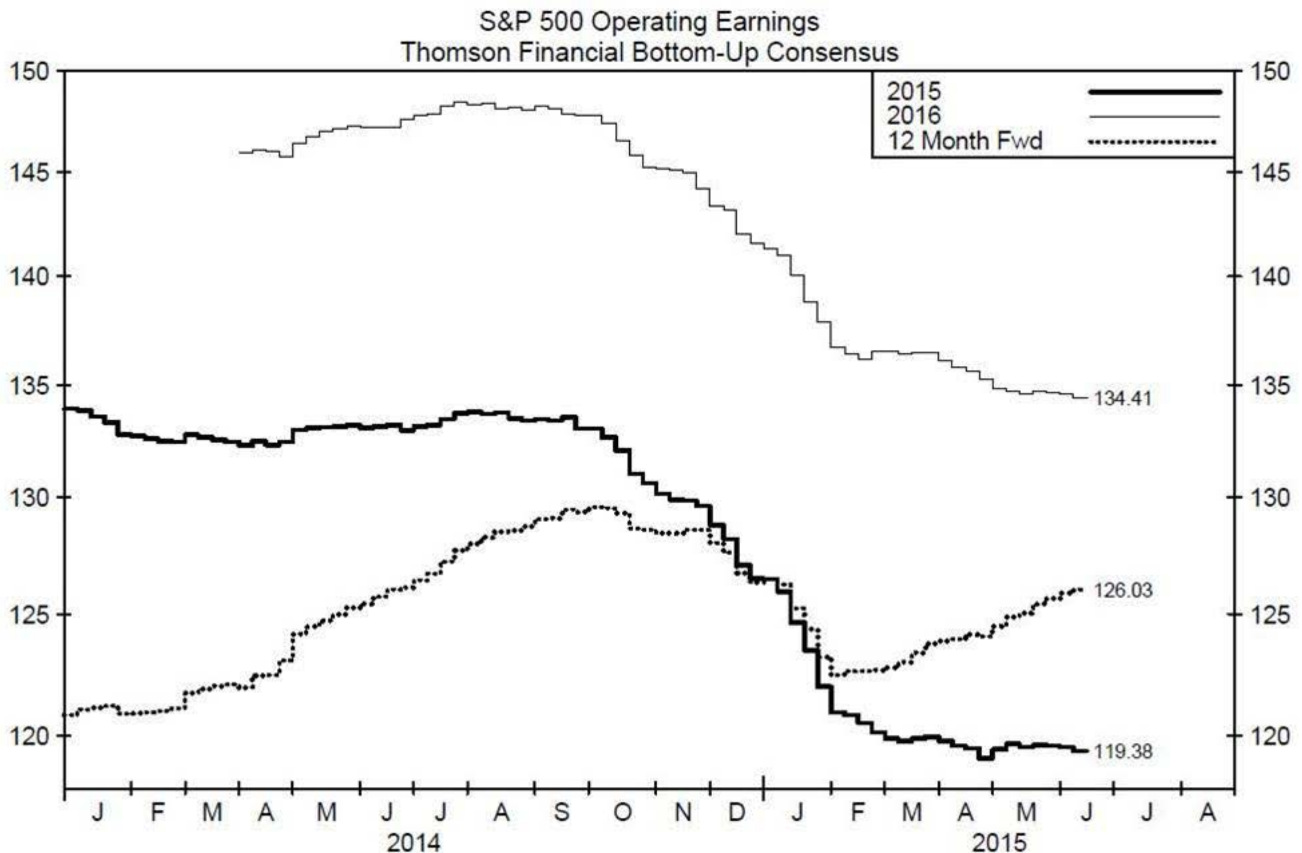
Basically, there are three ways for a market to experience a correction.

1. It adjusts through valuation (Declines)
2. It adjusts over time (Stays flat)
3. It adjusts through rotation (Stays flat)

The first one is what most of us worry about because the market experiences a sharp setback. Sometimes that decline is based on false assumptions about the economy or world events similar to what we saw in 2011 and 2012. At other times, it's a reaction to the actual numbers. Something that could have happened this time. As earnings expectations were cut 12.3%, one might have reasonably assumed the market would decline an equal amount just to maintain the same valuations.

However, it didn't and as you can see in this chart, valuations spiked higher.

The second type of correction is one that takes place over time.



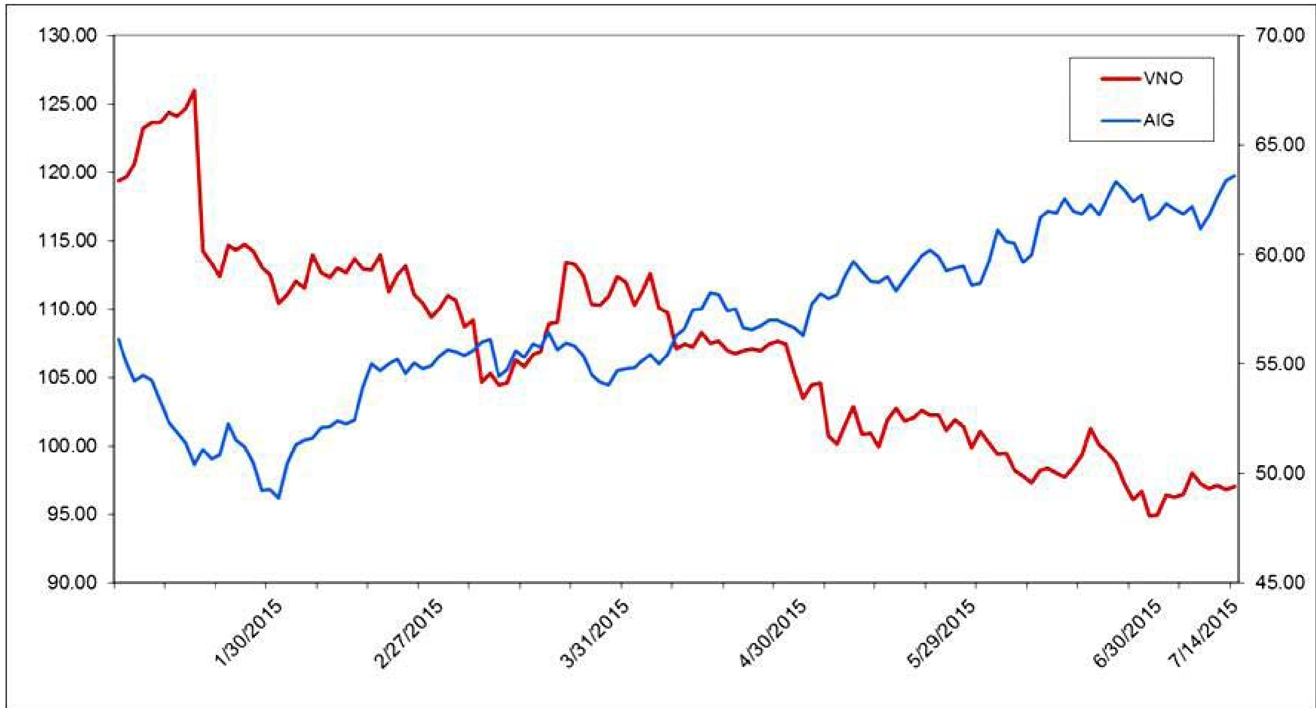
This chart depicts the earnings expectations for 2015 and 2016 with another set of numbers that time weights those two estimates. In other words, once you get to mid-year, you use half of this year's estimate and half of next year's for a twelve month forward forecast.

Consequently, if the market stands still, which it essentially has, the valuation on a twelve month forward basis gets better with each passing month as you move closer to the higher 2016 estimate. If this pattern continues for the balance of the year, the market's overvaluation will settle back from roughly 17x forward earnings to the long term average of around 15x. Not cheap but better.

A third type of correction can take place as stocks move in different directions.

Although the S&P 500 averages are relatively flat, over 20% of the constituents are off over 20% from their highs compared to only 4% a year ago.

The simplest way to see this is to compare two stocks, both within the financials.



In the above chart, you can see how well American International Group (AIG) has performed recently compared to Vornado Realty Trust (VNO). AIG will benefit from higher interest rates while VNO won't. Yet they are both in the same sector and offset one another's performance.

You're seeing something similar with economically sensitive companies declining while less economically sensitive companies like Healthcare are performing well. It's led to the Dow Jones Transportation Index actually breaking down which could be a bad omen, unless the economy catches a second wind.

From my perspective, it's remarkable that the market has now gone over 914 days without a 10% correction. Maybe that speaks to the underlying strength of this bull market.

Nevertheless, a correction over time and through rotation is obviously taking place and if this persists, it will probably set us up for the next leg higher in this market.

Conclusion

The foundation of this market is still based on the extraordinary amount of valuation insensitive buybacks and M&A activity that we are seeing which tips the supply demand balance in favour of the bulls.

Although valuations are high, they can probably be sustained due to the historically low interest rates. Nonetheless, it's an uncomfortable equation for value managers like us who would rather see the market sell off to more reasonable levels providing us with a margin of safety.

Nevertheless, if the market continues to go through its internal rotation, opportunities will present themselves, probably in the economically sensitive sectors where earnings can reaccelerate as we work our way into the back half of this year.

Overall, we do not expect a broadly higher market because valuations are already stretched. To make a case for higher price earnings ratios would suggest interest rates are about to decline, which is the opposite of what we anticipate. Consequently, appreciation has to be tied to earnings growth which isn't getting much help from the economy. So stock selection will become the overriding factor.

And, of course, all of this presupposes that there isn't some unpredictable exogenous event. Does Greece get pushed out of the Euro triggering a financial reaction, does Russia invade the Ukraine, could trouble in the Middle East result in an unexpected spike in oil prices that hurts the global economy or what happens if China's economy rolls over?

So, there's still lots to worry about.

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