CUMBERLAND

2014 - A Transition Year

Are we finally recovering from the financial shock of 2008 which saw some of America's major financial institutions collapse and personal lifestyles predicated on home ownership destroyed? It was a crisis that changed corporate, government and investor behavior, but it's been five years, long enough for things to heal.

Why's this important? In my opinion, for two reasons. First, this has not been a normal economic recovery. It has been denominated by monetary policy which has ventured into unexplored and untested territory that has yet unknown consequences when it is unwound. Just consider last spring's bond market reaction to a suggestion of "tapering" by the Federal Reserve.

So, something else is going to have to replace monetary policy to make sure the economy is self-sustaining.

Second, it's human nature for investors to extrapolate past experience linearly into the future in what is a cyclical world. My father always lived looking over his shoulder for another Great Depression. Today's investors watch their rear view mirrors for another 2008. That experience froze a number of them, and if they survived, it created a stampede for the safety of the bond market where many of them have continued to hide until recently. After almost five years, it now appears safe to come out. That's an unusually long period of hiding but as confidence recovers, it will mean that the life of the current bull market will be extended. Not that we won't have corrections along the way, but I would still contend we're in the middle third of this market cycle. Seasonally the thaw happened awhile ago, spring has passed and we're well into summer. You can expect some thundershowers to dampen a couple of picnics but fall is still ahead of us when you'll want to hunker down for some extended bad weather.

Now it's that time of year for renewed expectations and reflections on what was and could have been.

So, let me start by looking back before I build on why I think 2014 could be a transition year.

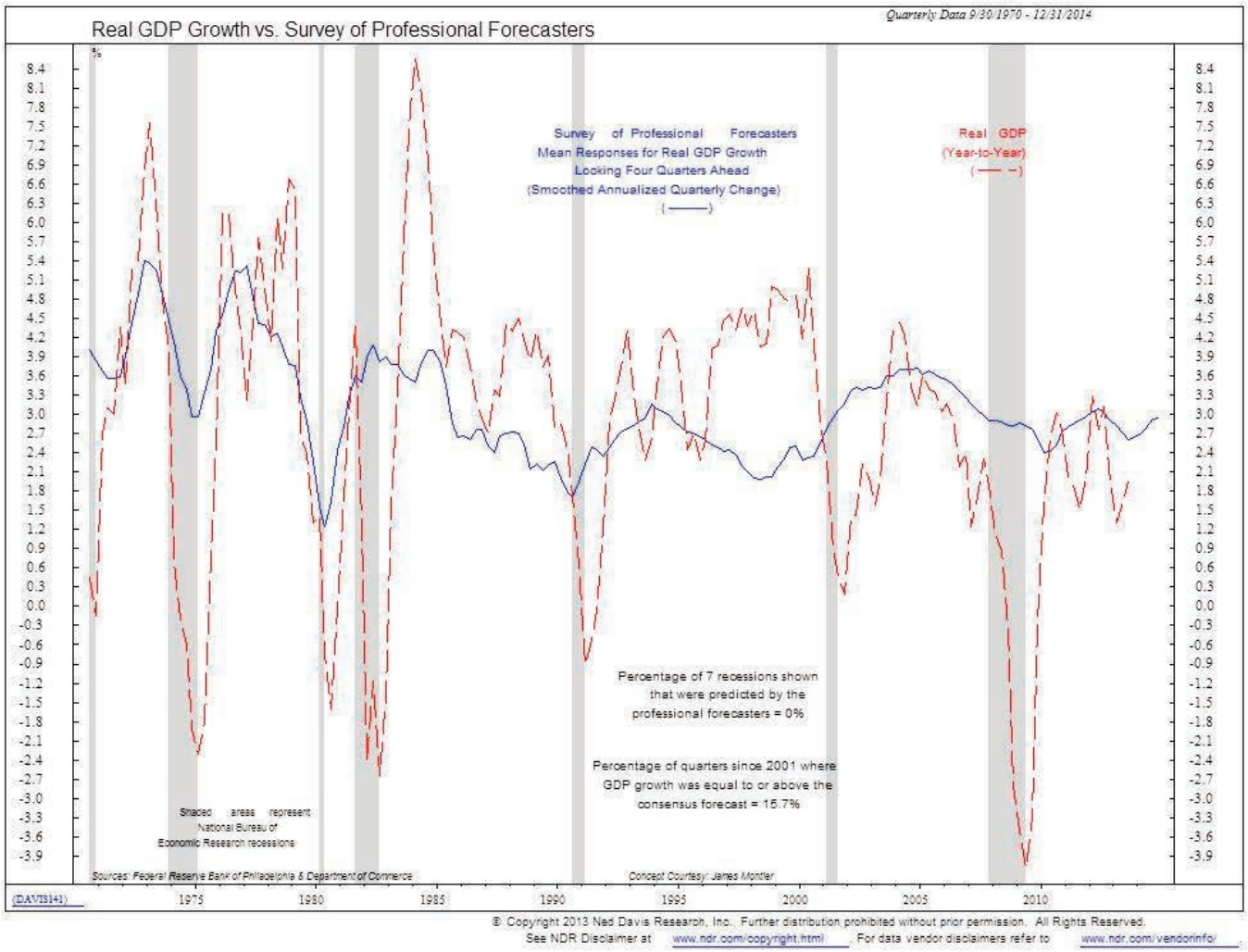
Last year we were pretty optimistic about the market as we felt that fear was going to give way to caution as most of the big serious macro issues, including Greece, European banks, etc., seemed to be behind us. The only one remaining was the "Fiscal Cliff" which, although diluted, still promised to take some of the wind out of the economic sails.

But, regardless of the economic forecast, we felt liquidity was still overwhelming and the primary force behind the market's advance.

We also used a top down earnings forecast that projected S&P 500 earnings of $108.00 per share based on 2.6% GDP growth and 2.2% inflation. Consensus was $112.99 and it looks like 2013 earnings will come in around $109.13. So we were close. Where we missed was guessing the earnings multiple (P/E) which we thought might expand to 15x giving us a target of 1620 on the S&P index. Instead the market soared to 1849, closer to 17x earnings. Our only defense to this is to suggest it's better to be directionally correct but too conservative than overly optimistic and wrong.

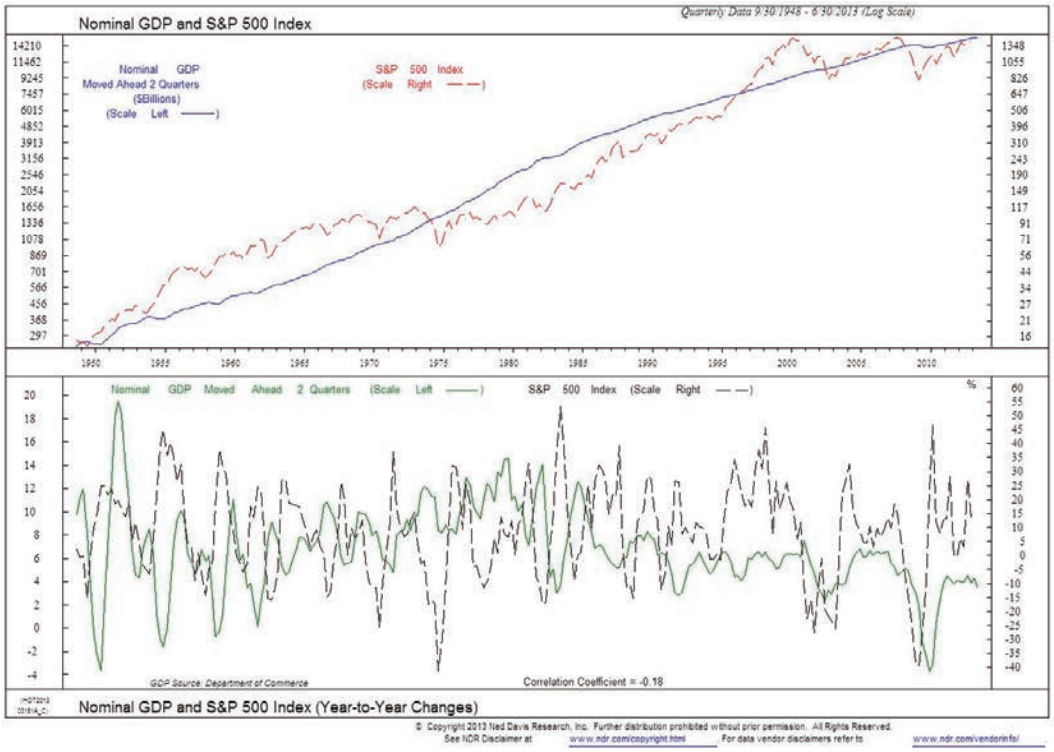
It also supports our reluctance to make forecasts. Not that we don't have expectations, but we're not about to get locked into a prediction if the facts don't support it. We've all seen too many high profile economists get trapped and feel compelled to stay with a bad decision. Not only is bad forecasting common amongst economists but the correlation between the market and the economy is also pretty flaky.

Consider the following:



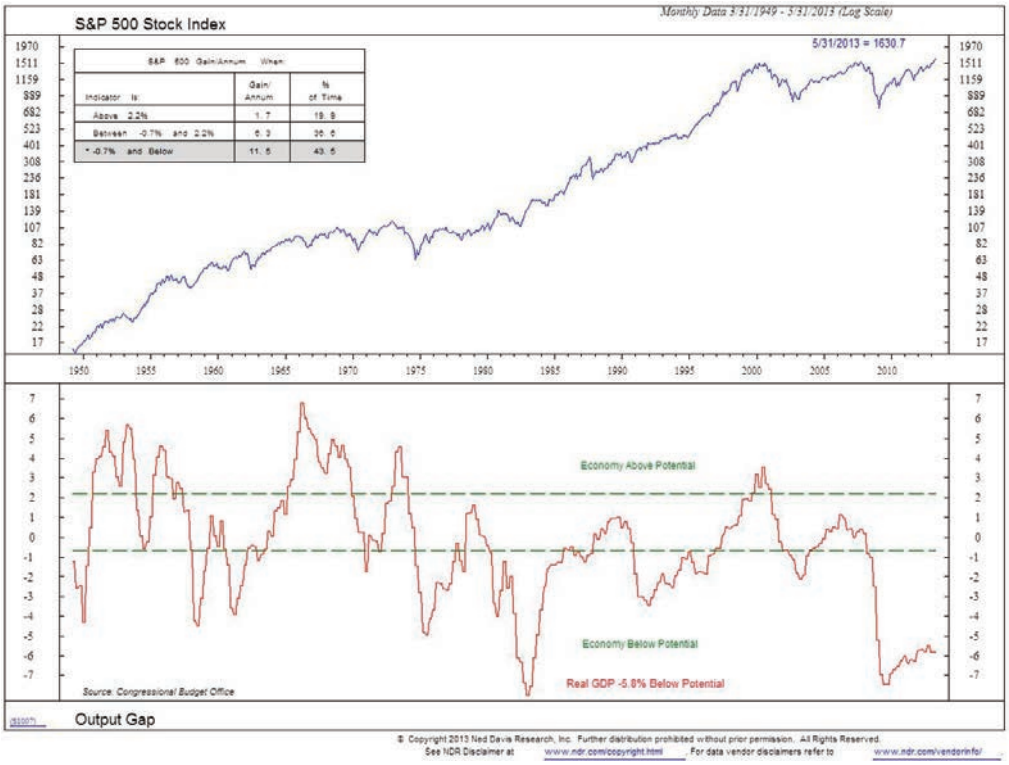
This chart plots actual GDP growth against the consensus of professional economists. As you can see, it isn't very accurate. In fact, the percentage of the last seven recessions predicted by the forecasters was zero. Furthermore, the percentage of quarters since 2001 where GDP growth was equal to or above the consensus forecast was only 10.4%.

But here's the real catch. Even if the forecasts were accurate, they wouldn't be very helpful in predicting the stock market.



As this chart shows, "*...the correlation coefficient between nominal GDP and the S&P 500 is just 0.18. Statisticians would say that changes in GDP explain less than 2% of the year-to-year variation in stock prices. In fact because the stock market usually leads the economy, it often does poorly when GDP growth is very strong and does well when GDP growth is very weak.*" (Ned Davis)

The only economic correlation that does have some predictive power is the Output Gap. It's calculated by the congressional Budget Office and compares actual GDP to potential GDP as shown in the bottom clip of this next chart, and as you can see it is currently negative.



Historically, a negative output gap has been positive for the stock market. It suggests that there is excess capacity or unutilized resources in the system and no reason for the Federal Reserve to tighten Monetary Policy.

So, why so much background on economic forecasting? Well, it's because I want to talk about the economy and wanted to get this disclaimer out of the way right up front.

I know I've said that this market is all about liquidity rather than economic statistics, and I'm not about to change that core belief.

But there are a couple of things about the economy that are important for the market. First, we're at a point in the cycle when we need some revenue growth to generate earnings growth. Profit margins have done most of the heavy lifting and have about topped out. Second, investors need to be optimistic about the future in order to commit to equity investments. And third, recessions are correlated to bear markets. If you see the preconditions for an economic downturn, it's time to get out. And believe it or not, too good an economy can be a precursor to such a condition if the Federal Reserve deems the economy overheating or inflation gets out of control.

So, as we transition away from total monetary policy dependence, it's worth looking at some of the main drivers of this recovery to determine if it's sustainable and see whether there will still be enough liquidity left to chase stock prices higher.

Economy

As I said, we need some economic growth to push earnings higher to justify further advances in this market. But economic growth will also have a big impact on the lifeblood of this bull market – liquidity. If growth justifies the Fed cutting back, then businesses themselves will start to use some of their surplus cash to expand capacity.

It's obvious that the Federal Reserve feels that the economy has made enough progress so that they can reduce their stimulative monetary policy. Not only has the Fed Chairman so stated but on December 18th, the Central Bank announced a reduction to their accommodative monetary policies by stating that they would begin the long anticipated "tapering" and reduce their acquisition of bonds by $10 billion per month. For perspective, this is analogous to their easing off on the accelerator, but not even close to tapping on the brakes. Originally this program started in September, 2012, with the purchase of $40 billion per month of Mortgage Backed Securities (MBS). They then added the purchase of $45 billion of Treasury Securities in December, 2012. They're now cutting $5 per month from each category. So, the existing program will amount to $75 billion/month compared to the initial phase of $40 billion. Since the start of third round of quantitative easing (QE), the Fed has seen its balance sheet swell from $2.84 trillion to $4.01 trillion and will probably reach $4.4 trillion by the time the program ends. Although this could be considered the beginning of the end and will likely lead to high interest rates, I think there are some offsetting factors that suggest that monetary policy may tighten from its ultra loose condition but remain accommodative by historical standards.

First, there is what I would refer to as philosophical policy overshoot. The Fed and most Washington politicians seem to feel that monetary policy is the only available tool to get the economy back on its feet. With the size of government debt, fiscal spending is not an alternative and so far, it would seem that monetary policy is working.

It's true that the designer of the current monetary experiment, Fed. Chairman Benjamin Bernanke, is retiring at the end of January. However, his replacement, Janet Yellen, has professed to be as dovish on monetary restraint as her predecessor. Furthermore, she seems to have a lot of support to keep the momentum going.

There is James Bullard, President of the St. Louis Federal Reserve who is now advocating zero interest rates on commercial bank reserve deposits sitting with the Fed and studying the outcome of using negative rates to encourage banks to lend.

The Fed's twin goal of targeting employment and inflation seems to have subtly shifted towards emphasizing inflation. Bullard noted that inflation rates of 0.7% year over year in October were well below the Fed's target of 2%. He had previously proposed that the Fed pledge not to raise rates if inflation was below 1.5%.

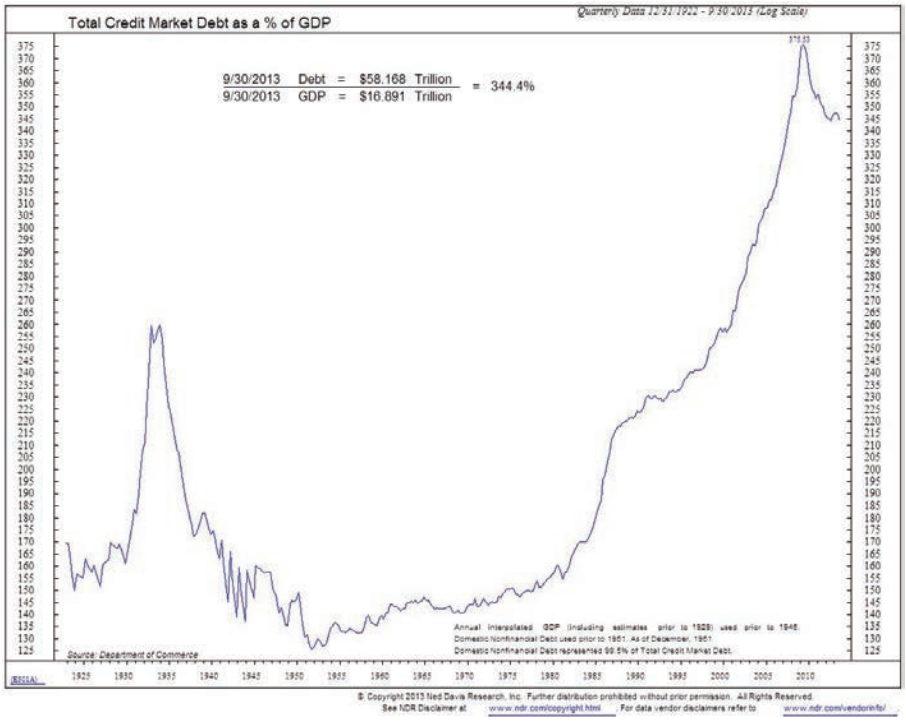
Then there is Bill Dudley, President of the New York Fed who stated that he believed Quantitative Easing was designed as an alternative to negative interest rates.

And finally, we have two highly influential economists who have sway in Washington. First, there is Paul Krugman, a distinguished economics professor at Princeton University. Second, is Lawrence Summers, who President Obama considered nominating as Chairman of the Federal Reserve to replace the current Chairman Bernanke. Not only was he the former President of Harvard University, but he was Secretary of the Treasury under Clinton.

An economist that we use at Cumberland picked up a quote from the two of them. Summers made the point, "Imagine a situation where natural and equilibrium interest rates have fallen significantly below zero. Then conventional macro economic thinking leaves us in a very serious problem because we all seem to agree that whereas you can keep the federal funds rate at a low level forever, it's much harder to do extraordinary measures beyond forever, but the underlying problem may be there forever". Krugman weighed in "...So how can you reconcile repeated bubbles with an economy showing no sign of inflationary pressures? Summers' answer is that we may be in an economy that needs bubbles just to achieve something near full employment – that in the absence of bubbles the economy has a negative natural rate of interest".

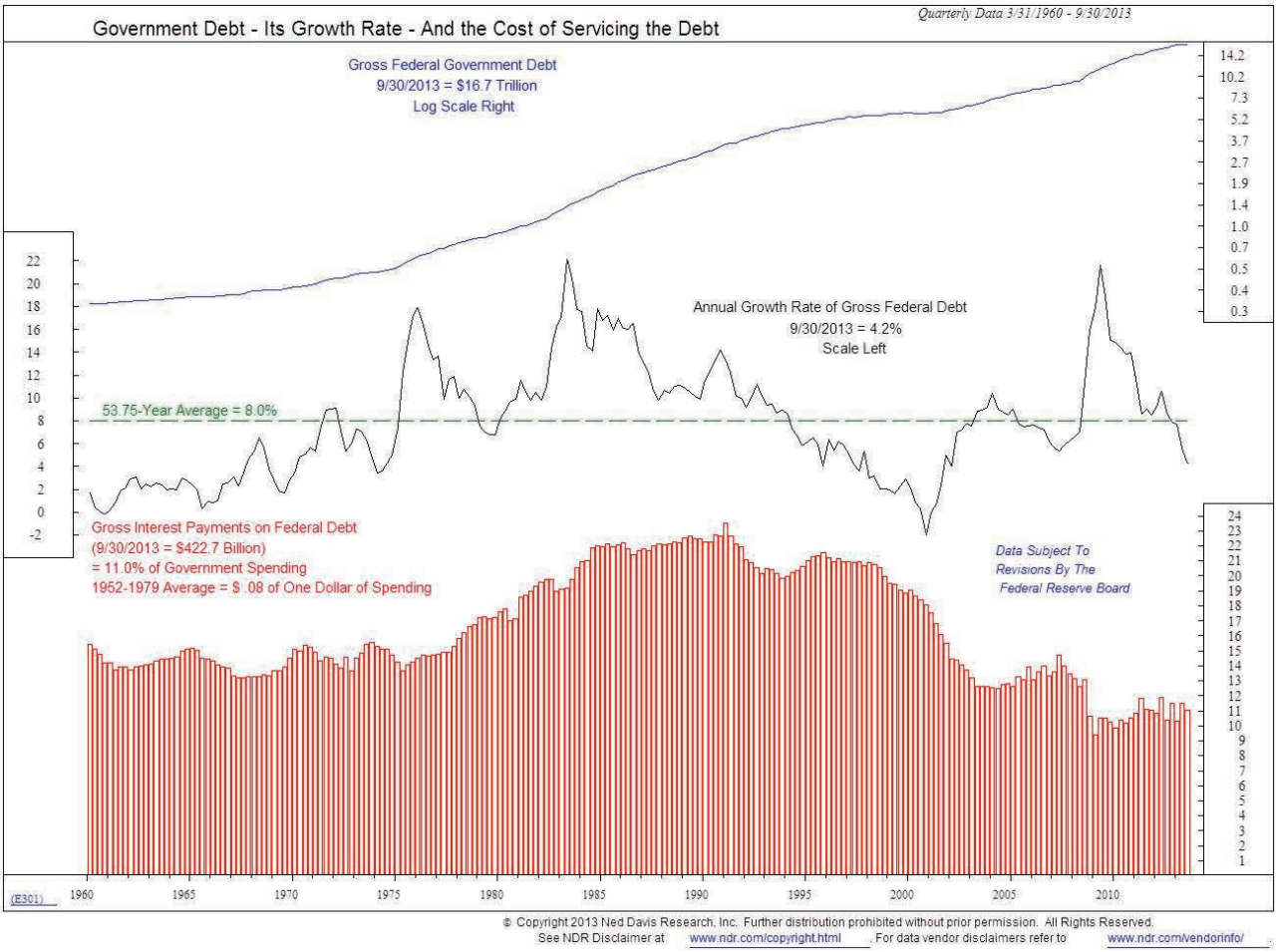
You got that? I think I do but I now know why I didn't get into Harvard or Princeton. All we need now is Buzz Lightyear proclaiming from "to infinity and beyond".

But you get my point. The Washington mentality is that monetary policy works and if at first you don't get the results you want, use more of it. I don't see this mentality going away too soon.



More fundamentally, the amount of debt outstanding between corporations, individuals and the government is better but still a staggering 344% of GDP but it's manageable because interest rates remain low.

By category, household debt is actually in pretty good shape so it will sustain further consumption. Corporate debt hasn't declined but short term financing has been termed out in the bond market so they are much more stable and liquid. The only major borrower still accumulating debt has been the government.



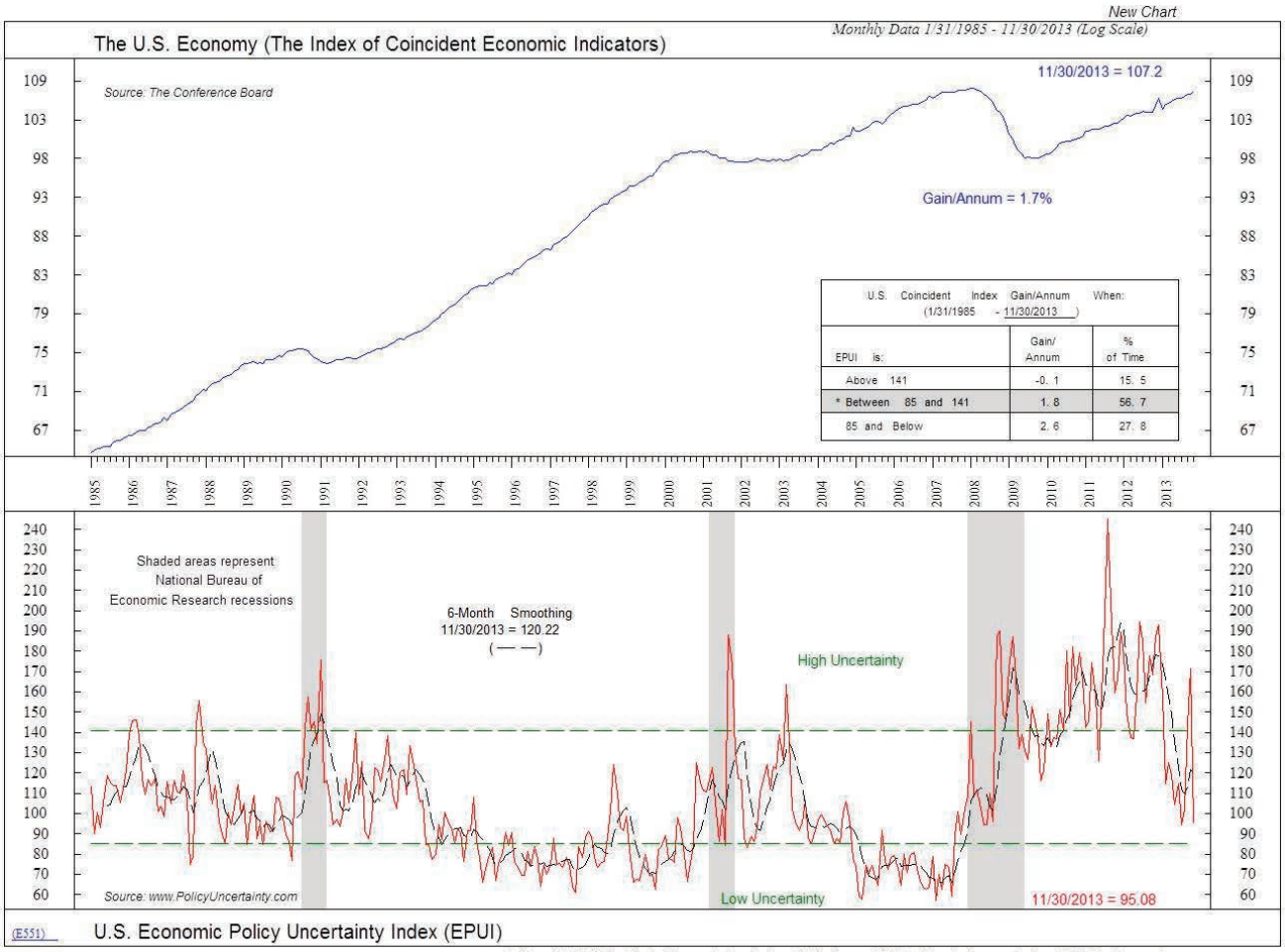
As can be seen in the top clip of this chart, federal debt is about the size of the U.S. economy. Interest service however, is low due to low interest rates. As shown in the bottom clip, gross interest payments amount to $422.7 billion annually or 11% of government spending. Higher rates would dramatically impact the government's deficit.

Consequently, it is doubtful that the economy could sustain its growth if interest rates were allowed to increase by any measurable amount.

Bottom line, I don't see monetary policy tightening; less accommodative, yes as the asset purchase program ends probably in mid-year. Otherwise, interest rates will remain below what would otherwise be considered normal. Liquidity as judged by the Fed's balance sheet and the capability of the banks to lend is abundant as are other sources of liquidity such as corporate cash balances that currently exceed $1.9 trillion and consumer savings.

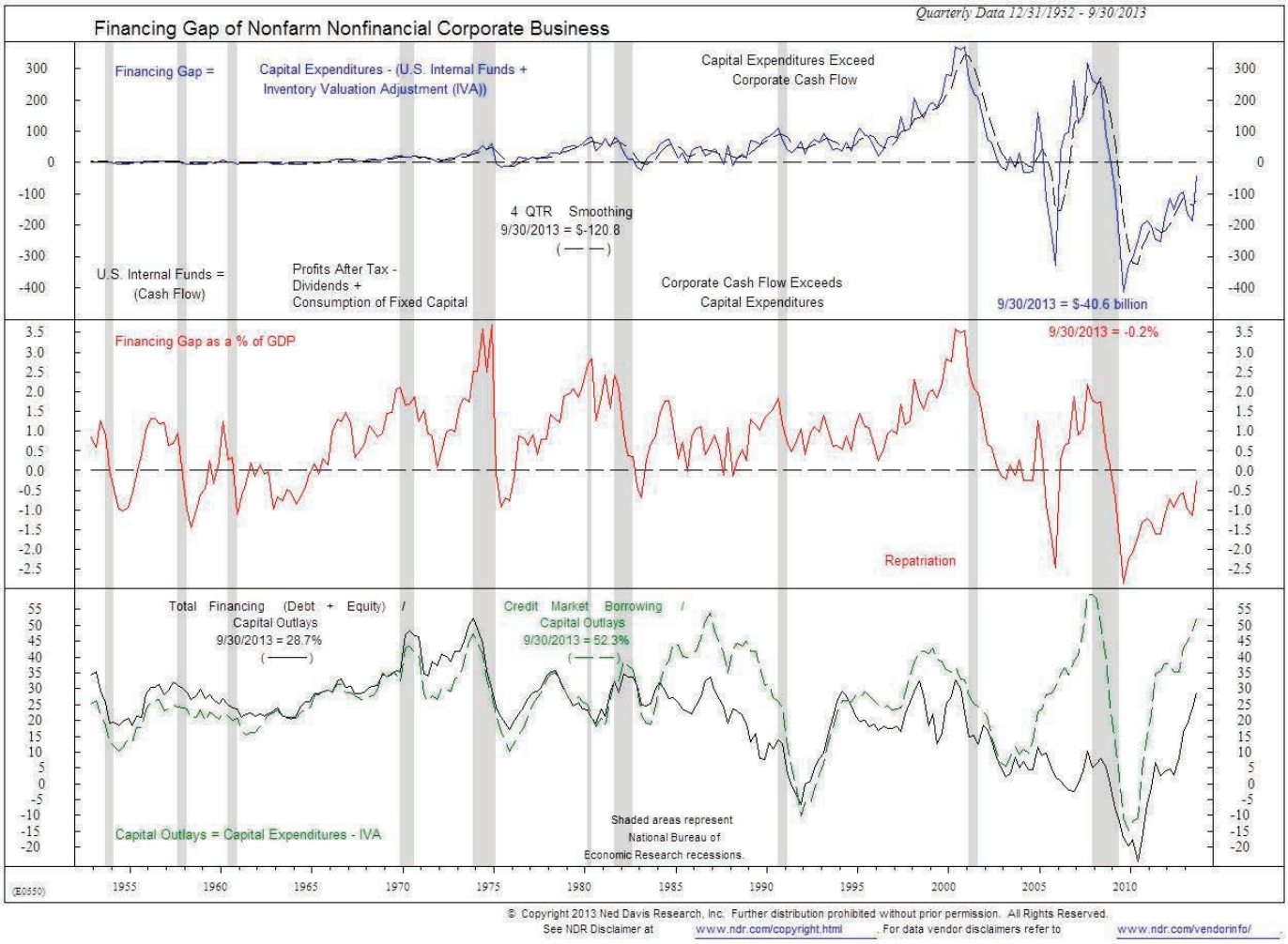
Otherwise, the other big factor that could transition towards normalcy is corporate spending which has been restrained during this expansion. Again the shock of the 2008 financial crisis and macro uncertainty on everything from the European Sovereign Debt concerns to gridlock in Washington has caused corporate CEOs to defer decisions. A recent Duke University study showed that CEOs in today's environment are not responding to interest rate levels in making investment decisions. Rather, they want an end to policy uncertainty in Washington and await government policies focused on growth.

To measure the impact of uncertainty on the economy, economists at Stanford and the University of Chicago developed an Economic Policy Uncertainty Index.



You can see the heightened level of uncertainty that began in 2008 and has continued until recently in the bottom clip of this chart. With fewer macro issues in the headlines, it's possible that corporate balance sheets may take over some of the economic heavy lifting as the Fed steps aside. This will probably be good for GDP but not so good for liquidity.

Regardless, corporations have plenty of room to increase capital spending which would help the economy.



As seen in the top clip of this chart, capex almost always exceeds cash flow after dividends. But today, corporations are underspending by about $50 billion annually.

The economy will also get help from other early cycle industries such as autos and housing that had a delayed start to their recovery and will benefit from pent-up demand and family formations as the echo boom generation moves into the work force.

Not all factors are positive however. The economy will experience fiscal drag from government spending as the budget gap is closed. The deficit has already declined from $1.2 trillion to $680 billion last August as tax revenues increased by 13.3% and spending declined by 5.5%.

There will also be negative effects from Obama's Affordable Care Act and reluctant bank lending after complying with the Dodd-Frank Act, Basel III capital requirements and punishing lawsuits causing a more risk adverse lending culture.

Then there is the aforementioned Fed tapering and the further restraining effect of still too much debt in the system. The upside of this is that it is unlikely the economy will overheat and require the Fed to tighten monetary policy.

Nor does the transition of the economy from monetary life support to something more normalized as consumers and businessmen alike shake off the effects of 2008 suggest we will get a recession.

The most likely outcome according to the Federal Reserve's own forecast, is modestly better GDP growth in the range of 2.9% to 3.1%, unemployment between 6.4% and 6.8% while inflation ticks up to 1.5% to 1.7%.

Market

So, what does this mean for the stock market?

Well, let's go through the same top down exercise that we used last year to project an earnings forecast but use the Federal Reserve estimate.

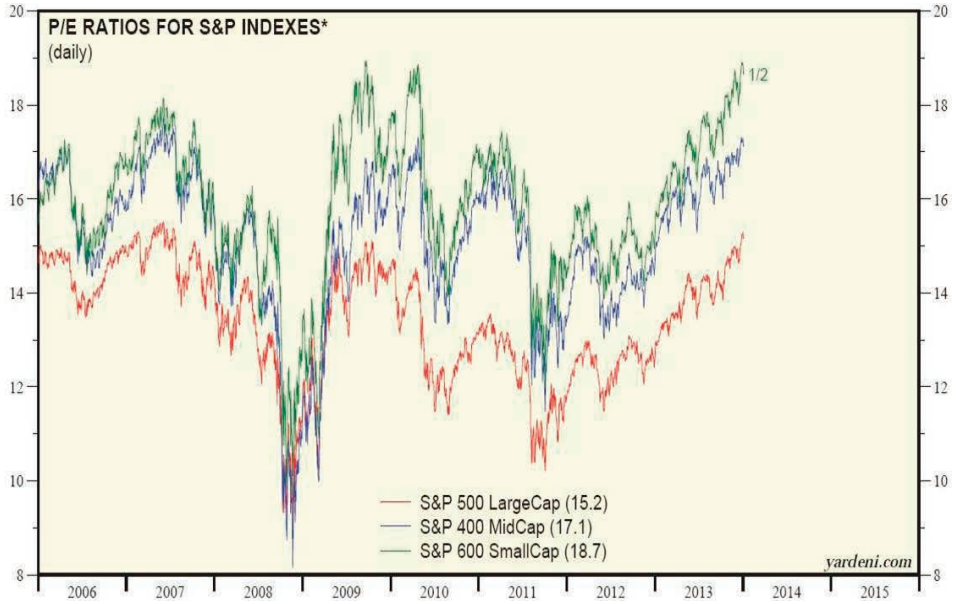
Real GDP 3.0% plus 1.6% inflation and a 0.5% factor to account for historical differences to get to 5.1% sales growth. Assuming peak margins stay flat, it would result in 5.1% earnings growth. Share buybacks have been about 2% in the last twelve months so that would result in 7.1% earnings per share growth which would put the S&P 500 earnings at about $116.92 versus consensus of $120.88 for the year. Compared to the S&P 500 year-end close of 1849, we're starting the year at 15.8X earnings or about the long-term average.

To build any kind of upside to the market, using absolute valuations, requires either higher GDP growth, more inflation or higher valuations. Anyway you look at it, there isn't much of a margin of safety from a valuation perspective. Maybe Europe will help. It's no longer a drag on multinational earnings which account for about half of the S&P earnings.

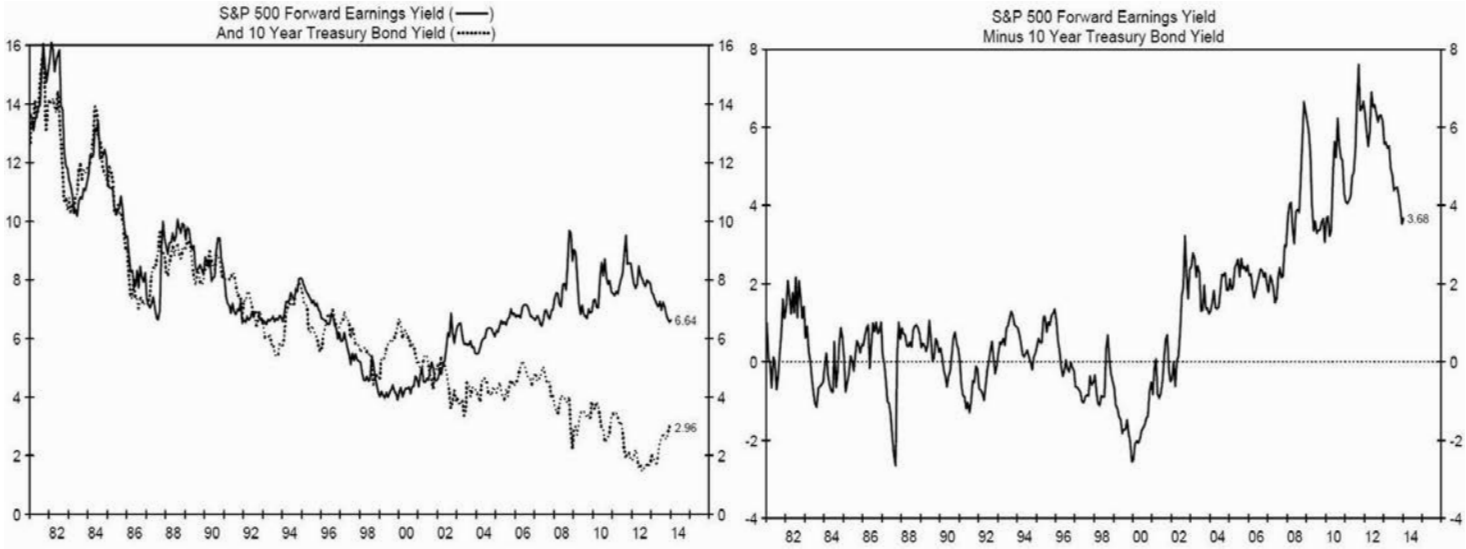
Consensus earnings estimates for 2015 are currently $133.91 and the market will start to discount these by year-end. If we again use the average of 15x forward earnings, we could target 2008.65 for the S&P 500 for a 9% upside by year end.

From this you can see why I've chosen to focus on the economy in this report. It has to come through and deliver the real goods. Last year, the S&P 500 increased 29.6% in US$ terms excluding dividends. 21% of this was from an increase in the forward P/E ratio from 12.6x to 15.2x while earnings rose only 7%.

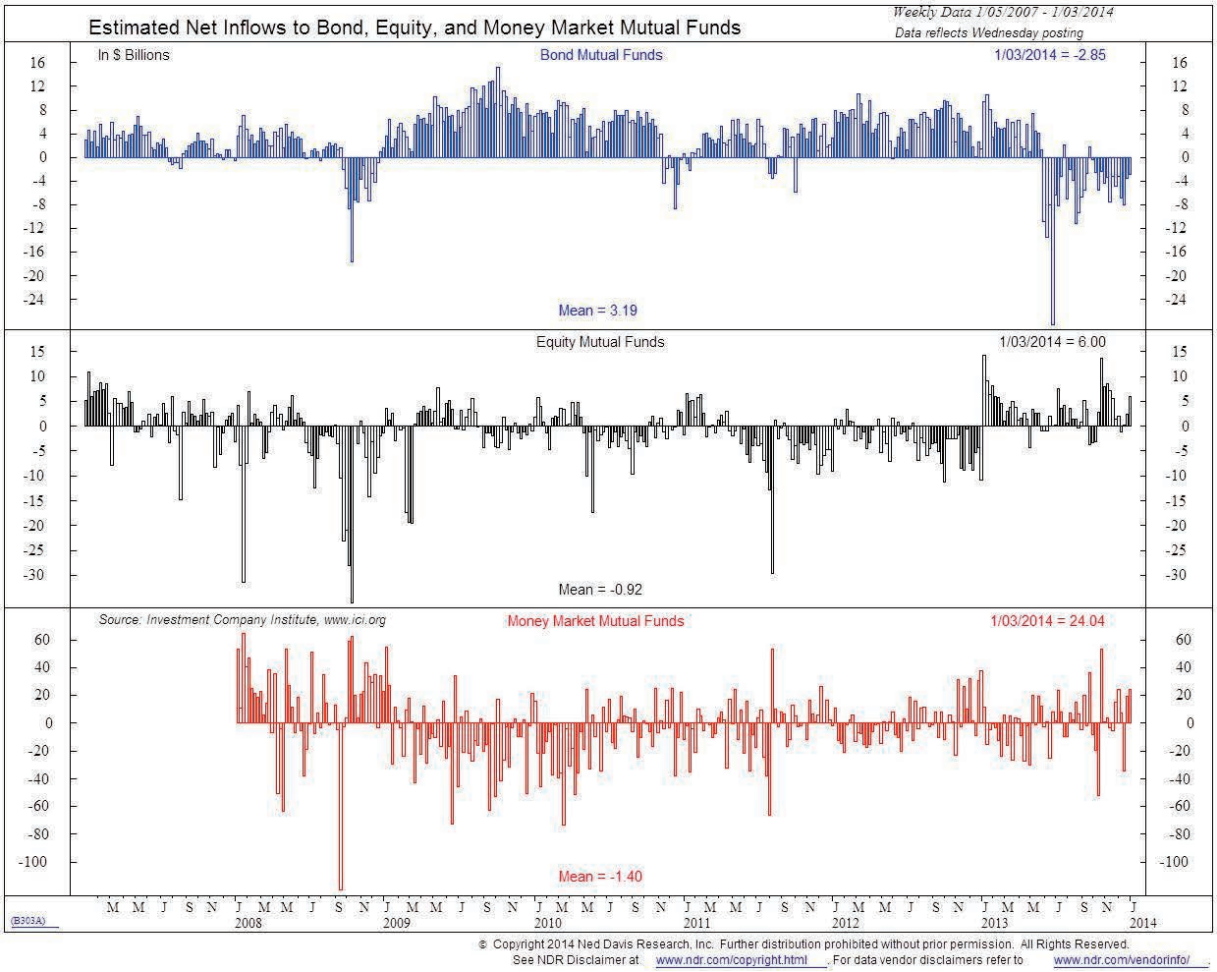
So valuation did the bulk of the lifting and the market is currently at fair value. I think valuations could go higher and as I've said, I don't think this bull market will end until multiples reach at least the high teens. After all, forward P/E's for the S&P 500 mid-caps are already 17.1x and the small caps index has reached 18.7x as shown below.



Of course the other way to look at the market is on a relative basis. If you don't like stocks, what are you going to do with your money – buy bonds?



These two charts compare the S&P 500 earnings yield (earnings divided by price) to the ten year Treasury Bond yield. The yields are usually very similar but today there is a gap which should close. This can happen by either the market advancing or bond yields rising, which they are. In theory, bond yields should match nominal GDP which we're projecting will be 5.1% next year. If bond yields did normalize, it would eliminate most but not all of the spread. But for reasons we stated earlier, we don't think this will happen. Consequently, stocks appear to be better value than bonds and investors are now acting upon this in what is being referred to as the great rotation. Out of bonds and back into equities.



As you can see in this chart there has been net selling of bond mutual funds (top clip) and net purchases of equity funds (middle clip).

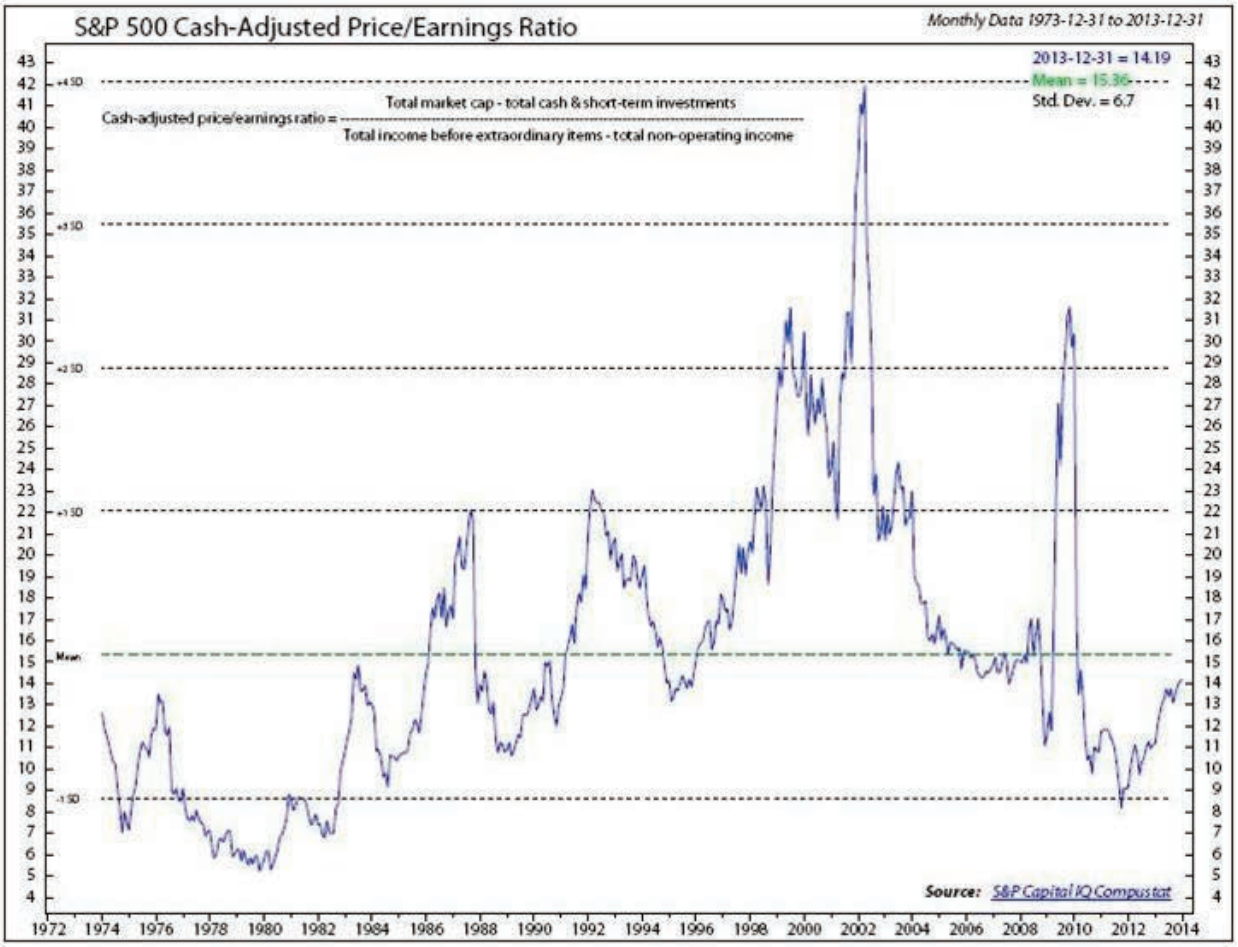
Equity funds experience net inflow of $23.1 billion in November and $192 billion over the past 11 months. On the other hand, bond funds saw their sixth straight outflow losing $11.7 billion in November and $110.6 billion over the six months.

But this shift from bonds to equities by individuals isn't alone.

Corporations have been the biggest buyers of equities since the market bottom in 2009 having acquired $1.6 trillion in shares while paying out an additional $1.2 trillion in dividends. In the third quarter, S&P 500 companies repurchased $128 billion of their shares plus again paid out $79 billion in dividends.

So the flow of funds is in the right direction.

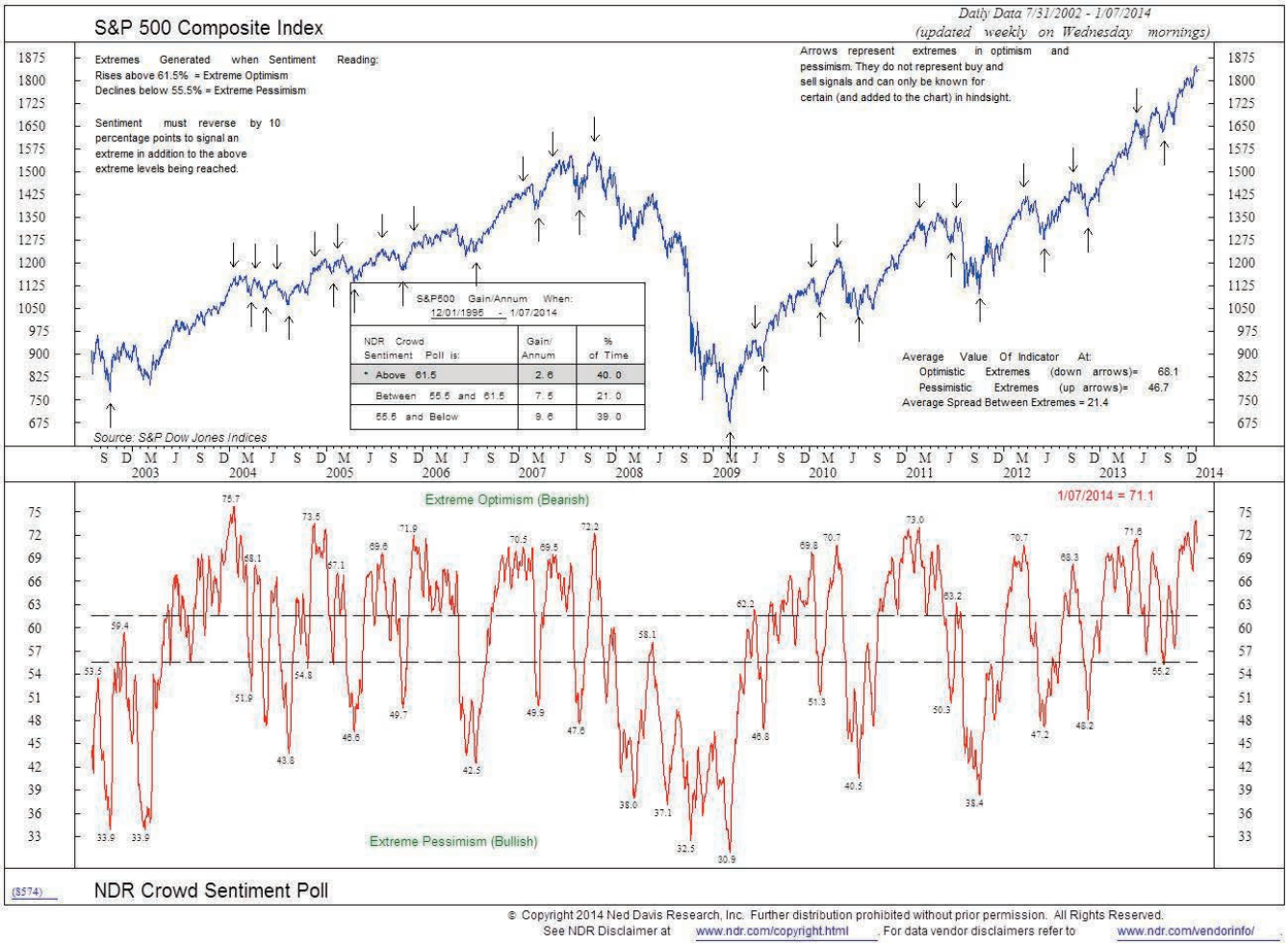
The only other valuation model that might have some relevance is one that measures P/E ratios that exclude the huge $1.925 trillion cash hoard that corporates are sitting on.



Currently, cash accounts for about 25% of total market capitalization while earning almost nothing. This chart adjusts both valuation and earnings to indicate that the market is more reasonably valued.

So, on balance, the market is fairly valued. It's not expensive yet but we've lost the margin of safety. Relative valuation models will continue to provide justification for higher prices so long as the Federal Reserve does its part by holding down interest rates which we think they will. But the market is not a table pounding buy.

If there are reasons to be cautious or negative on the market, they are mostly technical in nature and sentiment stands at the top of this list.



This chart on crowd sentiment suggests that investors are extremely optimistic right now and contrarian logic would suggest leaning against the crowd. Just contrast the current conditions with how we started in 2013 when we were fearful of the Fiscal Cliff and how poorly the economy was performing. There wasn't much expectation built into those stock prices in what turned out to be a very rewarding year.

Conclusion

I expect that 2014 will be viewed as a year of transition where our dependence on Federal Reserve policy for economic growth will be challenged by a more traditional business climate.

Tapering has started and brings to an end the synchronized globally accommodative monetary policy that we have witnessed for the last several years. Interest rates will probably rise modestly but will be held in check below levels that would otherwise be considered normal.

So, relative to bonds or almost any other asset class, we still favour equities, but the margin of safety has diminished. As we've said in the past, we think we're in the middle third of this market cycle. The easy money stage is behind us and returns will now be more selective and based on good industry and stock selection.

Although we could anticipate a market correction, the symptoms of a major top still seem remote. For us to change our mind would require one of two changes: either the failure of the economy to advance and the threat of recession which would alter our forward earnings estimates or a change in investor attitude from cautious to something more unrestrained. Right now there is still a record, almost $10 trillion sitting in savings deposits and money market funds earning almost nothing.

Before this bull market cycle ends, we would expect those sidelined investors to capitulate and chase equities for better returns, resulting in price earnings multiples of at least the high teens. Psychological symptoms of a top are usually exuberances and complacency, not the caution and concern you see today. We could also see an economy that becomes strong enough to set the stage for a tighter monetary policy which would bring an end to our liquidity thesis that is the foundation of today's market.

Otherwise we're at the stage of the market where one has to be more conscious of the negatives because the consequences of a mistake are greater. Although the future looks pretty good right now there are risks. At the top of this list, I would put Donald Rumsfeld's, the "unknown unknowns". The ever unanticipated piece of news that no one anticipated. We also have our concerns about profit margins that have soared to all time highs and whether they can be sustained.

There is also risk in the derivatives markets due to artificially low interest rates that have caused asset/liability mismatches that could surface with higher interest rates. And finally, there is the possibility of maybe too strong an economy and latent inflation levels that could revert to something higher than anticipated, as all the ingredients are there.

But for the time being, we'll remain short-term cautious but long-term bullish on this market.

Gerald R. Connor
January 12, 2014

Credits: TD Securities
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