A LONG OVERDUE CORRECTION

Warren Buffet says that "being early and being wrong look exactly the same 99% of the time." So, are we in a market correction or have we seen a major top? They'll initially look and feel the same.

A market decline is always predicated on a change of opinion for the worse. The difference between a correction and a bear market is when the changed opinion isn't vindicated, where the fear of recession is proven wrong, the fear of a banking collapse doesn't happen, or the fear that Greece will leave the European Union is over-estimated.

But before the correction can run its course, the negative belief has to be legitimate and investors have to buy into it and take action, that is, sell.

Well, we're at one of those inflection points once again. There are a couple of legitimate concerns out there and investors are starting to react, but I think they've got further to go. They're not scared enough yet for this to be a good solid correction on which the next leg of the bull market can build, if in fact it is only a correction.

So, what's bugging this market? There's a full cast of characters but the main culprits are an end to monetary stimulus, Europe heading back into recession, the collapse of resource prices, and the consequences of a strong U.S. dollar, none of which will be good for corporate earnings.

But, as we've said many times in the past, for this bull market to end, it will require either a recession or a tighter monetary policy.

So, the concerns are for sure legitimate and qualify as a good cause for a market pullback. But will the worst feared outcomes prove correct? Well, let's examine each of them and handicap the odds of them being lethal to this bull market.

Fed Policy

The Federal Reserve is mandated with the twin goals of full employment and controlled inflation. By their own pronouncements, 6.5% unemployment and 2% inflation were their early objectives.

We are now at 5.9% unemployment but qualitatively Fed Chairwoman Janet Yellen has declared the progress on unemployment substandard because labour participation rates continue to decline.

Further improvements on employment require a continued healthy economy and last quarter, we introduced the concept that the stock market was not only a lead indicator but directly affected the economy through the wealth effect. Consequently, Fed policy was being held hostage by the stock market in that any interest rate increase that was met by a market decline would probably be quickly halted if not in fact reversed for fear that it would damage the economy.

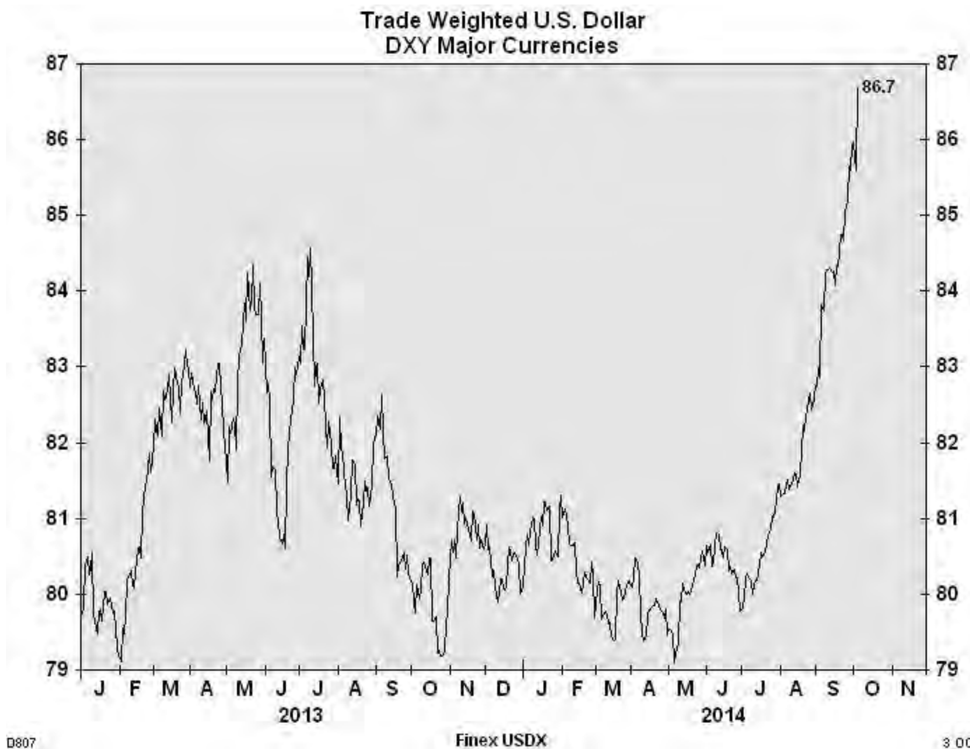
Well, policy changes have recently become even more difficult for the Fed as the second objective of 2% inflation is put in jeopardy by the rising dollar which lowers import costs.

Certainly the strength of the U.S. economy relative to other major economies has something to do with the currency's appreciation but so has the anticipated change in monetary policy towards higher interest rates.

Unemployment goals have been statistically reached and the economy seems to require less monetary support while Europe and Japan are proceeding towards greater monetary stimulus and lower currencies to stimulate their business activity.

As we've said, tighter monetary policy wouldn't be good for the stock market and investors have been overly sensitive to any indication that the Fed was about to reverse course and become less accommodating.

The Dollar



The strong dollar could put these tightening concerns to rest. Import prices are declining and there's an inverse relationship between the dollar and commodity prices, so, inflation could continue to undershoot the Fed's target and again compromise their ability to effect policy. Import prices fell 0.5% in September for the third straight month and have declined 0.9% year over year. Higher interest rates right now would aggravate the impact of the dollar.

A strong dollar also has some negative consequences for the economy and corporate earnings that would feed back into the unemployment goal.

For starters, U.S. imports are becoming cheaper while their exports are more costly to already weak foreign economies. That won't be good for either GDP or corporate earnings. Further, a strong dollar usually correlates with weaker commodity prices, including oil. This not only hurts companies that produce these commodities but the economies of emerging markets that export them. Given that most commodities are denominated in U.S. dollars, the lower commodity prices result in fewer dollars being exchanged (sold) into other currencies which further reinforces the dollar's strength.

There is also the compounding impact of foreign earnings of multinational companies being translated back into U.S. dollars at a lower rate. It's estimated that 47% of S&P 500 sales are generated outside of the U.S. A strong dollar won't help corporate profits or the market's valuation.

Bottom line, a strong U.S. dollar undermines both of the Federal Reserve's twin objectives and probably puts the likelihood of an increase in interest rates on hold, even in the face of improving unemployment statistics.

You can add to this the fact that liquidity is a global phenomenon. Today, Central banks cannot operate in isolation. So, as the Federal Reserve ends its expansion phase and goes into neutral, the Bank of Japan is expanding its balance sheet by $650 billion per year and the European Central Bank is about to expand theirs by between €500 - €650 billion per year. Collectively the G4 Central banks are facing an increase in their balance sheets of $1.3 trillion. As we've said in the past, liquidity will trump economic statistics in determining the direction of the market and right now monetary accommodation continues to support the case for a long term bull market.

European Economy

As I said earlier, we think the bull market will continue until liquidity is withdrawn or we see an economic downturn. While the Fed's monetary policy could potentially be placed on hold, other Central Banks are taking up the slack. So, liquidity doesn't appear to be an issue.

However, as with monetary policy, sovereign economies can also be intertwined. On its own, the U.S. economy is doing well and seems to be picking up steam. So we won't spend any time discussing it.

Europe on the other hand seems to be sliding back into recession, Japan can't seem to get any traction and China has reasonable but declining growth.

Overall, global growth is expected to continue at a modest pace. But recent weakness in Europe has dominated the headlines and created doubts as to whether monetary policy will work. Until now bad economic news has been good news for the market as investors anticipated a positive reaction from the Central banks. But the threat of recession can undermine this market and promises from inept Central banks are no longer reassuring.

Right now, the attention is on Germany. The International Monetary Fund (IMF) recently cut the country's GDP growth assumptions to 1.3% this year from 1.9% with the 3rd and 4th quarter expected to be flat. Next year's growth forecast has been cut to 1.2% from 2.0%. German's IFO Business Confidence Index fell for the fifth consecutive month during September and their flash Manufacturing-Purchasing Managers Index (M-PMI) fell to a fifteen month low. Exports also reportedly fell 5.8% in August suggesting that the declining Euro isn't stimulating trade, which shouldn't be surprising and calls into question the ECB's currency devaluation strategy. Much of the trade in the Euro zone is with other Euro zone members, so exchange rates have less of an impact.

Regardless, as a region the Euro zone's PMI is still hanging in there but at a barely positive 50.3.

Mario Draghi, President of the European Central Bank (ECB) has coupled his currency devaluation strategy with more monetary easing. In the latest policy edict, they have charged the banks to leave reserves on deposit, have lowered their lending rate to 10 bps and have proposed their own form of Quantitative Easing which will expand their balance sheet by as much as €1.0 trillion. All of this is an attempt to encourage banks to lend to corporations in an effort to stimulate the economy. This decline in banks' lending has amounted to €671 billion since reaching a peak of €11.1 trillion in September 2011, with €105 billion of the decline occurring in the first eight months of this year.

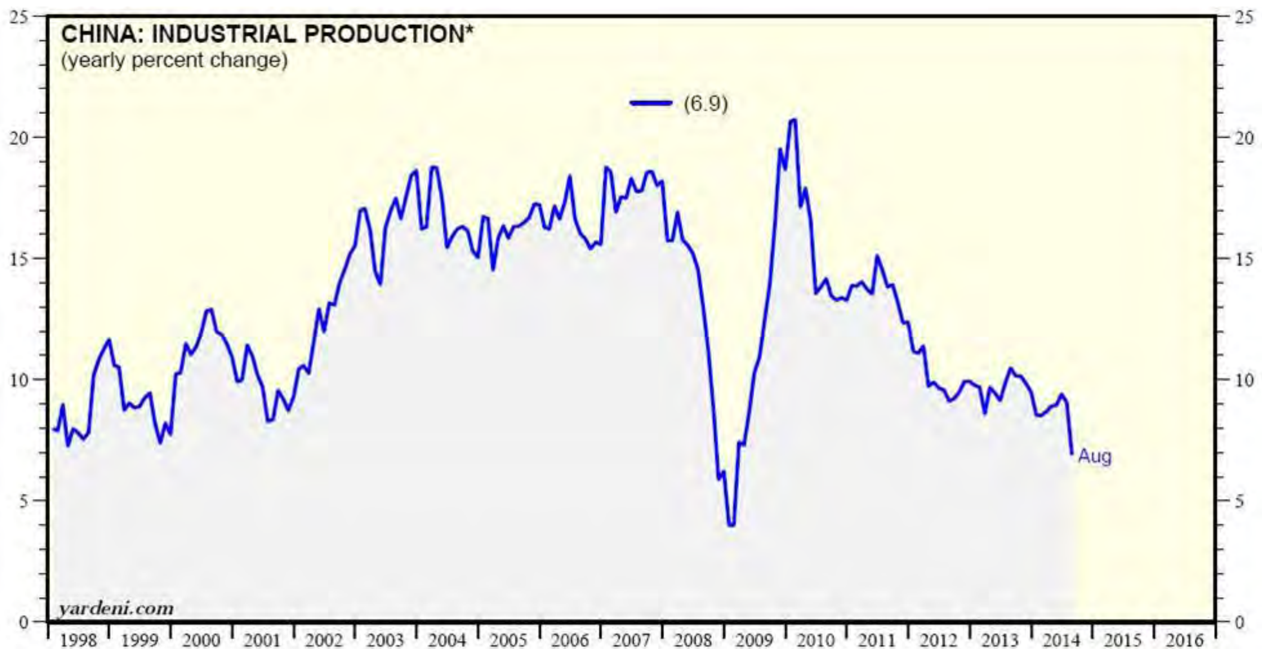
Draghi's first attempt to turn this around was a €400 billion program of low cost loans to the banks provided they lend to corporations. Only a disappointing €82.6 billion was drawn down. Regulations that are forcing the banks to raise their capital ratios and the questions surrounding asset quality could be one of the problems. This has impacted the European Sovereign debt market where 10 year bond rates of questionable peripheral countries such as Spain have fallen below those of the United States. This regulatory pressure has resulted in European banks buying U.S. government debt for not only a higher yield but a stronger currency which drives down U.S. interest rates while driving the US dollar higher.

However, there may be another answer. Similar to what we witnessed in North America, corporations have been paying off their bank loans by issuing bonds and according to the Fitch rating agency, "European corporate borrowing is set to hit a pre-crisis peak." €595 billion ($749.7 billion) of debt was issued by European corporations during the first half of the year of which €246 billion was in the form of bonds. At this pace, total debt issued could reach €1.491 trillion and exceed every year since 2007.

So, corporate borrowing activity in Europe may not be as dead as the ECB makes it out to be. The only caveat here is that business in Europe is much more dependent on the banks than it is in North America. However, small businesses in both markets have no access to the public markets, yet they're the ones that are creating the jobs. So, no bank loan growth is a problem but the statistics may be overstating it.

Japan continues to be an economic basket case. Industrial production dropped 1.5% in August and is down 8.1% from its recent high this past January. Further, household spending is negative year over year and has been for the past five months though August. Abenomics isn't working. Even with the Yen down 29.1% exports are flat for the past year. The Bank of Japan has continued to pump money into the banks but the economy has failed to respond, which is not a good indicator for similar policies being proposed by the ECB.

China's economy is also concerning. GDP growth is still projected to be 7.5% this year but is slowing.



* Value added basis.
Source: IMF International Financial Statistics.

This chart on industrial production (IP) is probably a good representation of that trend. IP at 6.9% was off from 9% in July and well off its peak of 20.7% in February 2010.

The list of China's concerns range from:

1. An under-capitalized financial system, ie. a shaky banking system
2. Imbalanced growth
3. Chronic over-capacity
4. Over dependence on exports
5. A property market that may be about to topple over.

According to the London Centre for Economic Policy Research, China has pumped more than $13 trillion of credit into its economy over the last five years and at the end of 2013, total private and government debt, excluding financial institutions, totaled 217% of GDP up from 147% in 2008. So China has been practicing their own form of Quantitative Easing for some time.

Although we doubt China is about to blow up given the government does have $4.0 trillion in reserves, it is a concern worth watching carefully.

But maybe more important are the related issues such as their impact on the resource market. Their ever expanding demand for everything from copper to crude oil may have been overestimated.

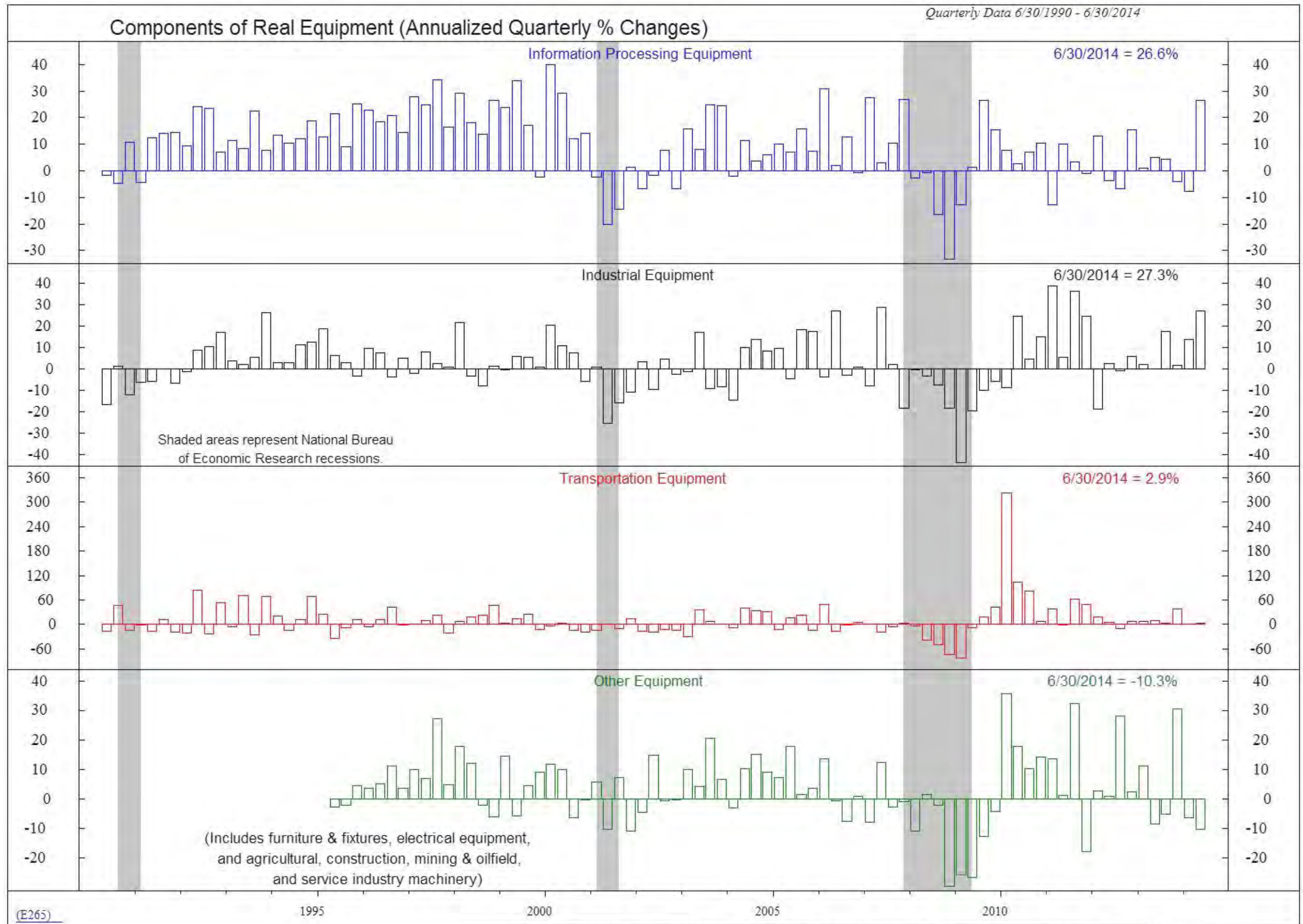
So, where does this leave the U.S. economy, can it remain the only island of economic strength? Well, for starters, it isn't alone. There are other countries that are also doing well, but they just don't get very much press. The fact that the world generally isn't hitting on all cylinders, however is a concern. Of course there is a positive to all of this. We're not likely to face an environment of shortages, inflation and tight monetary policy to counteract it.

The U.S. also experienced a similar period in the 1990's when a rolling financial crisis affected Asia, energy prices plunged and a wave of investments washed over the country for technology. Could the same thing be happening today but in the form of "re-shoring" – manufacturers returning production to the U.S.?

From 1995 to 2002 the trade weighted dollar index rose 39% as the IT revolution was very much U.S. centric while Europe was struggling with "Eurosclerosis" and Asia suffered a currency crisis while Russia defaulted on its debt in 1998. In April 1997, Japan raised its consumption tax to 5.0% and the economy sank back into a recession.

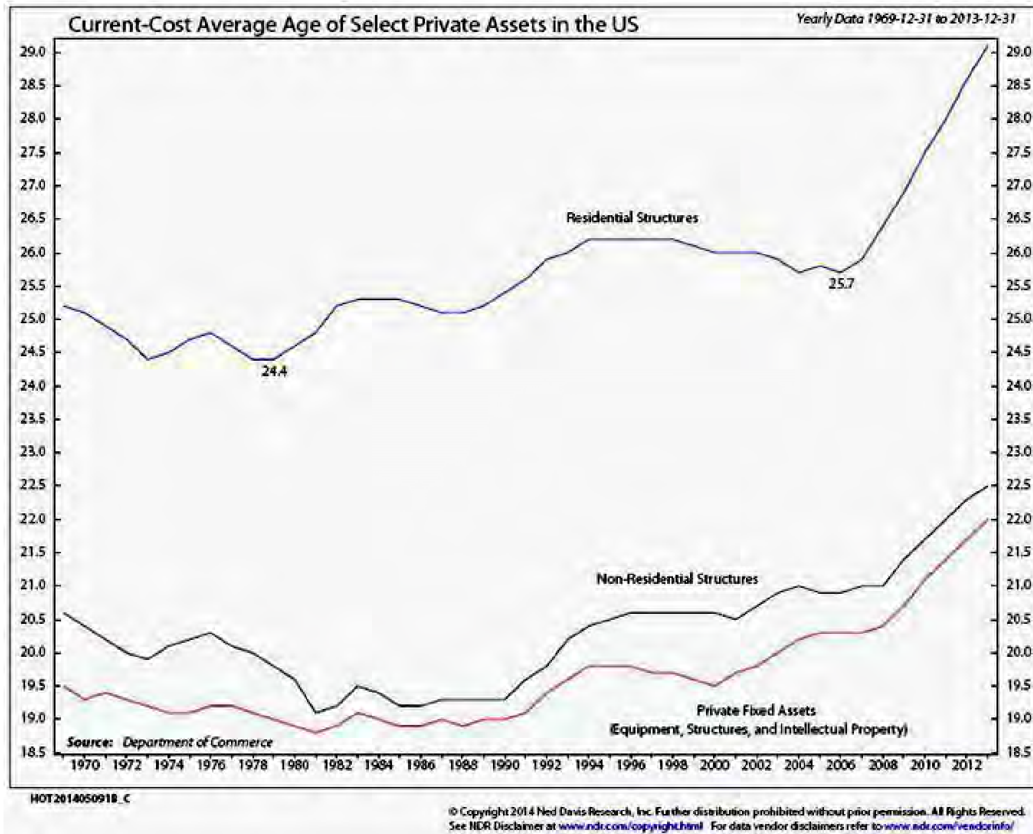
In past quarterlies, we've touched on two secular themes that we thought would anchor the U.S. economy for several years. Energy independence and re-shoring. We'll discuss the energy issue in a minute but manufacturing returning to the U.S., partially due to sufficient energy, may insulate the economy from the rest of the world. For sure, continued strength in the dollar could be a spoiler but we think it can go a lot further without reversing this trend.

Overall, manufacturing as a percentage of GDP has continued to grow. One of the best ways to measure this is by monitoring capital spending which grew at an 8.4% annual rate in the second quarter.



Spending on industrial equipment was the strongest at a 27.1% annual rate as seen in the second clip of the above chart, while investment in non-residential structures was revised to a positive 9.5% rate. Factory orders for industrial machinery also soared to a record high 37.3% y/y in July.

Not all of this is for green field type projects; a lot of it is to replace ageing plant and equipment which will likely continue even if we see a bit of a slowdown. Stuff wears out.



This chart shows how our stock of non-residential structures and private fixed assets have aged. The private capital stock is now the oldest since 1958. The average age of non-residential structures rose to 22.2 years, the highest since 1964. Manufacturing facilities reached a record of 23 years, power plants are 25 years old and communication structures have also reached a record average age of 19.3 years.

A number of factors are contributing to the capital spending boom:

- A more competitive U.S. manufacturing sector
- The need to replace the oldest aged private capital stock since 1958
- The increased availability of low cost capital
- Reduced policy uncertainty – businessmen are more confident.

What's going on in the world today could certainly slow this down but the U.S. is a net importer and less reliant on the rest of the world's economy. So with aging plants, this pillar of economic strength is likely to remain fairly solid.

Oil

Oil is a subject all onto itself, but we'll make it simple. There's too much supply and it can be summed up by one chart.

U.S. production has increased to almost 9.0 million barrels per day (mbd) from about 5.0 mbd at the start of 2009 and is projected to hit a 45 year high next year of 9.53 mbd – the most since 1970, while world consumption isn't growing.

Demand in the four major European economies (France, Germany, Italy and Spain) along with Japan fell from a record high of 14.4 mbd in October 1996 to a new low of 11.3 mbd in August.

The U.S. Energy Department estimates that consumption will shrink 0.2% this year to 18.9 mbd, the lowest since 2012.

Meanwhile, OPEC's production rose to a one year high of 30.94 mbd in September while Saudi Arabia reduced its selling price by $1 per barrel on October 1st. Iraq and Iran recently matched that price reduction.

It's somewhat reminiscent of the 1980's when U.S. production increased after the OPEC oil embargo and set-off a price war that saw the oil price collapse from $32.35 in August 1985 to $9.95 in April 1986 and averaged less than $30 until 2000.

If OPEC is intent on a price war to take the price of oil down to a level that shuts down shale production, we're probably looking at prices of sub $80.00 per barrel. Shale production costs are rising and probably requires $90 oil to be economic within a range of between $50 and $100/bbl while conventional oil costs are between $10 and $25/bbl in the Middle East.

Estimates suggest that just 70% of the U.S. reserves are economic at $75 per/bbl.

What might mitigate against this is that Saudi Arabia needs $87.63/bbl oil to balance their budget unless production is increased which it did in September by 100,000 bbls/day, while OPEC collectively raised production by 402,000 bbl/day, the biggest increase in almost 3 years.

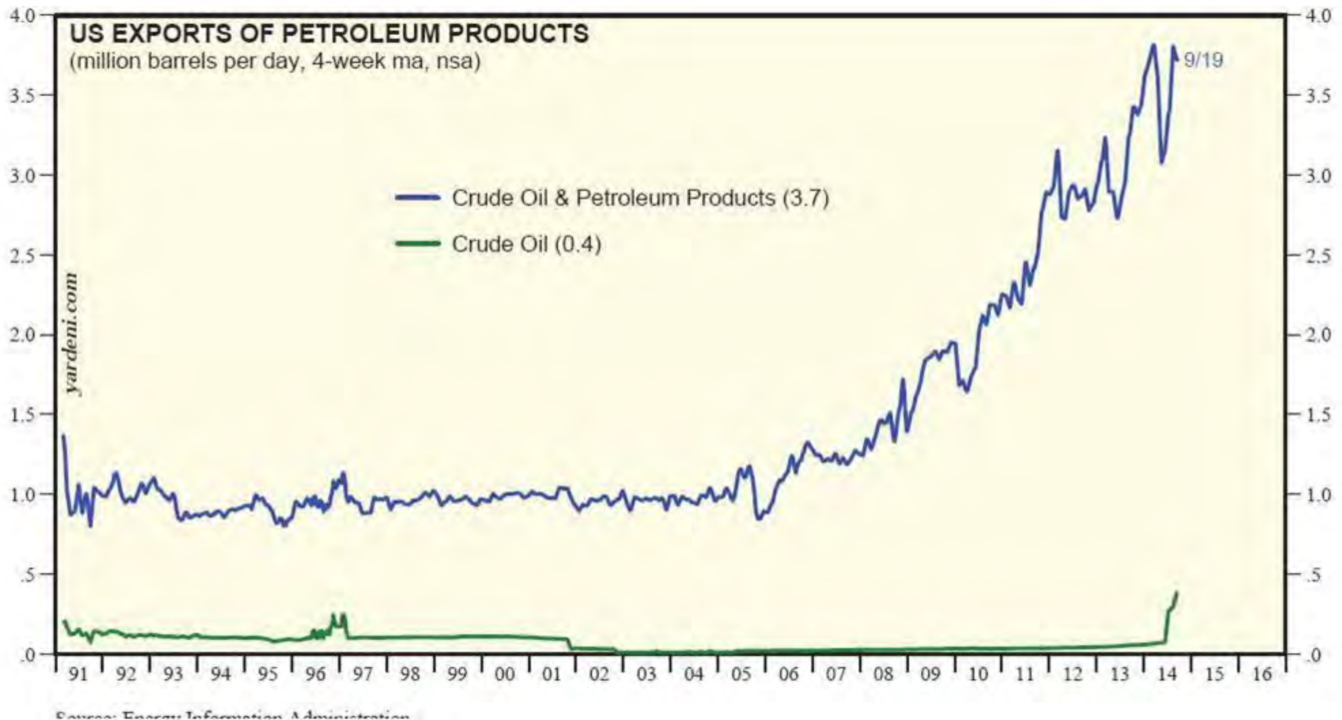
The United Arab Emirate needs $66.50 oil to break even and Iraq requires a price of $92.96.

The take away here is that it is highly possible that the price of oil is being reset to a lower level to curb the ongoing, high cost shale oil production.

Historically, lower commodity prices correlate well with a weak economic environment and this cycle wouldn't be inconsistent with that given what is happening in Europe. But the magnitude of the oil price decline is more a function of too much supply, rather than collapse in demand.

For sure this won't be good news for the Oil and Gas sector, however there are beneficiaries.

At the macro level, increased U.S. production helps the economy as the trade gap diminishes. Overall the shale oil revolution has probably narrowed the trade deficit by more than $100 billion at an annualized rate.



Since 2007, U.S. exports of crude oil and petroleum products have more than tripled from 1.0 mbd to 3.8 mbd.

Since 2009, oil imports have declined 3.7 mbd while qualitatively the source of those imports has improved. Since 2008 oil imports from Canada have climbed 35% while imports from OPEC have declined by 40% thus lessening the U.S. dependence on an unstable Middle East.

The shale boom is also bringing prosperity to those areas where shale drilling is being done such as North Dakota and Texas. This will help further strengthen the U.S. dollar, as it attracts capital and reduces the cost of imports.

There will also be a benefit to the consumer through lower gasoline prices. As a percentage of disposable income, annual household spending on gasoline amounts to only 2.5% for high income earners but nearly 15% for low-income households. The average U.S. household uses about 100 gallons per year so the recent $0.50 price decline is an extra $500 of buying power. Doesn't sound like much? Well collectively, this is estimated to be in excess of $150 billion.

So, this could be good news for the discount retailers.

Stock Market

Valuation is still a mixed bag but improving fast, provided the forecasts are correct. Historically, there are two correlations that should be monitored as shown in the chart below.

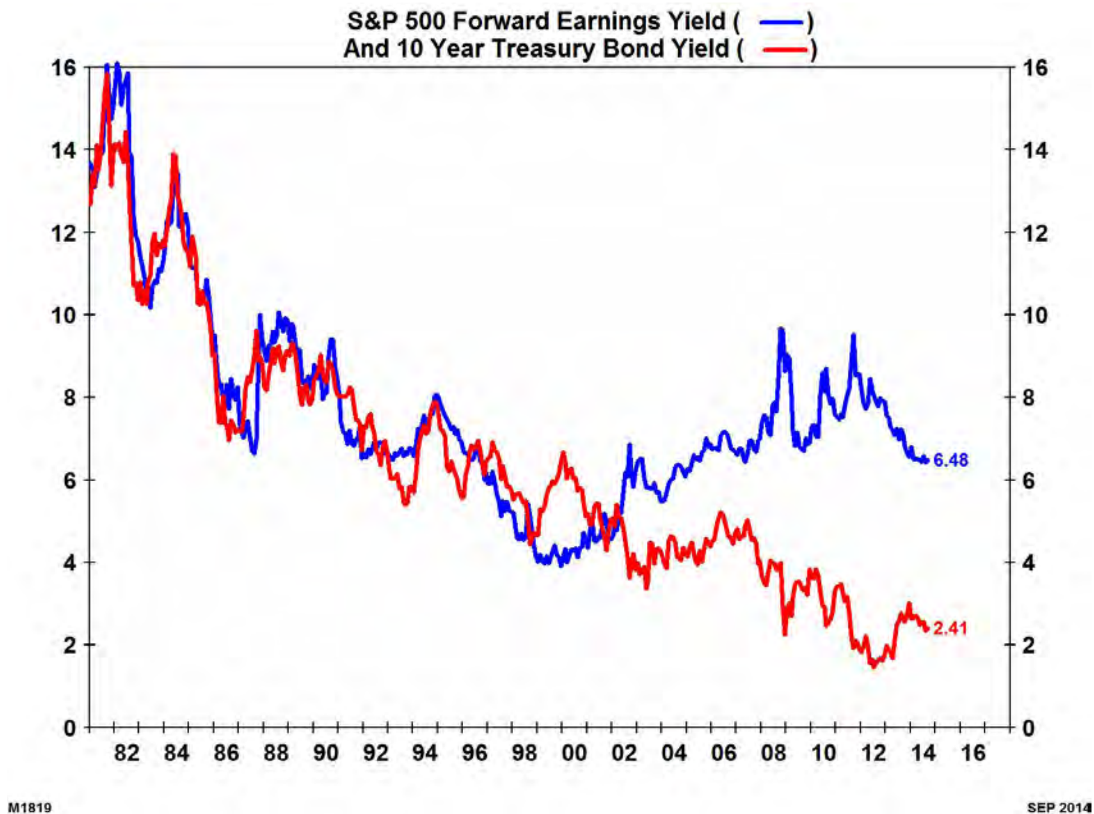
The first is the inverse correlation between the U.S. dollar and S&P 500 forward earnings estimates. As the dollar appreciates it will hurt exporters and the translation of offshore earnings back into dollars. We haven't seen many revisions to date but management teams may start to raise the flag in their third quarter earnings releases.

There is also a direct correlation with the CRB raw industrial spot prices and S&P 500 forward earnings. The strong dollar usually puts pressure on commodity prices, which we are experiencing again this time. But as we said, much of the commodity price weaknesses could be due to excess supply so the correlation of commodity prices to future earnings might not be as strong as we have seen historically.

Based on trailing earnings, the market valuation has improved with both the TSX and S&P trading a bit above their long term average price earnings ratios.

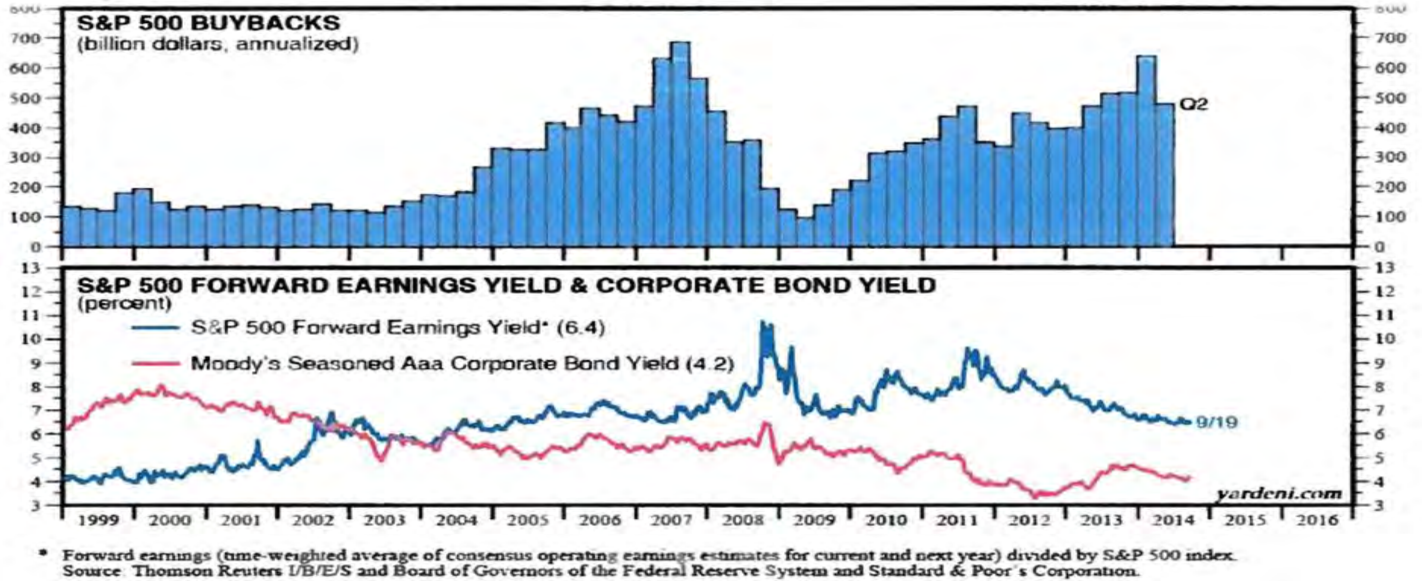
If we use forward projections, which could be questionable, the TSX and S&P are on either side of 15x, not far off the historical norm.

So we have absolute valuations that are still a little stretched but they are not at the extremes one would expect to see at a market top.



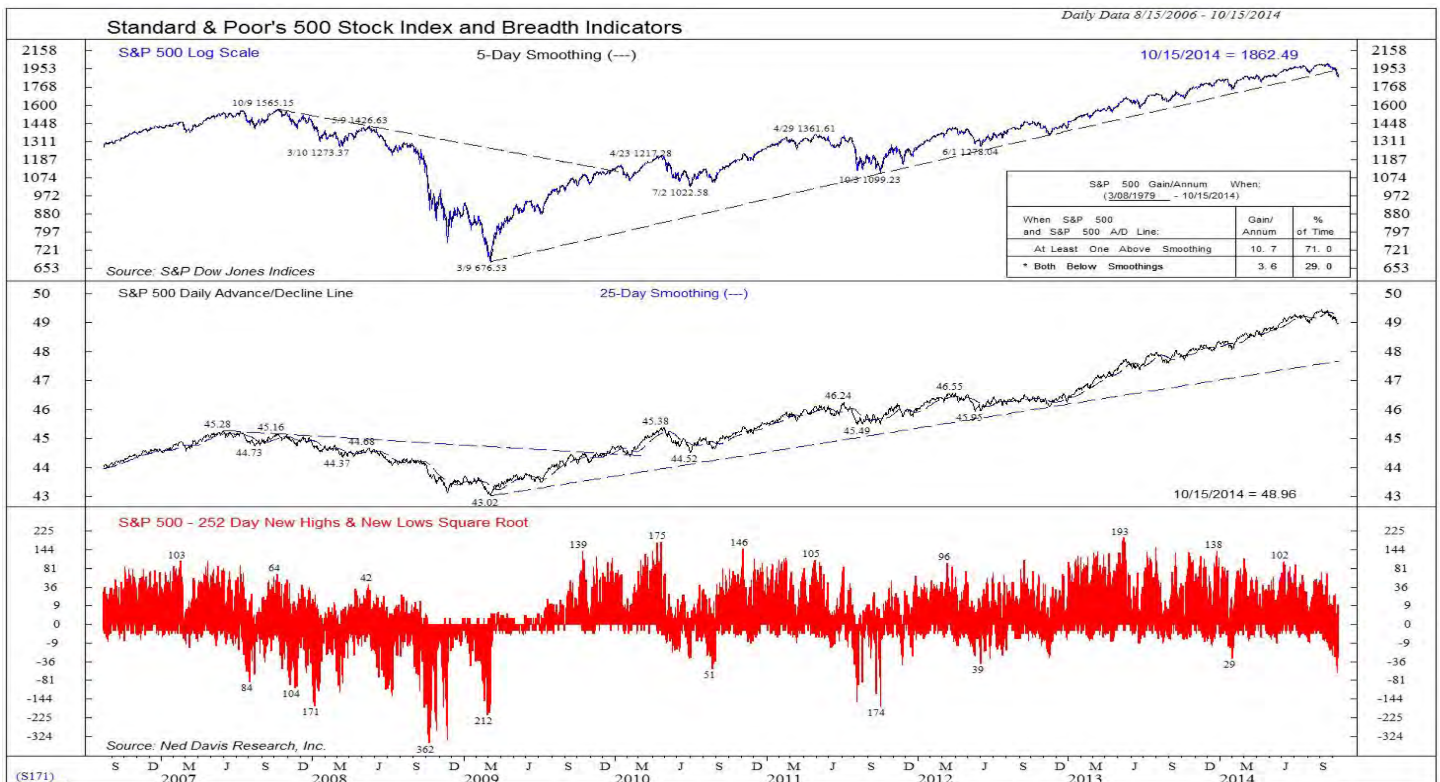
However, relative to government bond yields the stock market appears cheap. Here we compared the S&P 500 earnings yield to the yield on a 10-year government treasury bond. The yields should converge by either stock prices appreciating or bond prices falling. Right now, bond yields are still declining as their prices rise.

This yield spread also feeds back into corporate buybacks which have been the biggest driver for this market.

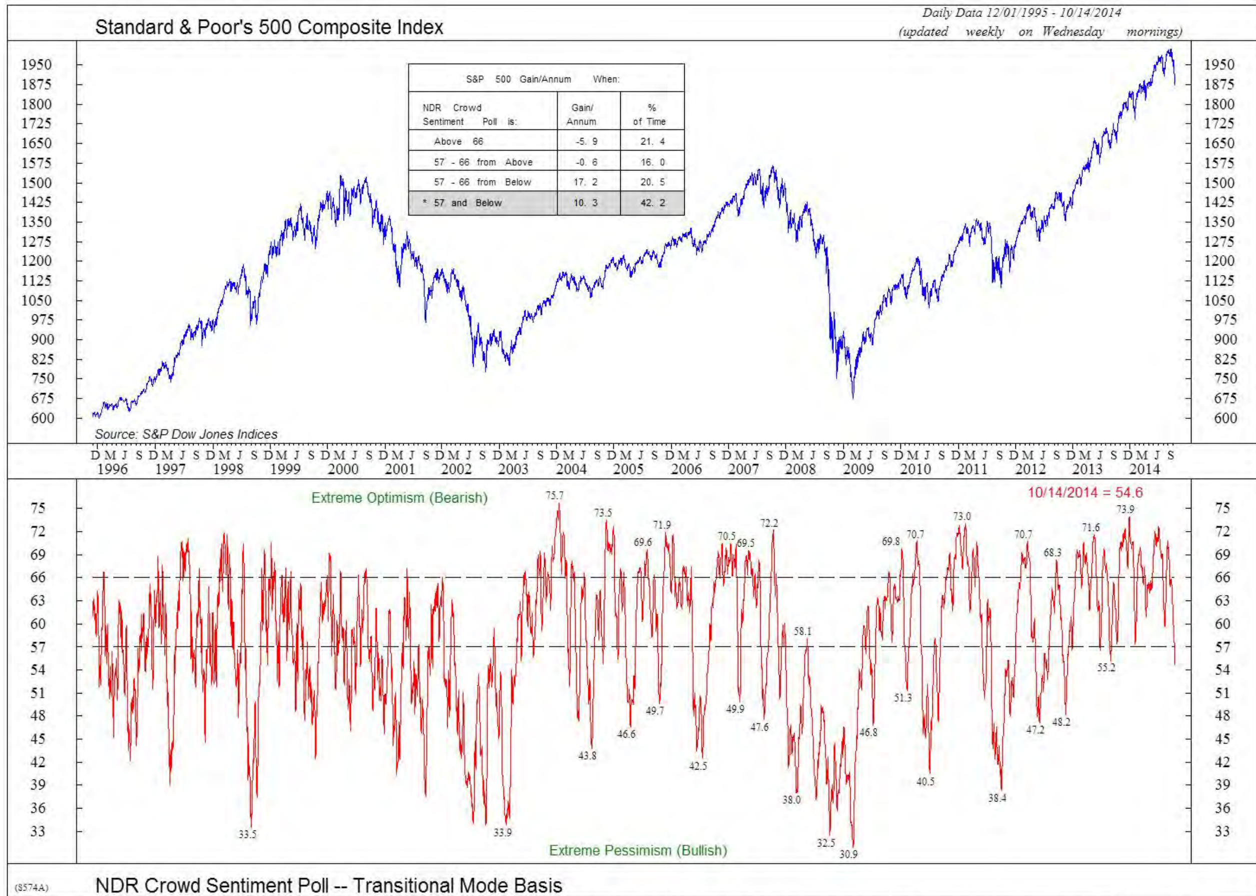


Until the earnings yield and corporate bond yield spread closes, the bottom clip in the above chart, it will make sense for companies to borrow money and buy back their shares. From the first quarter of 2009 through the second quarter of this year, U.S. corporations have purchased $2.0 trillion of their own shares. In the first half of this year alone, $275 billion in shares was repurchased.

So fundamentally, the market looks alright but technically, things could be better.



Breadth could improve. We've shown this chart before and we need net new highs to confirm the new highs in the S&P index. Right now, this measure is consistent with the breakdown we're seeing in the Nasdaq and Russell 2000 indices where more than half of the stocks are down 20% or more from their peaks.



Investor sentiment is a more sensitive market indicator. For most of this year, there has been too much optimism, but this is rapidly changing and should result in a buying opportunity this fall.

Summary

We'll stand by our belief that this bull market will continue until we face either tighter monetary policy or a recession.

Right now, the Federal Reserve is approaching neutral as employment and economic numbers say they should tighten sooner than expected.

However, their second objection is inflation which suggests that any tightening could be delayed. Our bet is the market correction we are experiencing now will push any decision towards accommodation.

Economic weakness in Europe and Japan is worrisome and could threaten the U.S. if they slide back into recession. Right now the jury is still out but even a mild foreign economic contraction is not likely to derail the U.S. economy. However, something worse could be contagious and that is partly what has this market upset.

Regardless, weak foreign economies assure continued monetary easing even as investors lose faith in the Central Banker's ability to stimulate growth.

The dollar and oil are inversely linked and probably balance one another. The strong dollar will hurt the trade balance and offshore profits but increased oil production has helped the trade balance and to some extent consumers through lower gasoline prices, even if it is limited.

We haven't seen a solid market correction in almost four years, so we're long overdue. But the fundamentals of monetary accommodation, a healthy economy, and I believe the secular themes of energy self-sufficiency and re-shoring are still in place. We'll monitor the economic concerns coming out of Europe and Asia but if they don't get worse, then the fears that we are currently seeing will dissipate and allow this market to get back on track.

GRC/amh
October 4, 2014

Credits: Ned Davis
Ed Yardeni
TD Securities
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