CUMBERLAND

WALL OF WORRY

Have you heard the latest one going around Washington? It's about the new Obama diet. Apparently he's letting Putin eat his lunch. It might be funny if it wasn't so true. Thirty-one Visas rescinded and a few frozen bank accounts are the reprimand for invading another country?

Now Russia's annexation of Crimea, invasion was probably too strong, doesn't seem to be rattling this market and perhaps it shouldn't, if it stops here.

My concern is that it doesn't. First, Russia is the 8th largest economy in the world and this action won't be good for world growth. Second, too often seemingly inconsequential, geopolitical events have taken an unintended direction turning minor issues into uncontrollable major ones. Right now, I wouldn't predict that and tend to side with the market. However, history says to be wary and for good reasons which I will elaborate on shortly.

In my year-end commentary, I said that this year's market was all about the economy. If it didn't come through, earnings estimates and valuations were too high. I also felt that interest rates had seen their lows and would gradually work their way higher. Both views were shared by the consensus of forecasters and both have, so far, been wrong.

Interest rates have crept lower on the 10 year U.S. Treasury from 3.03% at year-end to 2.72% and several economic indicators have been weak. Most economists have blamed it on the weather, which is fair, so the market has ignored most of these disappointing results.

Hopefully you see my train of thought here. The market isn't paying any attention to bad news. It's looking beyond current events with an expectation that things will either not get any worse or improve. Now, I'm not making the argument that they won't, but it's usually prudent to be prepared. In the past, when dark clouds have formed on the horizon, the market expected the worst. But not this time and frankly, I don't like it. I'd much rather see a cautious reaction that traps money and potential buying power on the sidelines. Think back to what we saw when Greece was on the verge of default or when the U.S. government reached a debt impasse and had its credit downgraded in the summer of 2011. In each of these cases the market sold off, anticipating trouble, but then rallied when those worst fears weren't realized. What we're seeing now could set us up for some disappointments and a broader market correction. Which, by the way, I would welcome.

So, it's probably worth examining some of the issues that have been confronting the market that could capture the headlines and the minds of investors in the future.

There's an old trader's adage that says, "a bull market climbs a wall of worry." Why? Because it traps buying power on the sidelines which provides support. It's only after all the money on the sidelines is committed that you get a top.

Today's headlines suggest that the market has plenty to worry about, but I worry that it isn't worried enough. So, let's take a tour of what could go wrong but hasn't been discounted in the stock prices.

WALL OF WORRY CANDIDATES

1. Russia and its intentions for the Ukraine
2. China's economic slowdown and problematic financial system
3. Recent economic weakness in the U.S.
4. Federal Reserve's tightening monetary policy
5. Europe sliding into deflation
6. Emerging markets' (The F-5) contagion and impact on global growth
7. Abenomics in Japan failing to revive its economy
8. Loss of market leadership from Biotech and Internet stocks

So far, these have just been concerns and the market has dismissed them. This happens in bull markets, especially if they don't come true. But what if some of these do get worse? Then there probably is going to be a reaction in the market. So, it's worth handicapping some of these issues as a reality check.

<u>Russia</u>

The one I probably worry about the most is Russia because I feel the risk of escalation is miscalculated. Putin is an ambitious leader who feels that the western governments and their NATO alliance have gone too far in engaging the border countries of the Old Soviet Union. The Ukraine was the last straw as they were on the verge of joining a European Economic Alliance. It was only Russia's last minute offer of a loan and discounted natural gas prices that caused the Ukrainian leader Yanukovych to abandon the European offer and side with Russia. This set off a series of demonstrations that eventually resulted in Russia annexing Crimea and threatening to do the same with other eastern Ukrainian districts in order to "protect Russian speaking residences."

Was what Russia did legal? Depends on whose view you take. They contend that it was not an invasion but a referendum on succession. Under Ukrainian law the referendum is illegal but not so under international law. Besides, the Russians contend that the United States and other NATO Allies broke international law by invading other countries such as Iraq, Libya and Kosovo, all friends of the Russians.

The problem here, from my perspective, is that there have not been any serious consequences for Russia's latest move, as indicated by the Obama joke. Europe is divided due to their own self interests. Does Germany want to see its dependence on Russian's natural gas shut off? Probably not. And what about their major commercial joint ventures with the Russians? Do they want to see these disturbed?

It's doubtful that NATO is going to be able to agree on a unanimous response, which is what is required under the European Union Agreement.

So, how ambitious is Putin? He just tested the Western resistance and didn't get any pushback. It would seem the only consequence of being more aggressive is economic as capital flees Russia. But, blind ambition dedicated to building a legacy is not often rational.

So, right now there is a lot of saber rattling with Russian troops stationed along the eastern border of the Ukraine. However, an invasion would be costly and a more pragmatic alternative would be to wage an economic war that cripples the Ukraine and creates social unrest leading up to their May 25th national election. Here, the Russians could win some concessions that would give them greater influence in the region. Maybe that would satisfy them but I don't think so. Putin isn't about to be embarrassed over an issue on his doorstep.

As a side bar, this isn't the only turf battle going on around the world. China is flexing its muscles over islands that Japan has laid claim to and has virtually annexed islands to the south off the Vietnamese coast.

Without material consequences, this issue isn't going away and too often these skirmishes lead to unpredictable outcomes and markets don't like "unpredictable".

<u>China</u>

Here we have two interrelated problems. One, slowing economic growth which won't be good for world growth and demand for commodities that a lot of emerging markets depend on. And second, a financial system that many feel could collapse.

It's true that China's growth is slowing and that they may not reach their targeted 7.5% GDP growth. In the first two months of this year, industrial production grew at its slowest pace since 2009 and retail sales growth dropped to a two year low. China's Premier Li Keqiang has redirected economic policy to focus on domestic consumption and away from exports and capital spending projects. These types of transition never go smoothly and when economic benchmarks appear weak, the markets anticipate a major stimulative fiscal policy response to pick up the slack. However, that hasn't been forthcoming as Premier Keqiang has not reverted to previous massive capital and infrastructure projects to generate growth. Instead, he announced a mini-package to bring forward some spending on five new railway lines in remote areas, to deregulate the industry and do some slum renovations, but didn't give exact figures on how much would be spent. In fact, he sounds more like Fed Chairman Janet Yellen in targeting unemployment and stating that the government's number one priority is to create 10 million new jobs. Apparently the government isn't too concerned about the slow down and is more focused on the transition. They have also left the People's Bank of China (PBOC) on the sidelines. If economic numbers get worse, the markets will expect a strong response from the government.

This leads to the question of how secure is their financial system? BNP Paribas estimates that China's total credit market debt is 250% of GDP and that Chinese commercial banks' assets represent 266% of GDP. With a lot of redundant production capacity, a slower economy is going to lead to impaired profits and consequently a lot of bad loans.

It's estimated that in the past five years, total credit outstanding grew by US$14 trillion to US$25 trillion which is bigger than the U.S. economy. And, at the end of January a trust product offered by China Credit Trust Co. threatened to default but was saved at the last moment.

This has led to a number of suggestions that China's banking system could face a collapse.

If China is going to transition its economy, they will have to allow bad financial products sold into the shadow banking markets default. But, will the government risk letting this get out of control? Well, that's the real question. You'll see more negative headlines on what's happening in the Chinese financial sector but the betting line has to be that the Chinese will put a safety net under it to prevent contagious damage to their economic aspirations.

The Bank Credit Analyst did a pretty good job of putting this into perspective. It's true that assets managed by all financial institutions have exploded from RMB 8 trillion in 2008 to RMB 36 trillion at the end of last year. Of this, about RMB 10 trillion is managed by China's 67 trust companies while the commercial bank's products are traditionally invested in low risk financial assets such as government bonds.

A lot of the assets managed by brokers and fund managers are tied to the stock market and because there has never been a meaningful loss, there is a perception of an implicit guarantee. This will have to change.

Of the RMB 10 trillion in trust products, 35% are in various forms of equity investments; 50% are in some form of debt financing subject to default risk. Trust company exposure to industrial and commercial companies, infrastructure projects and real estate developers amounts to about 70% of total trust assets, with real estate specifically about 10%. But this is what worries outside observers. Yet, it is highly unlikely that the authorities would allow local governments to default on trust loans.

Also, real estate loans are usually backed by a fairly high amount of collateral so the biggest risk is in industrial and commercial companies, which typically can't get credit from traditional sources. This amounts to about RMB 2.8 trillion.

Consequently, trust assets exposed to credit risk amounts to between RMB 3 trillion and RMB 5 trillion compared to the RMB 72 trillion loan book managed by China's commercial banks.

Furthermore, the government started dealing with the trust industry over two decades ago which has resulted in a 90% contraction in the number of trust companies in operation.

Furthermore, China's biggest banks have more than doubled the level of bad loan write-offs in the last year. The five largest banks, which account for about half of all loans, wrote off RMB 59 billion (US$9.5bn) last year up 127% from 2012.

Put in perspective, the Chinese shadow banking system is relatively small compared to the official banking sector and loan loss provisions have increased dramatically in recent years. So it would appear that the issue is being addressed, albeit in an area that lacks full transparency. But right now, isolated headline risk on defaults appears to be more attention-grabbing than reality. Most of China's financial institutions are state-owned or controlled, so counterparty risk is low. But, the government's intention to deleverage the system will be a headwind for the economy. So what's going on in China should not come as too big of a surprise. Regardless, it's a pretty murky system and one has to harbor a sense of suspicion for the numbers. So, I'm still worried.

The U.S. Economy

I won't spend much time on this. Economic releases early in the year were weaker than expected and inconsistent with year-end forecasts. The market has given these disappointments a pass and attributed the weakness to the weather. We'll go along with this because more recent statistics show that the economy is picking up. But, will it fully recover the lost production of the first quarter? Earnings estimates say it will but we have our doubts.

Meanwhile, one of the most telling indicators is employment and the Labour Department recently announced that total employment just hit 116.1 million workers, exceeding the previous peak of 116.0 million in January, 2008. Payrolls increased 192,000 in March which suggests that we're shaking off the effects of weather. Expectations are now for 1.8% GDP growth in the first quarter with weather having shaved 1%. We'll see.

The Federal Reserve's Monetary Policy

The fact is, there isn't really a whole lot new coming out of the Federal Reserve. So why worry? Unfortunately, Fed Chairwoman Janet Yellen made an off-handed comment at a press conference that led market forecasters to believe that maybe interest rates would be headed higher sooner than expected. Some of the other Fed governors then piled on by making their own predictions.

Until the March 19th press conference, the Fed had stated that interest rates wouldn't rise for "a considerable time" after Quantitative Easing (QE) was terminated. During the Q&A, Yellen was asked to define "considerable" and she said that it was probably something in the order of 6 months. That inferred that if QE is to end by the end of this year, then rates could be headed higher by next summer. That wasn't anticipated.

Each Fed governor also gets to make his own projection on interest rates and the St. Louis Fed President Bullard is on record calling for 4% to 4.25% by the end of 2016.

However, the consensus of governors is now predicting a 1% Fed Funds rate by the end of 2015, up from 0.75%, and 2.25% by the end of 2016 up from the earlier forecast of 1.75%. The reality is that 1% is hardly going to be an impediment to the stock market and 2.25% will still be below the normalized rate of 4%. In other words, monetary policy will still be relatively accommodative.

Europe

Bottom line, the European economy has continued to improve. European Purchasing Managers Index (PMI) has increased to a 32 month high, Greece's PMI is in growth territory and Spain's PMI hit a 45 month high.

Greece even returned to the bond market with a five year issue priced at 4.75%. Only a couple of years ago, they were written off with yields of over 30%.

So what's the problem? Well the European Central Bank (ECB) has been doing the opposite of Quantitative Easing (QE) by shrinking its balance sheet from €3.1 trillion in June, 2012 to €2.2 trillion now. It's caused analysts to cut their corporate revenue and earnings estimates for both this year and 2015. This has also raised the spectre of declining prices as corporations become more price competitive. It has resulted in Christine Lagarde, head of the International Monetary Fund (IMF), to counsel more rather than less monetary stimulus.

The ECB subsequently went on record as investigating how it might exercise more quantitative easing.

So here you might worry about the problem but look forward to the solution.

Emerging Markets

Concerns about the Fragile Five (F-5); (Brazil, India, Indonesia, South Africa and Turkey) gave the market a shake in January as investors worried that problems in these countries could be contagious to other developing economies and affect the world's GDP growth rate.

The easy comparison here is to Europe's PIIGS which were going to take down Europe.

The problem for the F5 is their heavy dependence on short-term investments from foreigners to finance large current account deficits.

The last emerging markets (EMs) crisis was in 1997 when East Asian economies melted down, and again in 1998 when Russia collapsed. EMs account for 54% of U.S. merchandise exports. Exports to the F5, excluding Turkey, are 5% of U.S. exports compared to slightly over 2% for the European PIIGS.

So far, the F5s have seen very significant declines in their currencies since the start of last year. South Africa -32.5%; Turkey -21.1%; Indonesia -25.5%; Brazil -18.4% and India -14.3%

These devaluations should help competitiveness but will also boost import prices and cause inflation. Governments will either have to let costs increase which aggravates inflation and the economy, or subsidize the cost of certain imports which will put a further strain on their budgets.

The market seems to have gotten over the contagion fear and in fact, we now have 76% of EM markets trading above their 200-day moving average.

So, stay turned to see if this issue resurfaces.

Abenomics

The worry is, can Japan's recent growth be sustained?

Most of Abenomics, named after Japan's Prime Minister Shinzo Abe who introduced the plan, is based on QE. However, his third arrow of regulatory reform is going to be difficult to implement. So far, the Bank of Japan (BOJ) has increased the monetary base by 51.9% year over year through January, but GDP has only grown by 1% on an annualized basis between the 3rd and 4th quarters while the Yen fell 17.6% against the U.S. dollar last year.

To stimulate more growth, the BOJ elected to double down on funding programs that will allow commercial banks to borrow at 0.1%.

Unfortunately, reserves held by commercial banks at the BOJ have tripled over the last year to 116 trillion Yen and cash holdings by nonfinancial Japanese companies rose to a record 224 trillion Yen. In other words, no one wants the money.

Now the economy is faced with a sales tax hike to 8% from 5% on April 1st. The last time the government did this was 1997 and consumer spending took a dive.

Household spending dropped 2.5% early in February and housing starts were down 12.9% over the past two months through February.

Something to worry about.

The Market

As I said at the outset, I like a Wall of Worry because it puts money on the sidelines. That provides support for the market and the wherewithal to chase stock prices higher.

And, if problems are discounted, they are less of an issue for the market if they should become reality – the paradox of investing.

So my worry is that the current worries aren't being discounted but are instead being ignored, which means that if any one of them does become reality, there is downside to this market.

Otherwise, I think you can look at the market from three other perspectives. First, let's look at the fundamentals, second the valuation and third, the technical indicators or sentiment.

My year-end commentary said that earnings and economic growth had to come through this year if the market was going to advance. Well so far it hasn't, but as I said in my worry list, investors are giving the problem a pass.

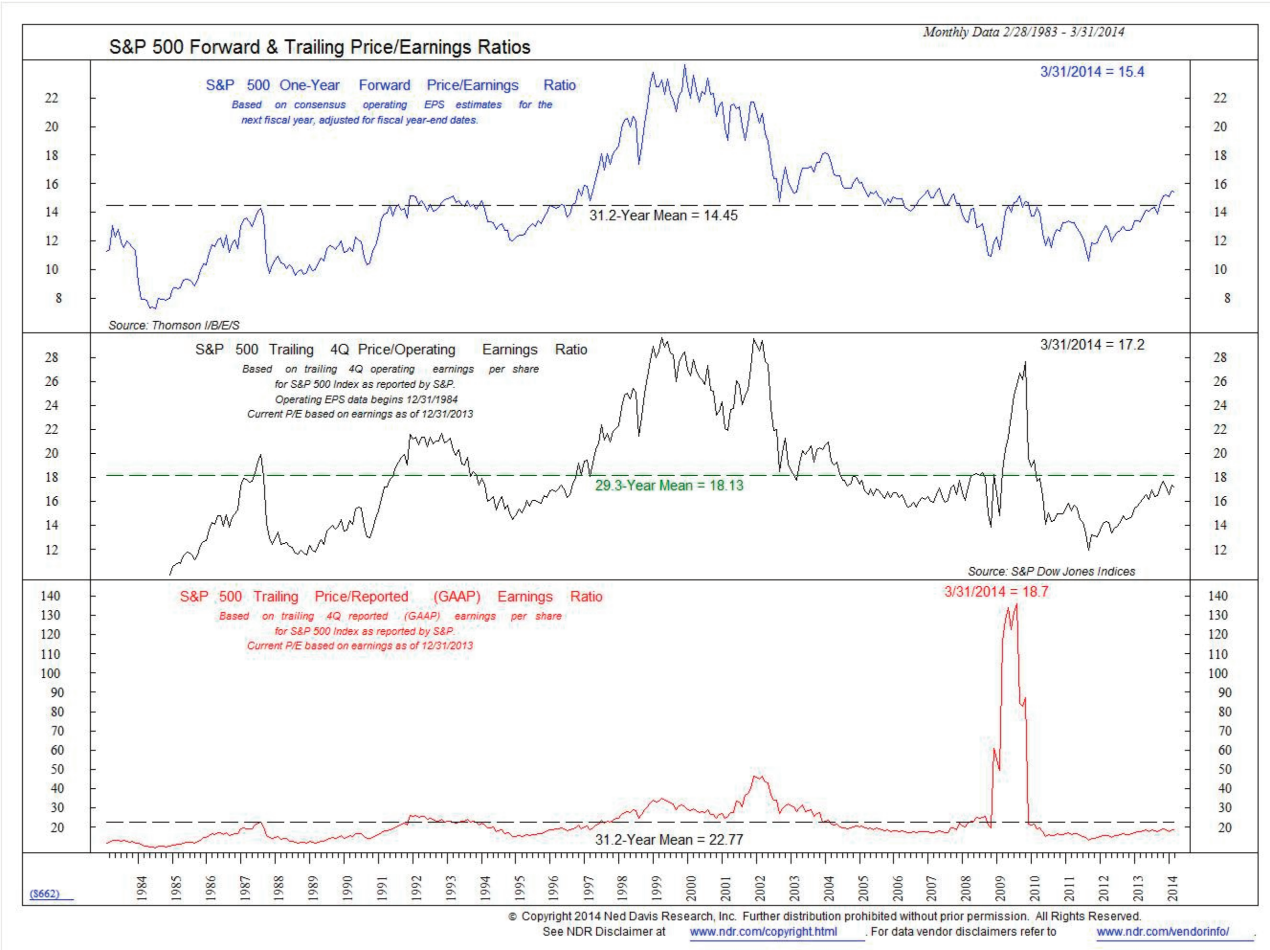
As we started this year, consensus earnings expectations were for the S&P 500 to earn $120.88 for 2014. Our estimate was $116.92 and consensus for 2015 was $133.91.

After disappointing earnings guidance, first quarter estimates have been cut by 4.4% but forecasts for the year are down only 1.6% and growth for the year is now estimated to be 8.5%, a cut from 10.8% at year-end.

For earnings, consensus now estimates S&P 500 earnings of $118.98 this year and $132.59 next. So from our perspective, not much has changed. We're still below the consensus and don't think that the first quarter reductions have been properly accounted for in the anticipated year-end results.

Because the forward estimates are getting a little flaky, it's probably prudent to look at the market from an historical basis. On reported earnings, the market is overvalued at 20.5x earnings compared to the 50 year average of 16.7x and this is a number that you will often hear quoted.

However, reported earnings include a lot of noise such as write-offs, so a better valuation metric is price earnings on operating earnings – which is what companies actually make.

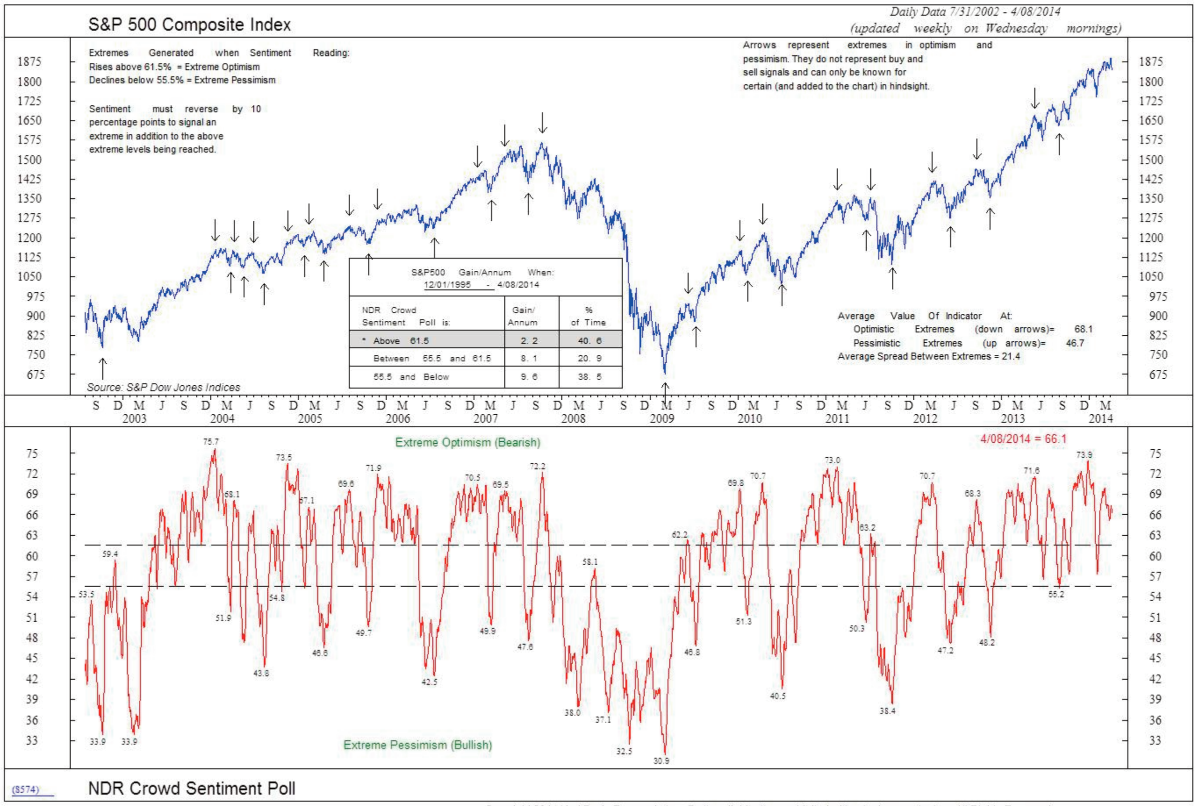


The middle clip of this chart says that valuations of trailing operating earnings are 17.2x, slightly below the 18.3x mean, in other words the market is fairly valued.

Forward earnings are shown in the top clip and here the market is valued at 15.4x earnings, not surprisingly about where it was at the year-end. It's a bit above fair value but I think there is downside risk to the estimates. If we use our estimate of $116.92, then market is trading at 15.7x earnings. Not a huge difference but still over valued by 8.4%.

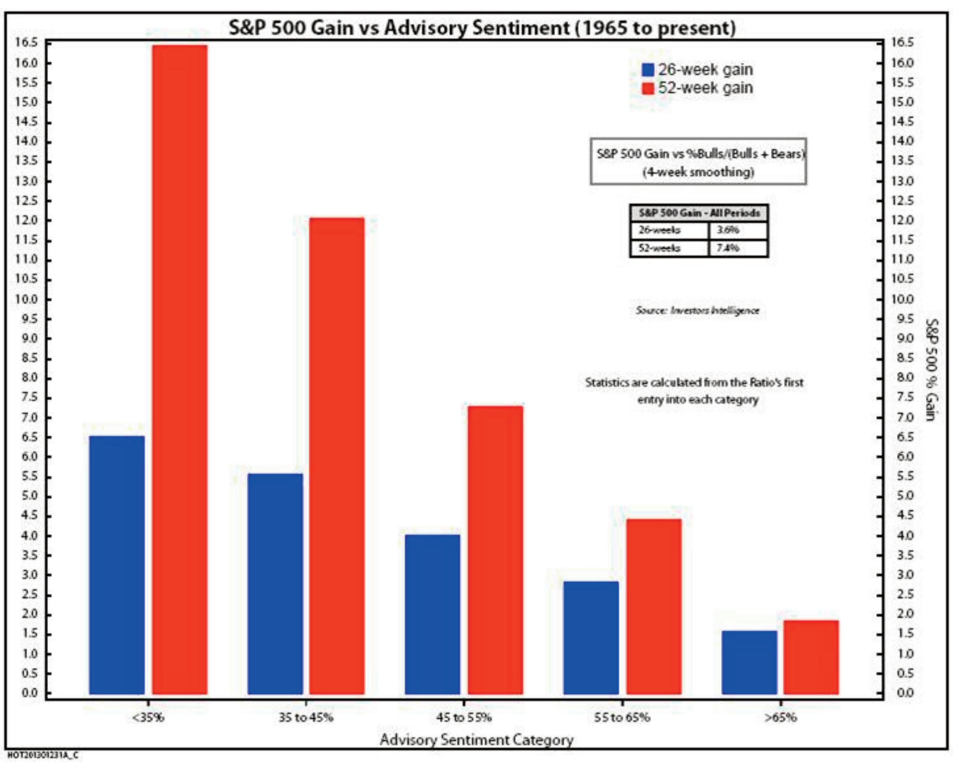
My biggest concern for the market is its technical underpinnings.

Investor sentiment is too high and investors are too complacent, which is why they haven't reacted to my worry list.



The bottom clip of the above chart, shows crowd sentiment and when it gets to an extreme, such as it is now, it pays to bet against it. It's usually a pretty good short term-timing tool.

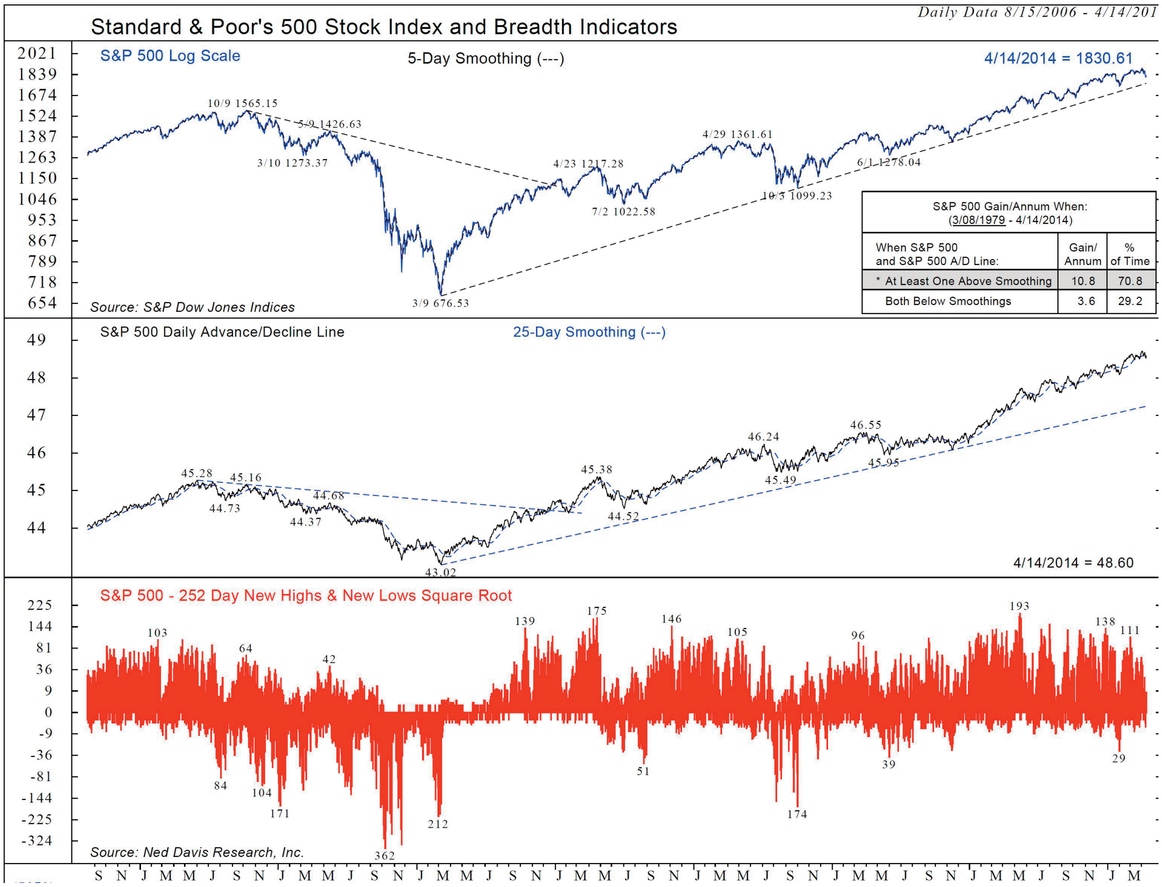
This next chart gives you an idea of how the market has historically performed at various levels of crowd sentiment. Over 65% isn't good.



Longer term, I've always watched the breadth of the market. Historically, the averages can continue to appreciate while the majority of stocks stall. That's exactly what we saw in 2000 as only the technology companies advanced and everything else failed.

We're seeing a little bit of that today with Bio-tech and the Internet software stocks racing to extreme valuations while the broad market marked time in the first quarter.

Although breadth in general is alright, certainly not like what we have seen at other market tops, it is still a little worrisome.



This chart only includes the S&P 500 stocks as it eliminates a lot of noise from listed preferreds and mutual funds. As can be seen in the bottom clip, new highs peaked last May, 2013, at 193 and each succeeding peak has been lower. The broad market has not been as strong as the averages. Historically, the peak in new highs is usually 9 – 12 months ahead of the market averages. About where we are now.

What's contributing to this is the recent setback in Biotech and Internet software stocks – think Facebook and Twitter. Valuations here are reminiscent of the tech bubble in 2000. Facebook at 45x earnings, Linkedin at 107x; Pandora Media at 130x.

Some profit taking isn't unreasonable. But is it a loss of market leadership or a rotation away from overvalued stocks to more reasonably valued companies? Only time will tell but by the work that we do, it should be the latter.

Conclusion

My outlook hasn't changed much since year-end. Short term, I'm cautious. The market is fairly valued and requires earnings and the economy to come through. If they don't, this market will selloff and so far this required support is off to a shaky start.

Otherwise, I'd welcome a solid market selloff to discount some of the worries and to put us back into undervalued territory in the context of what I think will be a continuing bull market.

GRC/amh
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