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Hedging our Bets

Are we in for a correction or are we seeing the top of the market before it rolls over into a bear market? That seems to be the question on everyone's mind. Even those who are long-term bulls on this market are cautious at best. I have read very few comments like I did in 2000 or 2007 about a market that is headed for the moon on the back of the "New Economy" or "Peak Oil." We're not at that stage yet, so the skepticism we're seeing is good.

So where do we stand? Well, I'm starting to sound like a broken record, although I'm not sure my grandkids would know what that means. Regardless, I'm cautious as well and think that the market is at best, fairly valued with some symptoms of overvaluation. However, I also believe that we are still in a long term bull market that won't end until we're solidly overvalued.

To be a good contrarian investor, you learn to lean against extremes. You don't make money reacting to historical averages. In other words, you wait to react to the market when it's either cheap or expensive and not fairly valued as it currently is.

Now, let me weasel out on why we're not fully invested if we think the market is ultimately going higher. First, markets are prone to corrections and valuation is a lousy timing tool. We can only look at the mounting evidence to determine where we are in the cycle. As topping symptoms pile-up against us, we hedge our bets. And second, we have a value-biased investment philosophy. The trouble with being cheap is that "average" looks expensive to us. We're always looking for a bargain and it occasionally causes us to leave some cash on the sidelines. This is especially true if we anticipate a pullback but also because our disciplines don't throw up as many opportunities as you would otherwise expect to see in an undervalued market.

In our opinion, this is not an absolute, black and white business. Some prudence and assessment of risk is required. But, let me get to some of the evidence that is concerning us in a minute.

Before I do, I think it's worth looking at some of the issues that are influencing this market:

1. The Fed being hostage to the stock market;
2. The perfect arbitrage;
3. The case for a Bear Market.

Federal Reserve

Let's start with the Federal Reserve. They've already started to reduce their monetary stimulus and it won't be a surprise to anyone that they will eventually tighten monetary policy by raising interest rates. But when and by how much is a debated issue.

We were originally led to believe that when unemployment declined to 6.5% and inflation reached 2%, these were the conditions that would favour a tighter monetary policy.

Well, the June employment report showed an increase of 288,000 jobs, the second most since January, 2012. It was the fifth consecutive monthly improvement above 200,000. The last similar run was in January, 2000 and has dropped the unemployment rate to 6.1%, the lowest since September, 2008.

CPI inflation in May was reported to be 2.1%. But on a rolling three month annualized basis, the core inflation trend doesn't look very good. Under this calculation the Core CPI, not including fuel and food, rose from 1.4% in February to 1.8% during March, 2.2% in April and now to 2.8% for May.

When asked about these trends, Fed Chairman Yellen, blew off the inflation report as containing too much statistical "noise". In fact, she said "Inflation has continued to run below the committee's 2% objective and the committee remains mindful that inflation running persistently below its objective could pose risks to economic performance." On balance, she contends that inflation is evolving in line with the Committee's expectation.

She also noted that wage inflation was only around 2% which was well below where she thought it should be at this stage of the economic recovery. In her opinion, wages were barely keeping up with inflation but should be rising faster to reflect productivity. She would also contend that the unemployment rate is more a function of people dropping out of the work force, so the current 6.1% understates the employment problem.

The IMF Managing Director Christine Lagarde is providing moral support for Yellen's apparent dismissal of the statistics. In her speech to the National Press Club in Washington D.C., Lagarde said that "if inflation were to rise more rapidly than expected and the economy was still well below full employment, tolerating a modest, temporary rise of inflation above the long-term goal could be consistent with the Fed's balanced approach as long as inflation expectations remain anchored and financial stability risks were low."

Now we know why there is confusion over when and by how much rates will increase. Right now the consensus of the Federal Reserve governors would suggest that rates will start rising next June. They are currently at 0.25% and expectations see them at 1.2% by the end of 2015 and 2.5% by the end of 2016.

Needless to say, the market is very sensitive to what the Fed says and the Bears believe they are already behind the curve and that rates will have to go a lot higher than expected. They also believe that the Fed tightening will be a major negative for the market.

So it's worth examining their case. But, first let me introduce a concept that I think is core to how the Fed will react; namely I believe the U.S. Central Bank is a prisoner to the stock market and not the other way around.

I think Janet Yellen is sincere in wanting to improve employment but to do so, she has to play to Wall Street. Their stated policy was to stimulate the economy with low interest rates and believed that the wealth effect would cause an increase in spending of an additional $0.05 to $ 0.10 for every dollar of increase in wealth.

Under former Fed Chairman Bernanke, their stated intention was to drive down interest rates to low enough levels so investors would have to take on more risk. They clearly signaled their intentions to drive the stock market higher and to create a wealth effect that they hoped would trickle down into the economy. One can argue the success of the strategy but the market is at an all time high, the economy is recovering and total employment is back over its previous high.

Assuming some cause and effect relationship, the Fed now can't let the market decline for fear of unwinding all the progress that has been made. So it brings into question, what data is the Fed watching to make its policy decisions – unemployment, inflation or the stock market?

Certainly with unemployment and now inflation reaching original targets, this should illicit some policy change. In fairness, it has. The Fed has started to taper its bond buying – less stimulus but a long way from tightening.

Yet, any comments, such as Yellen's suggestion that interest rates could rise six months after quantitative easing (QE) ends that impact the stock market are quickly reversed or explained away.

In other words, policy seems to be very reactionary to movements in stock prices – more so than in reaction to economic statistics.

Last spring, when Bernanke suggested that they could cut back on QE, both the stock and bond markets tanked. The Federal Reserve governors said they were surprised and did their best to explain it and backed away from any dramatic change in policy.

Further, the President of the New York Fed, Bill Dudley said that the reaction of the bond and stock markets, once the Fed starts hiking rates, might influence policy course.

Right now, Yellen says that "I don't see any tradeoff whatsoever in achieving our two objectives (controlled inflation and lower unemployment). They both call for the same policy, namely a highly accommodative monetary policy."

With regards to the stock market, Yellen commented, "so I don't have a sense – the committee doesn't try to gauge what is the right level of equity prices. But we do certainly monitor a number of different metrics that give us a feeling for where valuations are relative to things like earnings or dividends, and look at where these metrics stand in comparison with previous history to get a sense of whether or not we're moving to valuation levels that are outside of historical norms, and I still don't see that. I still don't see that for equity prices broadly."

The Bears believe that the Fed is already behind the curve, inflation could explode as the economy heats up and the level of rates required to cool the economy will crush earnings and stock prices. We'll take a look at this in the "Bear Case".

Current economic statistics are actually pretty good. Manufacturing PMI in the U.S. increased to 57.5, the strongest upturn in overall business conditions since May 2010, and driven by the fastest output and new orders growth in over four years.

New home sales in May jumped 18.6%, the most since January 1992 and the highest in six years while existing home sales improved 4.9%.

Consumer confidence also hit its highest level in six years last month.

Auto sales in June also reached a recovery high annual rate of 16.9 million units, the highest since July 2006.

Is the economy too strong and is inflation an issue? Well, let's try to put it into perspective.

The current economic cycle is 60 months old and the average of the last seven expansions since 1960 is 71 months. There have been some that have been longer such as February, 1961 to December, 1969 (106 months), November, 1982 to July, 1990 (92 months) and March, 1991 to March, 2001 (120 months) and we believe the current one will be longer than normal. So, if a recession is required for a bear market we're not there yet, time wise.

How strong is this recovery? Well the statistics support the Yellen approach. Real GDP is up only 10% since the expansion started in the third quarter of 2009. That's below the average of 21.1%. However, the cyclical recovery in profits has been in line with the average of the previous expansions. We'll come to why this is happening shortly because it is one of the main tenants of the Bear case.

Why has this been such a slow recovery? One popular reason is that the downturn was a "balance –sheet recession". Asset values fell sharply but debt remained high. The Fed has successfully reflated asset prices but many borrowers are still struggling with too much debt. In other words, the Fed has helped balance sheets but not income statements.

If that's true, the drag from too much debt will impair GDP growth and inflation. In the past decade it has taken $3.45 of debt to generate $1.00 of GDP. That compares to $1.36 in the 50's and $1.53 in the 60's and $1.68 in the 70's.

Consumption through borrowing often represents consumption today at the expense of future spending.

Globalization has also made markets more competitive and reduced pricing power, while technological innovation boosts productivity and lowers costs. This kind of capital spending is certainly one of the components of inflation that is actually benefiting from ultra easy monetary conditions.

So, maybe the Fed is right and there is nothing to worry about.

But, what about the inevitability of a tighter monetary policy? What we have been exploring to this point are the current conditions that support various forecasts. But ultimately everyone agrees, rates are going up. The Bears say that when that happens, it's all over. The evidence says maybe not.

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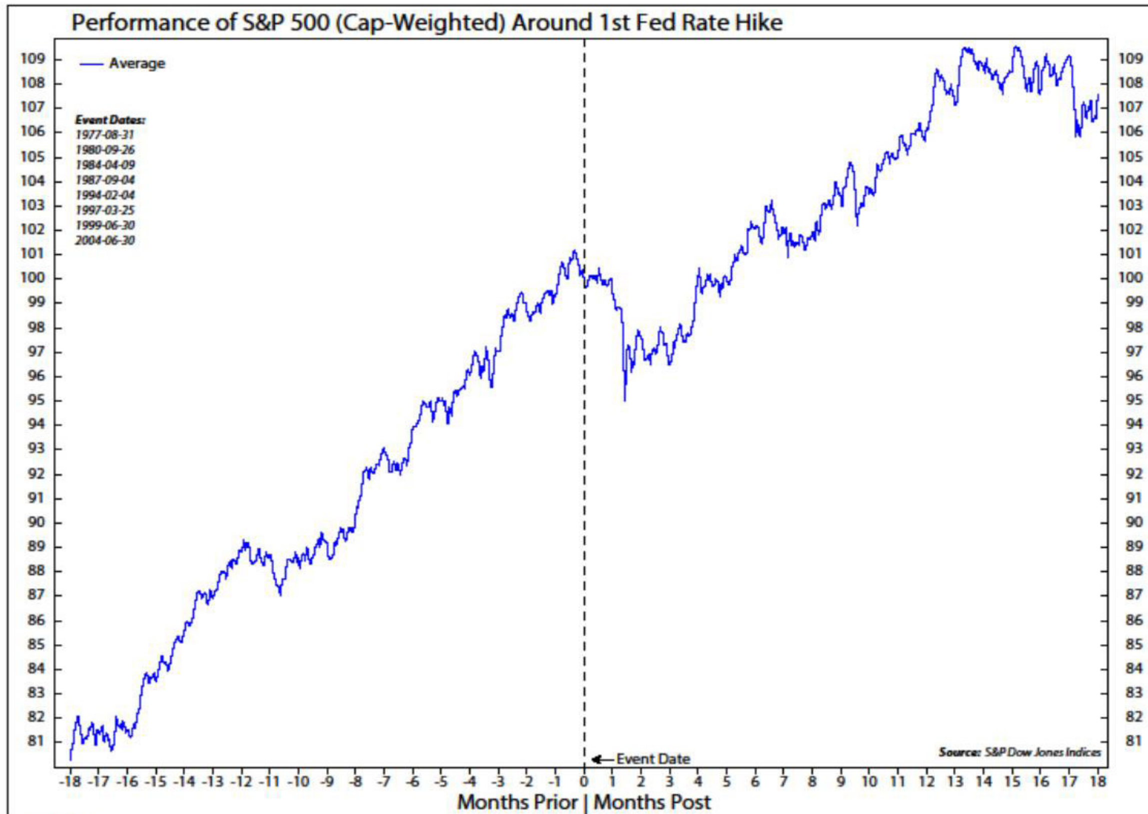

If you look carefully at this chart it shows the performance of the S&P 500 in the 18 months leading up to the date of the first rate hike and the performance of the market in the subsequent 18 months. As you can see the market stays healthy right up to a month before then sells off for a couple of months before resuming its advance.

As for the economy, most economic indicators perform better than the average in the year before the first hike and they continue to hold up but at a declining rate thereafter. Corporate profits also tend to increase at an above average rate both before and after a rate hike. Recessions, on average, start 25 months after the first rate increase.

So, where do we stand on interest rates and the Fed? Well, we think the economic cycle will be drawn out and there is a chance inflation picks up but at 2.1%, it's still below the decade average of 2.3% and a long way from what we saw in the 70's. With the structural issues facing the economy, it's going higher but we doubt it will get out of control.

Nonetheless, the market gets spooked every time there is a suggestion that rates are about to go up. That could give us the correction that we are hoping for. On this one, the Bears will only be right if the Fed loses control of rates. If that happens, a correction becomes a bear market because we will be headed for a recession.

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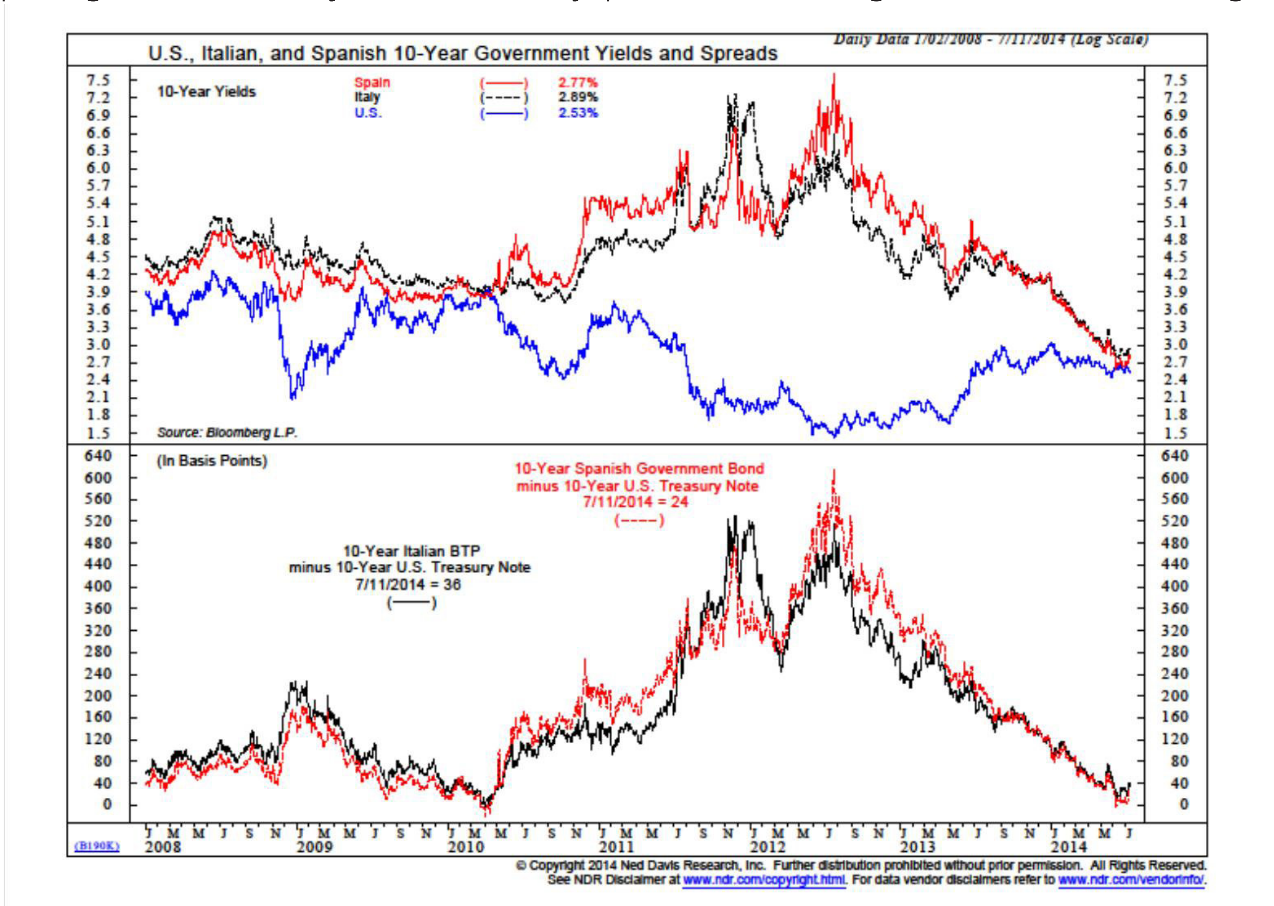
As an aside, the European Central Bank (ECB) is also helping the rate environment in the U.S.

Under Mario Draghi, the ECB has lowered its official lending rate by 10 bps to 15 bps and dropped the rate paid on bank reserves to a negative 0.1%. A bank now has to pay the ECB to leave money with them. The ECB is also starting another $542 billion lending program where banks can borrow cheaply from the ECB if they make loans to businesses. Draghi is also hoping that these changes will result in a lower exchange rate for the Euro. All of this is an attempt to turn around the decline in bank lending which amounted to an annualized €201.2 billion at the end of May and has been negative in every month but two since October, 2011.

What's causing this lack of lending is regulation stress and the requirement to build higher, capital reserves under the Basel III Accord. Sovereign bonds don't require reserves, while loans do and this has resulted in a collapse in government bond yields as banks buy questionable sovereign credits instead of making loans.



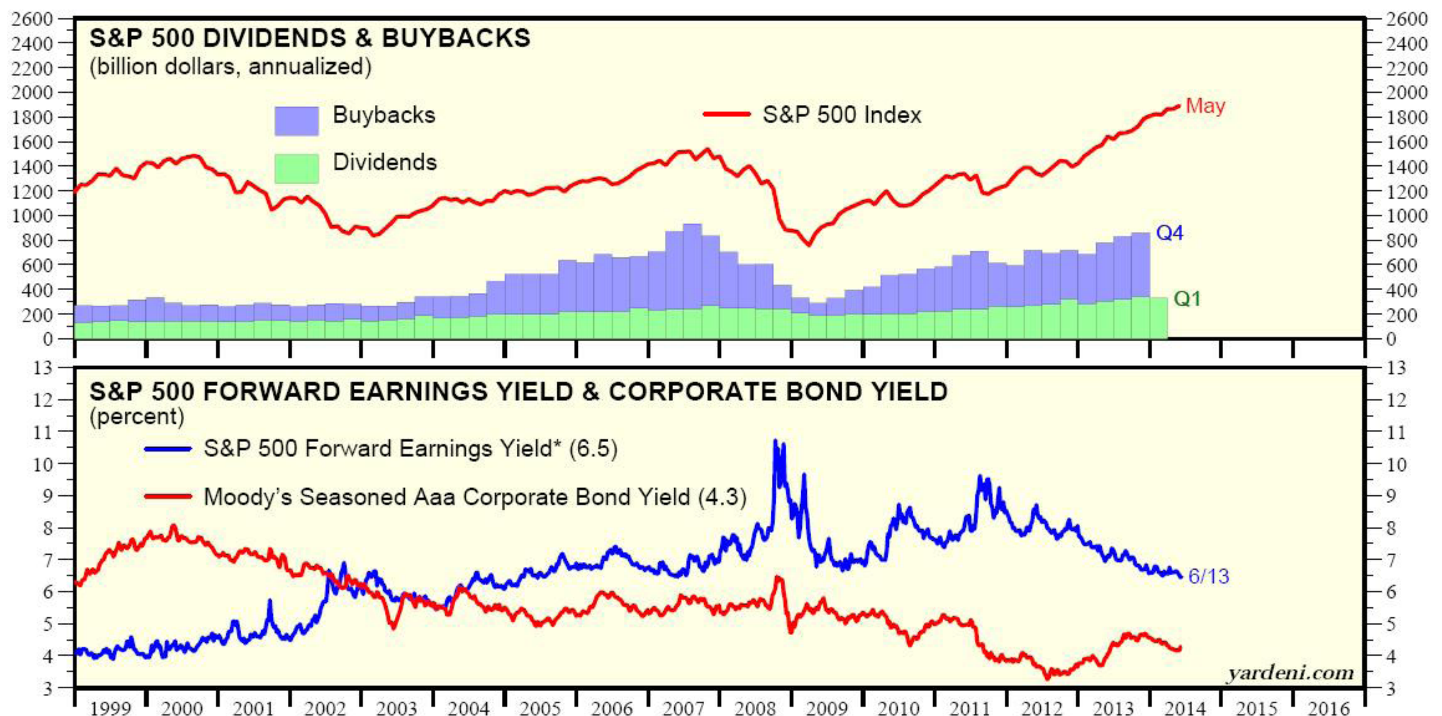
Today, as seen in this chart, Spanish, Italian and U.S. 10-year treasuries all yield roughly the same. Two years ago, there was between a 500bps and 600 bps spread. Even a Portuguese bond yields only 3.3% today while Greece is already doing its second offering of bonds since April.

With a move out of corporate loans because of the regulations, government debt has benefited. Yet with U.S. and European peripheral government rates roughly the same and Draghi talking the Euro down, it is not surprising the European banks prefer U.S. treasuries. That's another reason to think maybe rates will stay a bit lower than they should for longer.

The Perfect Arbitrage

Another interest rate dependent support for the stock market is what I refer to as the perfect arbitrage.

We often examine the flow of funds into and out of mutual funds for clues as to which way the market might go. On balance, money has been flowing out of the market and into bonds since 2008 with a bit of a reversal in early 2013.



However, the real story is what has happened at corporate treasuries as the top clip of the above chart shows. From the first quarter of 2009 through the first quarter of this year, S&P 500 companies have repurchased $1.9 trillion of their shares and paid out $1.3 trillion in dividends. In the first quarter of 2014, buybacks totaled an annualized $637 billion, almost matching the record high of the third quarter of 2007. However, recent evidence suggests that this might be slowing.

It's not hard to understand what the motivation is behind these buybacks when you look at interest rates. As the above chart, bottom clip, indicates, corporations can borrow in the bond market at 4.3% and buyback their stock that has a 6.5% yield on average. In a slow growth environment, it's an easy way to bump up your earnings per share and is one of the main reasons why profitability has done much better than the economy.

Will this support for the market continue? With over $1.9 trillion on corporate balance sheets and a favourable borrowing environment, we see little reason why this trend should reverse.

Bear Case

The bear market argument is very straight forward and quite plausible. Their bet is that profit margins are about to collapse.

Standard & Poor's 500 Sales, Earnings, and Profit Margin
Monthly Data 1973-03-31 to 2014-06-30
— Trailing Four-Quarter Sales Year-to-Year Change
2014-06-30 = 1.69%
— Trailing Four-Quarter Income Before Extraordinary Items Year-to-Year Change
2014-06-30 = 12.22%
— Income Before Extraordinary Items Margin
2014-06-30 = 9.02%
Shaded areas represent National Bureau of Economic Research recessions
NDR Calculations, subject to revision
Source: S&P Capital IQ Compustat, Ned Davis Research, Inc.
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Looking at the bottom clip of this chart, income before extraordinary items is at an all time high of 9.02% of sales, about 50% above their historic mean since 1972. Earnings are growing at 12.22% (middle clip) while the year-to-year change in sales is a meager 1.69% (top clip). How can profits grow faster than sales? Well, costs have to decline and the big two have been:

1. Falling interest expense;
2. Low labour costs

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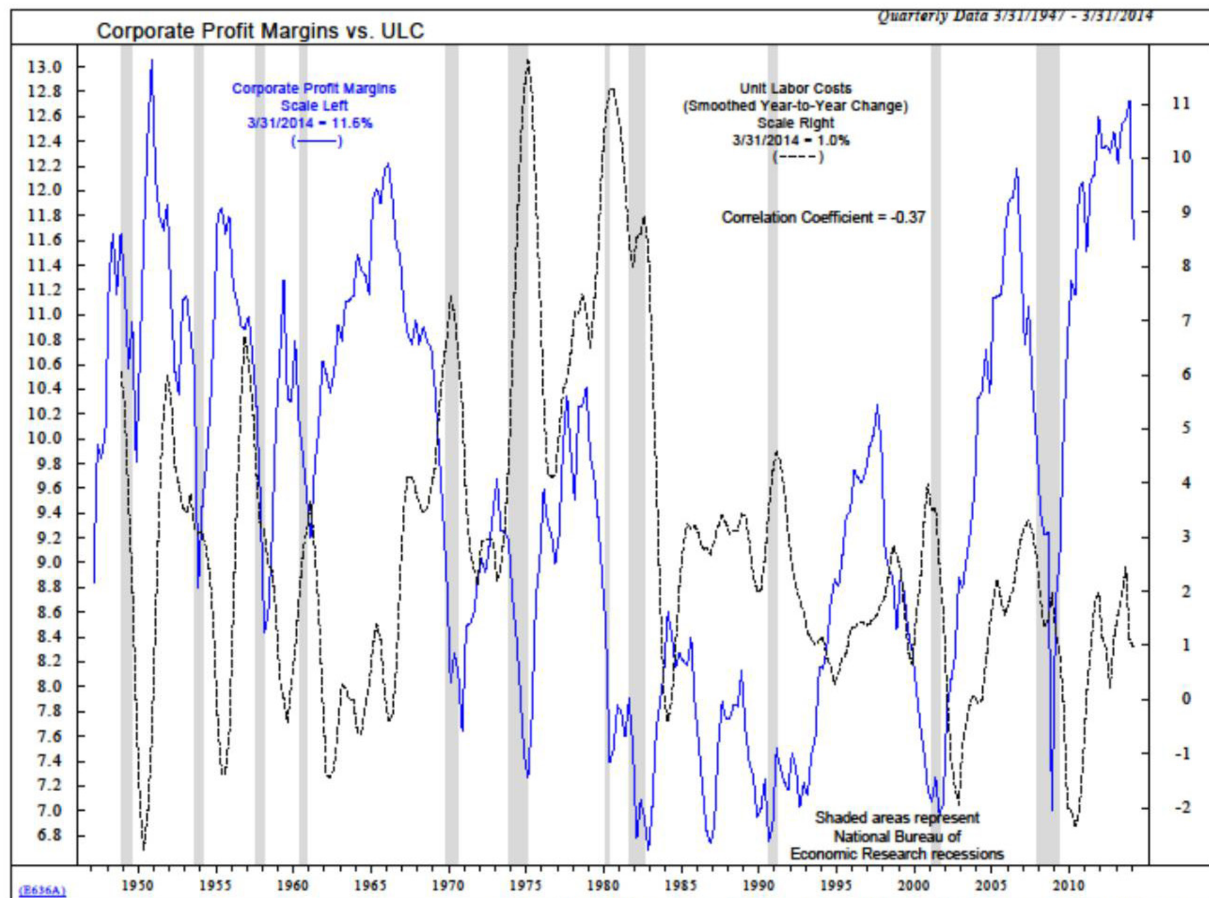
This is why the debate over Fed Policy is so important. If rates do increase too much, then profit margins and earnings per share are headed lower.

If interest expenses were at 2007 levels, the S&P 500 earnings in 2012 would have been lower by $39.50. Currently the trailing four quarter interest expense is the lowest since December 1997 and is now about 1.8% of sales compared to 6.2% in 2007.

In the long-term, we won't dismiss this concern but in the short-term we don't think it's likely to have the same historical impact. First, non-financial corporations have almost $2 trillion of cash on their balance sheets. They don't need to borrow much. Second, corporations have taken advantage of the ultra low bond yields and "termed out" their debt. In other words, rising short-term borrowing rates won't have much impact on corporate interest costs for a while.

Rising rates will, however impact consumer spending on big ticket items. So the effect of rising rates will be more industry specific.

Wage costs are the next biggest contributor to the profit margin increase.



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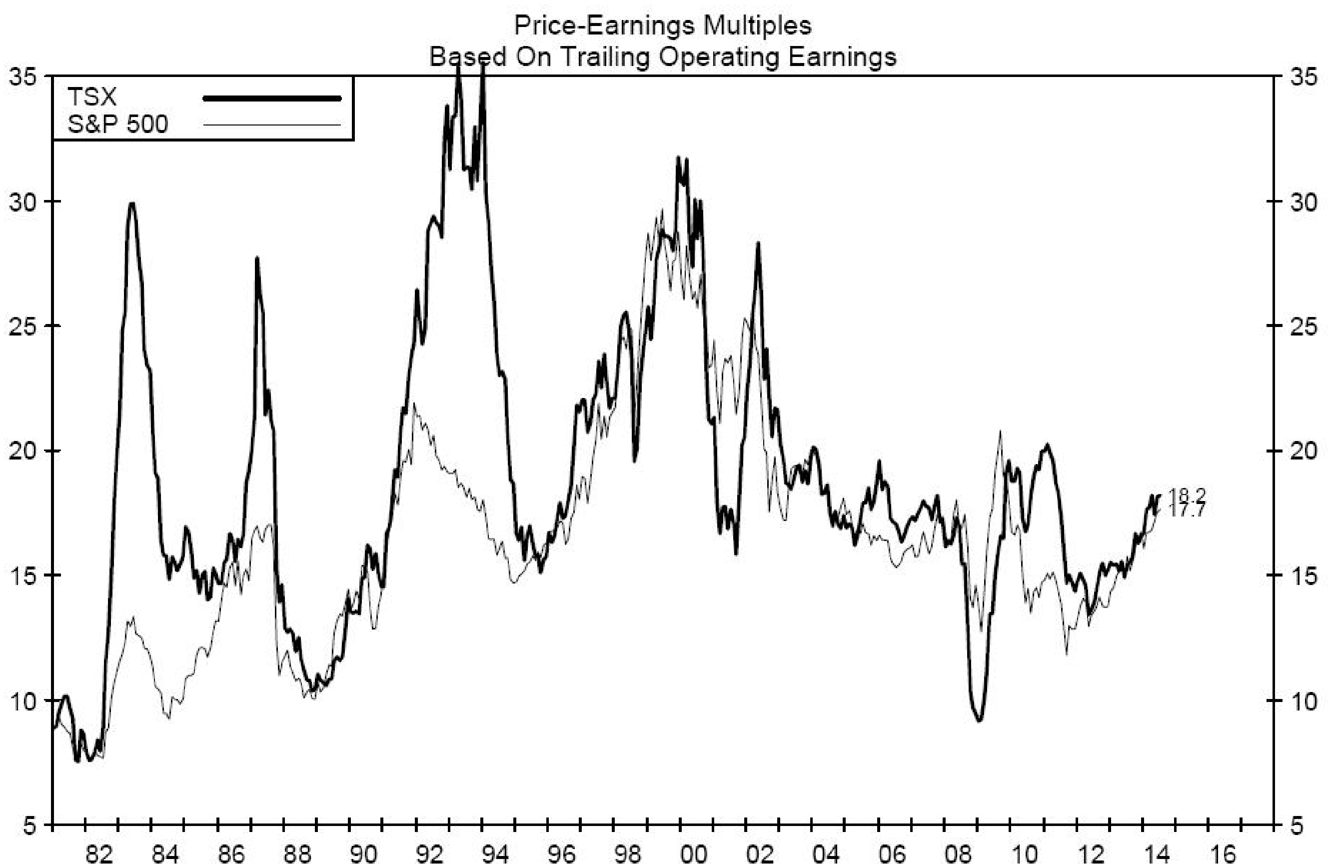
As you can see from this chart, they are inversely correlated with corporate profit margins and generally follow profits higher. There are some mitigating factors such as globalization but bottom line, wages are increasing if for no other reason than the increase in the minimum wage.

For profits to hold up, sales now need to improve.

We believe that wages are going to be a factor but probably not enough to affect overall profit growth, even with a diminished profit margin. However, cost increases without sales improvement won't be good news for the market.

Valuation

We've shown you these charts many times in the past.



This one shows the price earnings multiple for both the S&P 500 and the TSX. They're both close to 18x, which is above the long-term average but not at levels we have seen at other peaks. Regardless, you need to go back to the early 2000's to find higher valuations on the S&P. This isn't a clear cut sell signal by any means but on an absolute basis, it is part of the increasing body of evidence that says one should be cautious.

S&P 500 Forward Earnings Yield (——)
And 10 Year Treasury Bond Yield (••••••••)

6.42
2.63

This next chart compares the earnings yield of the S&P 500 to the 10-year treasury bond yield. Until they converge the market is cheap "relative" to bonds. The bear case is that bond yields are going up and earnings yields will collapse as those higher rates eat into earnings.

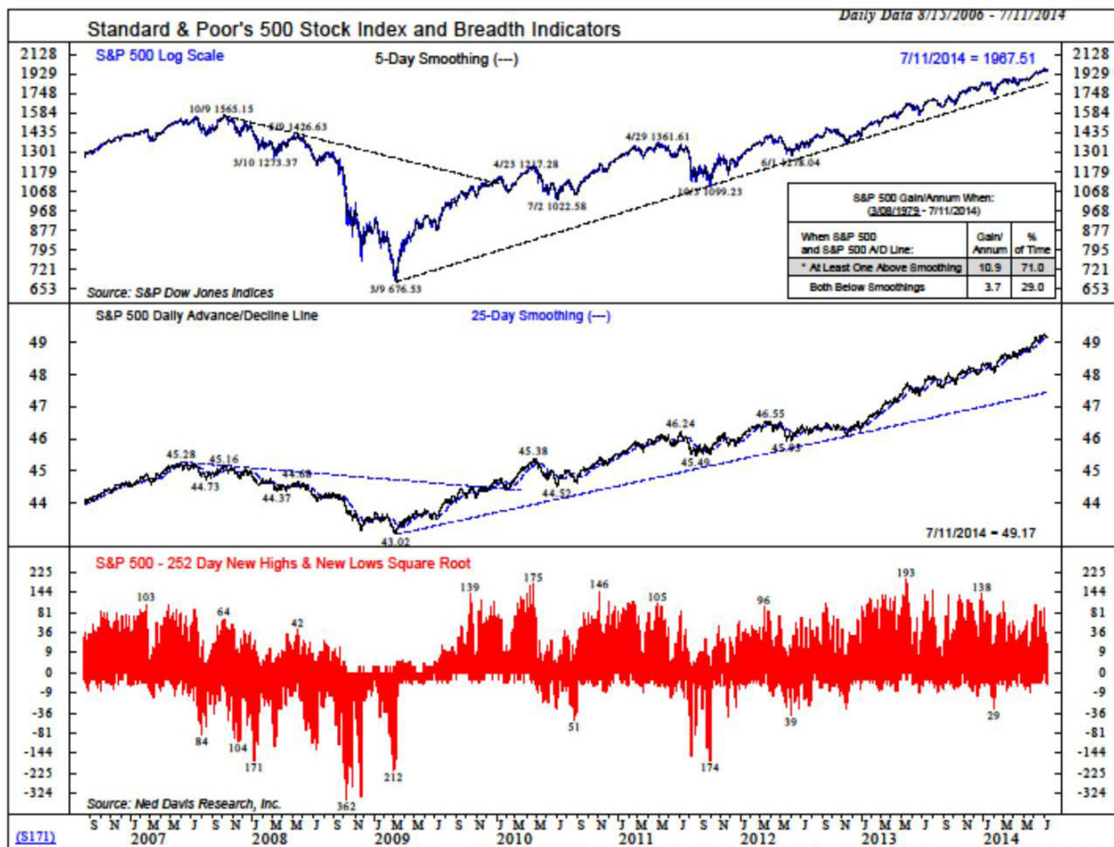
No one disagrees that interest rates are eventually headed higher, but for the 10 year bond to reach a "normalized" level of roughly 5% (horizontal line) it could take years if Janet Yellen is to be believed. Yet earnings are projected to grow 9.1% this year and 11.3% next year to $133.14 which will support the market's higher yield.

So, if you believe these numbers the market still has upside.

Technical Indicators

This is where the body of evidence becomes a little more concerning. It's been 1,327 days since the market has had a 20% correction and 678 days since a 10% correction compared to the norm of 635 and 161, representively.

Global M&A activity hit $1.75 trillion in the first half of the year according to the Financial Times. That's 75% higher than last year and the highest since 2007. High M&A and market tops are highly correlated.



When S&P 500 and S&P 500 A/D Line:	Gain/ Annum	% of Time
* At Least One Above Smoothing	10.9	71.0
Both Below Smoothings	3.7	29.0

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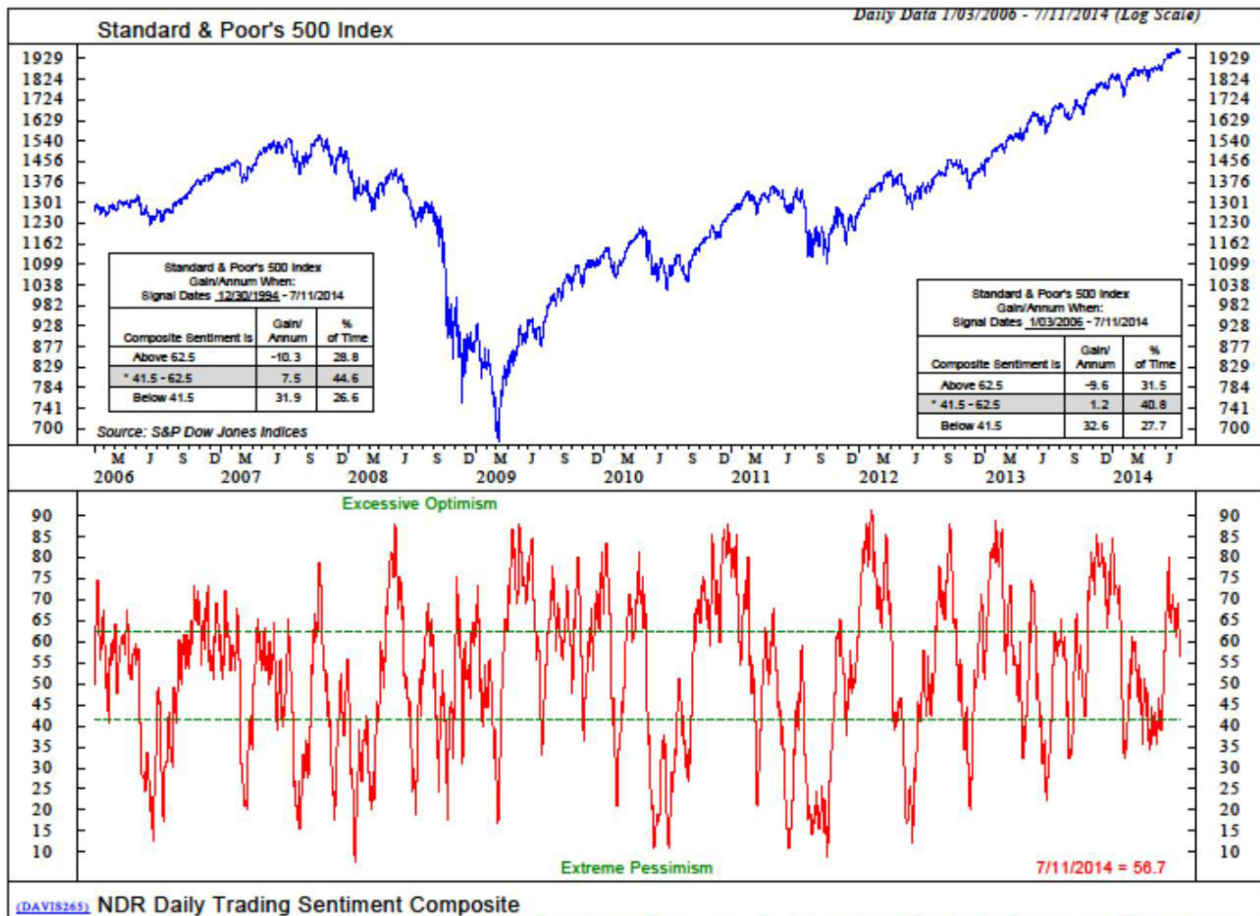
Market breadth as represented by new highs and new lows is not confirming the new high in the S&P 500 index.

The last peak in new highs was 193 in May, 2013 as shown in the bottom clip of the above chart. Looking at the 15 peaks since 1962 the median lead time from a peak in new highs to when a bear market starts is 182 market days while the average is 224 days or nine to eleven months. And the market generally advances an additional 8.2% to 14.0% after peak new highs. So, we're close unless breadth improves.



Market sentiment also remains close to the cautious zone of too much optimism.

In other words, you get the sense that we're probably due for a correction. Since this bull market started in 2009, there have been 5 corrections. The first started in the Spring of 2010 and the S&P dropped 16%. The worst was the 19.4% decline from April through October 2011. There was a further correction of 9.8% that fall and in 2012, we experienced a 9.9% decline in the spring and a 7.7% drop that autumn.

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Since then, it's been a Buzz Lightyear's market, from here to "Infinity and Beyond".

However, none of these are absolute indicators, so our tact is to incrementally react to the weight of the evidence.

Conclusion

Market corrections are usually a function of lowered expectations. Problems in Europe caused sovereign debt and banking concerns. Weak economic statistics call into question the earnings estimates. When reduced expectations are wrong, the bull market resumes.

Bear markets start when reduced expectations are confirmed. Weak economic statistics become a recession.

I don't see a recession coming. But, when interest rates start to increase, there is going to be a debate about the impact on the economy, profit margins, the stock market and how high they might go. It's very possible that expectations will be lowered. We'll then have to wait and see whether the bull or bear camp is right. We'll weigh the evidence at that time but right now, lowered expectations would likely give us a buying opportunity.

In the meantime, there is still an enormous amount of liquidity in the system and the stock market, fairly valued or not, is still the best relative investment alternative. So, can we go from fair valued to overvalued? For sure, but remember, no one will ring a bell at the top.

Nonetheless, the symptoms of speculation and an extended market continue to add up so experience and investment discipline suggest it's probably better to suffer the consequences of a relative performance shortfall than to lose money.

GRC/amh
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