CUMBERLAND

# BIG MAC IS BACK

Big macro that is. We haven't seen the newspaper headlines this focused since Greece threatened to take down Europe and the U.S. Fiscal Cliff jeopardized economic growth.

By late summer, the list of topics likely to set the market back had steadily grown to include:

1. The next Federal Reserve Chairman
2. Syria
3. Fed "Tapering"
4. U.S. budget showdown and debt ceiling
5. A failing Italian coalition government
6. German Elections

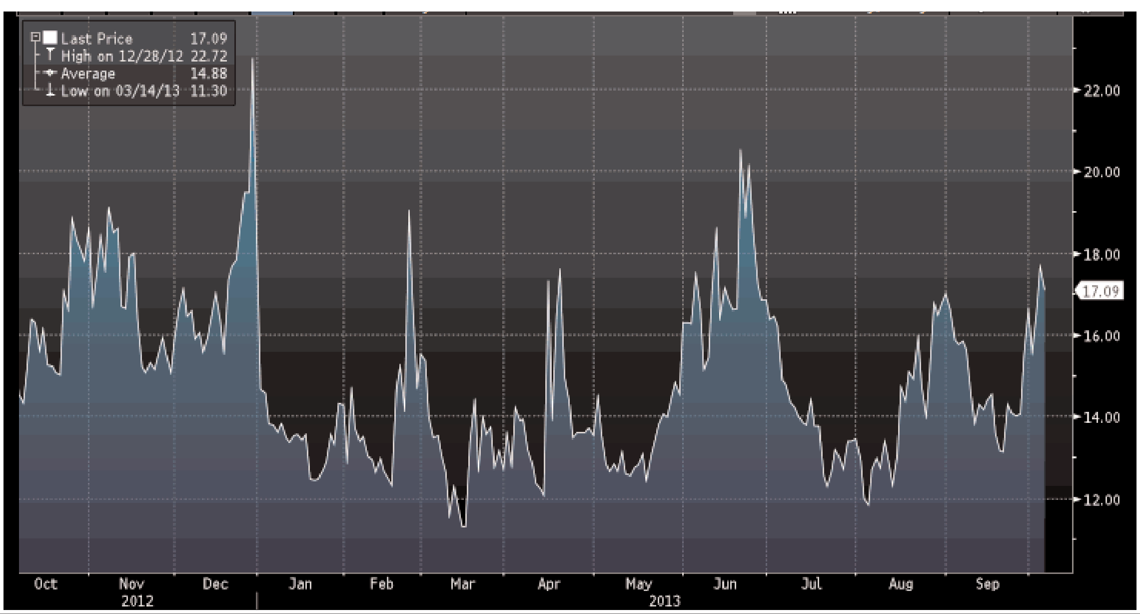
But slowly, each of these issues has been resolved, leaving only the gridlock in Washington D.C. over finances and the Fed's timing on backing off its ultra easy monetary policy as the remaining problems.

We hoped for a little more hysteria this fall and a solid market pullback to set us up for a solid year-end rally. But it seems that "Big Mac" is losing some of its punch, which really shouldn't be much of a surprise.

If you will recall from our previous quarterlies, two of our tenets for this bull market have been declining volatility and liquidity.

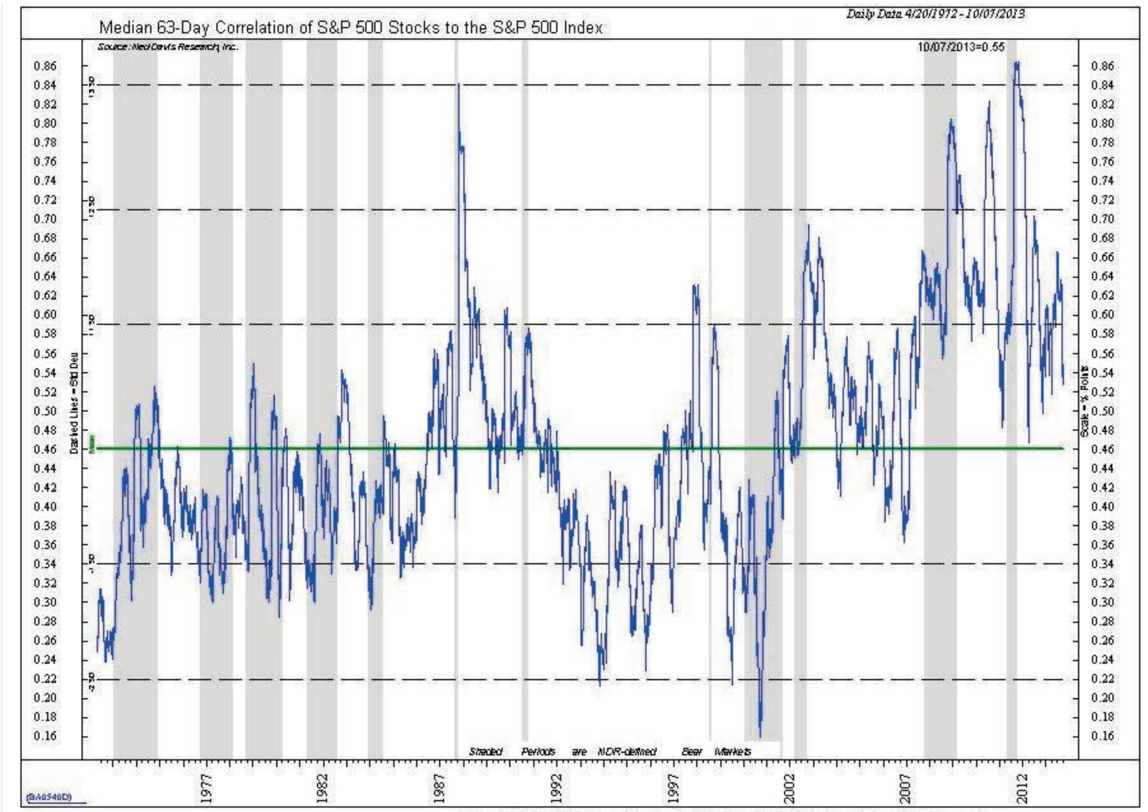
Correlated beliefs generated by macro headlines have been a leading cause of volatility. As it diminishes, the markets seem to be a safer place to invest and you get higher valuations. Exactly what we have experienced, especially since the fall of 2011.

In the short term a good proxy for this instability is the VIX, or Fear Index, which measures market volatility.



As you can see in this chart, the VIX has recently spiked higher but has remained below the June peak and well below the high set at the end of last year when the "Fiscal Cliff" was paramount in everyone's mind. It would seem that either investors are suffering crisis fatigue and are numb, or it's another bout of déjà vu. It could also be that the political drama in Washington isn't considered that serious so it isn't having the same impact.

It's been our belief that volatility has been reverting back to the long term mean and that fewer big headline stories that cause highly correlated reactions mean the market will appear safer and provide higher valuations.




Another measure of volatility is correlation, everyone going in the same direction at the same time. If you look at this chart, correlation on the S&P 500 peaked in 2011 after the U.S. debt was downgraded from AAA. Each subsequent expansion of risk has seen fewer stocks as a percentage of the S&P 500 react simultaneously such that correlation is now almost back to its long term average. Correspondingly, valuations have improved and this fall's composition of concerns is again triggering less of a reaction than one might have expected.

Nevertheless, the issues are real and worth discussing.

We'll start with the budget impasse and debt ceiling. The Fed's monetary policy is worth a little deeper look as it is directly related to my second tenet for this bull market, which is liquidity.

There are two issues being debated in Washington with very coincidental timetables. The first is a budget debate which impairs appropriation's authority on September 30th, the government's fiscal year-end. Without this authority the government cannot pay nonessential workers or those who do not have dedicated funding sources. It does not affect mail delivery, air traffic control or social insurance. The other debate pertains to the authority of the government to issue debt.

A partial shutdown of the government over the budget is nothing new. There have been 17 previous shutdowns since 1977. The average duration has been six days and the longest was twenty-one days from December 15, 1995 to January 6, 1996.

The debt ceiling debate is potentially the more dangerous issue as it could result in the United States technically defaulting on its debt with all of the ramifications that would entail, and it could result in the delay of support payments such as social security.

The politics of the debate are pretty straightforward. The Republicans want something for signing off on these issues and President Obama is unwilling to negotiate.

What do the Republicans want? Well, it changes, but generally they want a reduction in government spending and specifically, changes to Obama's health care law that was passed in 2010 but is only now being implemented.

On the surface those changes don't seem to be that dramatic as they would entail:

- Letting insurers deny abortion coverage based on religion or moral objections
- Delaying requirements for people to purchase coverage or face a penalty and postpone the creation of a market place where people could shop for coverage
- Repeal the 2.3% medical devices tax which they say will increase the U.S. deficit by $29 billion during the next decade

Obviously this debate can carry on for a while, although the longer it lasts the more impact it will have on the economy.

The debt ceiling is a little more serious. Treasury Secretary Lew says that on October 17th the Treasury will run out of extraordinary accounting adjustments that allow for more borrowing. At that point, the government will have $30 billion of cash on hand, enough to get through the balance of the month but not enough to meet the November 1st, $24 billion payment for social insurance, the $18.0 billion needed for Medicare reimbursement or the $25 billion for other payments to the veterans, civil service pensions, military, etc.

The revised ceiling needs to be passed in time for the Treasury to float a bond issue on October 31st.

How bad could this be? According to the government, "a default would be unprecedented and has the potential to be catastrophic; credit markets could freeze, the value of the dollar could plummet, U.S. interest rates could skyrocket, the negative spillover could reverberate around the world, and there might be a financial crisis and recession that could echo the events of 2008 or worse.", U.S. Treasury – October 2, 2013.

Really. The last time we had a threat of default was 2011 when the U.S. government lost its AAA status. In that year, the S&P 500 dropped 17% between July 22nd and August 8th.

Why is it that this time there is such a muted reaction? Maybe investors have heard the politicians cry "wolf" too many times.

But my guess is that the problem has unlikely consequences. If the Treasury is correct in its October 2nd predictions, count me in to be a big supporter and huge buyer of any distressed U.S. government debt I can get my hands on, and I'll bet I'll have a lot of competition too. This isn't Nigeria, it's not even France. The U.S. is not insolvent because some politicians can't agree on the issues.

It's a bit reminiscent of Y2K. Could they default? In theory yes, but I'm willing to bet they won't and if they do the consequences won't be as bad as most fear.

Pure conjecture on my account? Well consider some of the facts as detailed in the piece by Morgan Stanley on October 2, 2013.

*"Does a last resort option exist to save the U.S. from default?*
*Bottom Line: Yes, but it will break one of three laws.*

*If the Treasury is unwilling to stretch the definition of extraordinary measures, on the day that the Federal Reserve predicts that the Treasury will run out of cash in its account and the Treasury is bound by the debt ceiling, it should pend all payments and await instructions from the Treasury.*

*As a result, all principals will face the prospect of violating one of three laws:*

1. *The Second Liberty Bond Act of 1917 that establishes the debt ceiling;*

2. *The Federal Reserve Act that prohibits the Fed from lending directly to the Treasury; or,*

3. *The 14th Amendment of the Constitution that holds that the debt of the US government lawfully issued, will not be questioned.*

*They have to break a law. Full stop. We think at the end of day officials will avoid violating the Constitution by indicating that they have been given inconsistent instructions and are obeying the one with the most important precedent.*

*If it is the Secretary of Treasury that decides to contest 1, then the Treasury will issue debt and raise cash. However, the debt arguably does not have the protection of Amendment 14, as it was not necessarily lawfully issued, so it may not be default free. That is, in the European context, the Treasury will issue "red" bonds in order to pay the maturing principal and interest on "blue" bonds. The reds turn blue when the debt ceiling is increased.*

*If it is the Chairman of the Federal Reserve that decides to contest 2, then the Treasury General Account (TGA) goes into overdraft and all Treasury operations continue.*

*Either a Secretary of Treasury who holds 3 as the overriding instruction or a Chairperson of the Federal Reserve who waves 2 saves the global financial system and at most risk being impeached or fired. That seems like a reasonable risk and reward trade-off. The government of the United States is not going to default."*

For me the concern is the amount of damage that is done to the economy from such high drama. Unfortunately, consumer and business confidence is the collateral damage.

In July, the Federal Reserve Board in San Francisco released a study that concluded that the uncertainty about fiscal and monetary policy has boosted the unemployment rate. They found that "if there had been no policy uncertainty shocks, the unemployment rate would have been closer 6.5% instead of the reported 7.8% in late 2012".

Uncertainties include a fiscal policy (shutdown); monetary policy (tapering); and regulator policy (Obama Care).

My bet is that all of this will pass but not without leaving yet another scar on this economic recovery. As you will see in our discussions on the market's valuation, it's reasonable, provided we get a little help from earnings growth and that will require that the economy remains at least modestly healthy.

The other big macro issue influencing the market has been the Federal Reserve Policy. We've said repeatedly over the last several years that it is liquidity that makes this market go and investors are beginning to understand this. Suggestions last spring that the Fed might start to reduce its Quantitative Easing, i.e. taper, sent interest rates up from 1.93% on May 21st to 2.99% on September 5th, currently back down to 2.61%. It may not appear much of a move unless you own bonds. Year to date, long term treasuries have lost 9.9%.

But then at the September 18th Federal Reserve Board meeting they balked – no taper. So what happened after all the build up? We think there were a number of things that influenced that decision. Eventually, we think the Fed will have to back off, but their timing and the magnitude of the interest rate increases will affect the markets. So, it's worth spending a few paragraphs on the subject and what we think is influencing Federal Reserve decisions. First, there's moral suasion. When I initially learned about central banks and monetary tools, the kit came complete with interest rate adjustments, monetary growth, reserve requirements and moral suasion. They don't talk much about this later tool anymore but it's still very functional as it relates to the Bank's ability to influence the economy and money markets by inferences, all talk but lots of action.

The best recent example was the European Central Banks' announcement last summer that it would implement Outright Monetary Transactions (OMT) to do whatever was needed to keep the Euro together. Interest rates for most of the troubled Sovereign credits collapsed but the ECB has yet to use the facility. Not one single bond has been purchased. Pretty impressive results that we're sure weren't lost on Chairman Bernanke.

So, it's possible that this tapering discussion was lobbed to the press to see what kind of reaction it would get from the bond market and it was more than he planned for.

As I said earlier, 10 year treasury rates rose over 100 basis points without any tangible action by the Fed. Almost 3% bond yields were immediately translated into higher mortgage rates and lower mortgage applications. Not a welcomed economic consequence at this stage of the recovery.

Bernanke has said all along that the Fed's actions will be "data-dependent" and the jump in bond yields was a data point that didn't reconcile with the intentions of tapering.

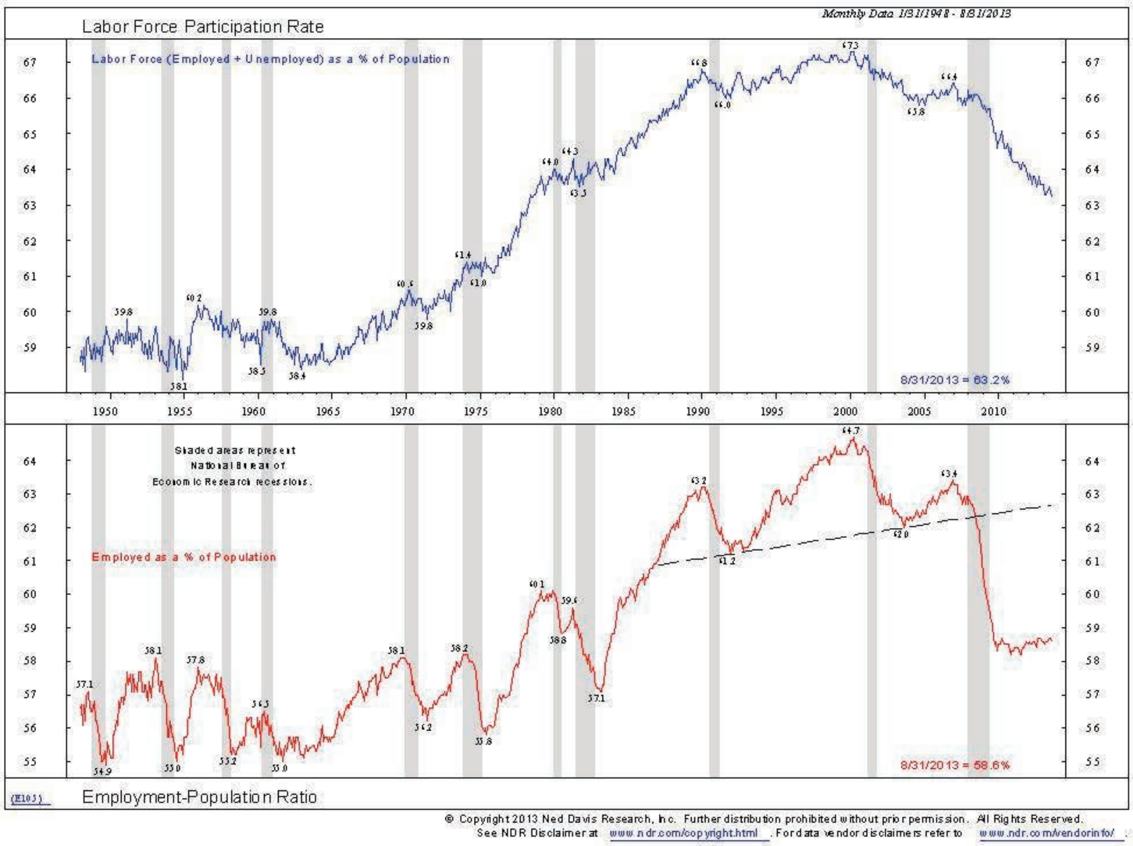
Second, as a generalization, this economic recovery and government policy has been overly reliant on monetary policy as fiscal policy has been restrained by enormous budget deficits and congressional budget battles that have negatively impacted business confidence and therefore economic growth.

We're currently witnessing another episode of political dysfunction leaving the Federal Reserve, the only keeper of economic progress.

It's very likely that the Fed will put its tapering warning on hold until the budget debate and debt ceiling have been resolved rather than potentially aggravating an economic pause and then having to reverse course in order to offset congressional headwinds.

Lastly, the Fed's use of a 6.5% unemployment hurdle could be problematic. Qualitatively it is not a good indicator of economic improvement. The Fed may be trapped by the use of a flawed indication and is looking for a politically correct way to back away from its use. Bernanke has already warned of using it too literally due to its difficult transparency and it's overstating the degree of economic improvement.

It's worth looking a little deeper into the unemployment rate to understand the Fed's dilemma. First, the unemployment rate is the ratio of those employed divided by those looking for work. So in theory you could get an improvement in the ratio without a single new job being created if people start to drop out of the work force, and to some degree, that is what is happening.




Right now, the share of working age people in the labour force has declined to 63.2%, the lowest participation rate since 1978. Since November 2007, the last peak in employment, the working-age population has increased by 12.6 million, yet the labour force has improved by only 2.0 million.

There are a number of reasons for this which will reverse over time, but others are structural and aren't likely to disappear.

•Demographics. The participation rate of young workers 16 to 24 has been in decline since the late 1980's and is currently 54.8%, the lowest since the mid '60's. Similar to the baby boom generation, the participation rate is partially due to increases in postsecondary school enrollment rates, which rose from 48% in the mid '80's to currently 56%.

Women's participation rate is also declining. After increasing from 38% in the early '60's to 60% in 2000 it has now backed down to 57.5%.

Maybe one of the reasons that young people are dropping out of the work force is because the older generation of 55+ workers refuses to get out of the way. As a percentage of the work force, they've surged from about 11% in the mid 1990's to over 21% today.

•Industry dislocation. This is contributing to structural unemployment. In the recession, a lot of industries cut back employment materially and with little hope that it will totally recover. Construction jobs and positions in financial services are obvious ones.

There are job openings out there, but unfortunately the decrease in unemployment has not kept up with these job listings, suggesting that there is a miss-match of skills with these positions.

Some of this could be due to the duration of unemployment which peaked at 40.7 weeks at the end of 2011. It has only declined to 37 weeks, which is still historically very high and unfortunately, skills deteriorate over time.

•Also, any employment growth that we have seen is taking place in lower wage industries and in the temporary help category.

•Bottom line: the unemployment rate is compromised as an indication of economic health and has left the Fed in a Catch 22. The Fed either has to back away from its use, or risk that its attempt at transparency is going to become clouded and confusing for the market. The number of unemployed fell to 11.8 million in June from a peak of 15.4 million in October 2009. That is still a higher number of unemployed than all previous peaks since the 1950's.

That said, jobs are being created. The economy lost 8.7 million workers during the recession but has recovered 6.8 million since the trough in early 2010.

Overall, the Fed has a dual mandate of maximum employment and price stability. Given that they are behind on both their unemployment target of 6.5% and inflation of 2.0%, the case is strong for continued monetary ease.

Conclusion

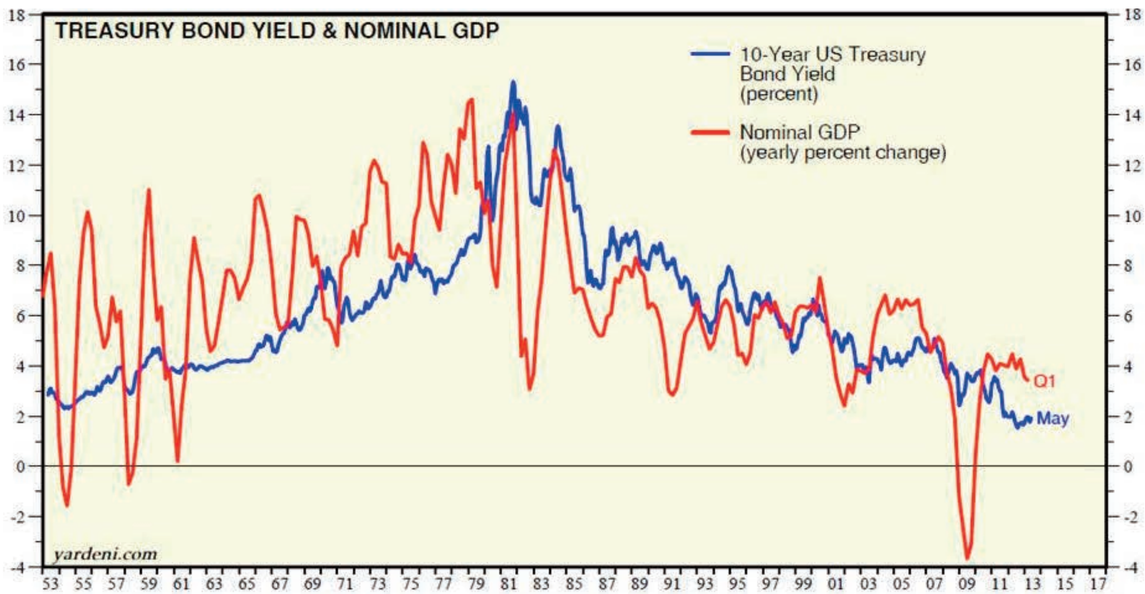
Discussions on Fed policy are probably a good segue into our thoughts on the stock market.

Certainly suggestions of tapering have been negative for stocks and so has stronger economic data which is what we warned of earlier this year in our piece, "Be Careful What You Wish For".

As we've said, we think there is going to be plenty of money around for quite a while and the cost or yield is going to be artificially constrained for fear that rising rates could damage the economy.

However, most believe, as do we, that interest rates have seen their lows and it's only a question of when and how far they move.

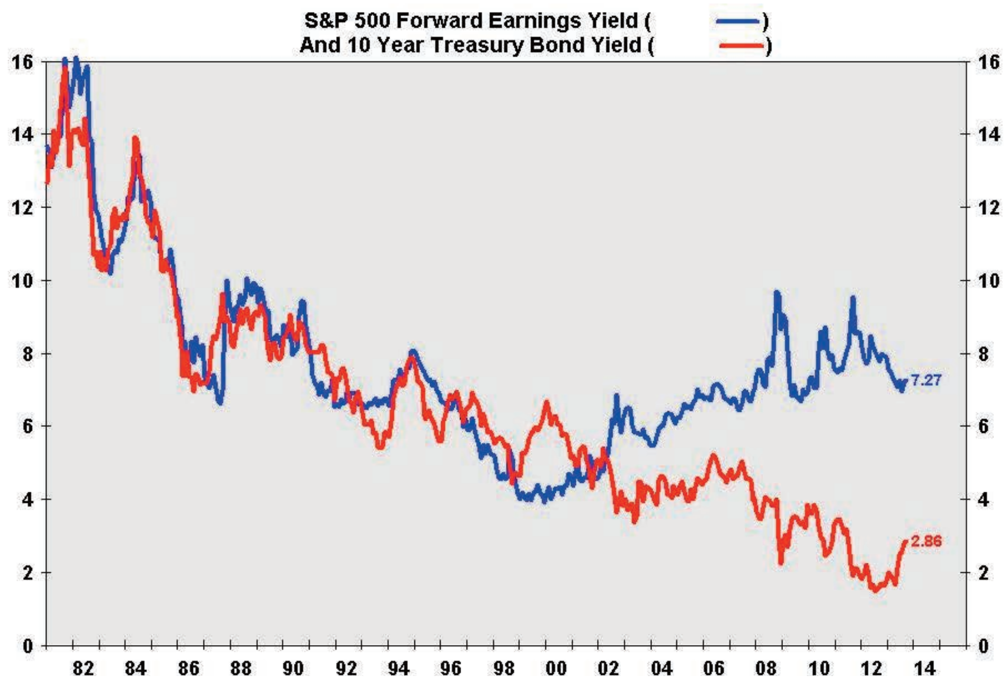
The 10 year treasury bond rate is currently about 2.61%, but in theory it should be a lot higher.




Source: US Department of Commerce, Bureau of Economic Analysis, and Board of Governors of the Federal Reserve System.

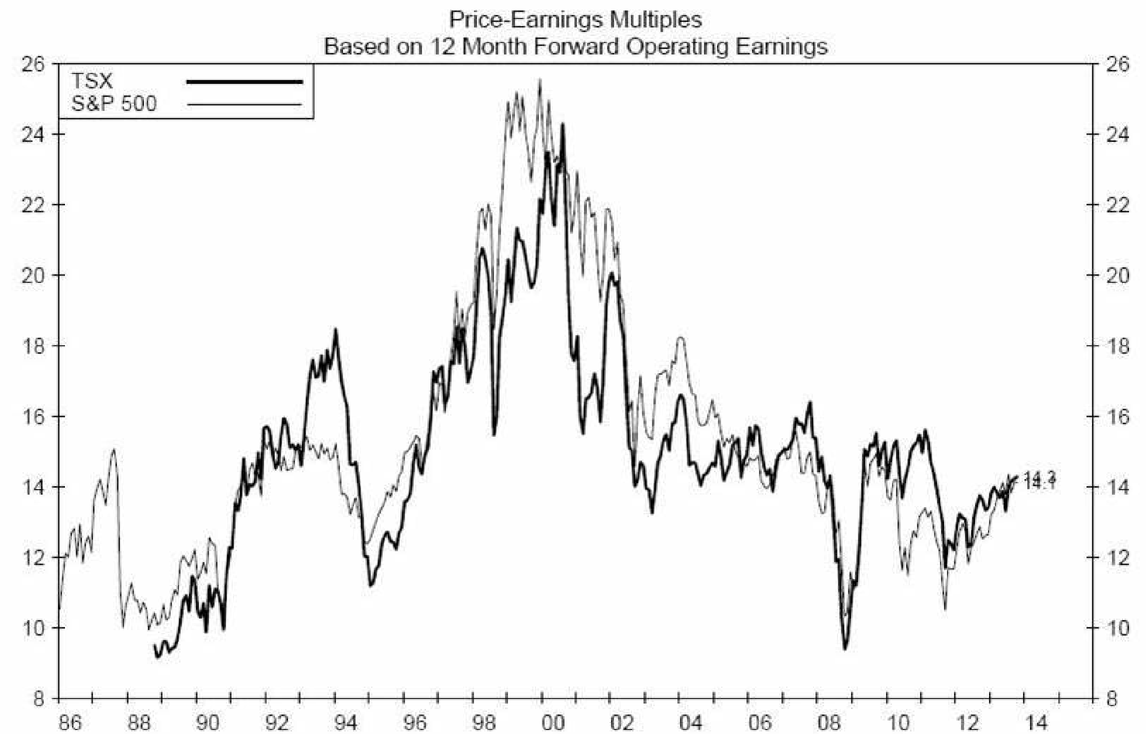
As a proxy for where rates should be we use the nominal GDP growth rate. This is simply the growth rate you normally see quoted in newspapers which is referred to as the "real GDP", as it does not include inflation and adding back the Consumer Price Index rate of inflation. Historically, the 10 year treasury yield and nominal GDP are close to the same.

For next year, economists are predicting real GDP of 2.7% and inflation of 1.6% for a nominal rate of 4.3%, which is well above current bond rates and testament to how much they are being artificially depressed.




Interestingly, as you can see from the above chart, the market's earnings yield and the 10 year treasury yield also tend to track one another. Right now there is a large spread. So on forward earnings, either the stock market looks cheap or bonds look expensive and the gap could close by bond yields increasing. By this relative measure, even if bond yields normalized, all else being held equal, the market would still appear cheap, but we would have lost a large cushion of safety. So you can see why strong economic statistics and reactions by the Fed can influence the market.

Another more absolute way to judge the market's value is to look at its price earnings ratio.




Based on next year's earnings estimate of $122.94, the S&P 500 is trading at a reasonable 14.1 times earnings while the TSX is modestly more expensive at 14.2X earnings. If we apply a 15 times multiple to next year's earnings, still a reasonable valuation, we could see 1,844 on the S&P 500 or about 9% upside.

To achieve the projected earnings estimate, S&P corporate revenues are going to have to grow a modest 4.3% next year versus 1.9% this year, which will give us earnings growth of 11.3% compared to 6.2% this year.

On a trailing earnings basis, the market is already fairly valued. So for this bull market to continue, valuations have to improve further and that's going to require a little help from earnings growth and the economy. Continued nonsense in Washington or much higher interest rates won't help an already anemic economic picture.

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 see 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. Right now there is still a record, almost $10.0 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.

On balance, we remain constructive on the market but hope that "Big Mac" will throw us a pitch that gives us a cheaper entry point.

GRC/amh
October 4, 2013

Credits: Ned Davis
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