CUMBERLAND

LAST CALL AT THE PUNCH BOWL?

The S&P 500 finished the June Quarter at 1,606.28. It was up 2.36% for the last three months and 12.63% since December 31st. That compares to -4.87% and-2.45%, respectively, for the S&P/TSX .

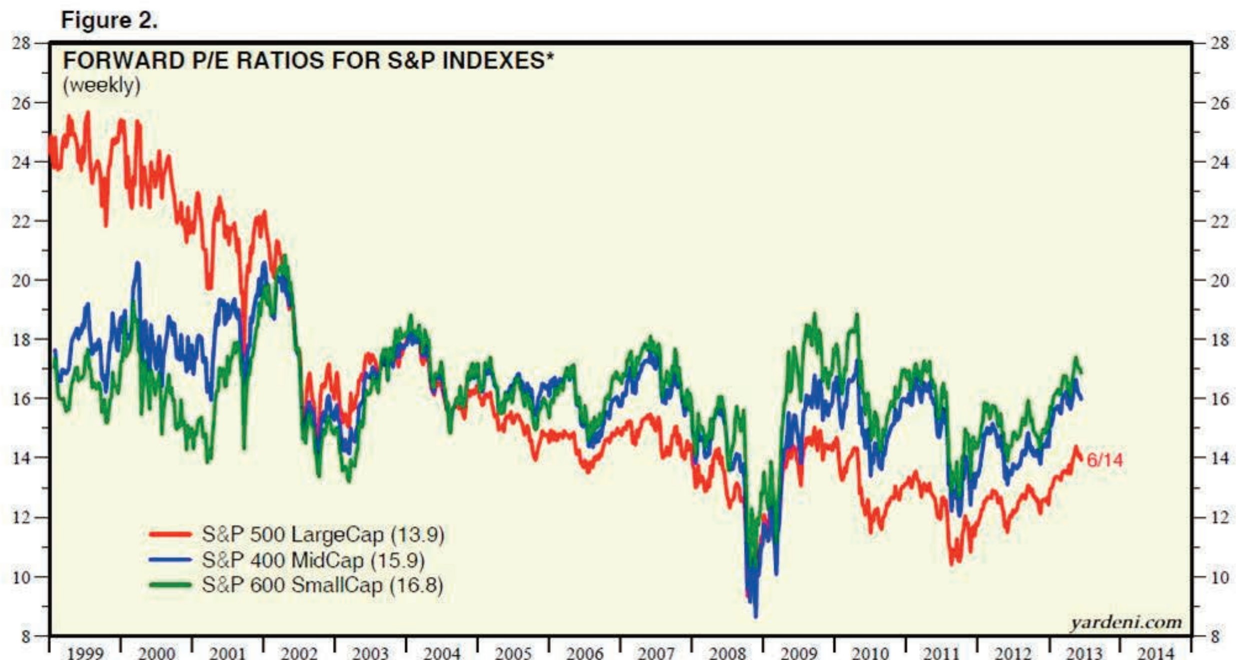
Given that I thought we could justify a move of 13.59% for the year on the S&P 500, I thought it might be time to reflect on what we were looking at back in January.

When we started the year, the S&P 500 Index was at 1,426.19. The consensus earnings estimate for 2013 was $112.99, so the market appeared cheap at 12.8x earnings. Our own "top down" earnings estimate was $108.00, so we thought there could be some negative earnings surprises. Regardless, we felt that the price to earnings ratio on these earnings would rise to 15x as volatility diminished and the market appeared to be a safer place to invest.

By our calculation, the market could reach 1,620 on these metrics. So far, we've been directionally correct. Earnings estimates have come down but analysts still anticipate $110.85 and the P/E ratio has gone up. Using our earnings estimate, we're at 14.87x, but it's slightly more modest at 14.49x using consensus estimates.

However, time marches on and as we get into the second half of the year the 2014 forecasts start coming into view. Consensus earnings for next year are $123.51, so if you average this year and next, you'll get twelve month forward earings of $117.18. That puts the market at about 13.9x.

Figure 2.



* Price divided by 52-week forward consensus expected operating earnings per share.
Source: Thomson Reuters I/B/E/S.

As you can see in this chart, the biggest and best companies are still cheaper than smaller caps. Perhaps it is because large caps are more reliant on foreign revenues where business prospects look less hopeful. Regardless, at less than 14x, the market, even after a strong first half, doesn't appear expensive.

At the end of March, the S&P 500 had already advanced over 10%, which didn't leave much upside to our 13.59% target and investor sentiment was extremely positive so we elected to reduce our equity exposure as many of our investments hit our target prices. The old market rule of thumb to "Sell in May and Go Away" arrived May 21st when the S&P 500 peaked at 1,669.19 and through June 24th corrected by 5.8%. Not much. The market then did what all bull markets do best, trapped liquidity on the sidelines waiting for a better buying opportunity.

As we pointed out in my April quarterly, it is liquidity that makes the market go, not economics which was what the market was focused on. In fact, our belief is that too strong an economy will be bad news for the market as businesses require some of the liquidity that has fueled this rally and the Federal Reserve will reduce its quantitative easing. Consequently, I titled that quarterly "Be careful what you wish for". I like economic growth to be slow and steady since no growth hurts earnings and too much pulls buying power away from the market.

Events since the end of last quarter have led investors to reassess the investment landscape with more internal adjustments than are apparent by looking solely at the averages.

Our concerns over the economy have allowed the Federal Reserve to fire a warning shot and threaten to take away the punch bowl even as the Bank of Japan decided to join the party late by adding some 100% proof alcohol to their own monetary cocktail.

I'll take you through some of these changes to provide a little colour on this market because its complexion is changing.

But, before I get into the details, let me give you my conclusion. I think we're past the "sweet spot" of surpluses that allowed for a bounce in the market off the bottom where the easy money is made. We're now in the middle third of the cycle where market drivers are no longer improving but have yet to materially reverse.

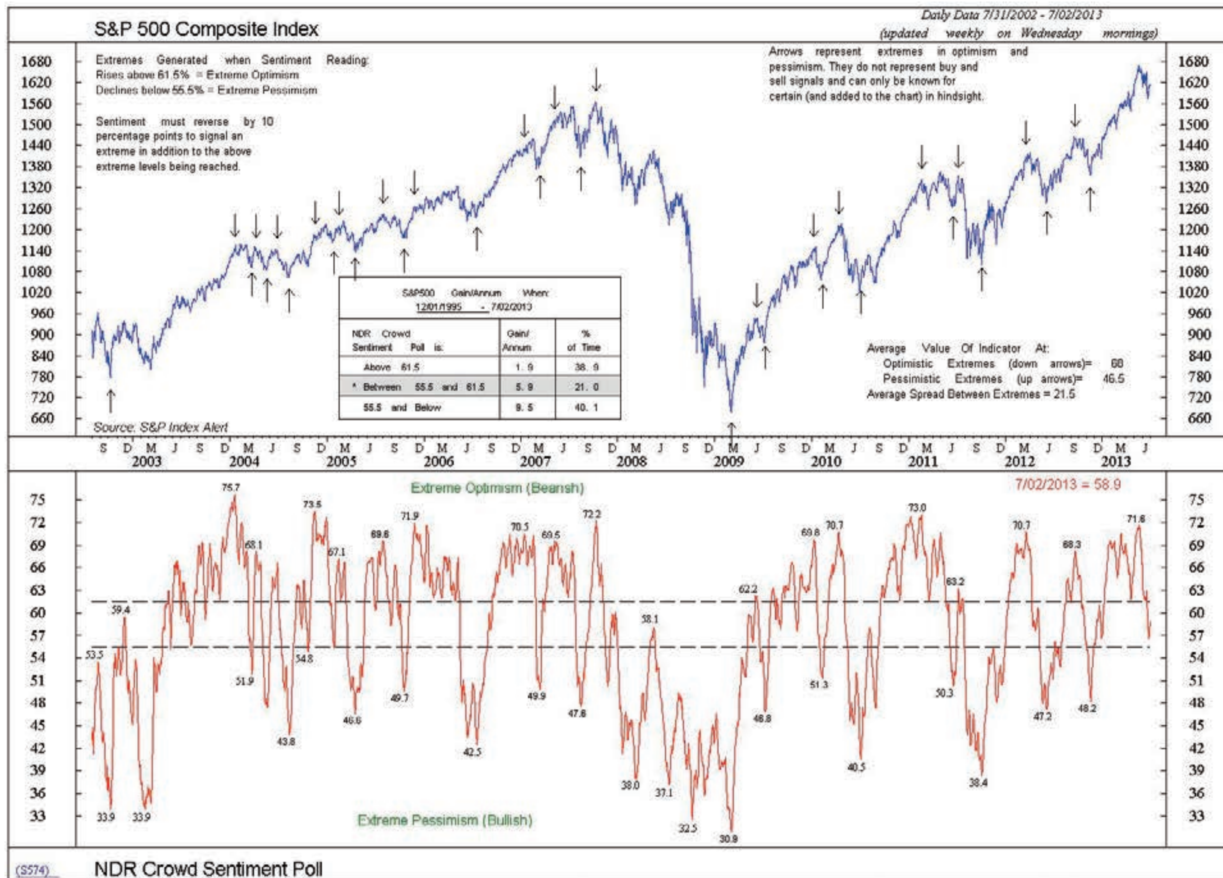
Unemployment is coming down, profit margins are at a peak, interest rates have seen their lows, monetary policy is still accommodative but "tapering" and corporate efficiencies have maxed out.

So why the middle third and not the final blow off stage? After all, the market spiked higher by over 17% in May.

The biggest reason is that a lot of investors and liquidity are still caught on the sidelines, looking for a pull-back which usually isn't as big as hoped for. Was 5.8% in June enough? I doubt it. So there remains a lot of trapped latent buying power.

The last phase is usually coincidental with these investors finally capitulating. They can't stand it any longer and finally jump in.

At the end of March, we were watching crowd sentiment as a gauge of when to start buying again.



As you can see from this chart, sentiment has corrected from extreme optimism of 71.6 to something a little less exuberant but not quite bullish.

Instead, I think what drove this market to a 17% gain was a seller's strike, not a buyer's panic.

Not unlike us, every time fund managers sold stocks that reached their target prices they were punished as they continued higher. At some point you're suffering from sellers' remorse and not willing to raise anymore cash, so you stop selling, even though you're hitting target prices.

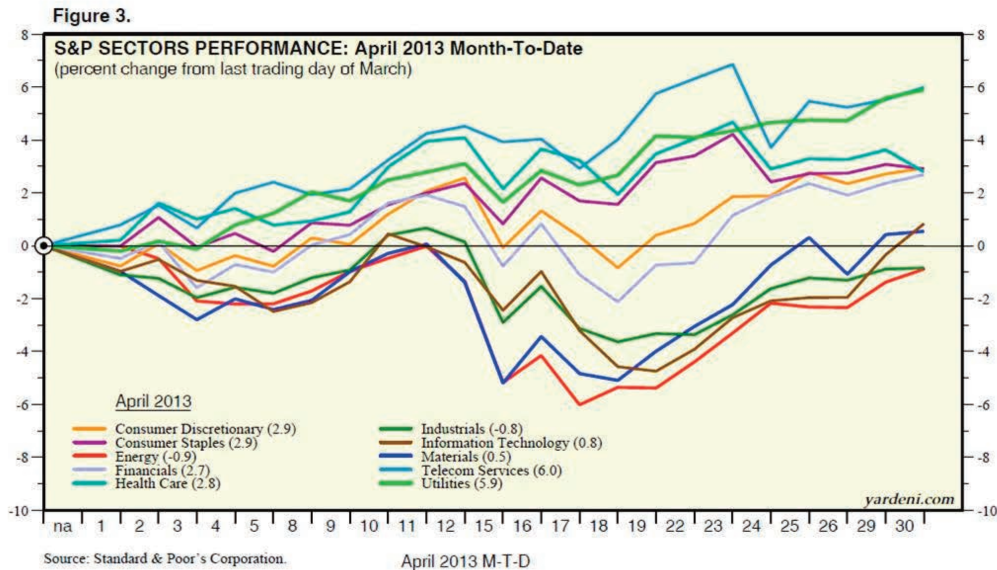
As prices continue to advance, you get the sense of working with free money. Gains that you wouldn't have had, if you had sold. However, given a good excuse you don't get too cute on price with sell candidates. That free money cushion gives you pricing discretion but it can also add a lot to volatility. You start thinking, I might miss the top by a point or two but I'm still out above where I would have sold if I had stayed with my disciplines. Consequently, you get the kind of reaction we saw following Federal Reserve Chairman Bernanke's comments on June 19th. A probable overreaction I might add. We've known that rates had seen their lows for some time. The only question left to be resolved was when they would start to rise.

Bernanke's testimony gave us a hint that the timing might be sooner rather than later. Regardless, I'll give you more detail on this momentarily because liquidity is the underlying premise of my bullish outlook for the market.

That said, I don't think the Fed's comments were totally unexpected. As I said earlier, there has been a lot going on in this market below the surface. In this phase of the cycle, a good strategy and stock selection are required. It's no longer the proverbial tide that will raise all boats.

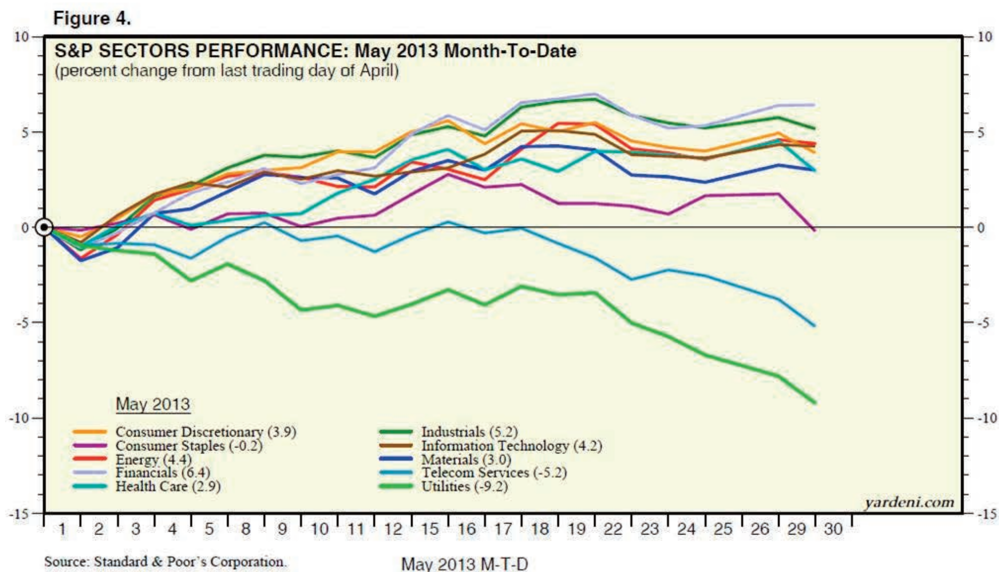
So, let me start out with the performance rotation that we've been seeing between industries. In earlier quarterlies, I've commented on how investors have moved out along the risk curve. First from safe, government bonds to investment grade corporates. Then to high yield corporates and junk bonds. Finally the stretch for yield caused investors to look at high dividend-paying stocks, but initially only in "safe" industries like utilities and consumer staple companies.

Figure 3.

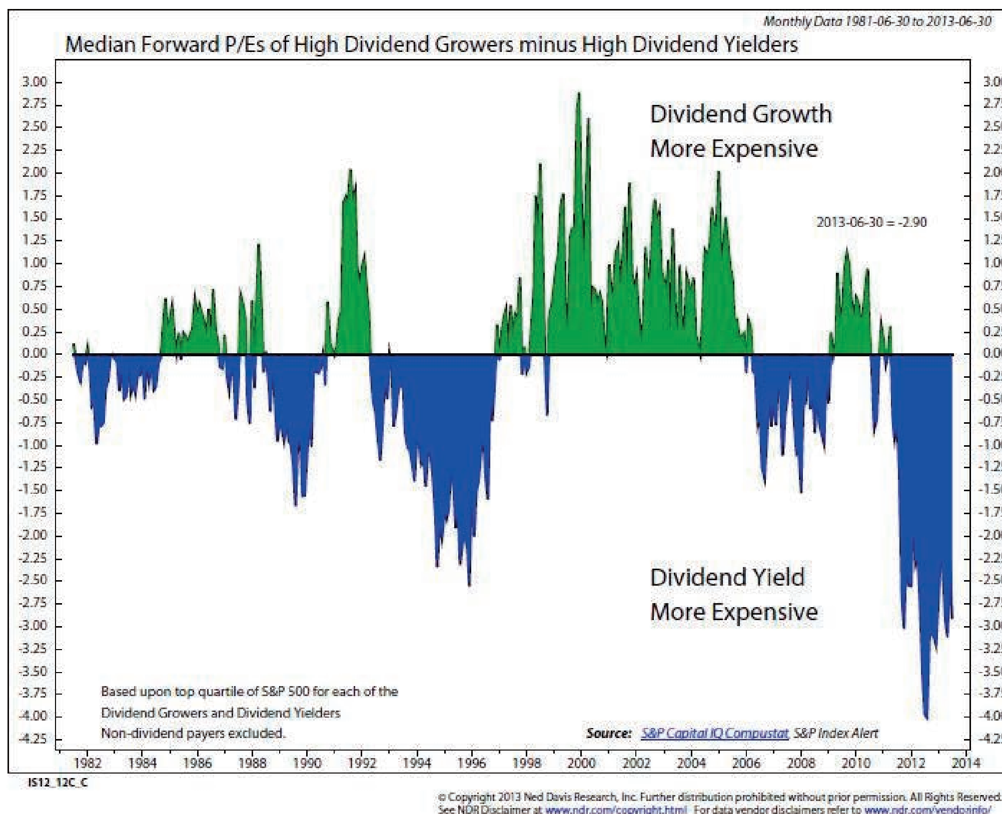


This first chart (above) plots the performances of the ten S&P sectors for the month of April. The two top performers are Telecom Services and Utilities, high dividend payers in what are considered safe industries. At the bottom, you'll find energy and material sectors, which tells you something about our Canadian markets.

Figure 4.



This is the same chart recording sector performance for the month of May, as the market peaked. At the very bottom are our bond proxies, namely telecom and utilities while more economically sensitive stocks outperformed.



You can also see that investors were chasing dividend payers as bond proxies by looking at valuations. In this chart, we compare the P/E ratios of dividend growers to the P/E ratios of the highest yielding stocks by subtracting the later P/E from the former. As you can see, the highest dividend payers saw their P/E ratios expand beyond what is normal. They got expensive and are now starting to reverse.

Each of these charts suggests that the stock market was already anticipating higher interest rates by May.

Getting more granular, we can look at some of the industries that are affected by interest rates.

Industry	QTD Performance	YTD Performance
Financials hurt by rising rates		
Real Estate Investment Trusts (REITs)	-4.42%	+2.55%
Mortgage REITs	-19.15	-7.15
Financials helped by rising rates		
Bank Industry	+8.44	+18.95
Life & Health Insurance	+16.04	+30.83
Multi-Line Insurance	+12.40	+26.39
Others		
Telecommunications Services Sector	-0.07	+8.12
Utilities Sector	-3.67	+7.73
Precious Metals & Minerals sub-industry	-23.75	-38.42

A little closer to home we have our own examples.

Trans Canada Pipe	Peaked May 21 and declined 12%
BCE	Peaked May 22 and declined 15%
Rogers Communications	Peaked April 22 and declined 23%

On balance, the interest sensitive stocks peaked April 19th while bond prices peaked May 2nd.

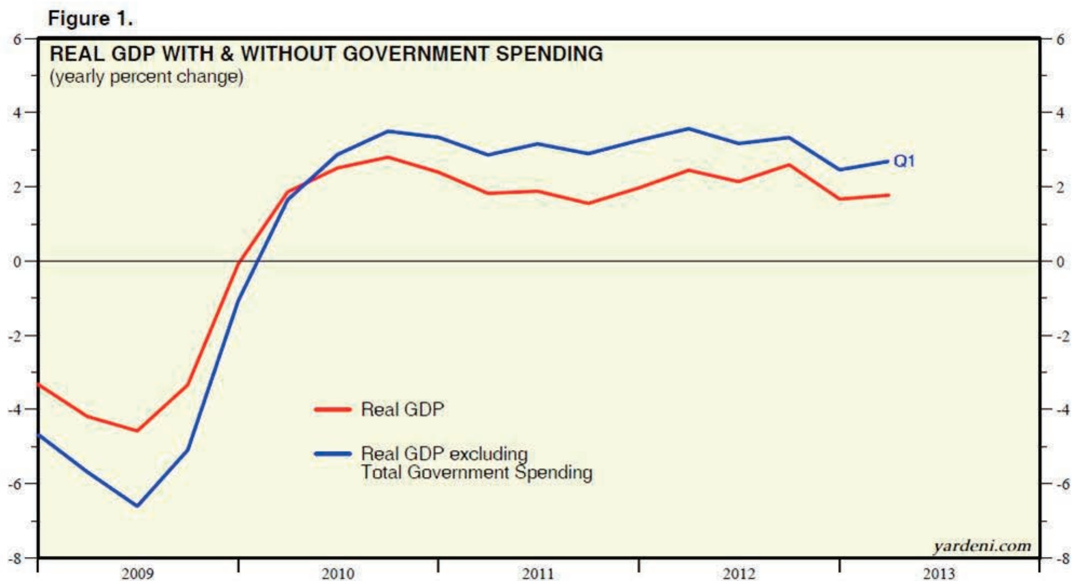
So, the market has been pricing in a rate hike for a couple of months as higher yielding stocks and those that are fundamentally hurt by higher rates sold off.

In contrast, the industries that benefit from a stronger economy and high rates, such as autos, aerospace, consumer electronics, apparel, luxury goods, banking and insurance are doing well.

Economy

So, what's caused this tidal shift in market sentiment? The apparent answer is the economy. It's doing better than expected. Only six months ago we were facing a "Fiscal Cliff", tax increases and cuts to Federal spending (sequester) which were threatening to put the economy back into recession.

Although tax increases on high income earners and an increase in the unemployment tax were enacted along with mandatory cuts in spending in the U.S., the GDP didn't tank as expected. In fact, the first quarter of 2013 was stronger than the 4th quarter of last year.



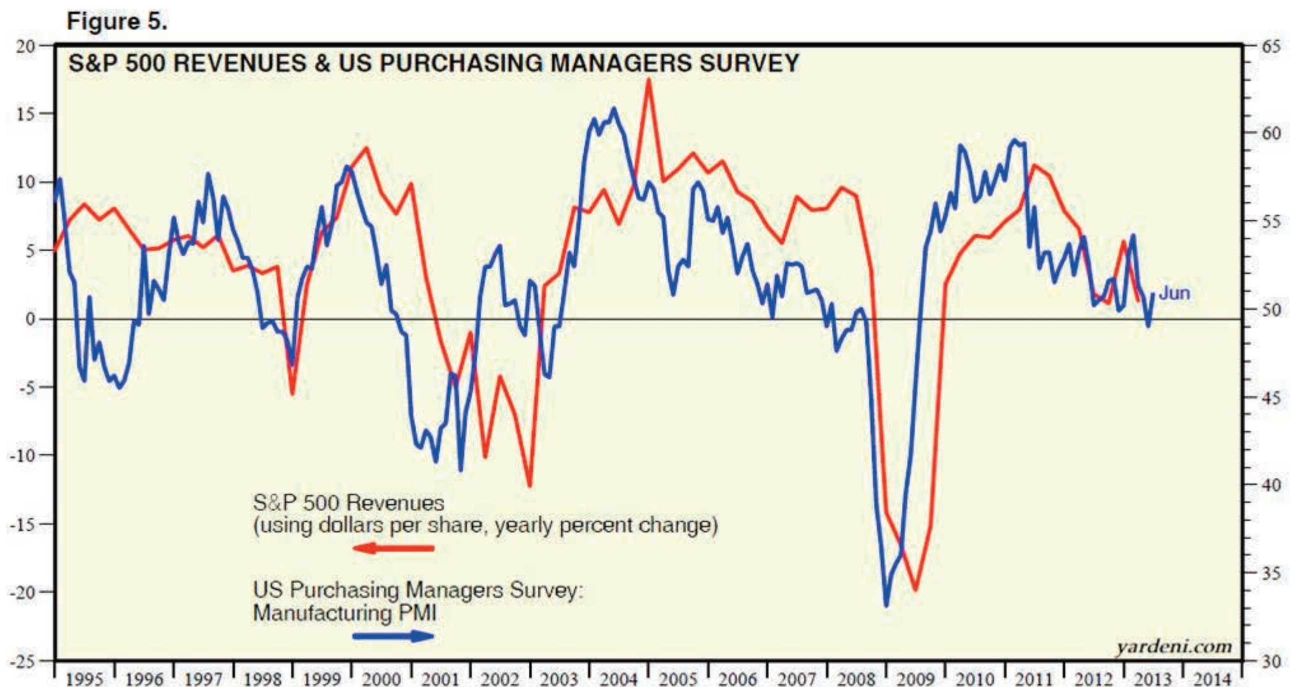
Reported GDP for Q1 was 1.8%. But, as indicated in this chart, it's up 2.7% if you exclude federal, state and local government spending which is experiencing the cutbacks. Federal government spending alone, due to the sequesters, dropped 8.7%.

Other economic statistics also support expansion.

•June auto sales came in at 16.0 million seasonally adjusted annual rate (SAAR) units, the highest since December, 2007.

•June's Manufacturing Purchasing Managers' Index (M-PMI) registered 50.9 versus 49 in May. The index has been below 50, the level indicating expansion, in only two months since July 2009.

Figure 5.



Source: Standard & Poor's Corporation and Institute Supply Management.

•The PMI is a carefully watched index because it is a good lead indicator for corporate revenues as shown in the above chart.

•The ATA Trucking index jumped to a new record high in May which is highly correlated to railcar loadings of intermodal containers.

•Short-term business credit has jumped to a new cyclical high which suggests that businesses are continuing to accumulate inventories.

•New and existing single-family home sales rose to 5.1 million units (SAAR), the best level since November, 2009 when tax incentives boosted sales.

•The small business optimism index rose to 94.4 in June, the highest level in a year and close to the pre-crisis level of 94.6, the 5th increase in the last six months.

•Even Europe seems to be improving. The UK's PMI rose for a fourth month to a 25 month high and its 3rd straight month over 50. On the continent, the Euro Zone PMI also climbed to a 16 month high, so Europe is becoming much less of a drag.

•Only China remains a question mark. Their PMI remains positive over 50 but continues to weaken.

•And of course the most closely watched statistic, unemployment just registered a 195,000 job increase for June and a 70,000 upward revision for April and May. These were bigger gains than expected.

With these kinds of improvements, it shouldn't have been a surprise that the Federal Reserve would become less accommodating. As I said in my April quarterly, "Be careful what you wish for", good economic news may be bad news for the market.

Federal Reserve

On June 19th, Federal Reserve Chairman Bernanke refined the Central Bank's monetary policy. We've known for a while that interest rates had hit their lows; the only remaining question was a timing issue as to when they might move higher.

The Bernanke news conference was enlightening and what had changed was the Fed's economic forecast.

They now expect the unemployment rate to fall to 6.5% - 6.8% next year versus their March forecast of 6.7% - 7.0%. For 2015, they are forecasting a jobless rate of 5.8% - 6.2% instead of 6.0% - 6.5%. The big change is that they now see their targeted 6.5% unemployment rate being reached in 2014 rather than 2015.

Bernanke also showed more willingness to let longer term interest rates increase. "If interest rates go up for the right reasons, that is, both optimism about the economy and an accurate assessment of monetary policy, uh, that's a good thing, not a bad thing." So, he's no longer averse to higher rates and will allow them to normalize.

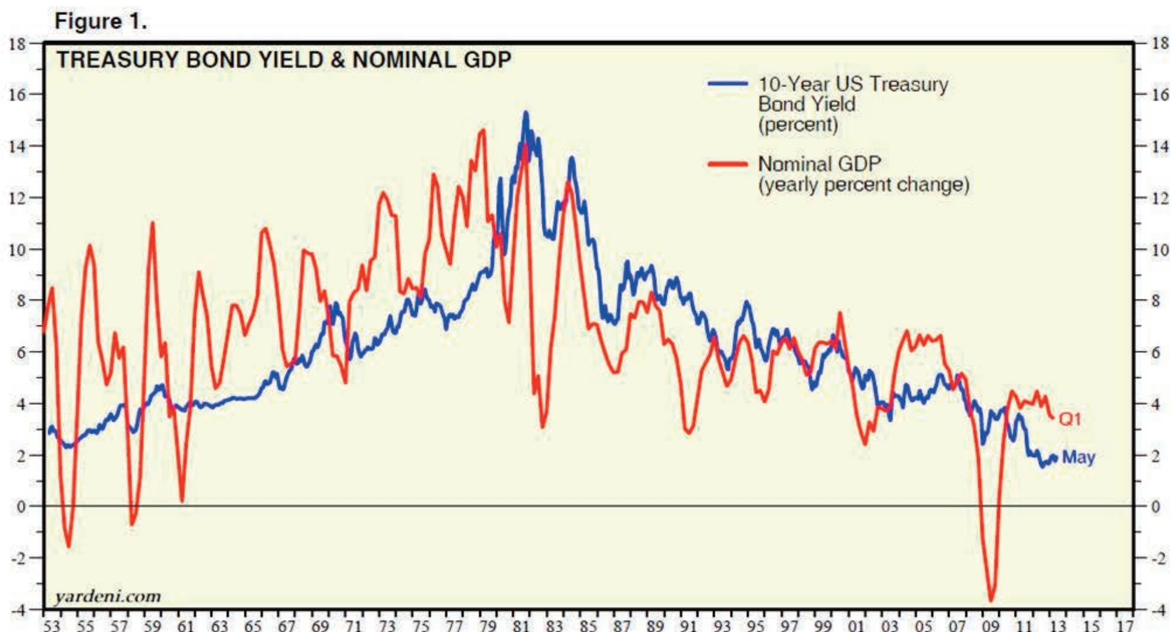
However, he did make it clear that monetary policy would stay extremely accommodative for years to come and did not see a Fed Funds rate increase until 2015.

What was concluded from his remarks was that a 7% unemployment rate would constitute the end of Quantitative Easing (QE) while a 6.5% rate could end monetary easing and low rates.

Bernanke further offered that the Fed would ease into this withdrawal of liquidity by "tapering" or buying fewer treasuries and mortgage backed securities as the unemployment numbers improved. The market is reading this as starting this September with a reduction in purchases from $85 billion per month to $65 billion and ending by mid June 2014, six months earlier than what was previously expected.

Yes, rates will go up. How high? Well, we can take a stab at where normalized rates should be.

Figure 1.



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

Historically, 10-year Treasuries should yield approximately the same rate as the nominal GDP (real rate plus inflation). At the end of the first quarter, this would have been 3.4% but the 10-year Treasury was at 1.85%. That means rates have further to go which will certainly put further pressure on bond investors.

But remember, this less accommodative stance is precedent on continued improvement in unemployment.

Thus far, the economy is surviving higher taxes and a sequester, so it's a question of how much of a rate increase it can handle on top of this already existing overburden. We do not expect the Fed to allow the progress made up to now to slip away.

Second, the markets may be overreacting to the future reduction in QE. The current program started last fall with $40 billion in purchases per month and was expanded to $85 billion in December. We're now going back to $65 billion, which is still more than what we saw last year.

Third, we haven't touched on Japan's latest Quantitative Easing. In April they announced a plan to double their monetary base over the next two years by purchasing $78.6 billion of bonds per month. Compared to the Fed's $85 billion that's an extraordinary amount for an economy that is only 40% the size of the U.S. economy. So it's doubtful the world is going to be short on liquidity any time soon.

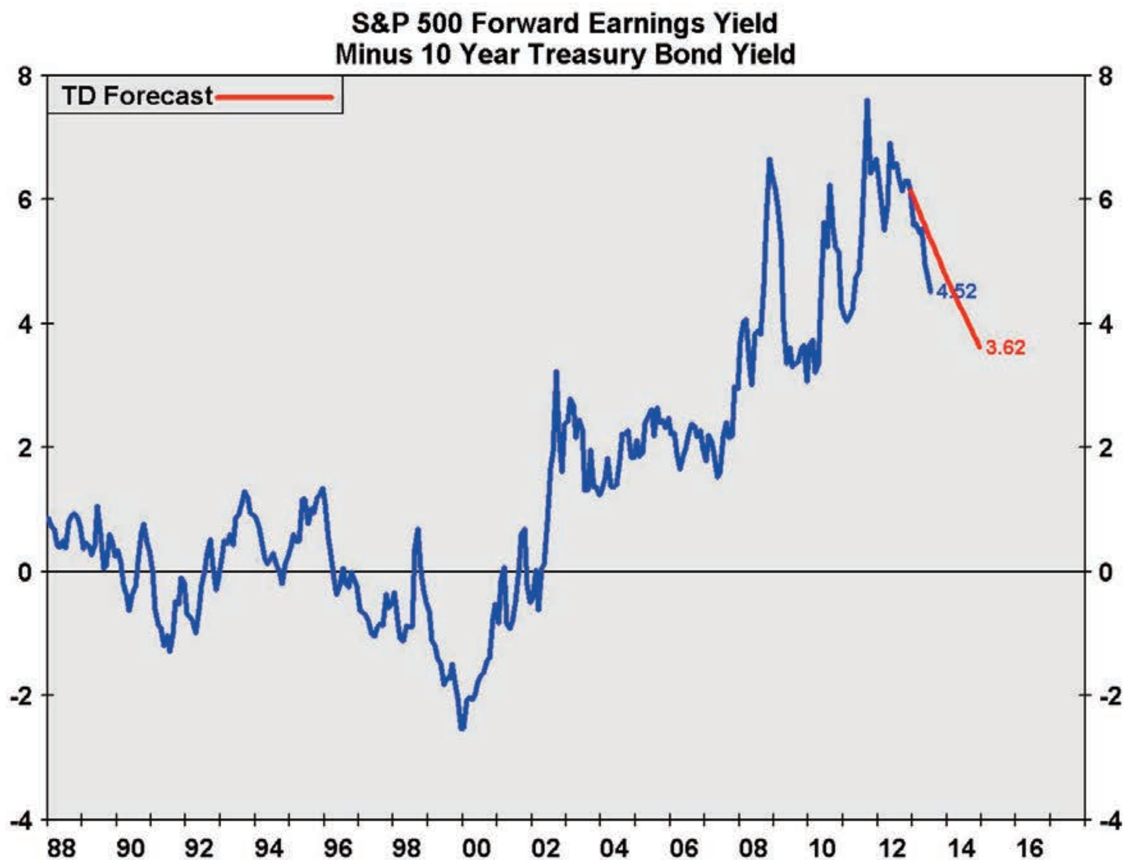
Conclusion

We haven't changed our mind on the market and still think we're in the middle third of the cycle where well thought out strategies and good stock selection will result in above average returns. The second quarter was a good example of what one can expect with a wide spread between winners and losers. The complexion of the interest rate environment has changed dramatically from favouring investments aided by lower rates to those benefitting from higher ones.

For the market generally, we haven't seen the kind of "buyer's panic" that would be symptomatic of a top. In fact, we have seen bond liquidation to avoid further loss but no discernible recipient of those funds. Certainly, we do not see equity mutual funds benefiting, so one has to wonder where those funds will eventually show up.

It could be that higher yielding stocks that can grow their dividends have overreacted and now offer a reasonably attractive entry point, a correction that we haven't seen in the broader index.

Otherwise, if the one year forward consensus earnings estimate of $117.18 is right, the market is still about 9.4% undervalued using 15x earnings.



Compared to 10-year Treasuries, the earnings yield spread would still be 3.62% and only slightly lower for the TSX with higher projected bond rates versus roughly 4.81% at the end of the quarter. On a relative valuation, stocks remain cheap even if interest rates normalize.

And finally, although the economy is doing well, there are still a lot of surpluses in employment and a long way to go before we see a peak in auto and housing sales.

As I've said in the past, the easy money has been made in this bull market but there is still further to go if monetary liquidity is maintained. As it stands right now, it is still full on expansionary but headed towards neutral. Tightening is possibly only on the horizon in 2015.

So we remain selective buyers of equities, especially on any pullback.

Gerald R. Connor
July 4, 2013

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