CUMBERLAND

How Do You Value No Growth?

Who am I to say the Fed was wrong? But it sure seems like they missed an opportunity at their September meeting to end this ongoing debate as to when they will eventually raise interest rates. Instead, we now seem destined to endure another few months of watching the "talking heads" on CNBC debate endlessly on an issue that should have been resolved by now.

From our perspective, if the Federal Reserve truly wants to see a strong stock market for its wealth effect and a strong economy as the elixir for employment, then resolving the uncertainty over the timing of their rate move would certainly be a benefit. Investors and businessmen alike hate uncertainty. It creates doubt and caution, delays decisions and confounds the spreadsheets the analysts use to project future corporate profits.

One may disagree, but the latest message from the US Central Bank certainly seemed to indicate that all is not well in the global economy. Considering that fifty percent of the S&P 500 revenues are generated abroad, this is not an encouraging message. On the other hand, the anticipated 25 bps rate increase would have confirmed that the U.S. economy was in a self-sustaining stage of growth. Somehow we have a hard time believing that a small interest rate hike, from nothing to almost nothing, would have had as many consequences as the message they delivered.

However, the Fed's ongoing reticence underscores the dilemma for the market; that is, how do you justify the stock market's current valuation? Do you base the current price earnings ratio (P/E) on low interest rates (justified) or on earnings growth (unjustified)?

The Federal Reserve's latest decision just amplified this debate. So it's worth considering both sides of the equation which we will address later in this piece when we discuss the market.

But maybe the biggest surprise from the Fed's recent announcement wasn't so much that rates remained on hold but rather the apparent change in what they are monitoring.

The Fed is on record as saying that they are intent on doing what is right for the U.S. economy, which will also benefit the global economy. Fed Chairwoman Yellen's message from the last meeting unexpectedly shifted gears. It now appears that they are global managers and have given up on the U.S. being the world's engine of growth. So now what? If U.S. employment continues to improve but global growth remains weak, will rates ever be increased? Hard to make plans when you're not sure where you are going and even more difficult to get people on the "destination unknown" bus. They'll probably wait for a clear indication of the route, which was reflected in the market's immediate and negative reaction to the Fed's announcement.

So, how bad is the economy one might ask? On balance it's still alright, especially the U.S. domestic scene but there are concerns and conflicting reports.

Considering that we're on record as a bull unless money policy tightens, which it just didn't or we get a recession, it's worth a little deeper dive into the numbers.

Economy

The current debate is whether the global economic weakness that we're seeing, especially in China and the emerging markets, will drag the U.S. into recession or conversely, is the U.S. economy strong enough to carry the rest of the world? It's not a topic that brings a rush of adrenalin to most investors' veins, so let me be brief.

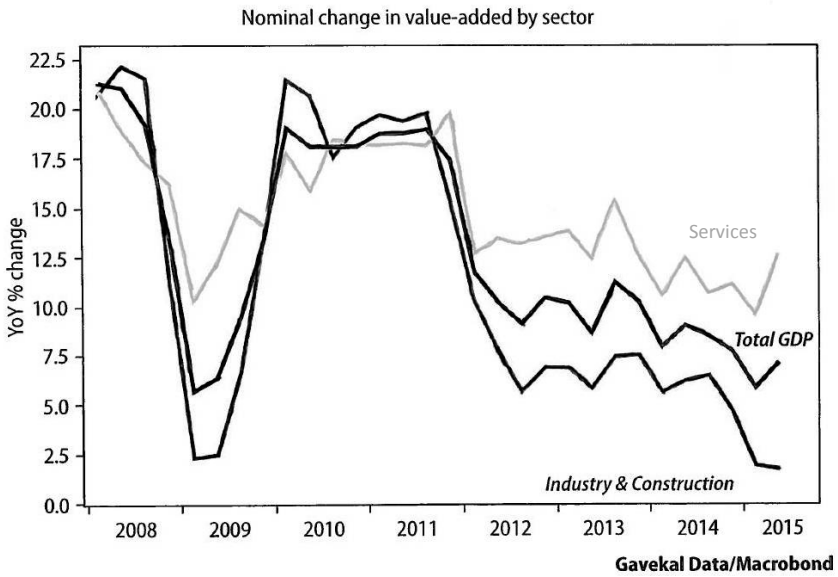
Let's start with the market's biggest concern, China. Most of the slow growth focus is on the Purchasing Manufacturers Index (PMI). It has fallen from a recent high of 51.7 (anything over 50 indicates positive growth) in July, 2014 to 47.1 this August. That's a 77 month low and the 6th consecutive monthly decline. It also has significantly negative implications for many of China's trading partners, especially emerging economies that are dependent on commodities. Australia, Taiwan and South Korea ship over a quarter of their exports to China while Brazil and Japan export in excess of 15% to China.

Of those exports, almost 70% of Australia's shipments are minerals and Brazil has a similar high exposure. Taiwan, South Korea and Japan ship primarily machinery and electrical equipment. Consequently, it shouldn't be surprising that the industrial production indexes are falling in a number of the emerging markets.

Furthermore, many of the emerging markets are financially overextended. Borrowings have quadrupled since 2004 from around $4 trillion to well over $18 trillion, with China accounting for a major share.

However, not enough is said about China's non-manufacturing PMI which measures sales and services. During July, this Index reached a five month high of 53.9 and has not fallen below 50 in the history of the index going back to 2007.

In August, inflation-adjusted retail sales rose 8.8% year over year. Furthermore, this shift in economic growth has widened over the last four years as seen in the chart below.



This transition is also showing up geographically in China as the northeastern provinces that are dependent on mining, heavy industry and state-led infrastructure spending are showing negative GDP. Meanwhile, provinces in the east and south-east that rely more on services and consumer-oriented manufacturing continue to see solid growth.

So, as exports peak and plateau, due to slow global demand, there is a domestic alternative that is more than emerging to pick up some of the slack.

As for Japan, Abenomics hasn't worked. Despite a 37% drop in the value of the Yen since late 2013, exports have not improved as much as expected.

In Europe, the Manufacturing (M-PMI) rose to 54.1 in August just below the 49 month high that was reached in June. This was the 26th straight positive reading, while the nonmanufacturing (Non-PMI) index improved to 54.3, close to the June record.

And as for Canada, our currency is down roughly 20% year over year, and not surprisingly, is highly correlated to the Commodity Research Bureau (CRB) raw industrial spot price index. This should boost Canada's exports which account for 31% of the country's GDP. Unfortunately, manufacturing accounts for only 10% of our economy. As a result, the weaker currency isn't likely to provide much stimulation.

Now for consistency, let's start with the M-PMI in the U.S. for September. It's at 53.1, the lowest reading since July 2013 and below its five-year average. The non-manufacturing PMI fell for the month but still remained at a healthy 55.6.

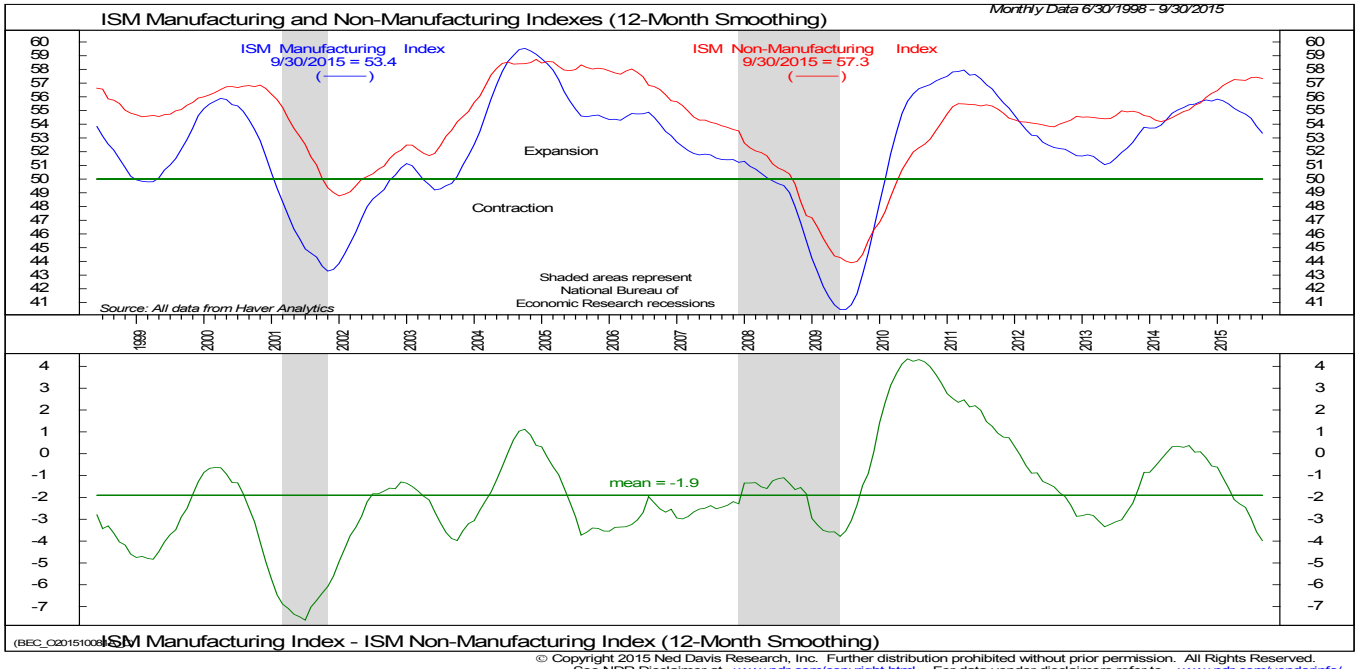
There are a couple of things influencing these indicators which are worth considering before putting too much emphasis on manufacturing. First, the M-PMI is being influenced by the strength of the U.S. dollar which hurts exports and the price of oil which impacts capital spending in the oil patch.

Second, manufacturing's share of GDP has declined to 12% from 27% in the 1950's and its share of non-farm payrolls has dropped to less than 9% from 30% in the '50's.

The dollar-driven slowdown in manufacturing exports is also showing up in higher inventories as sales slow. This will also be a drag on GDP as they are brought down to more reasonable levels.

The drop in exports has been compounded by the increase in imports, driven by a sharp 8.4% increase in consumer goods, the sixth largest on record. These facts are a bit contradictory in that the expanding trade deficit will hurt GDP but the increase in consumer spending suggests an underlying strength to the economy.

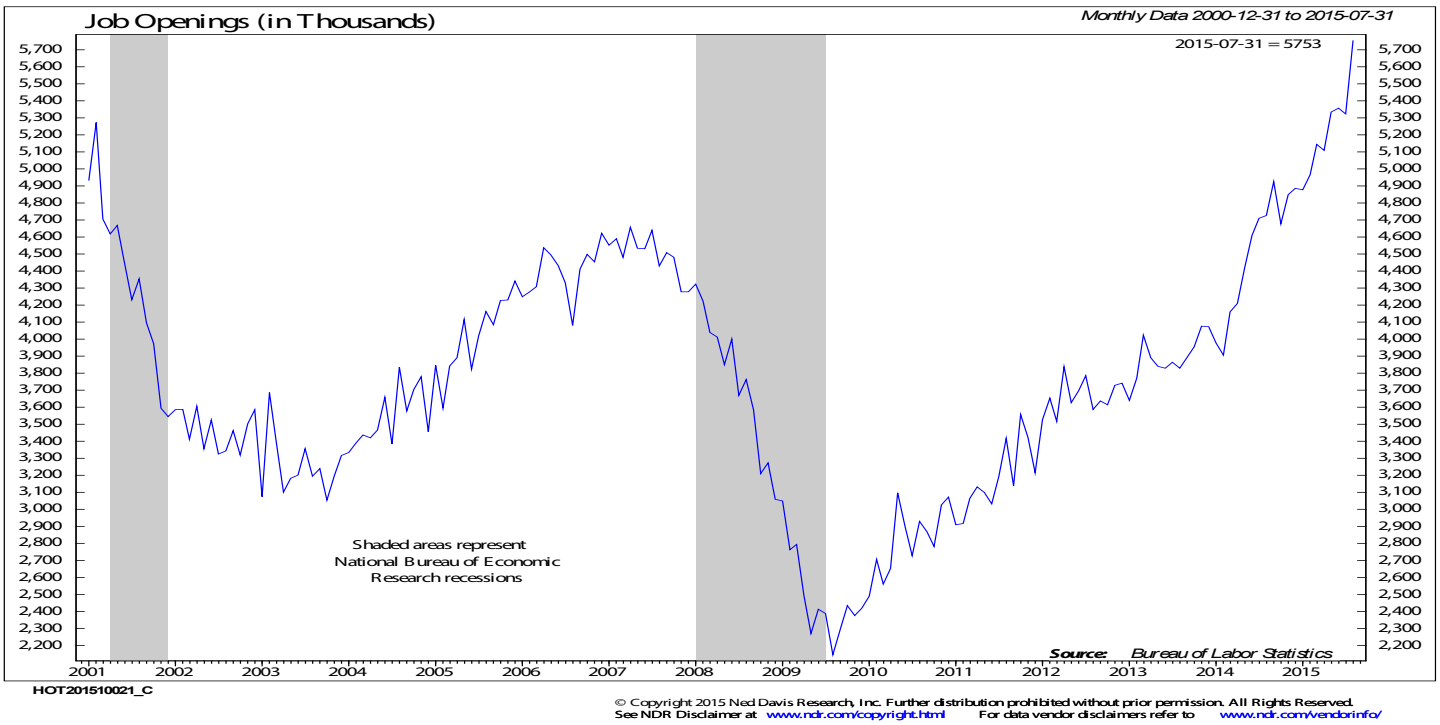
Today, the service sector accounts for over 80% of output and employment, dwarfing the impact of manufacturing.



This divergence can be seen in the chart above and suggests the underlying economy might be stronger than it seems. It is especially true when you look out to 2016 when we will have anniversaried both the strong dollar and weak oil prices.

Another recent concern was the weak September non-farm payrolls increase of only 142,000 and the decline in the labour force participation rate to 62.4%, the lowest in 38 years. However, if you dig a little deeper, the numbers don't seem so troublesome.

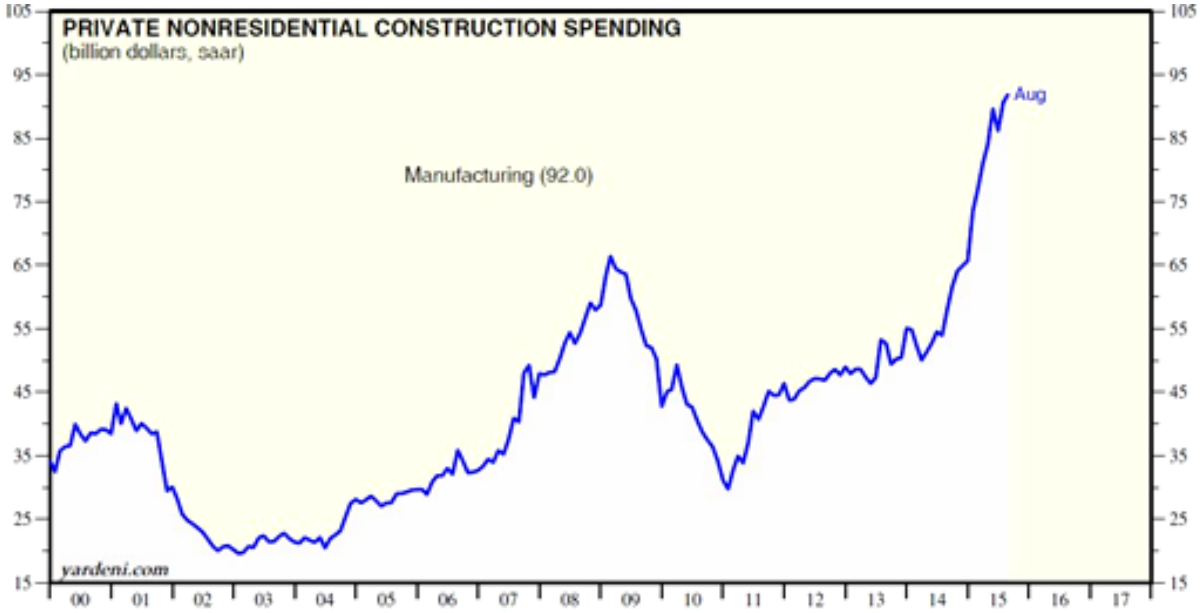
Start with the Job Openings and Labour Turnover Survey (JOLTS) report that shows that job openings jumped 8.1% to a record high 5.7 million as shown this chart.



But why the decline in participation?

There seems to be a number of reasons. First, a skills mismatch is developing creating a shortage of qualified workers. The National Federation of Independent Business (NFIB) Small Business Jobs Report found that 85% of small business owners have reported few or no qualified applicants. Second, there could be structural factors such as an aging population. Another explanation could be the preferences of Millennials to stay in school longer. Regardless, employment along with housing and auto sales still seems to provide strong support for the U.S. economy.

Capex has been another area of concern. But here again there are some anomalies that are worth considering. Under non-residential fixed investment, equipment spending, especially on informative processing, collapsed. So did spending on mining and oil fields. However, spending on industrial equipment jumped almost 20% in the first half. Structures remained the biggest drag amongst capex components. Again, a 68.1% annualized decline in mining structures shouldn't be a surprise but a 64.3% annualized increase in manufacturing construction probably is.



Source: Census Bureau.

For some time, we've emphasized two secular trends that we think will reshape the US economy. The first was energy self-sufficiency which is apparent from the collapse in the price of oil brought on by the shale oil revolution. Second, there has been a return of manufacturing known as re-shoring. Recent construction spending on new factories as shown above is symptomatic of this trend playing out.

Finally, let's look at China's impact on the U.S. Although trade is important, U.S. exports represent only about 13% of its GDP while imports amount to 15%. In contrast, German exports amount to 50% of their economy.

In 2014, 20% of U.S. imports came from China and as a percentage of GDP, this amounted to only 3%. So even with further currency fluctuations, China's not likely to have a material impact on U.S. GDP or, in theory, monetary policy.

So, back to the question, can the U.S. economy carry the rest of the world or will recession abroad pull it down?

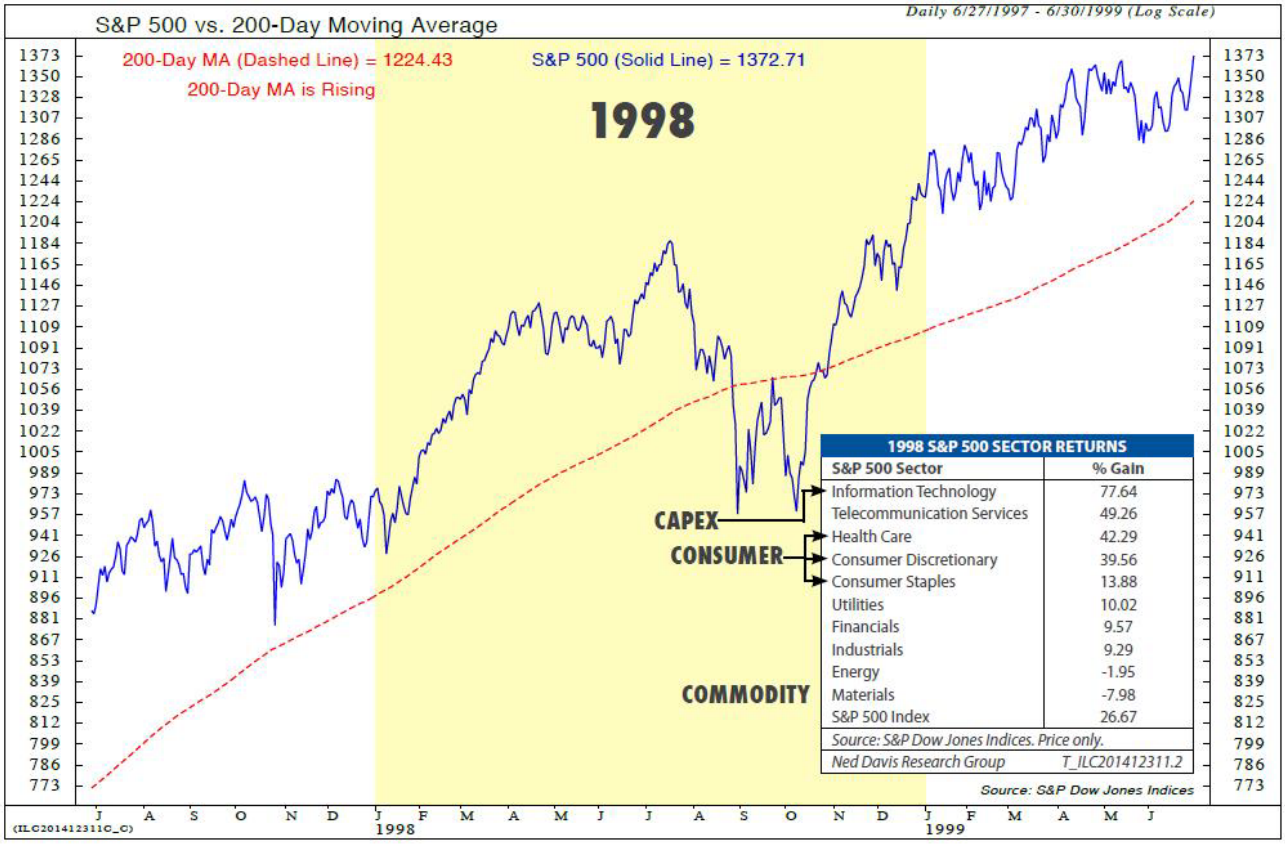
The facts say the U.S. economy seems to be doing a bit better than the headline numbers would indicate. However, we'll also side with history on this issue.

What happened in the 1990's is a good analogy to what we are experiencing today.

In the late 1990's

- Non-farm payrolls were growing but momentum was waning
- Unemployment was low and falling
- The trade-weighted dollar was relatively strong, rising 9.4%
- Corporate profits were declining
- Inflation was low and steady
- Commodity prices were falling. Oil fell 49% from its peak. Gasoline prices fell 17.4%

- Russia defaulted on their debt and Asia was experiencing a currency crisis which required the Federal Reserve to ease monetary policy
- Europe was struggling with "Eurosclerosis."
- Then the secular theme was "Technology" today it's "energy self-sufficiency and re-shoring."



As one can see in this chart, the market composition wasn't much different than today's including a market correction that started in the summer of 1998 and lasted into the fall.

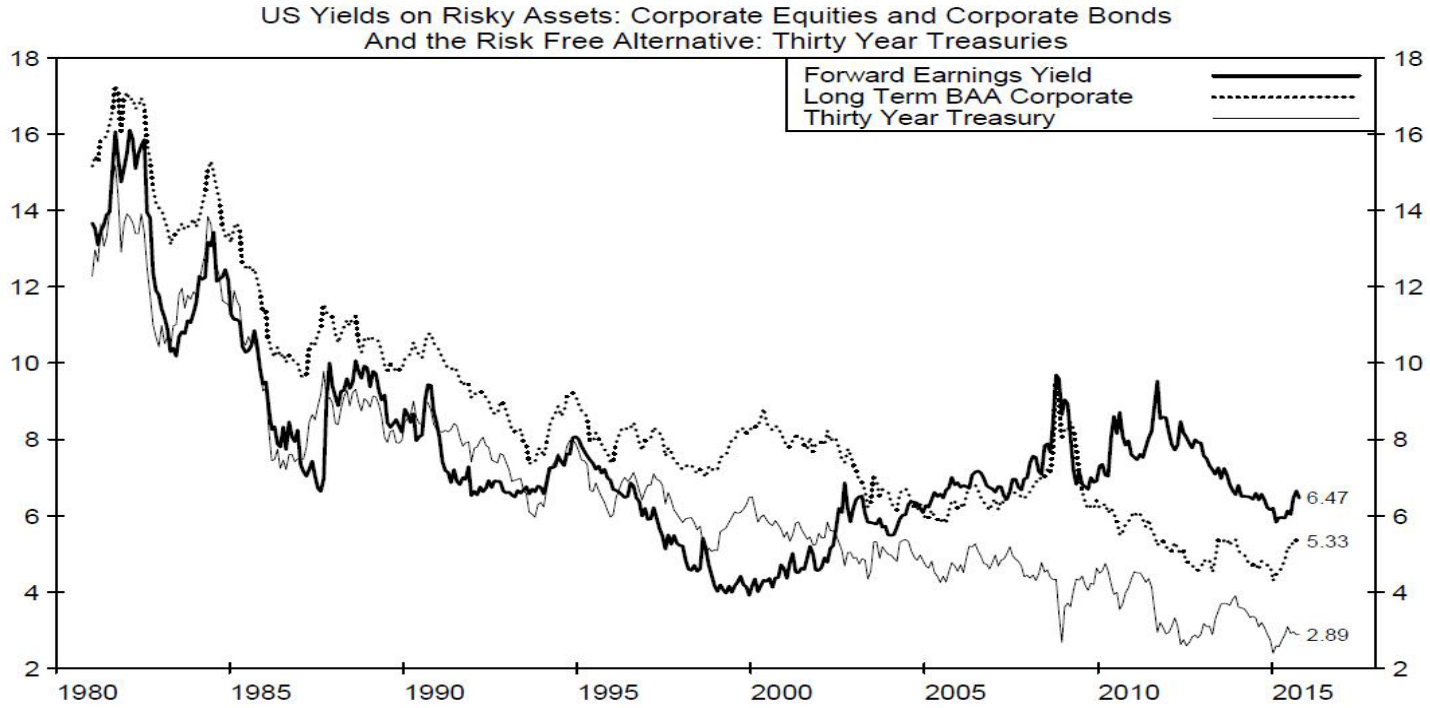
Bottom line, things could be better for the U.S. economy but we still can't make the case that it will bring this bull market to an end.

The Market

Notwithstanding our constructive long-term outlook, we've been reasonably cautious on the market and expecting at least a short-term correction. So, the decline of 12.4% in the S&P 500 from May 21st to August 25th shouldn't have been a surprise. Year to date, it has left the Index down 6.7% in U.S. dollars. The cause of this decline can be entirely attributed to valuation as forward price earnings ratios dropped from a high of 17.2x to a low of 14.6x at the August low.

As seen in this chart, the absolute market valuation is back to almost fair value, down from expensive.

The only valuation model that would suggest the market is cheap is one that compares the market's earnings yield to interest rates.



This chart shows the comparison of earnings yields to both BAA corporate bonds and 30-year treasuries and suggests that the market has considerable upside should the gap in those yields close.

In the past, we've extrapolated this argument to support the massive corporate buybacks that we've witnessed since the market bottom in 2009. In the intervening six years, corporations have retired over $2.0 trillion of shares and we would expect this trend to continue as long as borrowing costs remain lower than earnings yields and corporations remain valuation insensitive.

To this market cap shrinkage, you can add the decline in shares outstanding due to Mergers and Acquisitions. In the third quarter, M&A targets were valued at $577.8 billion which is an increase of 34% year over year.

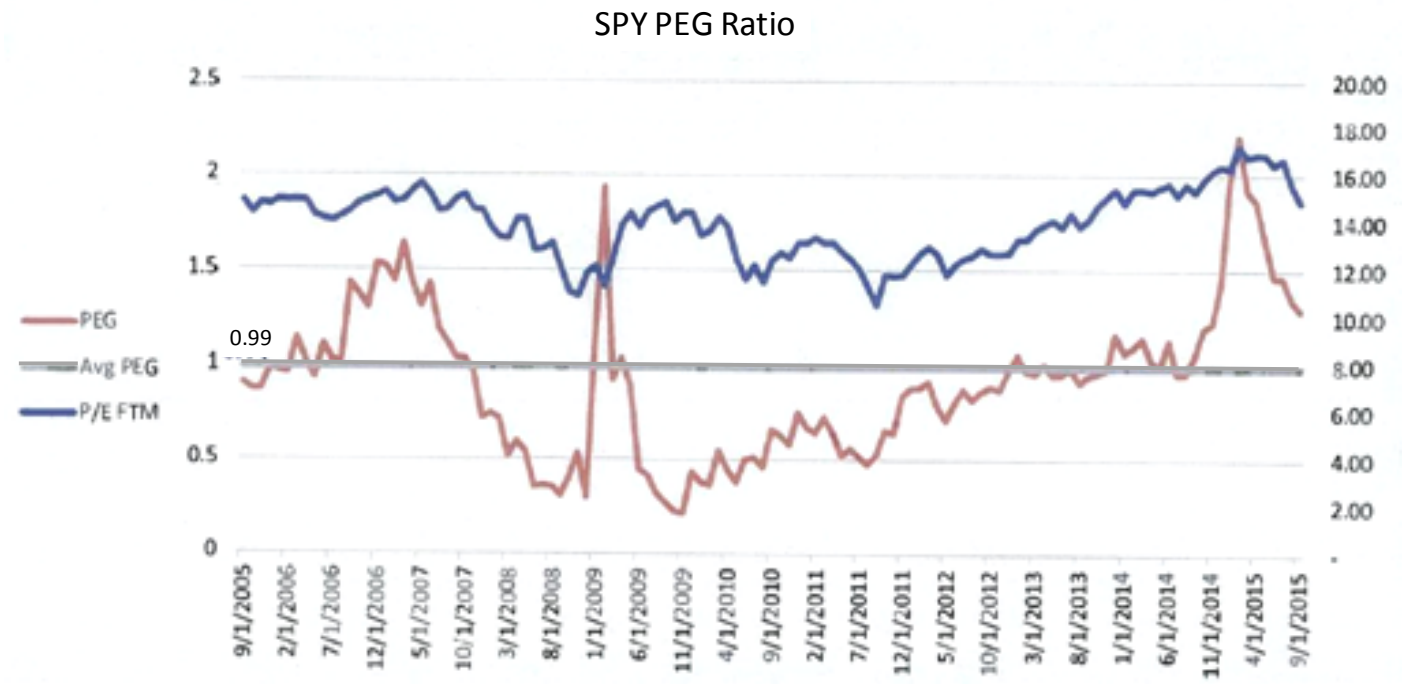
So, although in the long-term we remain constructive on the market, in the shorter term it continues to have a valuation problem due to one simple factor, no earnings growth.

For the third quarter, earnings are expected to decline 2.9% year over year, which will leave the S&P 500 earnings for the last twelve months essentially flat with 2014.

Consequently, the question is, what do you pay for no growth? Obviously not the 17.2x earnings multiple we saw earlier this year.

When I started in this business, I learned a simple rule of thumb. You never bought a stock that had a higher P/E ratio than its growth rate.

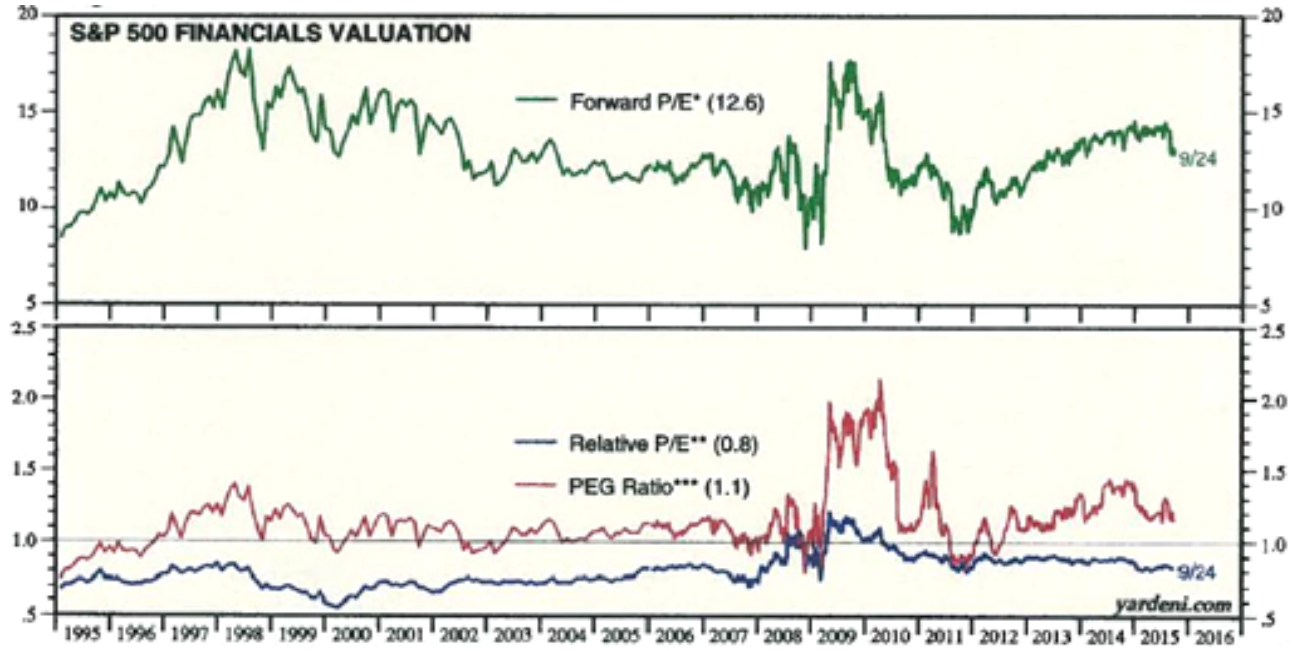
As an example, if a company had a long term growth rate of 15% you could pay up to 15x earnings. It's overly simplistic as most rules of thumb are but not a bad guide. In financial jargon, we refer to this as the PEG ratio (P/E ÷ Growth).



We plotted this ratio back to 2005 and you can see the spike last November when the market hit its initial peak as the oil price slump and the strong dollar started to take their toll on earnings estimates.

Will the ratio get back to 1x? I doubt it. That would suggest that the market has another 23% downside. Instead, one has to examine each industry to determine whether it is still over or under valued according to this method.

As an example, Telecommunications and Utilities got overvalued because of their divided yields. Although Telecoms trade at a below market P/E rate of 11.7x, they grow only at 7.2% giving them an overvalued 1.6x PEG ratio. Healthcare Technology, a hot market sector, has a long term growth rate of 16% but was trading at almost 34x forward earnings and a 2.1x PEG ratio. Expensive. This has now corrected to a P/E of about 25x and a more reasonable 1.6x PEG rate. Not quite one as the rule of thumb would suggest but not far above its historical average of around 1.5x.



This chart shows one of our more over-weighted groups, Financials. Long-term growth is 11%. So, you can see that the forward PE ratio is a below market 12.6x (0.8 relative to market) with a PEG ratio of 1.1x. Cheap.

Consequently, the key for this market is growth which has been nonexistent over the last year.

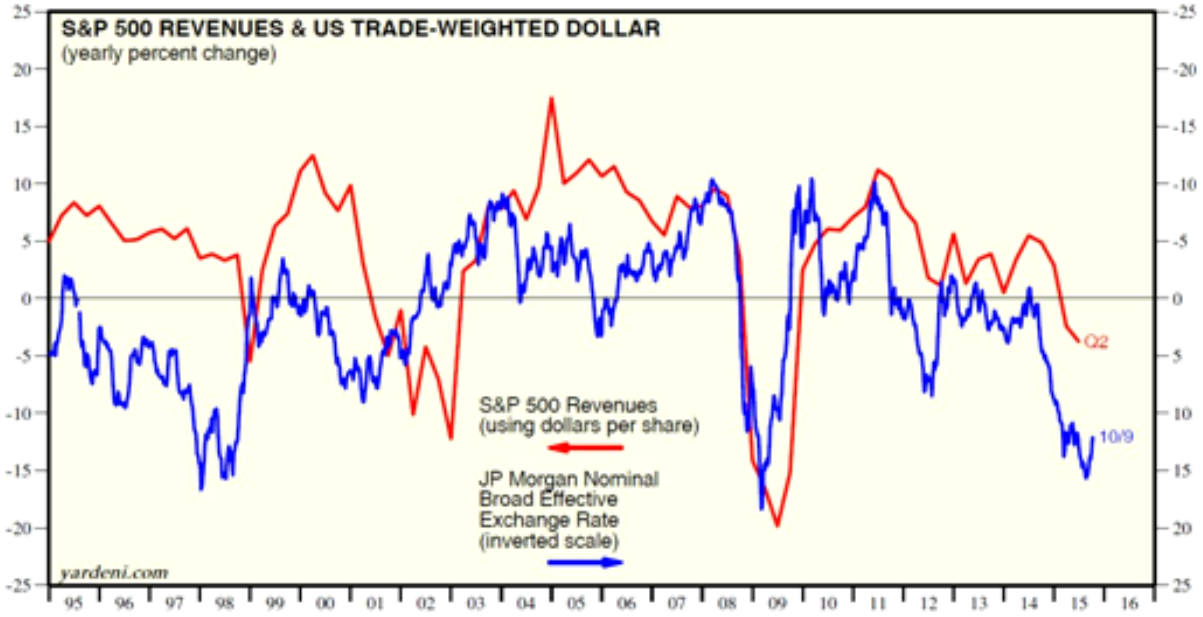
Estimates for S&P 500 are for earnings to reach $130.49 in 2016 for an increase of 10.3% year over year. 2017 is estimated to come in at $144.28, another 10.6% improvement. If these estimates can be achieved, it would probably justify today's PEG ratio and even suggest there might be some valuation upside provided interest rates remain low.

What gives me some hope is that this year's earnings have been disproportionately influenced by oil prices and the appreciation in the U.S. dollar. Remember, about 50% of the S&P 500 revenues come from abroad.

With the dollar up roughly 16% in the last year, this implies a reduction in S&P revenues of 8.5%. Brent crude oil is down 52% year over year. Given that the Energy sector accounts for about 10% of the S&P 500 revenues, that would knock another 5% off of revenues.

Ex-Energy, this first year's quarter earnings were up 11.5% while the second quarter would have seen an increase of 9.8% versus the +1.5% and flat reported earnings.

Consequently, if there is one thing that I will keep an eye on, it would be the value of the U.S. dollar.



As can be seen in this chart, there is a highly correlated, inverse relationship between the dollar and S&P 500 revenues. This also holds true for corporate profits, certain sectors of the economy and commodity prices.

Therefore, if the dollar continues to be strong, economic performance and earnings growth are likely to be impaired and future earnings estimates will have to be lowered.

Furthermore, if there is one chart that justifies the Fed's inaction, the one above is probably it.

Conclusion

The U.S. economy seems to be on a sound footing and if history is any precedent, it is not likely to be weighed down by the rest of the world. With monetary policy still accommodative, the bull market that started in 2009 is likely to stay intact.

Regardless, the strong U.S. dollar and weak oil prices have taken a toll on earnings and have set up the possibility of an earnings recession where we have back to back no growth or negative growth quarters. Not unreasonably, it's drawn into question the Market's high valuation which has now been partially corrected with its recent 12.4% decline.

Going forward, a lot depends on earnings growth as investors will increasingly focus on 2016 earnings estimates. Fortunately, the headwinds of lower oil prices and the strong dollar should be behind us while corporate buybacks, M&A activity and low interest rates will continue to support the market.

We would further expect that the rolling correction that started last fall with the energy stocks, then spread to the transportation, media and most recently the health care companies, will result in a change in leadership that favours many of the currently undervalued, economically-sensitive sectors and the Financials.

Consequently, we see the latest market pullback as an opportunity to add to our equity weighting.
October 4, 2015

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