CUMBERLAND

Digging Below the Surface

It's hard to not have your stomach in your mouth after the bungee jump the market took in the first quarter. That kind of volatility makes it difficult to figure out where we go from here.

Nevertheless, we're still positive on this market in the long-term relative to our other investment alternatives.

Let me give you our rationale but first let's start sorting out reality from all the noise by putting this market into perspective. Then we'll take a look at the three factors that will determine where this market is headed: the Federal Reserve's Monetary Policy, the economy and valuation.

Perspective

Since the market bottom in March 2009, the S&P 500 has advanced 249% through year-end 2015. The US GDP is 14.4% higher or 2.2% annualized and unemployment has dropped from 10% to 5%. At seven years old, this bull market is the third longest since WWII. Over this period, S&P 500 revenues rose 3.2% per year while profit margins expanded from 7.0% to 10.6% driving operating earnings to a 12.4% annual gain. The S&P's forward P/E ratio also rose from 10.2x to 16.3x. This leaves profit margins near all time highs and market valuations better than fair value.

That's a pretty good run and a proverbial hard act to follow. The economic cycle and the length of the bull market can be prolonged but one has to appreciate that they are already extended.

On the surface, it suggests that investors shouldn't expect investment returns to be any better than earnings growth, which is currently forecast to decline for the third consecutive quarter.

However, if you dig below the surface a little, things become a bit more black and white and less grey. Investors may not benefit from an overall market advance but there are certainly pockets of opportunity.

So let's see if we can separate the noise from the underlying facts on the factors that will influence this market.

Federal Reserve Policy

The Federal Reserve finally raised interest rates by 0.25% in December but their projection of possibly another four rate increases in 2016 didn't reconcile with either their stated strategy of a slow protracted series of rate increases or the market expectations.

It was certainly a factor in the market's sell-off.

However, the Fed's comments shouldn't have been a surprise. Their twin mandates are to control unemployment which has declined to 5.0% and inflation which has reached 1.7% against their target of 2%. However, when measuring only core inflation that excludes fuel and food, prices are increasing at 2.3%. In other words, the Fed has accomplished its easy monetary policy goals and it's time to tighten up.

However, if you dig a little deeper you'll see that those broad objectives have some rather subtle nuances.

It's true that the Fed has consistently targeted 2% inflation. But 2% on what might be a more appropriate question.

We've now come to learn that Fed Chairwoman Yellen has refined her definition to a subset, wage inflation. Although average hourly wages rose 2.4% in March, she feels that the appropriate range is 3% – 4% and is consequently willing to tolerate overall inflation higher than the original target.

Unemployment has also reached targeted levels unless you again dig below the surface to understand how the Fed is calculating their success which includes a participation rate adjustment. This can be a little confusing because if you are not working, but not looking for a job you are not unemployed. The minute you change your mind you are.

So, let's look at the numbers. The total potential labour force of eligible workers over 16 years of age in the U.S. is 252.7 million.

The participation rate hit a high of 67.3% in early 2000 then fell to a low of 62.4% last September. This is a number the Fed Chairwoman Yellen focuses on. The participation rate has recently reversed and is now up to 63% which amounts to an increase of almost 1.5 million workers.

This still leaves 37% or 93.5 million potential workers out of the workforce and 94% of them say they don't want a job, leaving 6% or roughly 5.5 million that might.

What the Fed apparently does is add 5.5 million workers to the unemployed. This would then push the participation rate back to 65% and suggests unemployment is really close to 8%. Fortunately, job openings remain at a record high of 5.5 million. Nevertheless, with this adjustment the Fed has not met its unemployment goal.

The Fed has also gone off script by determining that monetary policy should not only focus on employment and inflation but it should also factor in global economic and financial developments. This, in my opinion may be code for the dollar being too strong.

Bottom line, rates are eventually going higher but at a gradual rate and monetary policy will remain accommodative.

Economy

We've said for quite some time that we don't think you'll see a bear market unless we go into recession.

Although the economy has continued growing, the pace has been below normal. Once again, there is a bit of noise in the numbers and we'll give you a couple of examples.

The fact is, the US economy has created 2.4 million new jobs in the last six months, wages are higher, and the lower prices at the gas pump, amounting to about $1,500 per household are showing up in the savings rate. Consumption accounts for almost 70% of US GDP and the consumer's balance sheet has improved dramatically. There are no apparent excesses here such as housing that would warn us of a slowdown like the one in 2007.

Other broad measures of the economy such as the Producers Manufacturing Index (PMI) and Citi Corps economic surprise index are all now showing economic improvement after a slow start to the year.

But there is noise in a number of other statistics driven mostly by the appreciation of the US dollar and the collapse of oil prices which might be disguising the economy's future potential.

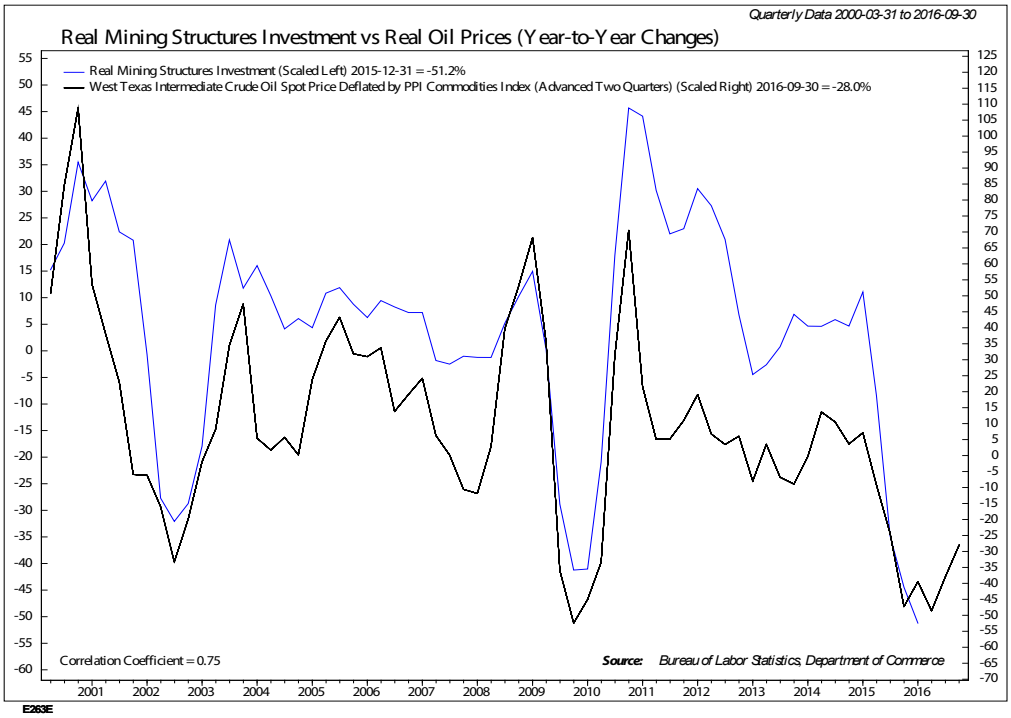
Consumer spending always gives you a baseline on how the economy is performing.

From this you can add or subtract a number of other statistics.

One is the trade deficit. The bigger it is, the more it detracts from GDP growth and it's been expanding. Over the past two years, exports have only increased 1.7% while imports have advanced at 8.4%. Much of this can be attributed to the strength of the dollar which has boasted imports and hurt exports. Although this reduces GDP, there has been enough domestic demand to purchase those increases in imports.

There has also been concern over capital spending which fell 2.1% in the fourth quarter. But below the surface, industrial equipped sales jumped by 11.2%. Offsetting this was investment in structures which fell 5.1%, dragged down by the fourth consecutive quarterly drop in mining exploration, which includes oil exploration.

For 2016, capex is expected to recover to a positive 2.5%. Spending on intellectual properties will remain about constant at 3.5% but non-residential structures should register a positive 1.1% versus last year's negative 3.5% as the drag from the mining and oil sectors dissipates as can be seen in this chart.



We also saw a 25.5% rise in orders for industrial, metalworking and material handling machinery to a record high in January.

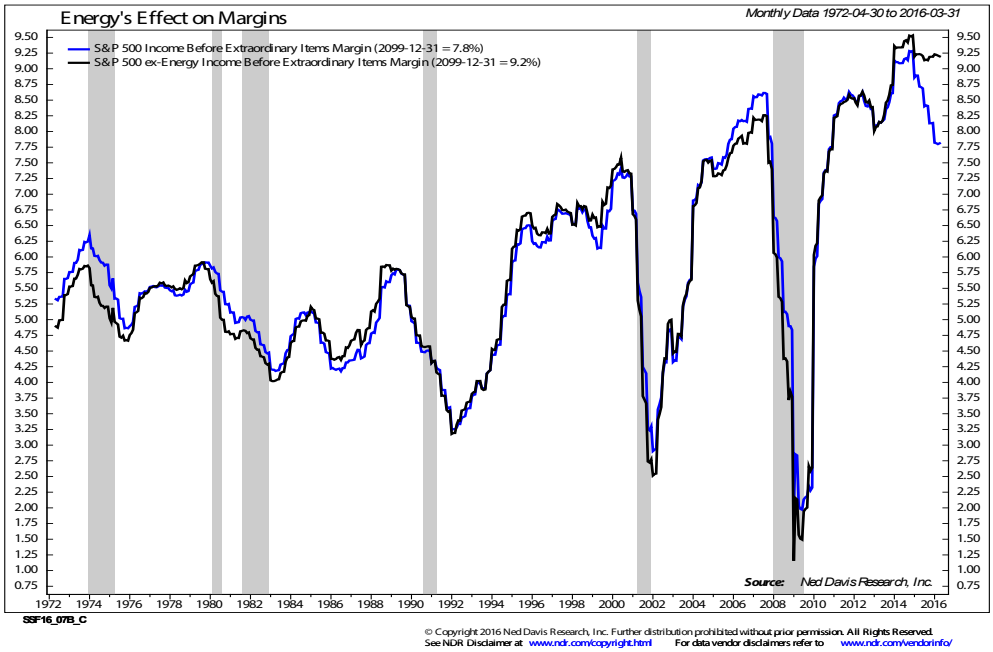
We could go on with other examples but the message is that the decline in oil has had a dramatic impact on the economy and has clouded the broader statistics. Under the surface, the economy appears to be doing better than the headline numbers suggest and should show improvement as the negative impact from oil and the dollar work their way through the system.

Earnings

Although the feared recession hasn't shown up in the economy, it certainly has in earnings. Fourth quarter 2015 S&P earnings were reported to be down 19.3% and this year's first quarter is expected to register the third consecutive quarterly drop of 7.7% followed by a further decline of 2.1% in the second quarter. Only in the second half of 2016 will things improve with sequential gains of 5.2% in the third quarter and a 10.2% improvement in the fourth for an overall gain of 2.2% for the year. 2017 looks brighter with an expected gain of 13.7%. Since the end of last year, those estimates have declined 11.9% for 2016 and 8.1% for 2017. Earnings revisions have now been negative for 18 consecutive months which correlates with when oil started to decline and the U.S. dollar started to appreciate.

What's accounting for the declines? The fourth quarter slide can be attributed to a 10.2% drop in domestic, nonfinancial profits that can mostly be attributed to a plunge in manufacturing profits of which nearly 90% was due to petroleum and coal products.

This outsized impact from oil can also be seen in profit margins.



As seen here, profit margins for the overall S&P are significantly lower than the S&P 500 ex-energy. Excluding energy, profit margins are still relatively close to their peak. If profit margins remain stable, earnings growth will be dependent on sales growth which has again remained positive outside of energy.

Unfortunately, the energy sector's earnings are expected to decline a further 36.1% over the next twelve months leaving the sectors forward P/E ratio at 49.5x.

Fortunately, the sector's impact on the overall S&P 500 earnings has declined to 2.3% from 8.1% at the start of 2014 while its market cap share has also dwindled to 6.9%.

In other words, we're getting the oil shock behind us.

This could also be true of the dollar and its negative impact on both the economy and earnings. Collectively, the S&P 500 companies generate 50% of their revenues from overseas which have been converted back to US dollars at lower rates.

Together, oil has chopped $15 off the S&P earnings while it is estimated that this dollar has cost the averages another $10 per share.

Stock Market

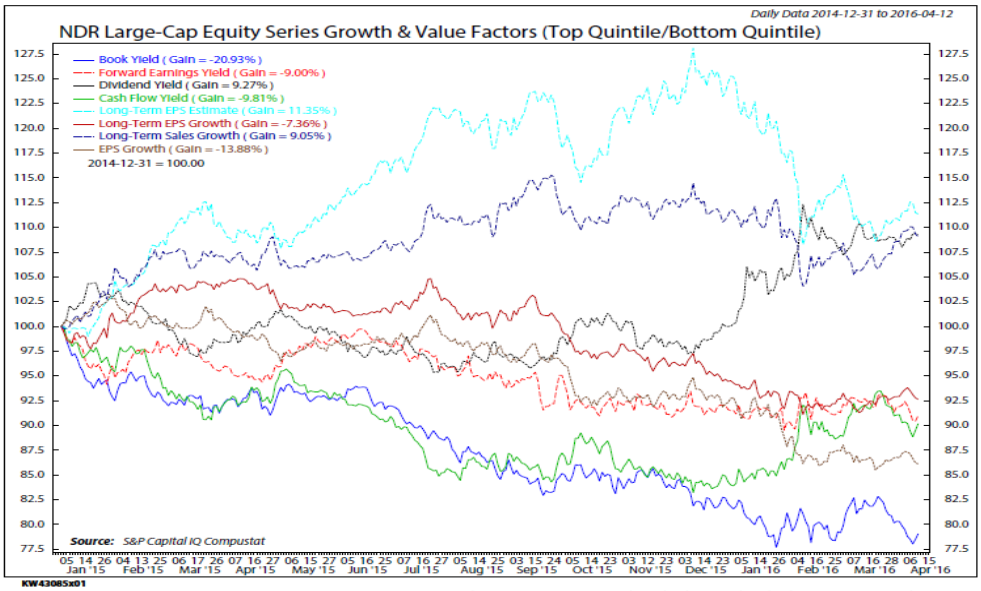
On balance, I think you can make money in the stock market but it won't necessarily come with the broad tailwind of rising averages. Usually, overvalued markets require a period of consolidation while earnings catch up. Unfortunately, the consolidation we've witnessed over the last year has been accompanied by declining earnings which hasn't alleviated the valuation problem.

That said, below the surface there could be some sorting out. For energy, the valuations either seem too high or oil prices have to rise which would be good for overall earnings. Financials trade at a 25% discount to the averages and there's probably room for their valuation to improve if the economy continues to grow. Not unlike last year, when the FANG stocks (Facebook, Amazon, Netflix, Google) did well while the broad market sold off leaving the averages relatively flat, you could see a different sorting out of valuations this year.

For this bull market to remain intact, I think it is contingent on the economy demonstrating some underlying growth as energy prices and especially the dollar either stabilize or reverse which would be accretive to both the economy and corporate bottom lines. But stabilization will allow some of the hidden positives to gain recognition.

In my opinion, the single most important variable for the economy is employment. With savings piling up and some wage inflation, there is a latent spending capability which should support the economy going forward. If the savings from the gas pump ever kick in, the economy could do better than expected and "value" stocks, which are more dependent on the economy versus "growth" stocks, could do much better.

In fact, this shift from growth to value already seems to be taking place and could be a major factor in determining success in the market this year.



In my last quarterly commentary, I highlighted the above chart to demonstrate how different investment characteristics performed. Our contention then was that companies that had growth or momentum characteristics as defined by long-term EPS estimates were overvalued while value stocks defined by cash flow yields were undervalued.

At year-end, the EPS estimate group was showing a 24.5% annual gain while our value stock characteristic was -15.85%.

As you can see, these two characteristics, EPS estimates in turquoise, and cash flow yield, in green are now converging. The growth characteristics have given up some of their gain and are now up only 11.35% while cash flow yields have improved to -9.81%.

Any shift in market sentiment towards value will also benefit financials, one of last year's biggest underperformers, as the group represents about 30% of the value composite.

A stronger economy would also likely result in a steeper yield curve which again would help Financials.

Furthermore, this would also shift investor's focus from this year's earnings to 2017 which could give you a broader market advance then most anticipate.

Another factor that could influence this market is the impact from Sovereign Wealth Funds. Most of these assets are sourced from oil revenues but are now being used to balance domestic budgets.

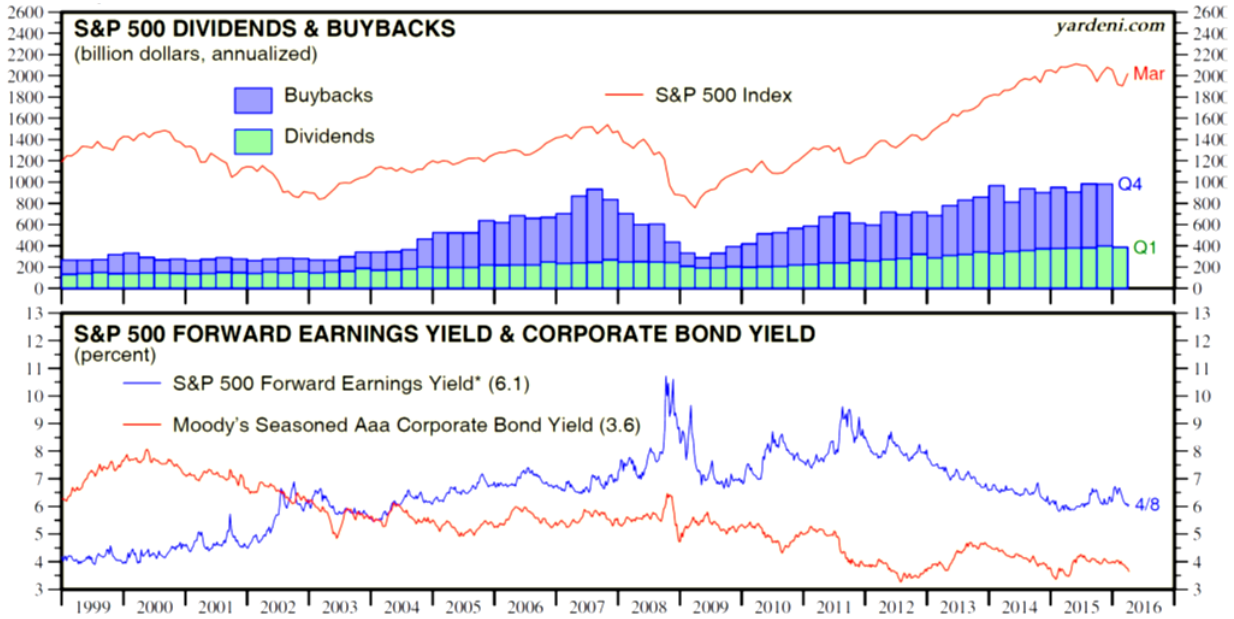
Four of the five largest sovereign funds are based in oil producing countries including Norway's $820 billion fund.

Collectively, these funds have an estimated $7 trillion in assets with a reasonable proportion invested in less liquid asset classes such as private equity and infrastructure leaving fixed income and equity portfolios as the only source of funds.

It's estimated that collectively sovereign wealth funds withdrew $46.5 billion from asset managers in 2015. Of these equity portfolios, almost 50% was invested in either U.S. or European banks which has added to the performance pressure on Financials.

Offsetting some of this has been the share buyback programs at most major US corporations. In the first quarter, share buybacks are expected to approach $165 billion, a near record.

Supporting this is not only the spread between earnings yields and the corporation cost of borrowing, as seen in this chart.



* Forward earnings (time-weighted average of consensus operating earnings estimates for current and next year) divided by S&P 500 index.
Source: Thomson Reuters I/B/E/S and Board of Governors of the Federal Reserve System and Standard & Poor's Corporation.

But also the fact that corporate cash flows are running at close to $2 trillion per year while cash on their balance sheets remains at close to a record high $1.9 trillion.

Share shrinkage is also being supported by the 2,940 M&A deals worth $3 trillion last year.

On balance, it's hard to make a case for a strong advance in the market averages as they remain fully valued. But that should change as the underlining fundamentals of the economy start to assert themselves as the drag from falling oil prices and a rising dollar diminishes.

There should also be a shift in market sentiment away from growth to value as the economy improves. When you filter out the noise, stock and sector selection with probably play a bigger role in returns than the overall direction of the market.

GRC/amh
April 5, 2016

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