The Full Monty

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One way to find out if anyone reads your stuff is to wait a year and see if someone notices. While acknowledging the occasional requests for an update (from my mother), our practice is to comment only when we have something substantive and new to say. Today may qualify.

Our catch phrase since the previous commentary in April 2013 was “Just Smile and Wave” and it has probably been an appropriate suggestion in the subsequent timeframe to “enjoy the ride while it lasts.” Taken from the movie Madagascar, penguins are an interesting bird in that they function well in a sea of liquidity despite lacking something most birds have – the ability to fly. We penguins in the stock market have likewise functioned well in this sea of monetary liquidity despite lacking something most bull markets have – a robust economy and more significant top-line growth.

Lacking robust revenue growth, we did focus on earnings per share at the time and earnings reports have generally cooperated, albeit with a highly managed sheen from the cost-cutting and share buybacks which have become customary. We’ve been largely satisfied by the earnings reports of our equity holdings this past year, and revenue growth has even picked up in pockets of the economy.

❖ *Stocks vs Bonds* ❖

The recent relationships between the stock market and the bond market have been very interesting. Stepping back a few years, a popularly discussed idea about this relationship was dubbed “The Great Rotation.” This idea was first noted in October 2010, more formally introduced in January 2011, and promoted every year since then by a major financial institution (the identity of which is unimportant), suggesting investors who had fled stocks and rushed into bonds in 2009 and 2010 would reverse course and rotate out of bonds into equities in 2011. Not lacking for persistence, when reality failed to comply in 2011 as bonds rallied and stocks withered, the concept was again promoted in 2012, 2013, and the beginning of this year.

Our observation at the beginning of 2014, and further noted in meetings, was that from a mental list of prominent investment strategists, one could not find a single strategist who felt the return from bonds would be superior to the return from stocks in 2014. Well, you can see this coming. Year-to-date the S&P 500 is up about 3% and the TLT (20 year Treasury bond) is up about 11%, though it’s been just a few months. Well-managed equity portfolios have been beating the return from most bond portfolios for years though, and last year was certainly a year when the S&P 500 index itself convincingly exceeded the return on bonds by a wide margin on a risk-adjusted basis.

Our own perspective on bonds was also more reserved, as stated in March 2012 (Underdog, page 3) that, after those strong rallies in the fixed income markets, continued gains were so much less likely. So in some ways there has been room for an argument such as The Great Rotation.

However, a counter thought we outlined a year ago (in the midst of expectations that interest rates would rise) was to be very careful of the idea that stocks could rise during time periods when the bond market declined. That theory tested very quickly, as stocks dropped and went flat over the summer when the bond market declined. As interest rates stabilized U.S. stocks could then again proceed higher as the "Smile and Wave" trend continued, but our argument was not entirely accurate or perhaps long-lasting. Market relationships started changing in the 4th quarter, as noted in our conversations at the time, and by mid-December the daily or weekly moves of bonds and stocks were more negatively correlated than positively correlated. It was a change. This was one of the first indications we noticed of an increasing focus on changing risks, and more were coming.

❖ *The Risk Environment* ❖

- Europe. We look for contrarian evidence at critical junctures, and the level of optimism today about the European economies seems unsustainable and likely misplaced. We can discuss the historical data and comparisons of the relevant sentiment surveys, but we've compiled historic behavioral readings of optimism about most major European economies and equity markets. There's no reason to select just one, but we could not be more skeptical of Italy.

- In terms of the additional interest rate that countries such as Italy or Spain or Greece must pay when compared to German Bunds, these spreads have moved full cycle from the compressed levels of 2006 to the very wide levels of 2011 and back to these low spreads in 2014. While credit spreads have moved full cycle (European monetary policy is easier today than perhaps any time in the last century), the economies have not cycled. Bankruptcies and unemployment and non-performing loans and debt-to-GDP ratios and so on are at extreme levels. It is difficult for me to find substantive indications that the primary structural problems Europe had in 2008 or 2010 or 2012 have been solved as of 2014. We will agree some problems are largely postponed until interest rates go up. Investors must judge whether European interest rates adequately compensate the attendant risks, and if the answer is "no" then we have a 2015 problem ahead of us.

- In comparison to Europe, US interest rates appear oddly attractive on a risk-adjusted basis, despite the very low rates of our Treasury yield curve. It's not as easy to find high quality paper these days as you might think. The recent drop in US interest rates is part of the process of a gradual and renewed recognition of global risks, and it slowly surfaced in late 2013 as noted above. A next step to monitor in that process would be a substantive expansion of credit spreads in Europe, reminiscent of 2007.

- Yale professor Robert Shiller calculates a cyclically adjusted P/E ratio (CAPE) with data back to 1881. The current reading is exceeded only by the 1929 high, the 1997-2000 highs, and the 2005-2007 highs. [1] Details are important, and his calculations use current stock prices against annual earnings figures which are averaged over the preceding 10 years and adjusted for differences in inflation levels during that time. Issues related to growth, leverage and the inflation benchmarking are appropriate to address, but any adjustments might lead in a worse direction. Will leverage and share buybacks increase further, will growth rates and margins expand from these levels, is inflation likely to boost earnings for a forward-looking calculation? Use other P/E ratios if one likes, but higher equity prices in 2014 will add to elevated valuation levels. Yes, valuations are lower than the late 1990s. It would be a mistake to label the year 2000 as the only relevant benchmark comparison for all future cycles.

- We mentioned on the prior page a virtual unanimous consensus from professional advisors that the stock market is the clear investment of choice. This sentiment is easy to understand when there appear to be few attractive alternatives, yet such consensus is typical at major tops. I see other sentiment surveys reaching similar conclusions. We think that, anecdotally and analytically, professional sentiment towards stocks is back to historically high levels.

- The flurry of activity surrounding initial public offerings is reminiscent of past peaks. The recent crushing price action of Twitter, Gogo, Potbelly, King Digital/Candy Crush, Nimble Storage, Container Store, Veeva (too many to list) represent both the optimism of late 2013 and a growing recognition of risk in 2014. The number of IPOs in the last several months has come full cycle, at price-to-sales ratios consistent with 2007. Less than a quarter of the technology sector IPOs are for profitable companies and the last time that was true was 1999 and 2000. [2]

- The stocks of smaller and more speculative companies, measured by the Nasdaq or Russell 2000 indices, peaked in early March and have experienced 8-10% declines in the interim. Much has been made of this in the media. It may be consistent with our concept of too much optimism followed by a growing recognition of risk in 2014, but realistically stocks such as Tesla and Pandora and other high flyers have just dropped back down to prices that most people never thought they'd get up to in the first place.

- Corporate mergers and acquisitions activity is apparently ramping up to levels not seen in many years. To be accurate I base this on the news flow from media reports, but coupled with corporate real estate activity it would be consistent with our view that sentiment has come full cycle.

- Borrowings on margin to acquire stocks had consistently increased, to record levels in February, and there should be few surprised by that. NYSE margin debt for March then declined noticeably for the first time since some minor reductions last summer. [3] The April figure seems predictable as well. To the extent margin debt measures speculation, this is consistent with our other observations.

- As perceptions of economic risk change, market valuations rotate away from longer-duration and volatile assets towards current cashflow and quality securities. In terms of a corporate capital budgeting example, the environment can create a preference for equipment or facilities with a quicker payback return rather than an asset producing higher distant cashflows, because of the rising uncertainties. The publicly traded markets are demonstrating such preferences in recent months, and there is information in that.

- This week we further learn the degree to which the newly installed head of the FHFA is focused on reducing requirements and improving access to mortgage credit. We foresee another New York Times article being posted to the great list of articles on our website which detail the progression of the real estate finance cycle. Too early just yet, as mortgage credit availability remains weak. For now, it is reminiscent of the September 1999 changes at Fannie Mae and simply emblematic of how sentiment rather than economics has come full cycle.

- Should we mention central bank balance sheets in this list?
  (We are rooting for the central bankers because we fear that, without them, the stock market will be like baseball without steroids. Sure, it's proper, it's just not as much fun.)

We have other metrics and anecdotes and can reserve the whole kit and caboodle for our conversations, but all of which reinforce this picture of investor behavior. Somewhat absent from this list are any extremes in more fundamental economic metrics, but I guess there are obvious reasons for that. If it's possible to measure extremes in mediocrity, add that to the list.

❖ *The Full Monty* ❖

The summation of this is that we are experiencing a full cycle on Wall Street without necessarily experiencing a full cycle from Main Street. At the time of becoming more positive in 2009 (All Skate, 3-9-2009) I for one would have never expected us to get The Full Monty:

Turning the page, you will be happy to know that our use of the term Full Monty refers less to the late 1990s movie (a time of another full cycle) and more the British slang term for "the whole thing." In my neighborhood we say "the whole shebang" (US 1920s) or "the whole enchilada" (Texan), but with our thoughts on Europe, a phrase from across the Atlantic seemed more appropriate.

This market cycle is developing, or already has developed, a full return to sentiment and valuation and technical structures consistent with some or all such periods as 2007, 2000, 1987, the late 1960s and so on. In reverse this process helped us identify the 2009 bottom and the energy stock theme from 2002. There are no perfect matches, there never are, and I think there are possible holes in some of these comparisons… but today rhymes with the past, and not just in the US markets.

Some might suggest Europe has bet the full monte or entire pot on a game of Three-card Monte, with the European Central Bank having learned the game from The Bank of Japan, who learned the game from the Federal Reserve, who learned the game from The Bank of... Well shucks, it's getting hard to keep track of which shell controls the nuts with the lowest interest rates and the largest support of asset values. These central banks have the developed economies looking like a bunch of middle-aged countries swinging their hips and putting on a show to compete and overcome structural problems of demographics and accumulated debts. That's as close as we get to the movie version, with a nod to efforts to build confidence as the foundation of a shell game. Such comments are somewhat harsh, but the essence of these problems and government solutions could not be more important.

A shell game is a confidence trick that exploits common character traits such as opportunism, greed, and the "reach for yield." I'm reminded of the very old quote from legendary Legg Mason broker/analyst Ray DeVoe, who if I'm not mistaken started writing The DeVoe Report in the late 1970s:

> *"More money has been lost reaching for yield than at the point of a gun."*

I would pay big money for a full archive of his letters, and I value the copies I do have. His quote may be applicable to today's environment – as noted with the scramble into Greek bonds, Puerto Rico bonds, Pakistan dollar-denominated paper, compressed credit spreads and such low global interest rates in countries that quite simply can not afford higher costs of capital. Our analysis is not so much to pass judgment on the wisdom of macro policies, but rather to observe the impact and evaluate the data. Later, market action may dictate that the analytical work should influence a portfolio strategy.

> Each of these observations in isolation may mean very little. In concurrent total, the significance surely increases, but let's stress and underline this statement: Not one of these observations has anything to do with precise timing. Still, taken together, the full monty of these conditions may help identify general timeframes which are more vulnerable to an inflection point. It has before.

❖ ***Timing*** ❖

We have noted the subtle significance of the November-January timeframe. As risk measures began to change, we were very alert to the sharp stock market decline in January. Sharp as it was, the internal nature of that drop lacked some credibility, and an important timing indicator we use then suggested the US stock market could make, at a minimum, another marginal new high for the bull market.

At this moment, that is a true statement although one might need to underline the word marginal. Still, the markets as measured by both the S&P 500 and DJIA have now satisfied that expectation, and we have written this commentary to coincide with that.

I will say this. Our work suggests that the next stock market correction can be more significant than just a "correction" – such that market action would leave no doubt the uptrend has been broken. If so, it will be a multi-stage affair and force a progression of uncomfortable issues to be addressed. We'll leave it at that for now, except to say that the credit cycle we've discussed for years … is not over.

While some technical requirements are satisfied at this time, for business cycle reasons we first think it more probable that the US stock market still moves higher this summer. Famous last words perhaps, but we'd place a higher probability on that, even though we have chosen to write these comments today. This is a dangerous segment of our commentary, and not just because it involves the future.

As an analyst, we work very hard to identify current opportunities and future risks. As a portfolio manager, we work to maintain strategies, to not change tactics until the probabilities have truly shifted, and to be skeptical of every analyst, especially ourselves. Thirty years of experience teach humility. Still, if we get that further rally, our observations about sentiment, valuation, and technical structure will surely expand and indeed more fully define The Full Monty.

❖ *Other Markets* ❖

We remain more positive towards Asia than Europe… markets such as Taiwan and Singapore. India and South Korea add to that group. Economic growth prospects coupled with financial strength and reasonable valuations bode well for the longer-term secular trends there, even as potential shorter-term cycles may interrupt those trends. The credit cycles also appear much more manageable in South Korea and Taiwan for instance, as compared to China. Although the slower growth in China impacts the other economies in the region and around the globe, we remain attracted to these four countries.

Gold prices retain a strong probability of making yet another low in the second half of this year. As mentioned about a year ago, when gold dropped below the $1500/ounce shelf of support, the potential for significantly lower price targets became so much more likely. We did discuss and evaluate a countertrend rally in January with some interested clients, but the economics and price action in gold still look to be subject to another downtrend to new lows this year. For planning purposes, the gold market may hold some interesting upside potential at that point, just not yet.

The dance between deflation and inflation continues. From the 4-4-2013 commentary we were bearish against most commodities, and mentioned copper cathode moving below $3/pound (reached by the end of June and again in March), wheat dropping to $6 (downtrend ended in January near $5.50), corn approaching $5.50 (was below $4.50 by year-end), and raw cane world sugar moving below 16 cents (reached in July and even lower in January). Those cyclical moves are behind us.

The CRB Index of commodity prices actually peaked in the distant summer of 2008, with a lower bear market rally peak in the summer of 2011. That bear market rally had launched from a low in January/February of 2009, and this rally has launched from lows in January/February of this year. I don't know if any of that rhymes, but certain rallies into the summer of 2014 would not surprise us. The supply/demand metrics in a number of commodity markets can support higher prices this summer, and these cyclical moves create media attention in regards to inflation concerns.

View it as temporary. We don't think these uptrends are going anywhere longer term. The prospect of strength in the US dollar (which we have been rather wrong about over the past year) is still something we see developing and that can alter the durability of these commodity price increases as well.

Oil prices are normally important to our macro work, but we mentioned last year that oil prices were becoming boring and that has continued. Our work does not identify a particular trend for world oil prices at this time, but that doesn't mean we don't like energy stocks, we do. We are just unsure what to make of the Russia/Ukraine/Europe situation. Our view of natural gas was for a sloppy 2013 and a stronger period for 2014 and beyond. The analysis today suggests we may need to become more patient with some rougher patches over coming months (maybe longer). Ultimately we see higher prices for domestic natural gas and this is a multi-year forward perspective. Natural gas prices have generally been rising since the summer of 2012, and we see a long cycle in terms of demand. It is taking longer to develop than we had previously thought.

The reach for yield certainly extends to real estate and we have much anecdotal evidence of money being thrown at real estate deals. With such intense global accommodation, it is human nature, and it is difficult to suggest that this trend is changing. The cost of capital is low. Interest rates are still drifting lower globally, but we wouldn't touch Japanese bonds, and there should be a wonderful opportunity to short European paper here in 2014 (probably much later in the year). We've reached the part of the presentation where I start to ramble, so

❖ *Summary* ❖

In aggregate, our equity portfolios have roughly doubled the returns of the S&P 500 Index year-to-date, and as a portfolio manager we have not needed to make significant changes in tactic. As an analyst, we've chosen today to update our comments because we think there is an immediate risk of some degree of downdraft in global equity markets, although decent odds exist that it will prove to be temporary. If the markets were to move below recent lows of the last couple months, our respect for such a downtrend would quickly grow. Absent that, and despite the changing risk environment we have described, the probabilities still suggest higher prices before a more significant bear market.

Investors are showing a preference for larger capitalization companies and for more liquid quality names. This behavior reinforces our view that risks are rising in an unusual low-growth world influenced by central bank experiments, yet it acknowledges that investors still feel they have few alternatives to stocks. That sentiment is prevalent, we have seen such sentiment before, and it can prove to be dangerous.

So I have to provide another great Ray DeVoe quote …

> *"The more things change, the more they remain insane."*

If the investment environment is not insane yet, we are likely to get there because we are definitely getting the whole shebang, and we think the next downturn will reveal the full monty for all.

-Brian

[1] Robert J. Shiller, stock market data used in "Irrational Exuberance" Princeton University Press, 2000, 2005, and as updated: *www.econ.yale.edu/~**shiller**/data/ie_data.xls*

[2] Jay R. Ritter, data from "Initial Public Offerings: Updated Statistics" University of Florida, analysis as of April 20, 2014: *http://bear.warrington.ufl.edu/ritter*

[3] NYSE Technologies Market Data Book updated through March 2014: *http://www.nyxdata.com/nysedata/asp/factbook/*