EPIC
INVESTMENT MANAGEMENT

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2013 -- Running of the Bulls

Everyone loves a bull market. And why not?
Stocks rose sharply in the past year, accelerating gains from the prior 12 months. Major indices rose 26 percent and more, with new all-time highs set by the Dow Jones Industrials, S&P 500, S&P Midcap 400, and Russell 2000 small cap index. If it looks like a bull, and roars like a bull.. well, it's a bull.

What caused it? It's not the usual suspects. Gains of this magnitude usually appear early in a market cycle, as a bear market exhausts itself and transitions to a sustainable upturn. It takes place when valuations are depressed and the economy is only emerging from recession. It happens as a combination of rising earnings, expanding multiples, and improving capital flows drive prices sharply higher. This all occurred according to form.. in 2009. But four years later?

This is a bull of a different ilk. Forget about the economy; its pace has improved from a walk to a jog, but it is still moving well below top speed. Real GDP is up just two percent in the past year, and with inflation subdued, nominal GDP is up only 3.4 percent. Corporate profits have grown nearly six percent, as have S&P 500 earnings, both in line with their long-term averages. The earnings growth in a sluggish economy is impressive, but does not support stock gains of 26 percent.

If it is not the economy, and it is not profit growth, there is only one explanation -- multiple expansion. Stocks continue to re-rate higher, setting their own pace in moving from undervalued to fairly priced. That pace accelerated in 2013. As the year began, the median PE on S&P 500 constituents' forward earnings stood at 13.9 times. That number is now 16.6.

All in all, 75 percent of the market's advance can be explained by rising multiples, and this in the face of higher interest rates. Thank Ben Bernanke and the Federal Reserve; all that easy money has to go somewhere.

Can it repeat? Well, don't count on it, certainly not to the same extent. Higher prices make for giddy investors, but do not create better values. Equities are still attractive versus bonds, allowing for additional multiple expansion, but less decisively so. Beyond that one comparison, stocks are not cheap at all -- not expensive, but no bargain either. After a five-year bull market, plenty of money has been made. There may be more for the taking, but it won't be so easy. It's time for investors to prove their savvy.

How will the coming year develop? Making guesses, disguised as predictions, is not our game. More valuable is a conceptual playbook for 2014 and beyond. Here it is…

1. The markets don't know what day it is

The turning of the calendar is rarely a turning point for markets. Yet investors, with plenty of prodding from Wall Street, are tempted to start over every January. Staying the course is typically a better option.

The most important day in the last year was in May, when the Federal Reserve openly spoke of tapering its bond buying program. Interest rates on the benchmark 10-year Treasury broke above the two percent ceiling and never looked back. Within four months, rates hit three percent. Nobody knew this on New Year's Day.

2. Interest rates have bottomed

Again based on the 10-year Treasury, rates made an all-time low in July 2012 at 1.39 percent. This past May, rates set a higher low at 1.63 percent. At year end, the yield is just over three percent. The great, three decade, bond market rally has ended.

A critical question for both bond and stock markets is whether long-term rates will stabilize, or move meaningfully higher. The former will allow bond investors to painlessly clip coupons, while setting a favorable backdrop for stocks. We may even revive the term 'Goldilocks'. The latter would be much more problematic, closer to a nightmare than a fairy tale.

3. The economy is not the stock market

Perhaps we should blame the popularity of business news. When you need to fill air time, you parse every economic data point and relate it to hourly and daily market moves. Of course this is journalistic poppycock, abetted by an investment community willing to play along.

Since the depression, the strongest decades of US economic growth were the 1940s and 1960s. The most rewarding decades for equity investors were the 1950s, 1980s, and 1990s. Where's the connection? The past five years have been one long run of economic disappointment, much to the joy of equity investors. The weak economy actually helped, prompting a major liquidity infusion from the Federal Reserve. Equity markets are more complicated than simply tracking the fits and starts of the economy.

4. Current income is not total return

For years, bond and equity-income investors have been riding the same wave -- lower interest rates drive prices higher and make income investing doubly rewarding. Those days are over. Yield without growth is now a value trap. Bond market rallies should be used to adjust positions and reduce interest rate exposure. Bond market swoons will be time to hope and pray -- that rates do not rise too far, too fast.

5. BRICs are crumbling

In 2001, Jim O'Neill of Goldman Sachs coined the BRICs acronym to denote four emerging powers in the global economy. The idea proved both clever and prescient. Yet even its author has cooled on the BRICs concept. Brazil, Russia, and India will deal with their formidable challenges, be it trade, infrastructure, overcrowding, poorly developed institutions, unstable currencies, or varied exposure to energy markets.

China stands apart. It has become the world's junior economic superpower, is still rapidly growing, reforming its markets and social policies, and is moving toward a consumer economy. It faces near-term risks of a fragile banking system, mounting debt, and a bumpy transition from development to consumerism. At the moment, these concerns predominate. Still, if there is another nation that offers the combined economic power, growth, market reforms, and attractive valuation of China, we would like to know where that is.

6. Expanded horizons

We have been well-served in maintaining a US-centric focus for the past three years. Domestic markets have performed well, while developed and emerging international markets have both struggled. But nothing lasts forever.

In the developed world, Europe has finally bounced off its bottom, not with much vigor, but it's a start. Japan has enacted a new stimulus plan, and its stock market has rallied resoundingly. Emerging markets begin with China, but do not end there. Global growth should accelerate in the coming year, boosting corporate profits in many locales. Yet equity valuations have compressed. It didn't take long for global markets to go from too hot to too cold. Someday soon, they may be just right.

Happy New Year!!

Source:
Bloomberg
Wall Street Journal

Tidbits..

Obamacare launches with website glitches, policy cancellations, angry electorate.

"I'm from the government, and I'm here to help."

Hedge Fund giant SAC Capital agrees to pay 1.8 billion dollar penalty for long-standing practice of insider trading, after receiving earlier criminal indictment.

Town of SeaTac, Washington raises minimum wage to 15 dollars per hour.

A micro-economic experiment disguised as flawed policy.

American Airlines merges with US Airways, as Justice Department gains minor concessions, backs down from dubious legal challenge.

US investment grade corporate bond issuance reaches record level, topping one trillion dollars for the year.

OECD forecasts 2014 global economic growth of 3.6 percent in 2014, up from 2.7 percent in 2013.

A global economy still well below its potential, but perhaps improving.

JP Morgan Chase agrees to pay 13 billion dollar settlement over mortgage claims.

A staggering sum, markets yawn.

Treasury Department sells its remaining equity stake in General Motors.

Government Motors: A bad idea whose time has passed.

Number of federally-insured US banks drops below 7,000 for the first time in eight decades, as community banks consolidate.

And the big get bigger.

Amazon proposes idea of delivering small goods via drones.

Why not just beam it over?

And then there were three.. after Holland's credit rating cut, only Germany, Finland and Luxembourg remain as Eurozone's triple-A rated nations.

US household net worth exceeds 77 trillion dollars, record level.

Global Foreign Direct Investment for the first time favors developing economies over developed nations, including the US.

No turning back globalization.

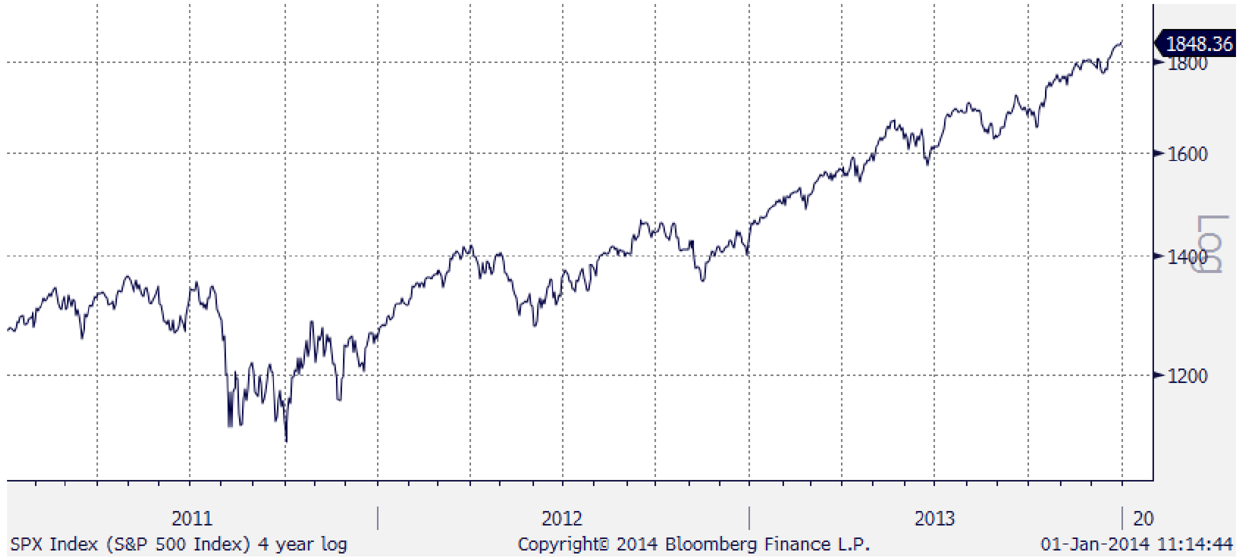
After three years, regulators agree on 'Volcker Rules' to apply to largest banks' trading operations.

Federal Reserve begins 'taper', reducing bond-buying pace of Quantitative Easing program.

Equities

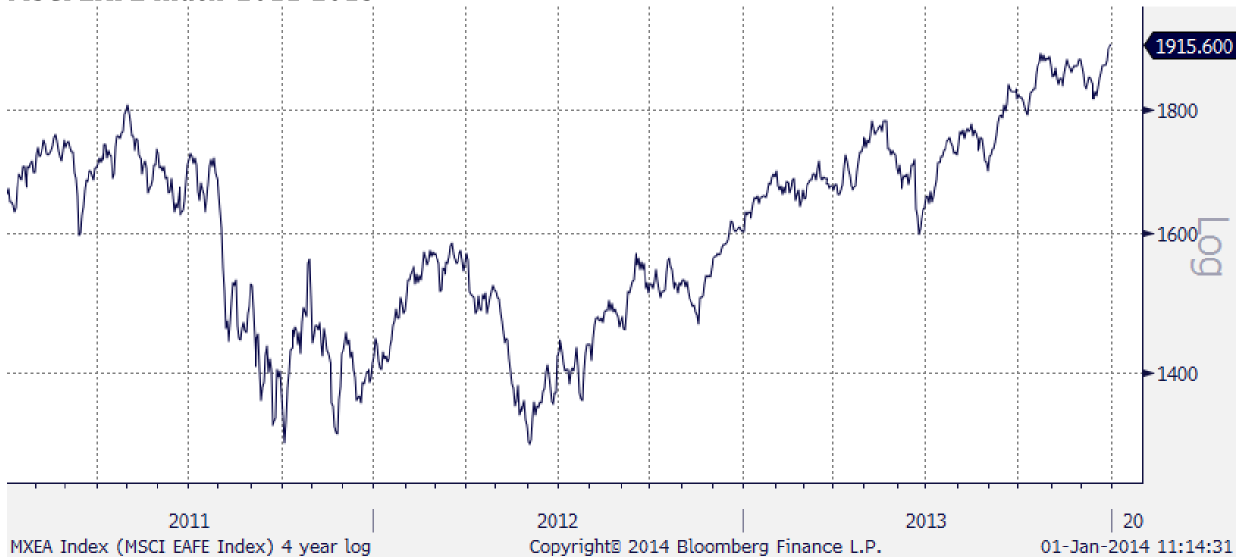
US equity markets were strong throughout the year, with pullbacks only short and shallow. Most major indices reached all-time highs.

SP 500 Index 2011-2013



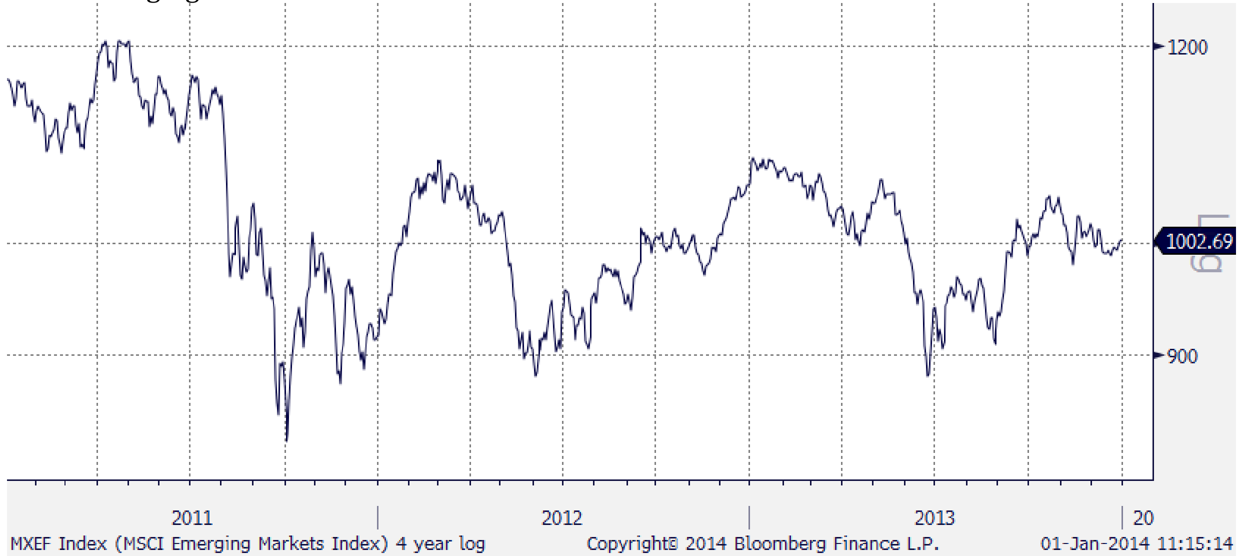
Developed international markets rallied strongly from mid-year through December, with Japan leading the way and Europe recovering nicely.

MSCI EAFE Index 2011-2013



Emerging markets were once again the laggards, producing negative returns for the second time in three years.

MSCI Emerging Markets Index 2011-2013



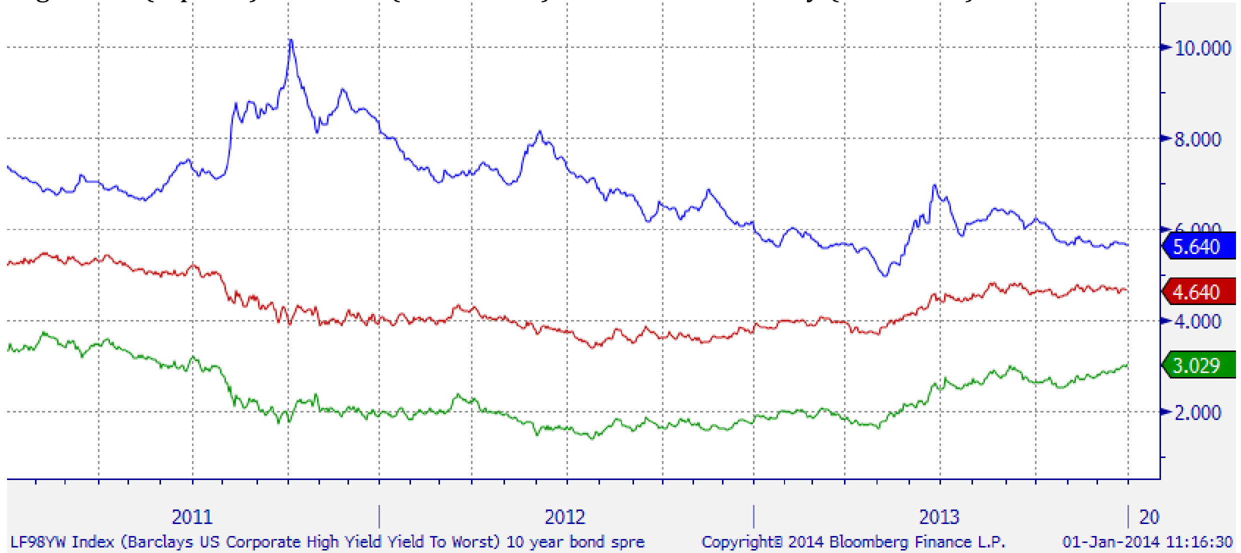
China is the new conundrum. Its economy is large and rapidly growing, while its major, mainland stock exchange is in a multi-year bear market.

Shanghai Stock Exchange Composite Index 2011-2013

Bonds

Bond yields declined into May, then awoke to the prospect of an eventual Fed exit from the market. High yield/ junk bond rates set record lows, and recently reached the tightest spreads in this cycle. For income investors, there is just not much value remaining, but there is plenty of risk.

Intermediate Bond Yields 2011-2013
High Yield (top line), AA rated (middle line), 10 Year US Treasury (lower line)



The Treasury market finally gave in to reality -- even with Federal Reserve support, yields under two percent made no sense.

US Treasury 10 Year Yield 2011-2013

Commodities

Commodities continue to reflect the weakness of the global economy -- too much supply, not enough demand.

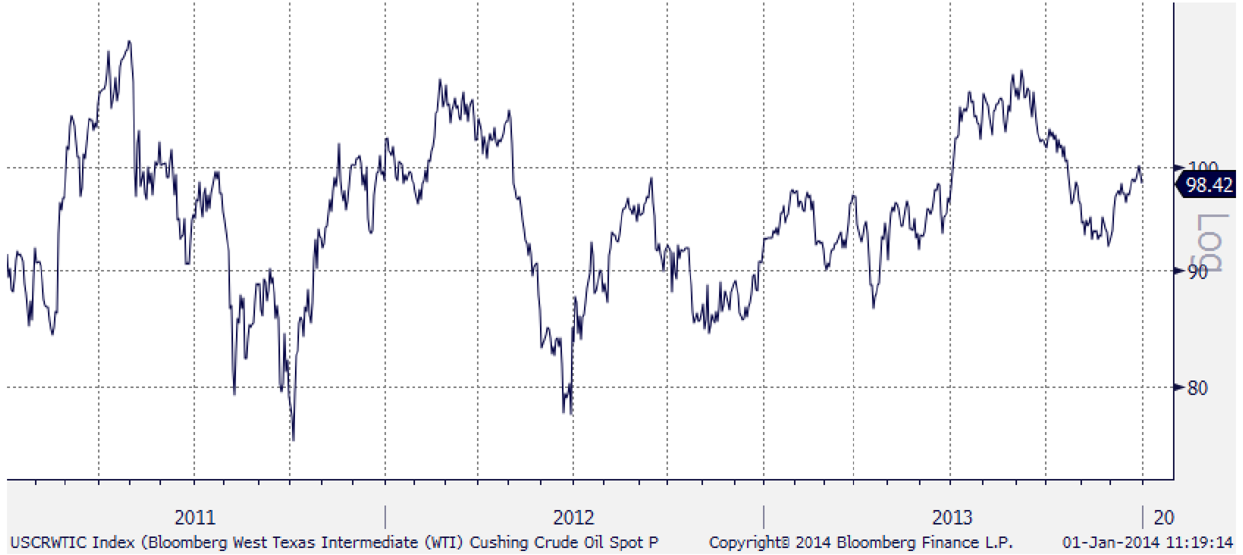
CRB Commodity Price Index 2011-2013

Gold broke its 12-year winning streak of higher prices, and entered its own bear market.

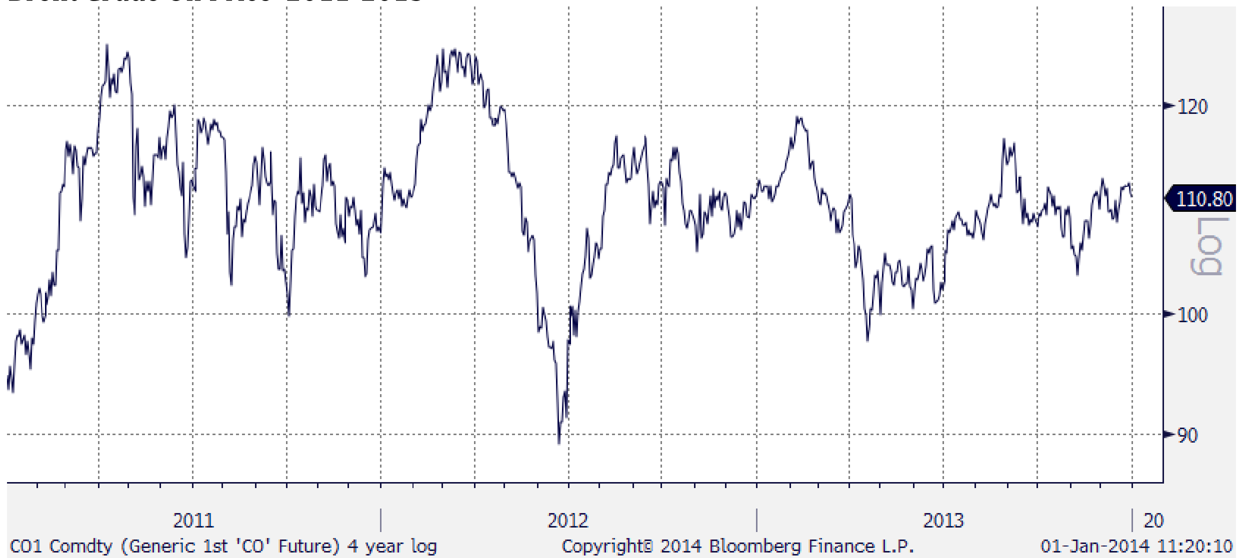
Gold Price 2011-2013

Oil prices were range-bound for the year, ending essentially flat. Once again the real story is the substantial discount of US-based crudes over Europe's Brent crude oil. There is a reasonable chance of US oil joining natural gas in a supply glut.

West Texas Intermediate Oil Price 2011-2013

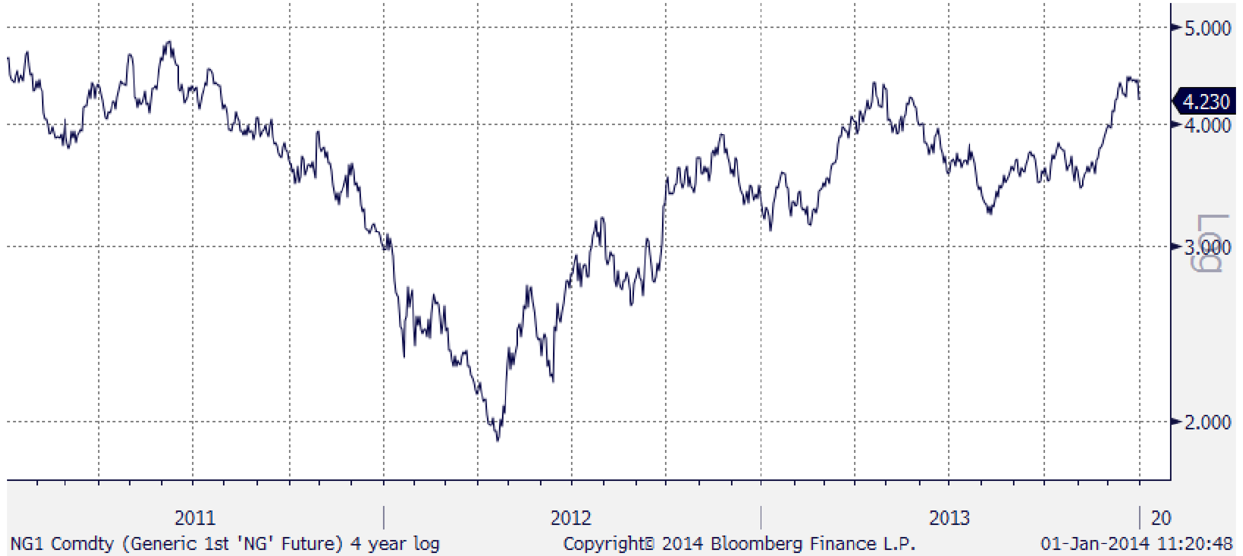


Brent Crude Oil Price 2011-2013



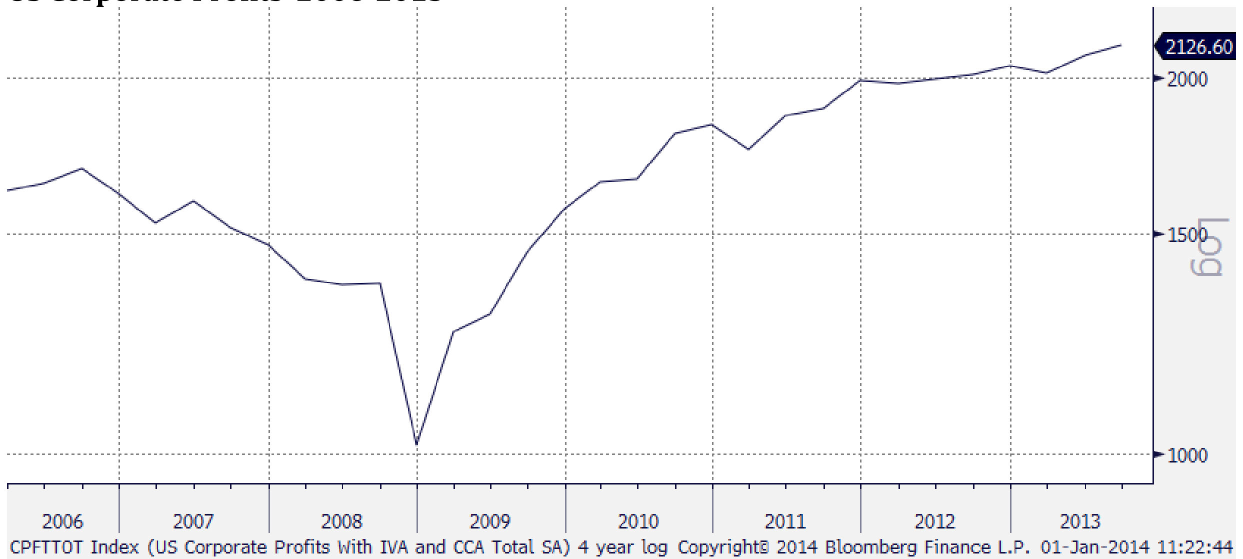
Although up sharply from its bottom, Natural Gas continues to be cheap and plentiful, thanks to domestic drilling activity.

Natural Gas Price 2011-2013



Ahead of schedule, and despite the Federal government, the US has become the world's largest producer of oil and gas.

US Corporate Profits 2006-2013

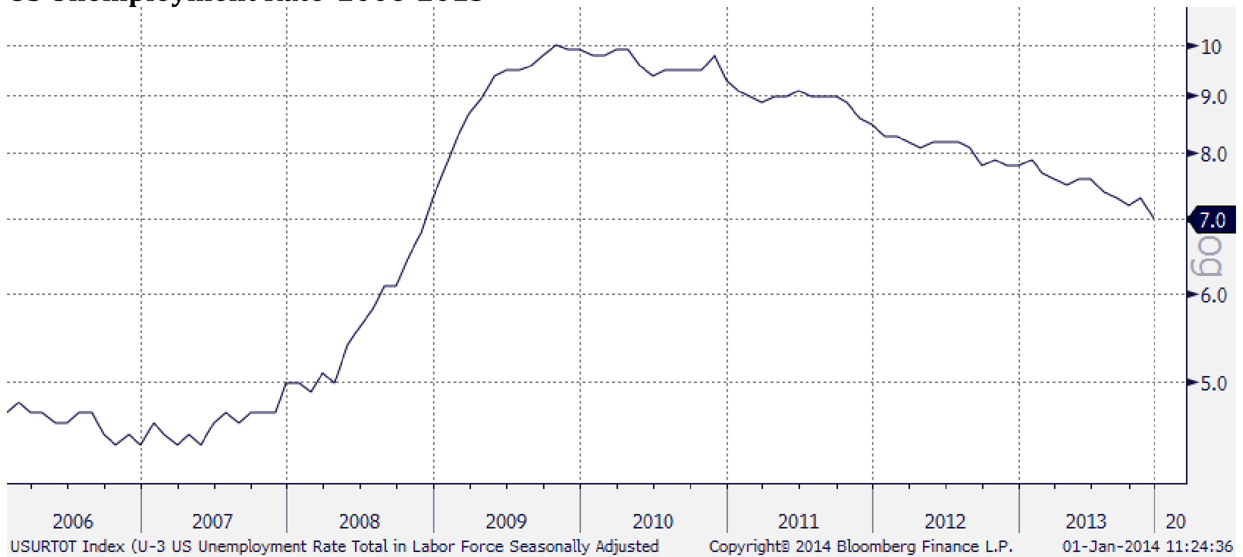


US corporate profits, boosted by nominal growth, global expansion, and tight cost controls, exceed two trillion dollars, doubling since their recession bottom.

S&P Case-Shiller Composite Home Price Index 2006-2013

Housing prices transitioned to a cyclical bull market, rising nearly 14 percent in the past year. Still, home prices are down 20 percent since 2006, and the recent double-digit gains are unlikely to repeat.

US Unemployment Rate 2006-2013



The unemployment rate, now seven percent, is at a five-year low.

But much of the improvement is explained by the lower labor participation rate -- a smaller labor force as a percentage of the working-age population. It's not so much that more people are finding jobs, but that fewer people are looking.

US Labor Force Participation Rate 2006-2013