EPIC
INVESTMENT MANAGEMENT

Issue 27 January 2015

2014 – Diverge and Conquer?

Another year, another extension of the bull market run. Yet, if there is anything resembling a typical bull market move, this was far from it.

In equities, US large-cap stocks continued their strong advance, registering double-digit percentage gains for the third consecutive year. Small-cap stocks did not share the joy, rising only five percent for the year. On a dollar-adjusted basis, global equities struggled. Both developed markets and emerging markets produced losses, the latter for the third year in the past four. With domestic markets rising and the rest of the world in a funk, the performance gap between US stocks and global stocks was the largest since 1997. In hindsight, the best call for 2014 was simply to own US large-cap stocks and ignore the rest of the world, big and small. This looks like a divergence within equity markets; still minor, but worth watching.

Fixed income markets told a similar tale. In the year's biggest surprise, US Treasurys rallied sharply, with the 10-year yield falling from just over three percent at the start of the year, to end the year at 2.17 percent. High quality corporates followed suit, with long-term yields dropping 80 basis points, to less than four percent by year end. The junk bond market was not invited to the party, as high yield rates increased nearly 100 basis points. This divergence -- falling Treasury yields and rising junk bond yields -- sent high yield credit spreads to their widest level in two years.

A rising US equity market, combined with a general decline in yields, created a favorable backdrop for equity-income. Real Estate Investment Trusts (REITs) in particular advanced sharply, more than recovering from the disappointing performance of the prior year.

Commodities suffered, ending the year in near free fall. A strong dollar and sluggish global economic growth set a weak tone for commodities, topped off by the year-end collapse of oil prices. All in all, it was a terrible time for the commodity complex, leaving some to wonder if this is truly an investable asset class. Years ago it was not. Sure, you could buy silver and gold coins; but if you wanted to own ten barrels of oil, or a hundred bushels of wheat, where would you store it, and how would you sell it? The development of futures markets, and later of exchange traded funds, made it easy to bet on commodities as a class. Then again, you can bet on the winner of the Super Bowl, or the Super Bowl coin toss; that does not make it an investable asset. We are on the fence on the broader question of investability, but note that for over two decades, commodities have underperformed all other asset classes we consider for investment. Our direct exposure

through the year was zero, and when commodities finally rally, we expect our direct exposure to still be zero. In all likelihood, that includes gold.

Volatility returned to equities, commodities and currencies in 2014. Nobody complains about upward volatility, but we should not expect accelerated price moves to always be favorable. Nor should we assume that a collapse of both oil prices and the Russian Ruble are unequivocally bullish developments. Economic stress mixes with geo-politics to create a dangerous cocktail.

In US equities, the year saw four pullbacks measuring four percent or more, though none breached the ten percent 'correction' threshold. The 'VIX' volatility index spiked twice in the fourth quarter, marking its highest level in nearly three years, and ended the year 80 percent above its summer lows. At the start of the year, 74 percent of New York Stock Exchange stocks were in an uptrend; by year end, the number was just 55 percent. And as referenced earlier, small cap stocks significantly underperformed for the year.

The picture being painted is of an aging stock market, with gains narrowing, divergences widening, and volatility increasing. In a sense this should be expected, as the bull market is nearing its six-year anniversary. The obvious response is to ask what this means for the coming year or more. The answer requires a bit of context.

You won't read this in any Finance textbook, but bull markets generally have three phases. The initial phase is marked by sharply rising prices and investor disbelief. The issues accompanying the fading bear market are still evident -- typically including a weak economy-- yet the collective wisdom of the market shifts its focus to future growth and attractive valuations. Phase two provides broadly higher prices for most risk assets -- large-cap and small-cap stocks, corporate debt both investment grade and high yield, global equities, and perhaps other asset classes such as real estate and commodities. At this stage asset correlations run high; most markets are moving in sync, and investors cannot help but make money.

Phase one is long gone. Most likely, we ended phase two in 2014.

That brings us to phase three -- present-day conditions and the outlook for the coming year. Expect a continuation of these emerging themes: divergence, volatility, narrowing markets. An investor might ask, "why not just sell everything if phase three is more perilous?" Here's why: Stocks can still move meaningfully higher, and this phase can take years to play out. For example, in the great bull market of the 1990s, stocks reached their peak momentum sometime around late-1997 to early-1998; a stealth bear market struck in the summer of 1998; interest rates bottomed that autumn; value stocks topped out in May of 1999. Yet the bull market charged ahead until March of 2000.

The current version will certainly not play out in the same fashion, as no two cycles are ever the same. While it is possible the market is already setting a top, it seems unlikely. We won't point to a strengthening economy and robust corporate profits as proof; the stock market is well ahead of

the economy, while record earnings are reflected in current prices. Furthermore, markets have an annoying habit of peaking on good news.

Instead we rely upon two pillars of support: easy monetary policy, and a favorable valuation of stocks over bonds. Since 1970, there have been eight bear markets. Only one of these, the brief bear market of 1998, took place without a prior or simultaneous tightening of monetary policy, as signaled by a hike in the Federal Funds rate. The first rate hike in this cycle is probably six months away, or more; and when the Fed does tighten, it will likely move with utmost caution.

In terms of stocks versus bonds, the equity earnings yield remains 330 basis points above the yield on bonds. In the past half century, no bear market has started when the spread was greater than 130 basis points. That makes 330 basis points a big cushion. Stocks are no longer cheap; by many measures they are fairly priced; but stocks still offer value compared to bonds.

So we hang our hopes on easy money, and stocks priced cheaper than bonds. And we keep a close watch on everything else.

Happy New Year!!

Source:
Bloomberg
Wall Street Journal

Tidbits..

Major banks settle charges of manipulating foreign exchange markets.
Large US banks likely to face tougher capital rules than smaller and foreign counterparts.
New York state regulator to raise scrutiny of banks, including on-site monitors.
After years of bad behavior, large US banks are in cross-hairs of regulators, prosecutors.

Two dozen states boost minimum wage for 2015.
The belief that capitalism and 'free money' can co-exist.

President Obama calls on Federal Communications Commission to regulate the internet as a public utility.
No satiating regulatory appetite.

Berkshire Hathaway to buy Duracell battery business from Procter & Gamble.
Halliburton to pay 35 billion dollars for Baker Hughes in oil services deal.
Drug companies Actavis and Allergan agree to 66 billion dollar merger.
Global merger activity exceeds three trillion dollars for the year, highest level since 2007.

Aereo, TV-over-internet service, files bankruptcy shortly after losing case at Supreme Court.

Google search and email functions are blocked in China.
European Parliament passes resolution to split Google into two companies, separating search engine from other businesses.
Google is the new Microsoft.

US corporate bond issuance exceeds 1.5 trillion dollars, hits all-time high level in 2014.
Global bond issuance tops four trillion dollar mark, also record high.
Leveraged buyout activity plummets in 2014, lowest activity level since 2001.
With low interest rates around the globe, more refinancing and merger-related borrowing, surprisingly fewer buyouts.

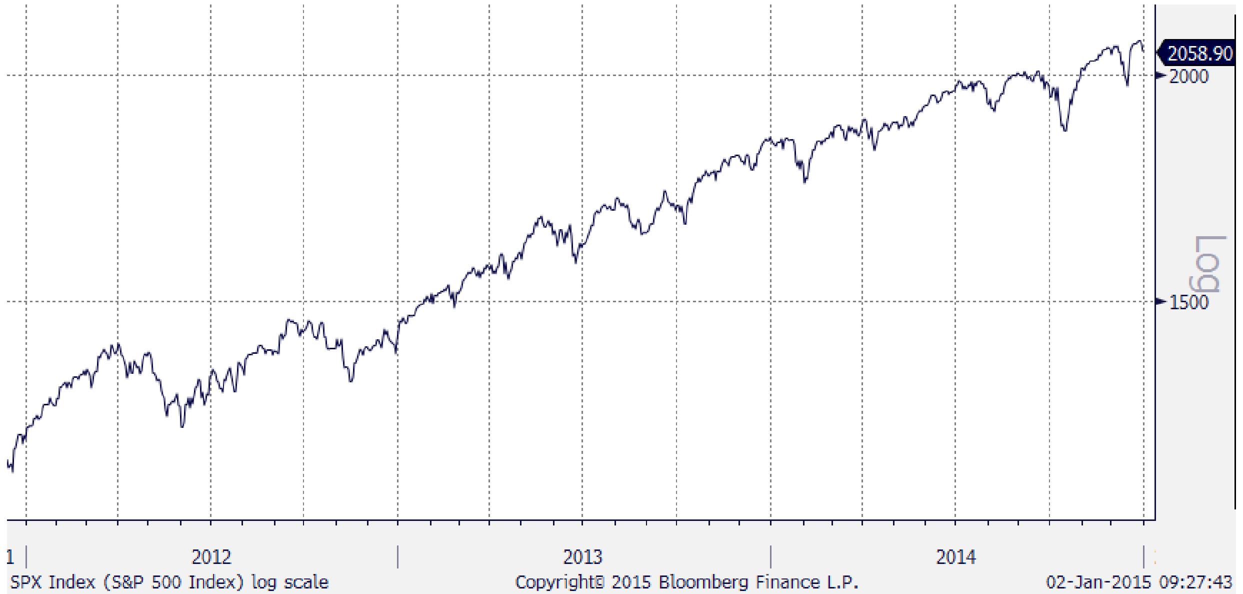
Thanksgiving weekend retail sales drop 11 percent as promotional season begins earlier, online sales gain traction.
Maybe "shop 'til you drop'" is passé.

Hedge funds close at fastest pace in five years as lagging returns and high fees make for a losing combination.
"Heads I win, tails you lose" was never in the clients' interest.

Automobile recalls in the US top 60 million vehicles in 2014, setting dubious record.

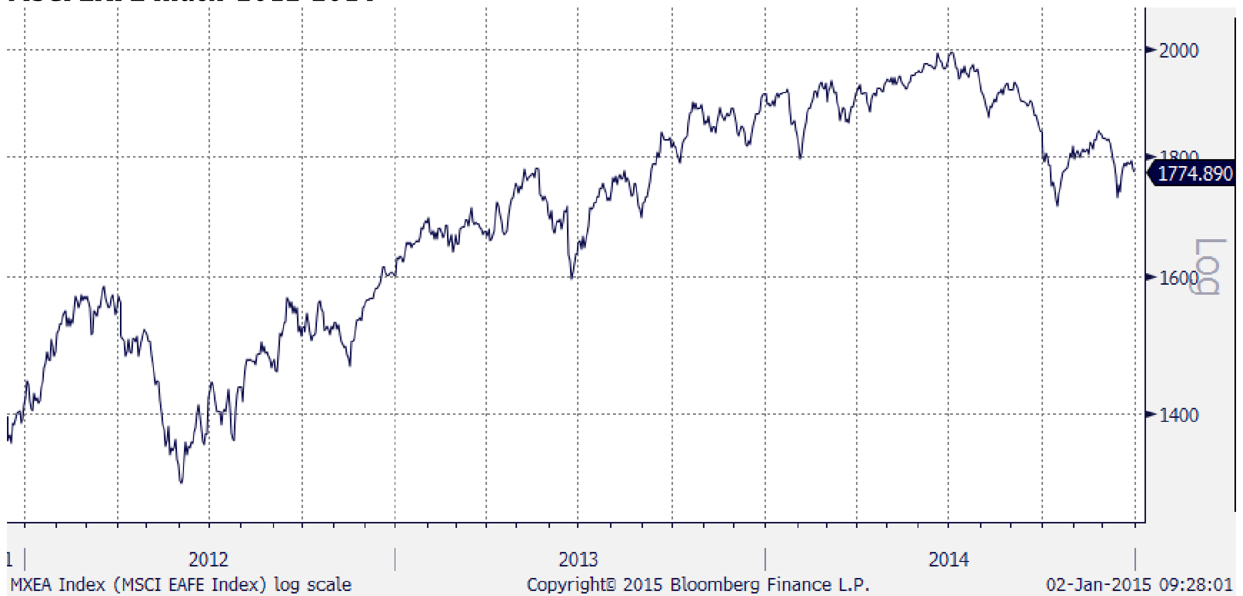
Equities

SP 500 Index 2012-2014



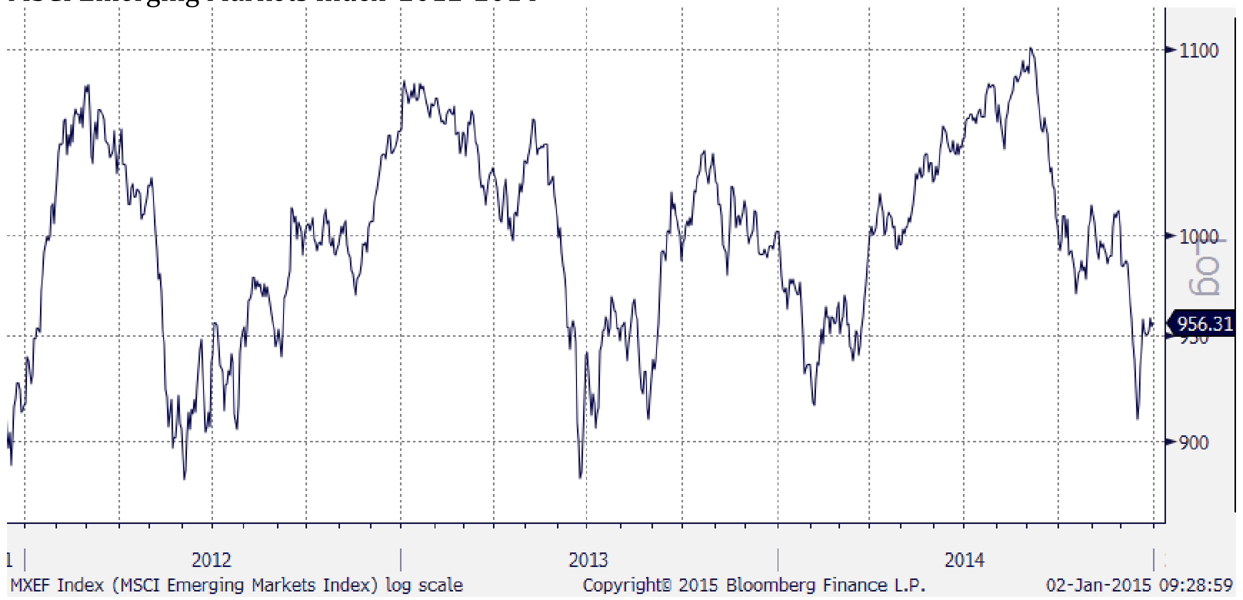
US equities maintained their uptrend despite rising volatility, ending the year near all-time highs.

MSCI EAFE Index 2012-2014



Developed international markets entered the year with strong momentum, only to suffer a second-half correction.

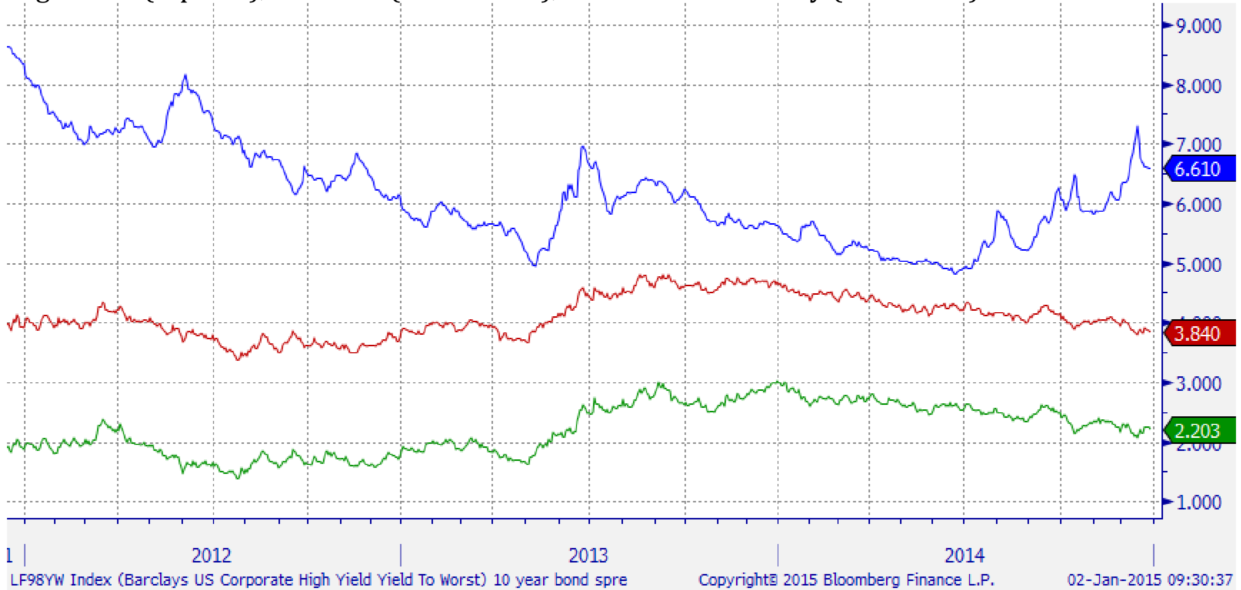
MSCI Emerging Markets Index 2012-2014



Emerging markets declined for the third time in four years, and have made no progress since the end of 2009.

Bonds

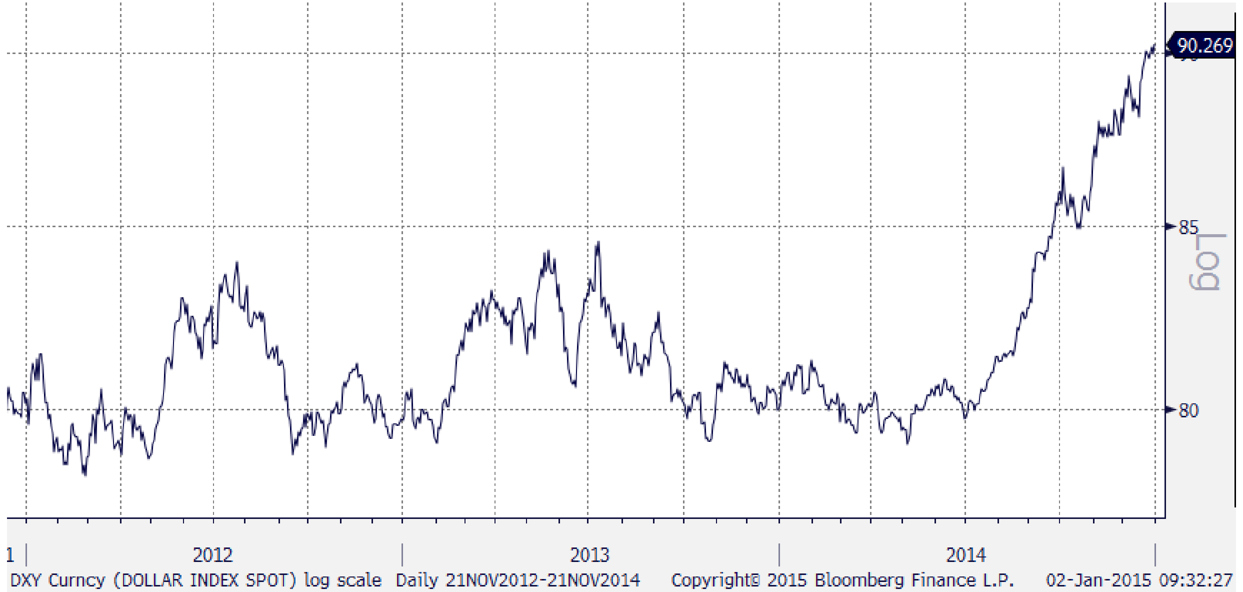
Bond Yields 2012-2014
High Yield (top line), AA rated (middle line), 10-Year US Treasury (lower line)



Treasurys provided the year's big surprise, with the 10-year yield falling to near two percent. Quality corporates followed suit, but the junk bond market changed direction mid-year, with yields rising over 170 basis points since June.

Currencies

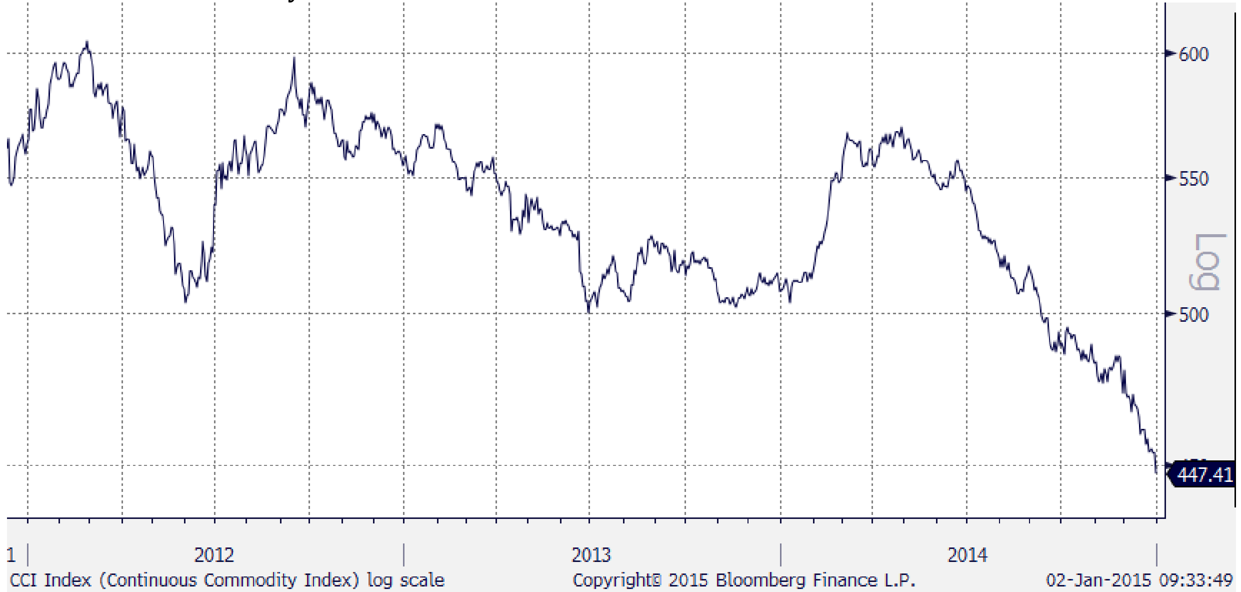
US Dollar Index 2012-2014



Fears of the Federal Reserve's easy monetary policy trashing the dollar proved unwarranted. The US Dollar regained its status as the world's leading major currency.

Commodities

Continuous Commodity Index 2012-2014

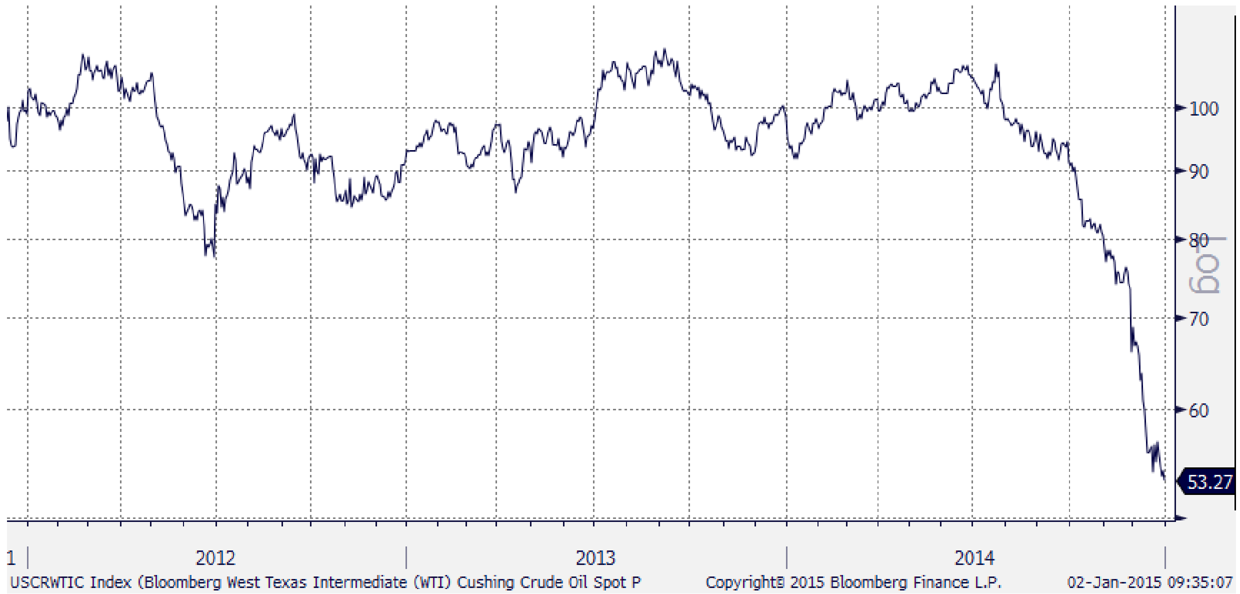


Commodities reflect a sluggish global economy, along with a collapse in oil prices.

Gold Price 2012-2014

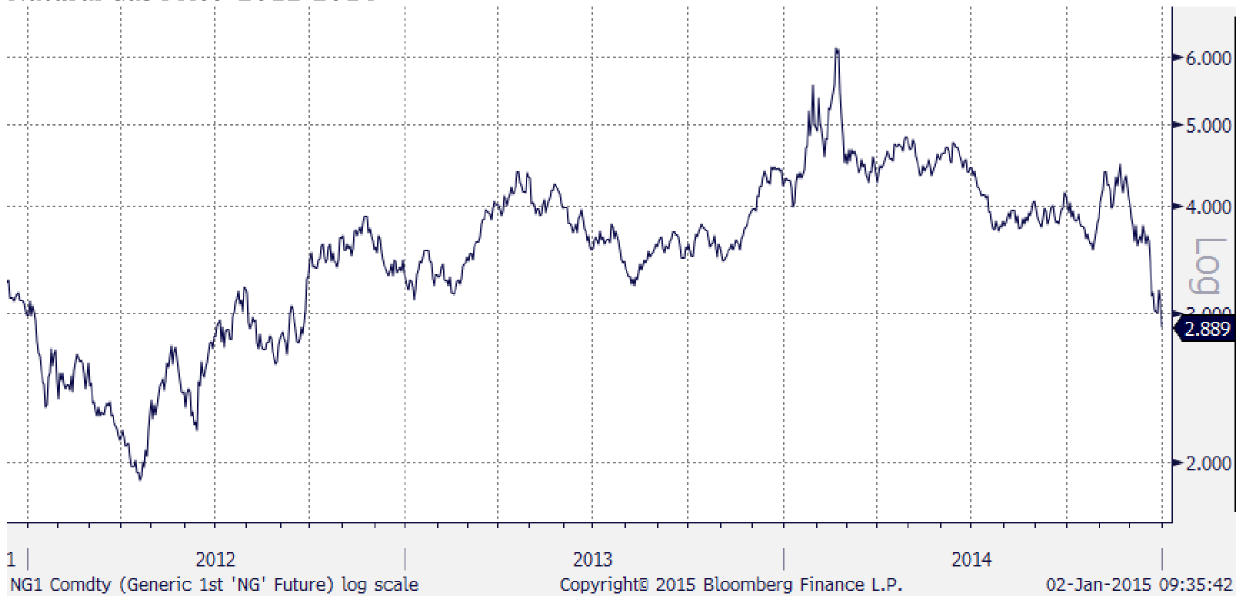
Gold was range-bound for the year, and remains in a bear market.

West Texas Intermediate Oil Price 2012-2014



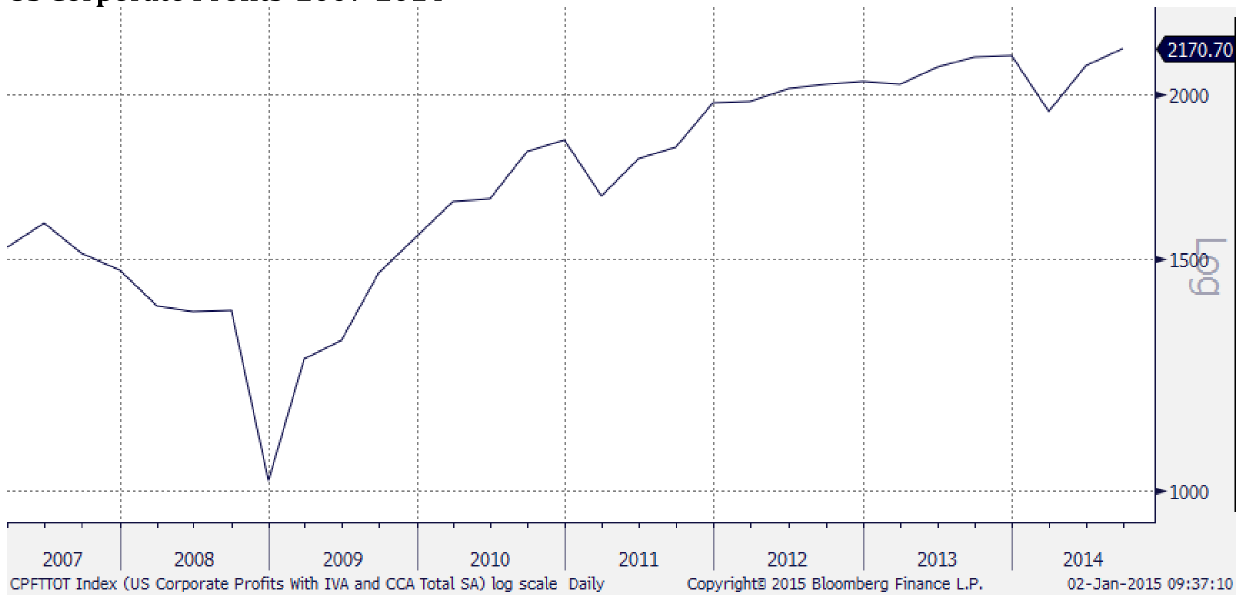
Oil prices were cut in half late in the year, as Saudi Arabia withdrew from its traditional role of swing producer. The oil market will set a new equilibrium price, likely well below the prior 100 dollar level.

Natural Gas Price 2012-2014



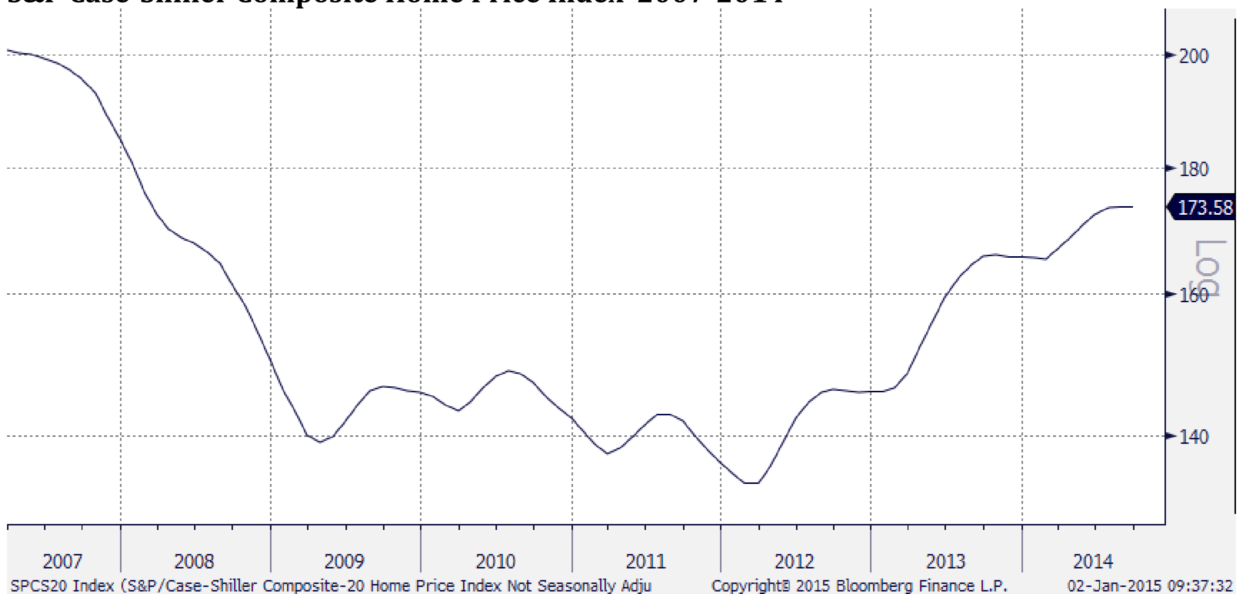
It seems only harsh winter temperatures can support natural gas prices.

US Corporate Profits 2007-2014



US corporate profits remain the highlight of the economic recovery, doubling since their recession bottom to over two trillion dollars. Expect profit growth to slow considerably, with an outright decline a possibility.

S&P Case-Shiller Composite Home Price Index 2007-2014



After rising nearly 14 percent in 2013, home prices moderated in 2014 amid a general deceleration of housing activity.

US Unemployment Rate 2007-2014

In one of the year's positive surprises, the job market strenghtened, with the unemployment rate falling below six percent. 2014 looks to be the best year of job growth since 1999.

There is still the issue of a low labor participation rate -- a smaller labor force as a percentage of the working-age population. Wage gains have been hard to come by, keeping a lid on inflation, and on middle class prosperity.

US Labor Force Participation Rate 2007-2014