EPIC
INVESTMENT MANAGEMENT

Issue 17 July 2013

# Here We Go Again

Be careful what you ask for.

This year's bull market has been met with a mix of skepticism, angst, and at times utter disdain. The reason is nothing new, too many people were missing the party. The excuses are always a rehash of familiar themes heard over the years: stocks are expensive; the market has risen too far, too fast; the economy is weak; the world is full of uncertainty.

So what do investors ask for? A second chance, in the form of a market correction. They got it. After six months of a bull market -- not just in US stocks, but in numerous asset classes here and abroad -- the party ended abruptly. In late May, Federal Reserve Chairman Bernanke suggested that the central bank's bond-buying program might end sooner than expected. The reason, if it comes to pass, would be a strengthening economy. All in all, that sounds like a fair trade.

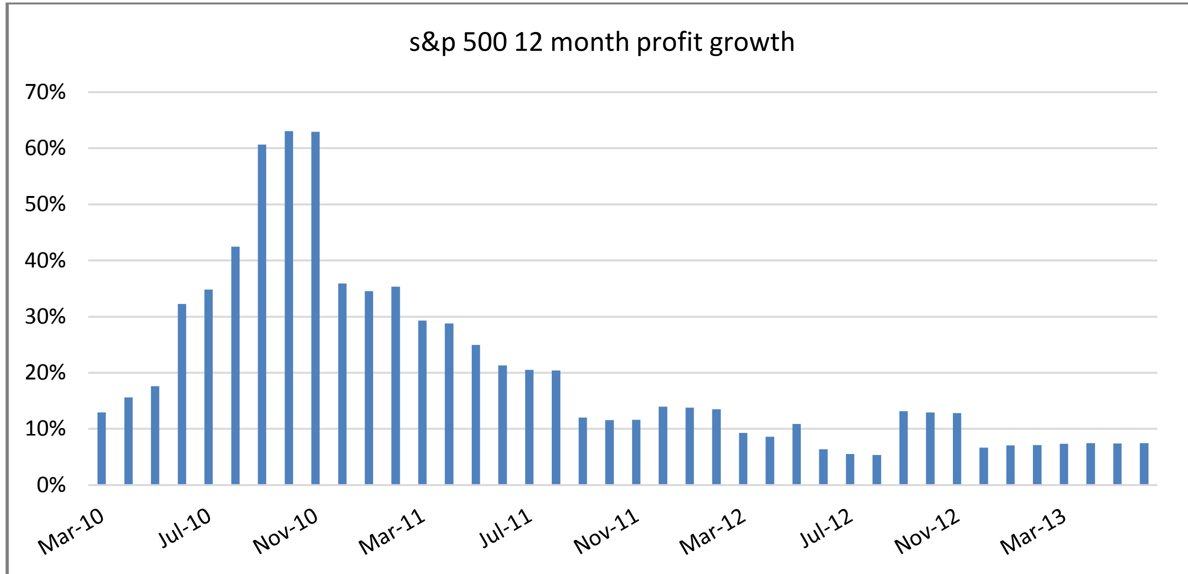
Well, not this time. Japan's stock market went into free-fall, including a one-day drop of seven percent. China fell into a bear market. In a month's time, benchmark US Treasury yields jumped 50 basis points. Everything interest-related felt the pain, including corporate debt, REITs, and dividend-driven stocks in the utility and telecom sectors.

Once the momentum turns, it builds on itself. Prices drop, yields rise, worries abound. Asian stocks weaken because the liquidity trade is off. US markets drop in unison. Europe declines because… well, in Europe, decline is the normal state of being. Back to Asia, China appears vulnerable to a crash, its economy and financial markets in distress.

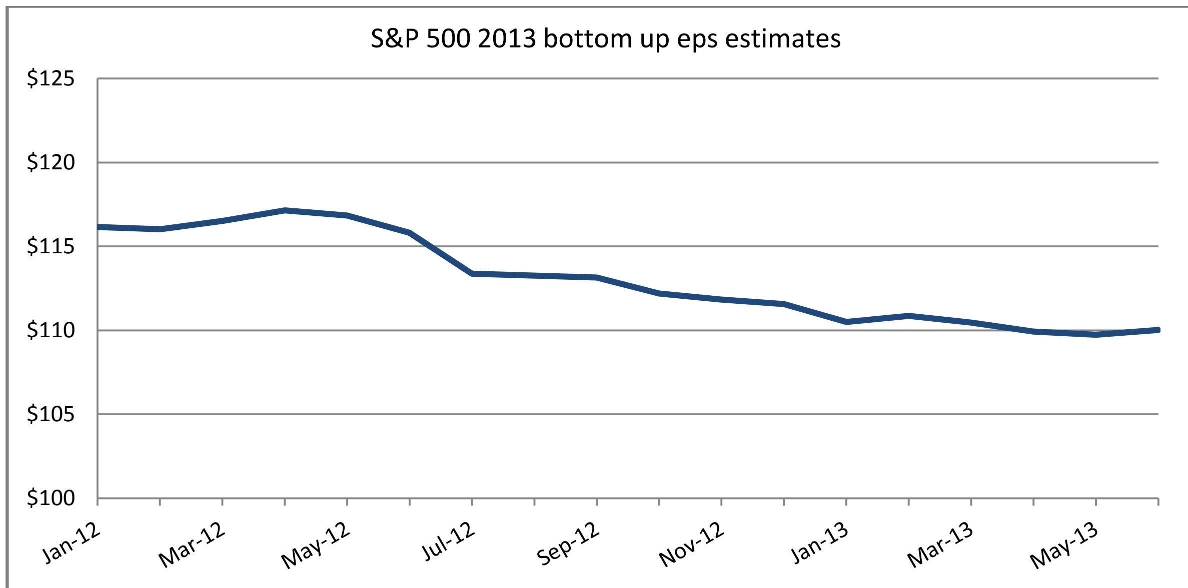
Suddenly we forget what the bull market was all about, or why anyone wanted a second chance.

From the start of the year through the third week of May, US stocks rose 17 percent, as measured by the S&P 500. The gain was widespread, accompanied by rising prices in numerous asset categories, and in markets from Japan to Germany to the UK. Typical market commentary would link strong markets to the economy, but in this case the connection was weak. The two most recent reports of US GDP average out to an anemic 1.1 percent annual growth rate. Global growth forecasts have repeatedly been scaled back, highlighted by continued recession in Europe and worrisome weakness in China. Whatever the bull market was about, it was not about a strong economy.

Nor was it about earnings.  Once the standout in this recovery, corporate profits have slowed like a tiring racer.  Trailing 12-month earnings growth for the S&P 500 is now running at seven percent (see chart below), with quarterly growth making little headway at all.  That's no disaster, but below expectations, and hardly enough to warrant double-digit equity gains.




Furthermore, earnings estimates continue to weaken.  At one time, this year's bottom-up estimates on the  S&P 500 exceeded 117 dollars per share (see chart below).  That number is now 110, and likely heading lower.



If the bull market was not about the economy, and not about earnings, what was it about? The explanation is two-fold. First, stocks continue to close their valuation discount against bonds and other assets. In other words, after becoming exceedingly cheap, stock price multiples are re-rating to a higher level. Second, the Federal Reserve and other central banks have continued to inject liquidity into the global financial system. This 'priming the pump' has accrued more to the benefit of financial markets than to the real economy. Central bankers understand this, hoping for a 'wealth effect' to stimulate the broader economy. And if it doesn't work, at least they tried. To date, stockholders win, bondholders win, and the middle class loses. Nobody said it was perfect.

There is a great sense of déjà vu about all this. For the fourth consecutive year, stocks have rallied sharply through the winter months and into springtime. The summer months have all been problematic. An old Wall Street adage says 'Sell in May and go away.' Could it really be so simple? Four years in a row?

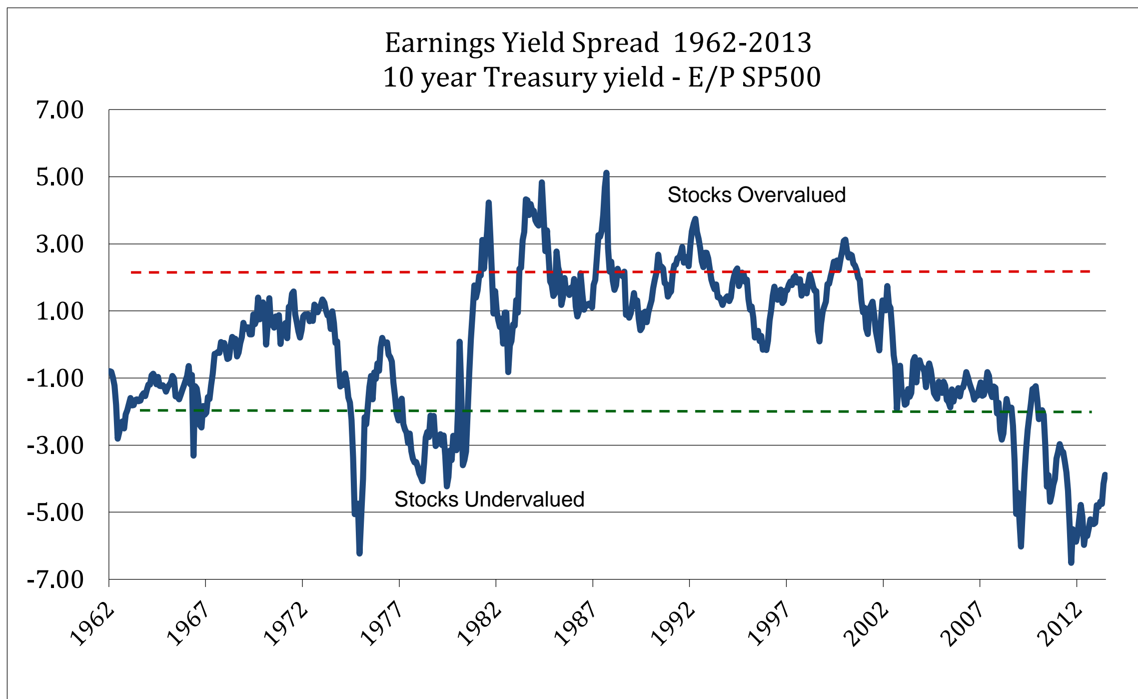
Our best guess is that this year presents a twist, something out-of-sync with the prior three summer swoons. What lies ahead? Here are some ideas, moving from the most obvious to the most troublesome:

1. Interest rates have already bottomed. After setting a historic low in July 2012, Treasury rates have made a series of higher lows and higher highs, a classic sign of a new trend. When 10-year Treasury rates hovered around two percent, bond bulls posited that rates could remain low for years. While plausible, the theory misses the mark. A Treasury note manipulated to a two-percent yield does not represent investment value. Investors should never hope to hold a pricing level offering 'no value'. That is wishful thinking, or a fool's game. Capital will move elsewhere, seeking higher returns.

US Treasury 10-year Yield January 2010-June 2013

2. The yield craze is probably over. With Treasury rates so low, investors in alternative income products -- corporate bonds, REITs, high dividend stocks including utilities and telecoms -- pushed yields to ultra-low levels. No more. These assets may still generate positive returns, but their valuation peak is likely behind us.

3. Given the rise in interest rates, stocks have lost some of their valuation support, but not all of it. Equity investors assumed that rates would eventually move higher, and priced stocks accordingly. The valuation case for owning equities is best supported by comparing either stock dividend yields or earnings yields (chart below) to Treasury rates. While limited in scope, this valuation support remains intact.




4. China is the new wildcard. We should worry less about Europe -- its economy will bottom out, the Euro will survive, and upside surprises will finally emerge. And we should worry more about China, with its primitive financial system, its empty buildings, and its super-sized exposure to construction and commodities. China's economy, second largest in the world, is in transition. For the first time in ages, it seems vulnerable to a hard landing. If that occurs, nothing else will matter. If avoided, the market's second chance will be worth pursuing.

Sources:
Bloomberg
Wall Street Journal

**Dazed and Confused**

Nostalgia is overrated. The past really was not so great, nor the present so grim. Give us present-day, modern life, with all its warts, and let someone else wax poetic about days gone by. Most things improve with time, or with the benefit of fine-tuning.

But there are exceptions. A case in point is the Federal Reserve, which was once cloaked in so much secrecy, policy was only inferred based on market action. The Chairman was known by name, but little else. When he spoke, few people heard him, and fewer still understood. Now we watch the Fed Chairman provide hours of testimony to Congress and give televised press conferences after FOMC meetings. When it comes to monetary policy, clarity is the new norm. The trouble is, numerous Fed officials have decided to join the party. Everyone has an opinion, and by-golly we are going to hear it. And when too many people have something to say, the only certainty is that the message will get fuzzy.

Sure enough, consider comments from William Dudley, President of the Federal Reserve Bank of New York. Mr. Dudley not only heads the most powerful branch of the Federal Reserve system, he is also a former chief economist at Goldman Sachs. Now trust us on this.. you don't attain those positions by being an intellectual chump. But that doesn't prevent a man of his stature from verbally 'stepping in it'. In a recent interview, Mr. Dudley said he was unsure whether the Fed's next policy action would be to increase or decrease its bond buying program. "Because the outlook is uncertain, I cannot be sure which way -- up or down -- the next change will be", he said.

Let's make sure we have this right: We are four years into economic recovery, short-term rates are near zero, the Federal Reserve is buying securities at the rate of a trillion dollars per year.. and our central bank does not even know which direction to move next? And when has the outlook ever been anything but uncertain?

Weeks later, James Bullard, President of the Federal Reserve Bank of St. Louis, voiced strong concern over a central bank timetable for exiting its accommodative policy. To his thinking, a dovish stance is appropriate with inflation levels well below Fed targets. Deflation, it seems, is the new bogeyman, and you don't tighten one bit when facing deflation. Days later, two more Fed Bank Presidents chimed in. Everyone has an opinion.

Sandwiched in between, Fed Chairman Ben Bernanke told the world that the central bank is looking to taper its bond-buying program, perhaps as early as this year. From there, it may complete its latest version of Quantitative Easing sometime in 2014. Mr. Bernanke also reminded us that all Fed decisions are data-dependent. If the economy falters, all bets are off, and the money spigot stays on. But the goal is to end the program, not double-down. This from the Fed Chairman, years ago the only voice we heard on monetary policy, and the only voice that is supposed to matter.

So there you have it. The Fed will either phase out its bond-buying program in the next year, or not. Clear enough?

**Tidbits..**

Occidental Petroleum shareholder vote ousts long-time Chairman after years of poor results.
Hess Board of Directors is restructured in response to activist shareholder proxy battle.
Procter & Gamble CEO is replaced after ongoing pressure from investors.
JP Morgan leader Jamie Dimon overcomes critics, proxy vote, successfully defends dual role of Chairman and CEO.

*Shareholder activism is alive and well, and much needed.*

OECD reduces global economic growth forecast; World Bank follows suit.

*Again and again and again for global growth.*

Initial Jobless Claims drop to five-year low.
Unemployment rate hits four-year low.
Consumer Confidence reaches five-year high.
New Home Sales approach five-year high.

*As with the overall economy, moving in the right direction, just too slowly*.

Greece credit rating is upgraded while Europe remains mired in second year of recession.

Germany's DAX index makes all-time high, UK's FTSE index makes 12-year high. Japan's Nikkei index makes five-year high.

*Before all tumble in global market correction.*

Yahoo to purchase blogging network Tumblr for 1.1 billion dollars, promises 'not to screw it up'.

*Funny line, if not for Yahoo's history of doing just that.*

US Budget deficit projected to drop to 'only' 642 billion dollars, Congressional Budget Office says.

*Improving numbers distort reality of out-of-control federal spending.*

Ford Motor to close Australian production after 88 years of manufacturing Down Under.

*Strong currency plus high labor costs equal competitive disadvantage.*

Computer tablet unit sales expected to exceed portable-PC sales this year, to surpass all PC unit sales in three years.

US household net worth reaches record level of 70 trillion dollars.
US crude oil production grows by largest amount in nation's history.
Core inflation rate slows to lowest level since 1960.

White House proposes new carbon standards for power plants, energy pipelines.

*Still biting the hand that feeds us, all in the name of goofy green science.*

Latvia moving to become 18th member of Euro-zone common currency.

*Strength in numbers, or misery loves company?*