EPIC
INVESTMENT MANAGEMENT

Issue 34 March 2016

Taking Measure of the Bear

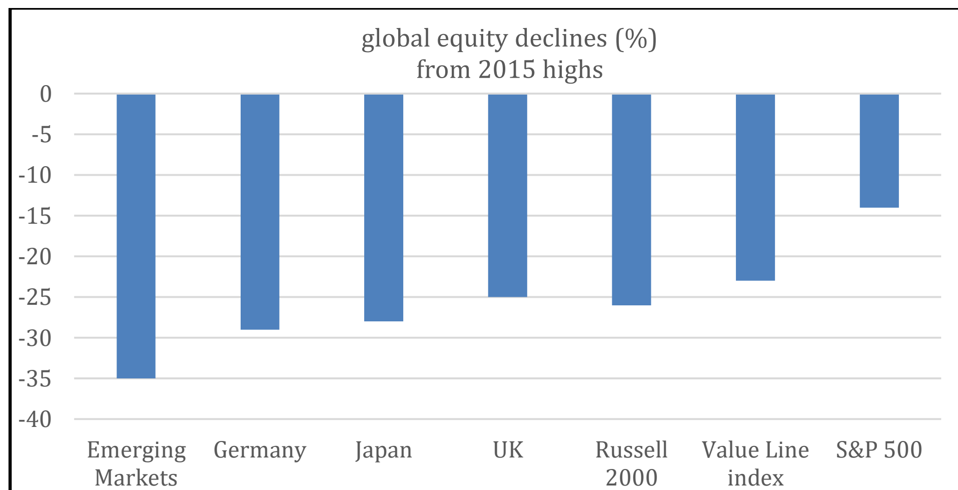
No sooner did the calendar turn the page to the New Year, then equity markets around the world accelerated their decline. For the most part, all major markets are in, or were recently in, bear territory, typically defined as a drop of 20 percent from recent highs.

Taking a quick tour of global conditions, before the rally of the past few weeks: emerging market equities plunged 35 percent from their April 2015 high, retracing their entire gain since mid-2009. Among developed international markets, Japan's Nikkei, Germany's DAX, and the UK's FTSE index all dropped by 25 to 29 percent.

In the US, the Russell 2000 small cap index fell 26 percent from its 2015 peak; while the Value Line index, an equal-weighted measure of some 1700 stocks, gave up 23 percent.

Absent from these dire market readings is the S&P 500 index, which managed an almost-graceful swan dive of only 14 percent.

As for the cause, round up the usual suspects: tepid global growth, deflation scares, earnings recession, turn of the credit cycle, China worries, and the ever-present geo-political strains. Or try financial jargon: global investors have re-priced equity assets, demanding a higher risk premium. It's all the same.



We are left in an unfamiliar condition, with global equity markets in bear territory, as a broad basket of US stocks follows suit; yet our benchmark index is holding well above bear market levels. Something's gotta give.

The weeks and months ahead will resolve this market dichotomy, settling among three likely developments for US equities. Fortunately, the outcomes are weighted favorably. To twist the words of the late football legend Woody Hayes: there are three things that can happen, and two of them are good.

First, the S&P 500 may remain resilient, holding above bear market levels and offering support to the broader US market. If this occurs, we have nearly completed a sharp correction, but nothing more, and stocks are a bargain to be bought. International equity markets will have to fend for themselves. Some may tag along, while others continue to struggle.

More likely, the same index will follow the broader market into bear territory, a peak-to-trough decline of over 20 percent. With little additional damage, it will bottom out. History will record this period as a run-of-the-mill bear cycle, akin to the declines of 1990 and 1998. In this case, stocks, while not yet at a bottom, should be accumulated in anticipation of an eventual rebound.

The final scenario is much more painful, hitting investors with a third consecutive severe bear market, a total loss of 30 percent or greater. A decline of this magnitude occurs in roughly half of all bear cycles, and is usually accompanied by conditions that neither exist today, nor seem likely to arise in the coming months. Among these conditions are an extreme over-valuation of equities, as in the years 1987 and 2000; or a deep, nearly-cataclysmic recession, as began in 1973 and 2008. The extreme valuation risk is already settled -- it does not exist. A once-in-a generation recession can never be ruled out; it is just improbable.

Also, consider that our last two bear markets -- starting in 2000 and 2008 -- were among the worst of the post-WWII era. We can either conclude that equities have become more treacherous, or that reversion to the mean should work in our favor. Neither choice has solid empirical backing, but we choose reversion to the mean, siding with the optimistic view. Every so often, lightning strikes twice, but three times is something we will bet against.

In light of current conditions, and acknowledging the difficulties in predicting the near and intermediate future, let's consider a broader perspective on equity investing, and how to deal with the inevitable downturns.

There are three views of equity exposure a prudent investor may adopt:

Ride out the cycles. Stocks rise and fall in seemingly random fashion, but win out in the end. Corrections are difficult to foresee, and by the time we identify a bear market, most of the damage is already done. With every downturn, investors fear the world is coming to an end, yet history says otherwise. This strategy avoids the emotion-driven pitfalls of buying high and selling low. It

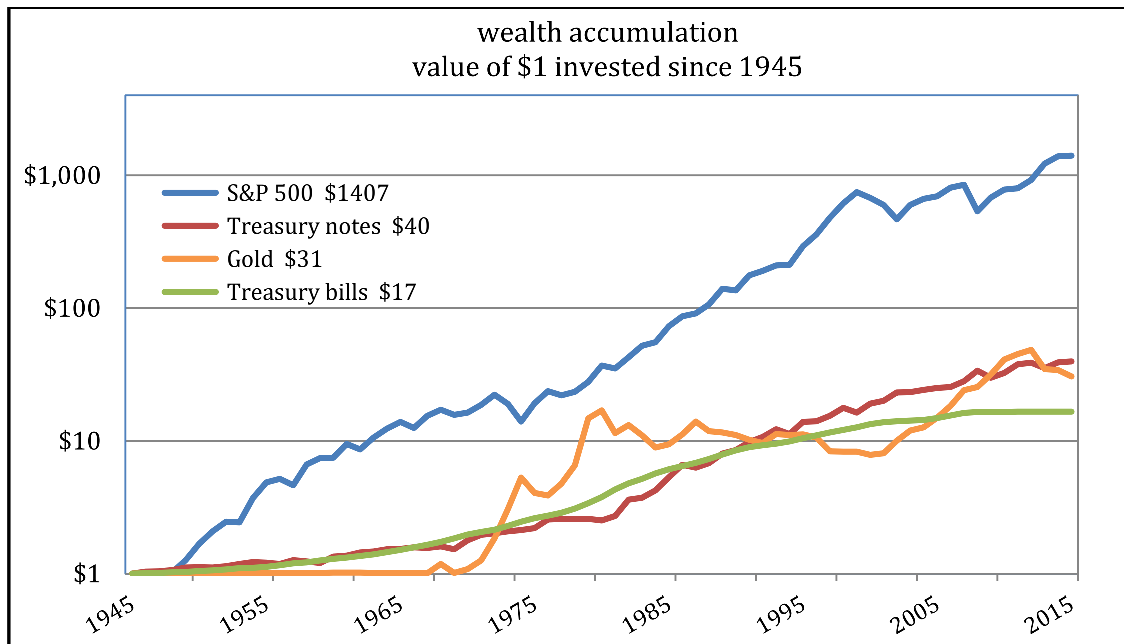
always captures a bull market rise, and likewise suffers through bear cycle losses. The trade-off is well rewarded.

Selectively opt out. This view modifies the above baseline strategy. It posits that investors should own stocks, except in times where they are clearly expensive, or when obvious risks are not reflected in prices. Under this rule, an investor would have sold well before the market declines of 1987 and 2000. The downside to this strategy is a risk of not just selling early, but so early as to be wrong.

Selectively opt in. The third option views stocks as an equal alternative to other asset classes, no better, no worse. Under this rule, an investor only owns a significant weighting in stocks when they are selling at bargain prices. The problem with this approach is that, even at bear market bottoms, stocks are not always clearly cheap; and equities priced near fair value can still produce outsized gains for years.

Wait, wait, wait. We can almost hear the chorus of objections. A fourth choice is to simply avoid equity risk, to always own something other than stocks.

This position should be dismissed out of hand, under the original premise of a prudent investor. For decades and centuries, US equities have been among the best, if not the absolute best, of all investable assets. Equity returns have far outpaced alternatives including Treasury bills and bonds, corporate debt, gold and other commodities, and real estate. Equities also offer daily liquidity, a dividend income stream, and ownership rights on productive assets. Gains are not taxed until realized, and then generally at a favorable rate. The price of all this is volatility, including bear markets. No prudent investor would ignore these qualities.



Minimal Math on the Minimum Wage

The left-wing re-distributionist movement, which includes Presidential candidate and avowed socialist Bernie Sanders, seems to have settled on 15 dollars per hour as the appropriate minimum wage in today's economy.

For simplicity's sake, let's ignore the implications of forcing businesses to pay an excessive wage, the likely loss of jobs and companies in an economy which can afford to lose neither. Let's just play along with the idea, using a sharp pencil and basic arithmetic in rebuttal.

Archie and Edith are a couple of 18-year old love-birds living together right out of high school. They boast a minimal education and no particular job skills, other than an ability to show up at work on time. Their combined intellect would qualify them slightly above 'mental midget'. But they do possess a government-granted right to earn 15 dollars per hour from their employer.

Archie takes a fancy to flipping burgers at the local fast-food joint. He works a standard 40 hours per week, 50 weeks per year. Edith works the same hours as a grocery store cashier. Even before any work-related benefits, such as health-care coverage and paid vacation, Archie and Edith accumulate 2,000 hours of paid employment annually. Multiply 2,000 times 15 dollars, and their yearly wages total 30,000 dollars.

Each.

That's 60,000 dollars of household income per year, before any benefits. Sound fair?

Well, that income level places Archie and Edith squarely in the middle class, earning comfortably above today's household median income of 54,000 dollars. All this, without a day of technical-school training or college exams; with no prior work experience and no motivation in life other than to eke out an existence and wake up tomorrow in the same world as yesterday.

Yet from their first week at work, they have exceeded their modest financial goals and vaulted into middle-class America.

This is impossible. It is within our government's power to mandate a minimum wage. It may even be justified. What our government cannot create is a Lake Wobegon wage, where all family incomes are above average. No amount of left-wing rhetoric can turn this story into reality.
It just doesn't add up.

Source:
Aswath Damodaran, New York University
Bloomberg
The Wall Street Journal
U.S. Census Bureau

Tidbits..

World Bank cuts global growth forecast for 2016 to under three percent; International Monetary Fund follows with its own reductions.

Water torture of slowing economic growth.

Bank of Japan adopts negative-interest-rate policy in bid to boost growth and inflation.
Japan's 10-year Treasury yield falls below zero for first time in history.

Memo to Japan: negative interest rates are not simulative.

International Energy Agency says oil collapse could deepen as market 'drowns' in oversupply.
OPEC and Russia agree to freeze oil production… near record levels.
Crude oil drops below 27 dollars per barrel, lowest price since 2003.
US natural gas prices fall to 17-year low.

US auto sales reach record level in 2015, at 17.5 million units.
Auto recalls also hit record, at 51 million vehicles.

So much for quality control.

Global personal computer shipments drop 10 percent in 2015, to lowest level since 2008, says IDC.

Brewery giant Anheuser-Busch InBev raises 46 billion in debt, second largest corporate debt offering in US history, to fund acquisition of SABMiller.

General Electric plans to move headquarters to Boston, leaving what it describes as an 'inhospitable' business climate in Connecticut.

Johnson Controls to merge with Tyco International in 14 billion dollar deal partly inspired by tax inversion strategy.

Still waiting for corporate tax reform to save American businesses.

Obamacare individual health insurance premiums estimated to rise between nine and 15 percent in past year.
Aetna chief executive expresses 'serious concerns' about the sustainability of public health exchanges.

Healthcare reform in need of reform.

White House considers budget proposal adding 10 dollars per barrel 'fee' on oil companies.

An endless supply of bad ideas.

United Kingdom to face self-imposed referendum on exiting European Union.

A bold move, or politicians leaving toughest decisions to the masses?