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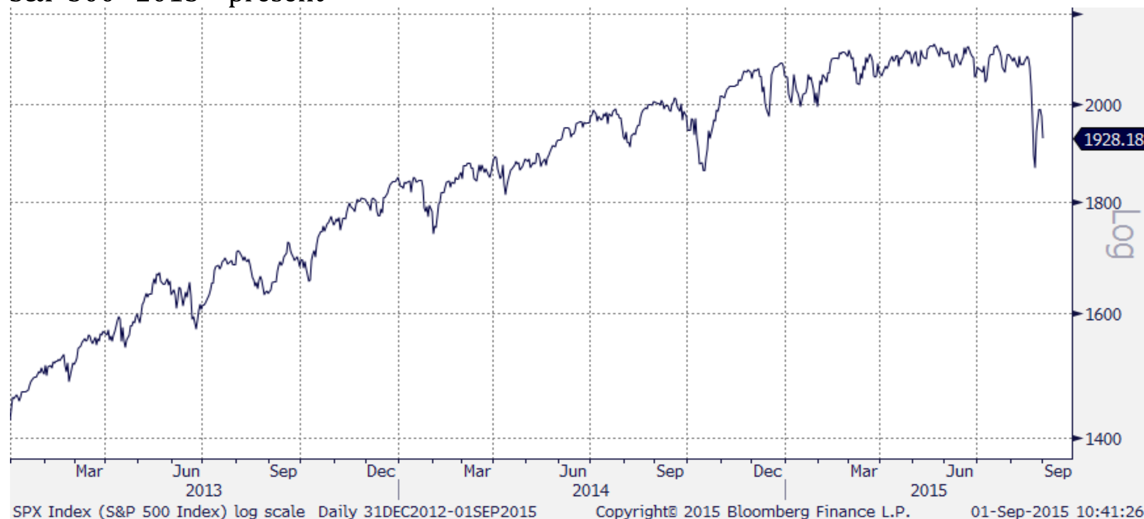
Summer Storms

Recent stock market turmoil has produced a 12-percent decline in the S&P 500 from its May high, marking the first correction in four years. Previous to this summer swoon, the US stock market had been both calm and rewarding. The calm has been broken by heightened volatility, much of it to the downside and the only volatility that earns notice. The rewarding issue, now more in doubt and far more important, is still to be determined.

S&P 500   2013 – present



The key question is whether we are heading for a bear market, a decline of 20 percent or more. At this point, our guess is NO, the bull market cycle has not ended; but nerves and resolve will be tested by conditions not just in the US, but around the world.

Many foreign stock markets are in distress, including bear markets; commodities are in free fall; foreign exchange markets have become quite volatile; corporate bond spreads have widened; and China's economy is decelerating. As China accounts for the largest single component of global growth, what happens in China really matters to the rest of the world.

Expect to hear about these and other problems in the financial media. At some point we might be convinced the sky really is falling. That's just human nature trying to both explain and understand the complexity of markets -- that if prices are falling, there must be a myriad of reasons, and we can all make sense of it together. Here's one sensible reason: stocks are priced on the margin; that is, the last buyer and seller set the price of a stock, or any financial asset for that matter. An abundance of sellers, or a dearth of buyers, will drive prices lower. Whether these lower prices are justified will be determined in the coming months or year.

It is still our best guess that a bear market will be avoided, but that is only an educated guess. And as conditions change, opinions and actions must also change -- which is the only honest, objective view of the world. We should also know that bear markets are part of the investment cycle, that periods of losses are inevitable. In both corrections and bear markets, we will lose money. That will never change, but we should also understand that lower prices eventually present great opportunities; assets become more attractive when their prices are cut. The trick is remembering this when everyone else is running for cover.

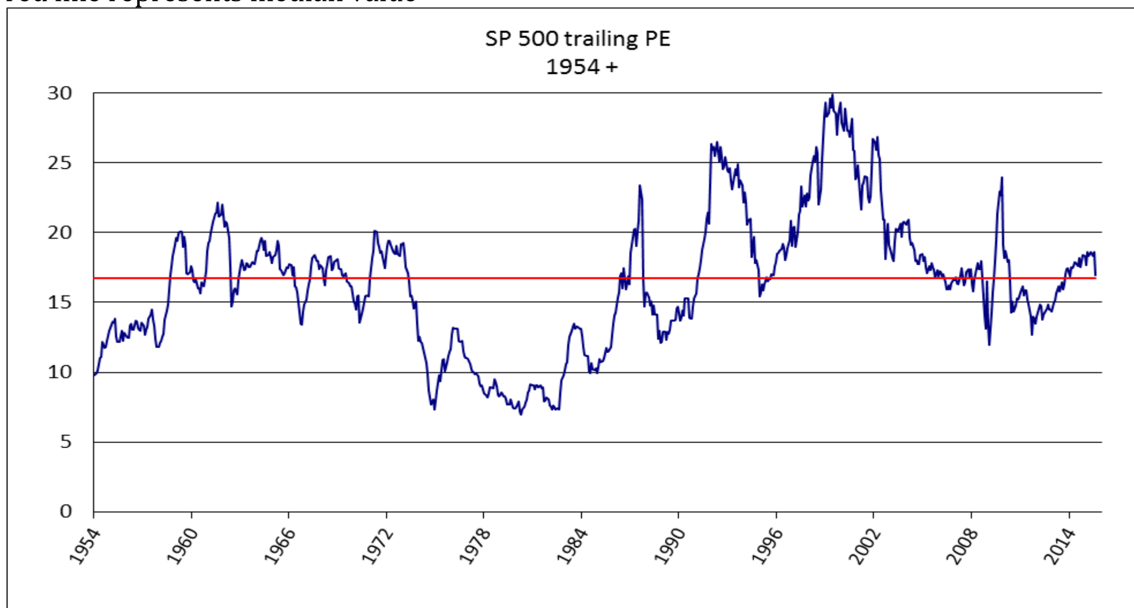
In the midst of a market decline, it is inevitable to hear pundits declare that stocks are, or were, over-priced. But is this true today? Is the market correction simply a re-adjustment of excessive valuation?

On the following pages, we focus on this one aspect of the investment equation. In particular, we examine the valuation of US equities, both in comparison to historic norms, and to hypothetically risk-free Treasury market alternatives.

Let’s begin with a conclusion: US stock prices might fall from here, but if a meaningful decline occurs, it will not be a price correction from an over-valued level. More likely culprits will be earnings shortfalls, or external shocks that lower asset prices around the world. Indeed, the latter has been driving our markets for the past month or more.

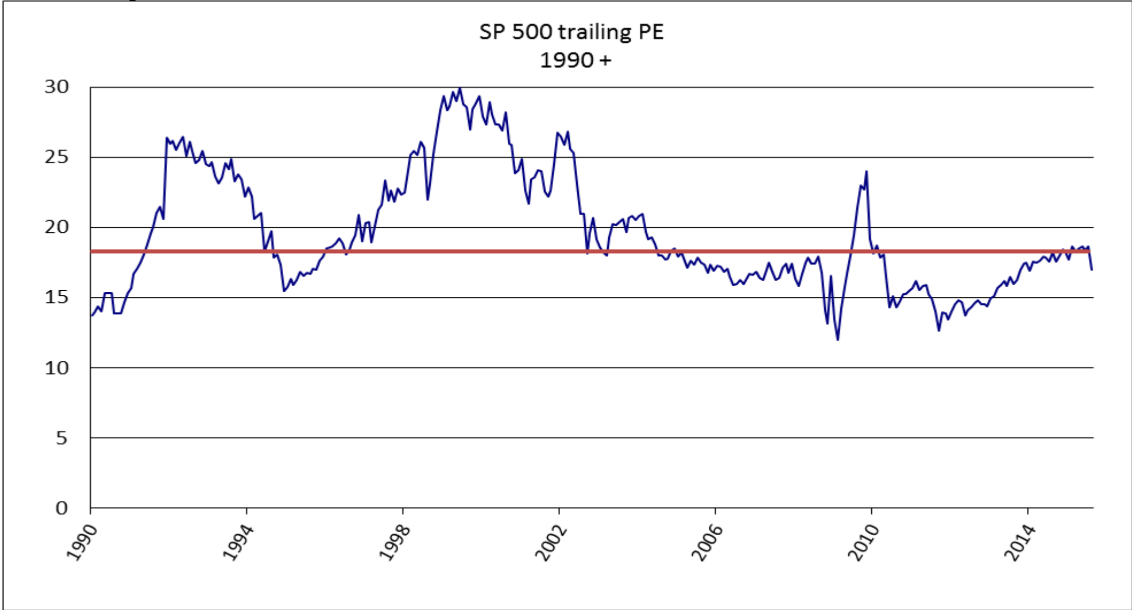
For the S&P 500, the current price earnings ratio (PE) on trailing 12-month earnings is 17.0. This is the lowest valuation since January 2014 (month end data), and compares only slightly unfavorably to the median valuation of 16.7 since 1954.

red line represents median value



If six decades of equity market pricing is too much, we can narrow the timeframe for comparison to the past 25 years. On this basis, stocks are selling at a discount of 1.3 multiple points to the median valuation over this period.

red line represents median value



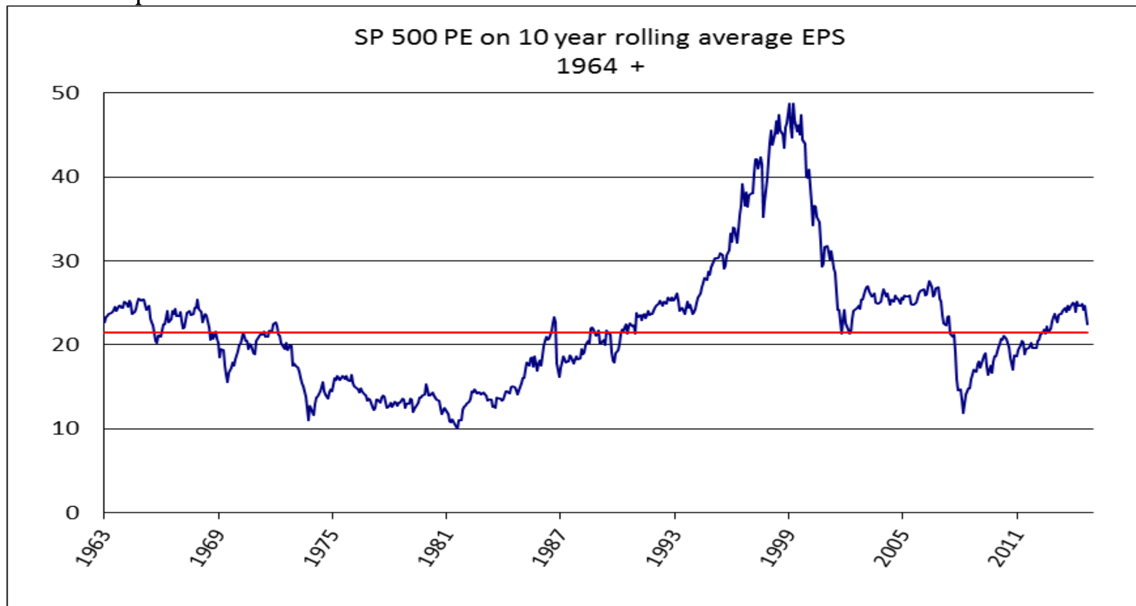
The most interesting valuation discussions have focused on the Shiller ‘Cyclically-Adjusted PE’ (CAPE), developed by Yale Economics professor and Nobel Laureate, Robert Shiller. At current levels, the Shiller CAPE suggests stock valuations are elevated versus historic norms, and by measuring norms Professor Shiller goes back as far as the year 1881. Our chart below is a simplified version of the Shiller concept, with two meaningful adjustments.

First, it only uses data beginning in 1954, the first year for which S&P 500 earnings are available. Thus we eliminate market valuations from the late-19th century, and first half of the 20th century. As equity multiples were generally lower in those early years, this adjustment effectively raises the median, or ‘normal’, valuation we use for comparative purposes. This may smack of stacking the deck for easier comparisons, but is not worrisome. To put it bluntly, who cares about stock prices in 1910?

The second significant change is that we forego an inflation adjustment Professor Shiller applies to his data. This makes Shiller’s work more robust -- he is after all a Nobel Laureate -- but it is debatable whether this adds any insight in assessing current prices.

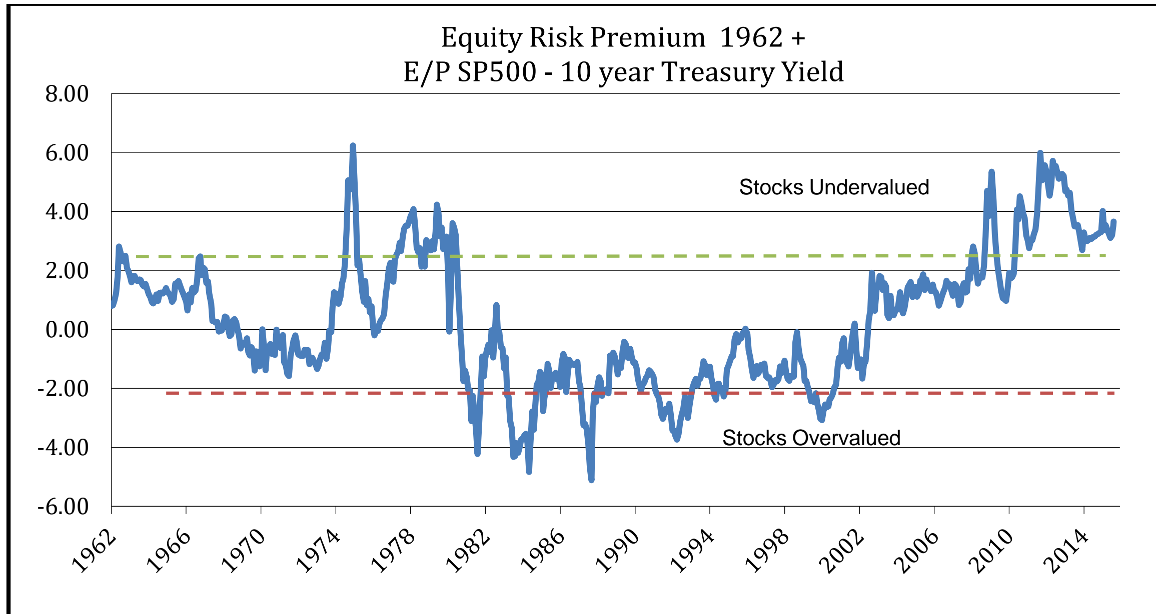
The current PE on trailing 10-year average EPS is 22.4, versus a median value of 21.4. This hardly seems alarming. In contrast, the two prior peaks were 48.8 and 27.6, clearly elevated levels that provided warnings ahead of bear market downturns.

red line represents median value



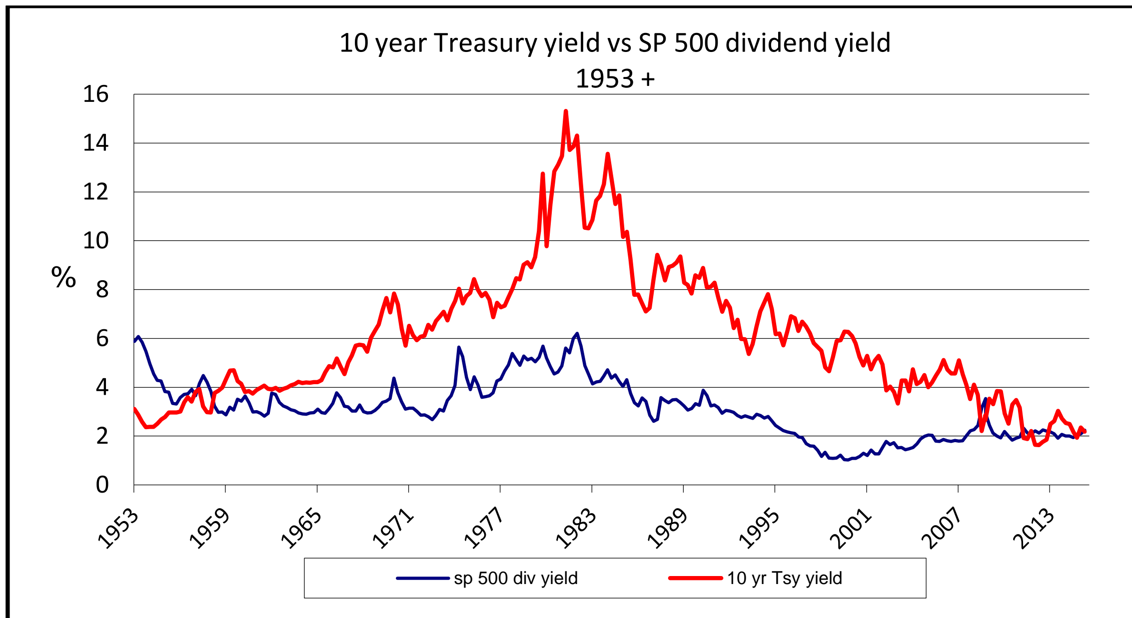
Next we compare the stock market's earnings yield (inverse of PE) to the 10-year Treasury yield. At this time, the spread is highly favorable for equities, with a current value of 366 basis points. That is, the current equity earnings yield of just under six percent offers a significant premium to the 2.18 percent yield on the 10-year Treasury.

Since 1962, no bear market has begun from a premium above 130 basis points. This suggests 366 basis points is a big cushion of support. Measuring monthly data, for all values over 200 basis points, the stock market has generated positive one-year returns 88 percent of the time.



Déjà vu, all over again. Stocks are not expected to provide dividend yields above the 10-year Treasury yield. Those days were supposedly behind us; yet here we are once more. This has typically signaled a buying opportunity for equity investors.

Furthermore, the dividend yield on the S&P 500, at 2.2 percent, compares favorably to its 20-year median of 1.8 percent. Low dividend yields have been with us for a long time, and may be here to stay.



It's far from rosy for US equities. Global economies are at risk of a slowdown, and global financial stress may weigh on our markets. The commodity collapse has left many businesses in distress, while a strong dollar creates a headwind for our multi-national companies. For stocks themselves, volatility has clearly returned. If there are more sellers than buyers, stock prices will decline; a bear market could even develop.

We also cannot say that stocks are unequivocally cheap. Cheap appeared in 2009, when most investors were scared out of their wits. What we can say, to re-affirm our prior conclusion, is that US equities are not expensive -- that on the list of worries, we can cross off 'excessive valuation'.

Jibe Ho!

Imagine you are at the helm of a sailboat. As you glide across the bay you become bored with the leisurely pace, so you let out the sheets, precisely two feet. The response comes within seconds. The mainsail opens, filling with the wind. The bow pitches forward ever so slightly, slicing through the water. You can feel the boat accelerate as the freshening breeze cools your face. Still a novice sailor, you take note that letting out the sheets improves the boat's performance.

After a few minutes you grow impatient, ready for more speed. So you let out the sheets, this time slowly, methodically, again targeting a precise two feet. As you begin, the mainsail responds and the boat accelerates once again, only this time marginally so. The more you let out, the wider the sail, yet the boat seems to slow. As you reach the two-foot mark on the sheets, the boat is back to its original speed, the leisurely pace that left you bored into action minutes ago.

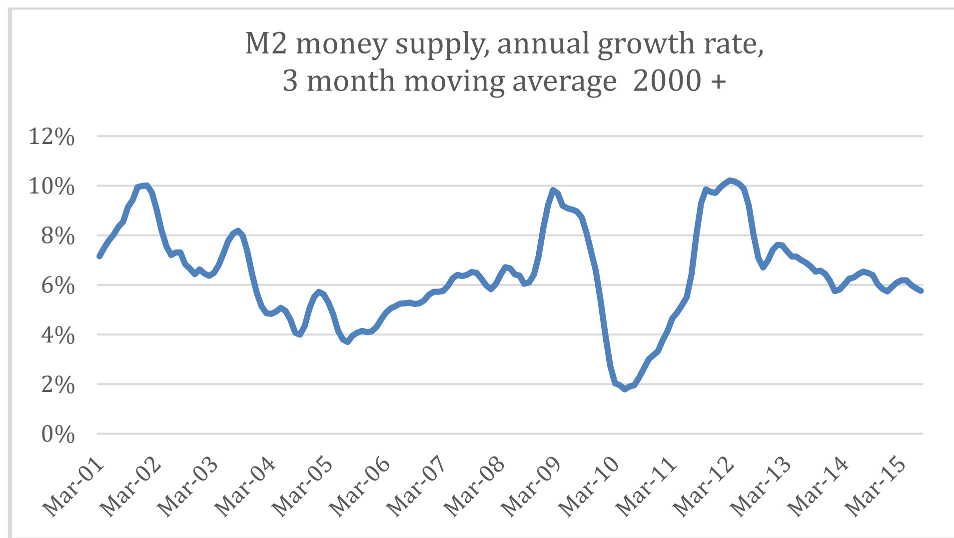
Now shift roles, trade your Ray-Bans for reading glasses. You are a central banker, intent on boosting the US economy. You cut interest rates by two percent. The response is not immediate, yet in time you sense the desired improvement. Not content, you cut rates another two percent, with similar results. Still, there is slack in the economy and surely you can add even more stimulus. So you cut once more, taking short-term rates to zero. And nothing happens.

As sailor and banker, you have experienced different versions of the same phenomenon -- diminishing returns.

The Federal Reserve has not raised interest rates in nine years. Over six years ago, for the first time in its history, the central bank adopted a zero interest rate policy. When slack developed in our economy, the Fed purchased long-term Treasurys and mortgage backed securities, an unprecedented move it labeled 'Quantitative Easing'. Not content with one iteration of Quantitative Easing (QE), the Fed went back for more, in the form of QE2 and QE3, with the same predictable results experienced by our novice sailor. Sometimes 'more' does not equal 'optimal'.

There is a growing body of economists, investors and institutions voicing disapproval of the Federal Reserve's zero interest rate policy. It is likely that the Fed's actions to reduce short-term rates from five percent to three percent were beneficial; so too the cuts from three percent to one percent. And it is also plausible that moving rates to zero, and holding at zero for nearly seven years, was a mistake.

Low rates do not equate to available credit, nor the proper allocation of credit. Low rates cannot offset a regulatory vice grip on the banking industry -- mandating higher capital levels, placing federal monitors in bank offices, and extracting a hundred billion dollars of legal settlements from our nation's banks. Low rates do not mean an acceleration of money supply -- we are at a four year nadir in money growth. (see chart below)



Sometimes low rates just mean a Fed-induced division of winners and losers.

Consider a Fed rate cut intended to revitalize the home building and commercial construction industries, while easing ownership costs for first time home buyers. The first beneficiary of the rate cut will be big government, whose profligate spending gets a free pass via extraordinarily low borrowing costs. Next will be large corporations, willing to borrow simply because money is cheap, more often than not stashing the funds on the balance sheet, or using them to repurchase stock. This might boost stock prices, rewarding investors nicely, but it does little for the real economy. From these two responses, we are left with an increasingly-leveraged economy, in a nation that is already up to its neck in debt.

Losers include small businesses -- our usual engine of job growth -- who cannot compete for credit against corporate America. The other clear losers are savers -- the shrinking minority of Americans who act responsibly, living within their means -- who see their fixed income returns dwindle away.

And what of the targeted building industries and first time home buyers? They are stuck in limbo, as tighter lending standards leave the supply of credit -- as opposed to the price of credit -- insufficient for market needs. The economy suffers for it with slow growth, low wages, and widening income inequality.

Then again, a decade ago a similar policy induced a housing bubble and economic crisis. Nobody said central banking was easy.

The Federal Reserve has expressed a readiness to jettison its zero interest rate policy, and begin a rate-hiking cycle of uncertain magnitude. What it has not done is express any doubt about the effectiveness of its policies. Diminishing returns is a foreign concept. The hardship of losers never offsets the bounty of winners. This suggests the Fed will continue to err on the side of low rates, likely offset by tight regulation, creating a conflicted monetary policy still far from optimum. In a world where certainty rarely exists, where every policy decision involves trade-offs, the Fed's groupthink and institutional arrogance are costly behaviors.

The Fed has left our economy's sails luffing in the wind. It's time for a new tack.

Source:
Bloomberg
Wall Street Journal

Tidbits..

Greece negotiates bailout pact with European creditors, avoids default and Euro exit.
Athens stock market closes for five weeks.
Puerto Rico misses debt payment, enters restructuring talks with creditors.
Ukraine re-negotiates its debt, with widespread support.
China unexpectedly devalues its currency.
Emerging market equities drop 20 percent from peak, enter bear market.
Equity sell-off strips five trillion dollars from global market values.
Global financial markets offer plenty of cause for concern.

Federal investigators bust insider trading ring based on hacking computers for press releases.
Justice Department probing airline industry over anti-competitive practice of restraining growth.
For the most bankruptcy-prone industry in the US, profits must be taboo.

BP settles last major claim over Deepwater Horizon offshore oil rig disaster of 2010. Total payments reach 54 billion dollars.

Health insurance consolidation:
Anthem to buy Cigna for 54 billion dollars, to create nation's largest health insurer.
Aetna to acquire Humana for 37 billion dollars.
Centene to buy Health Net for 6.3 billion dollars in merger of two smaller, Medicaid-focused health insurers.

Warren Buffett's Berkshire Hathaway to acquire Precision Castparts for 37 billion dollars.
Continues Berkshire's shift toward industrial businesses.

US initial jobless claims fall to 40-year low as employment continues slow but steady progress.
Unemployment rate, at 5.3 percent, drops to lowest level since 2008.
Labor force participation rate reaches worst reading since 1977.
Employment Cost Index, a measure of wage, salary and benefit trends, shows slowest worker compensation gains in three decades.
Mixed messages from labor market data.

Google to form holding company, re-named 'Alphabet'.
Smart people have dumb ideas too.

Gold price falls to five-year low before staging minor rally.
Oil prices briefly breach 40 dollars per barrel, down 65 percent from 2014 highs.
Broad commodity indices plummet to decade lows.

Apartment vacancy rate, at 6.8 percent, reaches lowest level since 1985.
Rental costs as share of income rise to record high.
Home ownership rate drops to five-decade low.
At some point, owning a home will again be desirable.