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INVESTMENT COUNSEL

2014 FALL INVESTMENT OUTLOOK

The S&P 500 achieved yet another all-time high by mid-September after digesting second quarter earnings, a closely-watched Federal Reserve meeting, and the much-hyped IPO of the Chinese e-commerce company Alibaba. The year-to-date total return of nearly 9% is approaching the average annualized post-WWII gain of 11.3% with 3 ½ months still remaining in 2014.

Leading indicators of U.S. economic growth have shown recent momentum and partially explain the continued rise of equities, which have generally tracked the leading data higher throughout the current cycle. Jobless claims have been falling and new orders for goods have been rising amidst a very loose and highly liquid credit backdrop, which augurs well for further economic progress in the coming quarters.

Strong corporate share repurchase activity also continues. According to Credit Suisse, corporate net buying (share repurchases plus acquisitions) is around 2.9% of total market capitalization, further shrinking the supply of public equity. Additionally, earnings revision trends have turned favorable as the net percentage of S&P 500 companies having their estimated future earnings revised higher compared to lower has trended into positive territory for the first time in three years. A strong dollar has further underpinned share prices. Historically, dollar strength is associated with lower inflation and rising P/E multiples. Finally, excess liquidity continues to exist with developed market central banks growing the narrow money supply at a faster rate than GDP, which is historically associated with rising valuations. Such policy has created a favorable but irregular valuation gap for equities over bonds on a relative basis.

A broader examination of stock markets shows leadership narrowing with investors preferring the haven of large multinational equities over smaller issues. Recently compiled Bloomberg data shows 47% of stocks in the tech-heavy, multi-cap Nasdaq Composite index down at least 20% from their peak, while the small cap Russell 2000 index has more than 40% of its constituents down the bear market minimum. Meanwhile, the S&P 500 has made new highs on 34 different occasions throughout 2014 with just 6% of its members off more than 20%. Such an underlying consolidation is typical prior to a market correction or a commencement of a Fed tightening cycle. Furthermore, despite continued gains in equities, junk bond returns have weakened since late June and spreads have widened 90 bps relative to Treasuries. Historically, credit markets have led equities by 3-4 months so further weakness here could soon portend some negative volatility for stocks.

Stock markets can be psychological thrillers at times, as history has taught us. Bears seem to be capitulating in the media and on Wall Street. Current survey data of investment newsletters from Investors Intelligence show the least bearish sentiment readings since 1987. Such an occurrence should raise a yellow flag for the long term investor.

2014 YTD Equity Market Returns (excluding income)

	9/23/14 Price	Y/Y % Change
Dow 30 Industrials	17,056	+2.9%
S&P 500	1,983	+7.3%
NASDAQ Composite	4,509	+7.9%
MSCI All Country World Index ex-USA	280	-0.3%

Near and Intermediate Term Outlook

As equity markets oscillate near all-time highs, monetary policymakers are vigorously debating the timing of the first hike in the federal funds policy rate since June 2006. Although geopolitical risks are rising and global economic growth is uneven and out of sync, perhaps the greatest risk to stock returns in the coming year or so is this tightening of policy. Following the enormous 5-year snap-back in household wealth due to an unprecedented and extraordinary loose central bank, is it finally time to pay the piper?

According to data from Credit Suisse, history of the previous four tightening cycles shows that markets tend to peak anywhere from 0-11 months and correct anywhere from -0.3% to -8.9% *before* the first Fed rate hike. Then *following* the first rate rise stocks see an average correction of -9% over a period of 1-12 months before eventually turning upward again in response to continued economic growth.

Although opinions vary, consensus seems to be for the first rate hike to occur sometime in mid-2015. In past economic cycles, the decision to raise rates was usually in response to rising growth and/or rising inflation. Policymakers wanted to avoid an overheating of the economy. We would view the current cycle as being slightly different; the potential rise in short term rates this time is as much to get off the low 0% bound and begin to normalize policy than it is about growth being robust.

Underlying growth does seem to be picking up somewhat for the U.S. economy per recent leading data. However, one risk is that the economy does not have enough so-called “escape velocity” to function on its own should long rates spike in tandem with the rise in short rates and cause financial conditions to tighten. The current economy is probably more sensitive to higher financing rates in the near term as we learned over the past year. Following Chairman Bernanke’s hint at tapering QE in early May 2013, 30-year fixed rate mortgages spiked nearly 125 bps in four months, subsequently slowing broad housing market activity. Although mortgage rates have eased 50 bps since then, the trend in housing activity since the “taper tantrum” has been flattish. Current single family housing starts of 643k on an annualized basis are still at prior recession lows going back to the 1970’s despite the 65% recovery since early 2011. Overall private investment in the economy net of depreciation at 3.1% of GDP is at half the average that persisted from 1970-2007.

Recent strength in the dollar could give the Fed some leeway to normalize policy in a gradual manner. The U.S. Dollar Index vs. major currencies has risen 5.5% since early July and is up more than 17% since mid-2011. Such currency appreciation has led to a -0.2% annualized decline in imported inflation over the past two years.

Further support for the dollar could come from a divergence of monetary policy in developed markets. The Fed is moving towards a tightening of policy while the European Central Bank has embarked on its own form of quantitative easing for the first time and the Bank of Japan is further expanding its balance sheet. It is quite possible that the dollar is at the beginning of longer-term, multi-year moves upward against the yen and the euro as both the Eurozone and Japanese economies face more serious near term structural, growth, deflation, debt, and demographic concerns than the U.S. Intermediate-to-longer term U.S. Treasuries may actually benefit from a flight to yield by foreign investors in the near term considering the 2.54% yield on the U.S. 10-year note is above most other developed market comparables; 10-year Japanese government bonds (JGBs) yield just 0.52%, 10-year German bunds are at 1.02%, and even the Spanish 10-year yield is down to 2.21%. The Fed has already created a supply-demand imbalance for longer-dated U.S. Treasuries with it taking a large chunk of the supply out of the secondary market via its quantitative easing (QE) programs. This could result in a flatter yield curve as short rates rise, keeping financing rates low for mortgages, autos, and business loans.

Oil prices have fallen nearly 15% since mid-June, leading to a decline in retail gasoline prices of more than 9% since the summer peak. Such relief could buttress the real spending power of the U.S. consumer in the coming months. The consumer has faced volatile conditions during the current recovery including a spike in inflation in 2011-12 from the impact of QE2 and the 2013 rollback of the payroll tax break. Real hourly earnings growth has been essentially flat on an annualized basis since the end of 2009.

Prospects for the consumer seem to be improving, however. The demand for labor has risen in 2014 with private sector job openings for external hire rising to levels not seen since late in the previous recovery. Growth in nominal wages is also rising at the fastest pace of the recovery with average hourly earnings up 2.5% yr/yr in August. Amidst a shrinking pool of qualified labor, consumers could see further wage gains in the coming quarters. Household balance sheets are also in much better shape than five years ago. Thus, consumer spending could pick-up in the near term vs. the 2.1% annualized growth realized since the end of the recession.

While economic growth in the U.S. seems to be gathering pace, the Eurozone and China are facing prospects of a slowdown. The conflict with Russia and Ukraine seems to be taking a toll on export activity out of Europe. German GDP contracted at a 0.6% annualized rate in the second quarter with the overall Eurozone growing just 0.2%. The latest purchasing manager index (PMI) data out of Europe for the month of September came in at a 9-month low, offering little hope for a near term rebound. The region continues to suffer from high unemployment, excess capacity, weak demand, falling prices, and weak credit growth. Household, corporate, and bank balance sheets have not been restructured or repaired to the same extent as in the U.S.

In response to the lost momentum, the European Central Bank (ECB) has unleashed its own form of QE within the Eurozone with the goal of expanding its balance sheet by €1 trillion. While it will refrain from buying government debt for the time being, the ECB will offer liquidity injections to Eurozone banks at just a 0.15% interest rate that direct lending to small and medium businesses within the economy. It will also participate in the market for asset-backed securities (ABS), buying for its own balance sheet. Unfortunately, this monetary easing is likely to be more impotent than it was in the U.S. since the Eurozone economy suffers from structural challenges like rigid labor markets and business environments that inhibit corporate restructuring. Already the €82.6 billion of initial liquidity injections in mid-September out of a possible €400 billion disappointed most analysts, leading them to call for even greater QE measures while fiscal authorities suffer from inertia.

There is increasing risk that China falls short of its 7.5% official GDP target for this year as various data portends a further growth slowdown. The country’s physical capital largely exceeds its needs across manufacturing, real estate, and infrastructure following years of debt-fueled investment spending. According to a recent Morgan Stanley report, Chinese companies in sectors like mining, property development, and industrials are seeing lower profit margins, excess capacity, and eroding pricing power. Cash burn rates are rising and corporate leverage is back to 2006 levels.

Chinese industrial production grew at just a 6.9% rate in August, the slowest pace since the 2008 global financial crisis. The latest iron ore prices fell below $80 per ton for the first time since September 2009 as the country's massive infrastructure buildout is slowing. Authorities are refraining from adding more stimulus due to already high debt levels. Credit conditions are also tightening. Pressures seem to be particularly sharp in China's property markets where a downturn has occurred in transaction activity, increasing the vulnerability for house prices. The amount of newly-started floor space declined 16.4% in the first half of the year, which could soon pressure overall construction activity.

Frankly, China's level of quality GDP—that which generates future productivity for the economy and positive returns for enterprise—is probably 10-20% lower than the $9.2 trillion headline number due to the misallocation of capital and credit towards unprofitable state-owned enterprises (SOEs). These are some reasons why the Shanghai Composite Index is up just 25% since the end of 2008 vs. the 120% advance for the S&P 500.

Investment Conclusions

At this point in the economic and capital market cycle, an observation by prominent venture capitalist Bill Gurley is noteworthy. In a recent Wall Street Journal interview Mr. Gurley—renowned early investor in Uber, Zillow, OpenTable, Instagram, and some other Web startups—warns about the excessive amount of risk being taken by Silicon Valley and the broad venture capital and startup community at the current moment, "…unprecedented since 1999." He states that "…no one is fearful, everyone is greedy, and it will eventually end." According to him the average cash burn rate for venture-backed Silicon Valley companies is at an all-time high and more humans in Silicon Valley are working for money-losing companies than at any time in the past 15 years. In the public markets, Chinese e-commerce company Alibaba completed the largest IPO ever on September 19th, raising $25 billion. Public and private markets alike, these are the types of events that tend to occur in the latter stages of cycles.

Finally, the decision by the California Public Employees' Retirement System (CalPERS) to shed its entire $4 billion hedge fund portfolio should raise some eyebrows across the investment management industry. When Long Term Capital Management collapsed in 1998 the industry had about $240 billion under management, which has since ballooned 10x to a record $2.4 trillion. Simply stated, superior returns are unlikely for the industry as a whole. We have long thought that an allocation to hedge funds is inappropriate for almost all clients considering the poor returns, questionable risk management, high fees, tax inefficiency, and lack of transparency. Now the nation's second largest public pension fund agrees with this view and has decided to simplify its investment process by eliminating its hedge fund interests.

We remain cautious with new investment dollars as equity markets are near all-time highs and valuations full. Increasing levels of cash and fixed income should be viewed as an insurance policy against future market stress and as a source for redeployment at more attractive equity multiples down the road. While the growth outlook for the U.S. is improving, capital markets are discounting mechanisms and will soon contemplate tighter U.S. monetary policy. Europe and China should be viewed as downside risks to global growth, and the impact of increasing geopolitical unrest should not be underestimated.

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