August 9, 2013

"A masterly retreat is itself a victory."
-NORMAN VINCENT PEALE

POINTS TO PONDER

1. Evergreen GaveKal had a cautious view of most investment sectors over the last year. Although this stance has been off the mark with regard to the US stock market, at least thus far, it has been correct in terms of most other global asset classes. Now, many non-US markets look appealing, particularly in Asia. In fact, both emerging country stocks and bonds appear materially undervalued versus US equities and fixed income. (*See Figures 1 and 2*)

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2. Contrary to popular belief, stocks in fast-growing nations actually underperform those from slower growing countries over time (per a comprehensive London School of Economics study on this topic). One of the most persuasive examples of this is China. Despite spectacular GDP increases over the last 20 years, its stock market is up just 29% since 1993, including dividends, in real (inflation-adjusted) terms, versus 350% appreciation in US stocks in that timeframe.

3. Investors who are being seduced by the latest Wall Street serenade that US equities, particularly small cap, are the asset class of choice should remember that three years ago emerging markets (EM) were the Street's favorite tune. The degree of developing stock market underperformance, and especially the once deified BRICs (Brazil, Russian, India, China), has been astounding, even to one who touted US stocks over those from emerging markets in 2010 and 2011. (*See Figure 3*)

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4. Although China's economy is inherently far more dynamic than those of the developed world, it shares a disturbing trait with its rich rivals. Maintaining economic growth in the Middle Kingdom is requiring an increasing amount of debt, as has been the case for years in the US, Europe and Japan. (*See Figure 4*)

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5. With America's oil production soaring and usage essentially flat, China has now replaced the US as the world's largest oil importer. (*See Figure 5*)

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6. China's government is desperately attempting to invigorate consumer spending to reduce reliance on its capacity-bloated industrial sector. Unfortunately for these commendable efforts, consumer confidence has crashed by 14 points over the last four months to the lowest level on record. In the US, on the other hand, consumer confidence has been marching up in lock-step with the domestic stock market.

7. Highlighting just how serious Japan's debt problems are, its overall governmentindebtedness is 24 times its annual tax revenue. Even in the fiscally profligate US, thecomparable multiple is "just" six.

8. While there are incipient signs that Europe's excruciatingly long economic contraction is winding down, the extent of the devastation to the once-thriving building industry in Spain, Portugal, Italy, and Greece has been beyond extreme. (*See Figure 6*)

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9. Like most developed countries—with the US as a notable exception—Germany's population is shrinking. This is likely to make funding its social spending obligations even more challenging. (*See Figure 7*)

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10. Underscoring that risk complacency is a global phenomenon, even in the chronically underachieving eurozone, the number of European companies selling unrated bonds has doubled since the start of 2010

11. Thanks to a healthy economy, combined with sound fiscal and monetary policies (in stark contrast to most of the developed world), the fair-value estimate of the Canadian dollar continues to rise. According to Toronto-based investment firm Gluskin Sheff, the intrinsic worth of the "Loonie" is now essentially at par versus a current market price of around 96.

12. A recurring EVA theme from several years ago was that the US savings rate has been consistently underestimated. The federal government's Bureau of Economic Analysis (BEA) released a new analysis late last month raising the official savings rate by 1% retroactively back to 2005. The BEA now includes full pension benefits not just the cash contributed to these plans. (*See Figure 8*)

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13. Beyond last week's disappointing jobs report, part-time hiring has been occurring at twice the pace of full-time employment so far in 2013, according to Cornerstone Macro.

14. One of the brighter elements of the US economic landscape is that private sector growth is much stronger than overall GDP. This reflects the fact that the for-profit part of the economy is expanding while the public portion is shrinking. (*See Figure 9*)

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15. Notwithstanding the superior growth profile of the non-government sector, the data continues to be extremely mixed. Another example of this muddled condition is that both manufacturing and industrial production have flat-lined of late even as other indicators, such as the important Institute of Supply Management (ISM) surveys, have improved. (*See Figure 10*)

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Those were the days. Remember way back in olden times, like before what many call the Global Financial Crisis, when things such as corporate earnings and economic trends were what drove the markets? In those days of yore, economists and strategists didn't have to spend most of their waking hours dissecting Fed minutes minutia looking for slight changes in the conjugation of verbs to determine how much longer the central bank will continue to pump amphetamines into the financial system.

Nostalgia aside, the fact of the matter is that the Fed's latest stimulus campaign, popularly known as QE3, is now the dominant market consideration and it is unquestionably creating some serious distortions. If you doubt that, consider this factoid from money manager par excellence, Seth Klarman: "US share prices rose for 20 straight Tuesdays through late May, literally a one-in-a-million probability occurrence."

Of course, when the Fed is printing a trillion, million-to-one shots go from nearly impossible to highly probable. Along similar lines, contrarian economist Gary Shilling—who, among other achievements, called the great bond bull market in the early '80s, the housing bubble, and the collapse of the commodity mania in 2008—recently ran the following charts. (*See Figures 11 and 12*)

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If you are as tired of this Fed fascination as I am, get ready for it to get worse. Next month is when the Fed may begin to dial down its magical money manufacturing machine. As others have wonderfully described it, such an event (if it happens) is likely to cause the market to undergo a "taper tantrum" (geez, I wish I'd come up with that gem!).

The investment team at Evergreen has been intensely debating what this might mean to stock and bond prices. Regular EVA readers will not, I'm sure, be surprised that we believe the stock market is much more vulnerable to a taper tantrum than bonds. Part of our reasoning is based on the charts above but also that stocks, especially those of a more volatile and lower quality nature, are priced for perfection.

Bonds, and particularly related instruments like closed-end funds that invest in them, have already been rather severely spanked.   Additionally, as described in last week's *EVA*, the fact of the matter is that rates have risen during QE phases and fallen when they end. Stocks, on the other hand, as illustrated above, have been totally dependent on the Fed's unprecedented munificence. Therefore, per prior *EVA*s, we believe it is reasonable to expect bonds to rally and stocks to swoon, should QE3 be terminated. Recent market action, however, would seem to indicate just the opposite, at least until this week when some ~~speculators'~~ buyers' remorse has become evident.

Of course, the Fed may not taper at all. As relayed in this week's *EVA*, and many others in the past, the US economy's current condition is so muddled that the Fed can either agree with the

Jim Cramer view of "escape velocity" lying just over the horizon (for the fourth year in a row) or Gary Shilling's of continuing lethargy.   Thus, Bernanke and company can pick and choose which set of data to focus on, thereby rationalizing either a taper-yes or taper-no decision.

The stock market's bullish thesis on tapering has been that it will only happen when Jim Cramer is finally vindicated. In other words: when there's no doubt the economy is on a roll. But what if the Fed, at long last realizing the ineffectiveness of its repeated QEs, decides to declare victory and retreat? Based on the recent change in tone among the more "dovish" Fed officials, there is a decent chance it could happen next month, more than I previously believed. This may be why stocks have softened a bit this week, as even a mild tapering is likely to be viewed as the swan song for QE in all its many iterations.

There are also some big changes coming at the Fed which I don't believe has caught the attention of most investors—yet.

Fed Ex-odus? Mike O'Rourke, the uber-astute chief market strategist for Jones Trading, has pointed out that there could be as many as 9 of the 12 voting members of the Federal Open Market Committee (FOMC), the entity that directs US monetary policy, turning over early next year. This, of course, is in addition to what looks like the near-certain departure of Fed chair Bernanke. Mike also has looked at the line-up changes and concludes that most of the new players will sport much less QE-friendly attitudes.

Should it become apparent that QE-Infinity is finite after all, and this realization sinks in when the economy is still stuttering, stocks might react in a highly petulant fashion—even if in the long run that is the best outcome for the country.   Naturally, no one knows; we are all speculating on the Fed, but there are some realities with very strong historical precedent as illustrated below.

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First, as you can see, sentiment on treasury bonds is currently exceedingly negative and such intense bearishness has usually led to spirited rallies. Second, episodes of sharply rising interest rates, like we have seen since late May, have not been kind to stock prices. Third (and one of my very favorite charts), whenever profit margins have been this elevated earnings growth has been below trend over the next four years (thanks to John Hussman for this graphic). These facts, and many others, lead us to conclude there is far more risk in the US stock market presently than there is in bonds and other yield-oriented securities.

With a radical changing of the guard at the Fed approaching, and a stock market that is up 155% over the last four and a half years, investors might do well to remember the 10 Investment Rules of one of the most influential market technicians of all time, Bob Farrell.

1. Markets tend to return to mean (average price) over time.
2. Excesses in one direction will lead to an opposite excess in the other direction.
3. There are no new eras—excesses are never permanent.
4. Rapidly rising or falling markets usually go further than you think, but they do not correct by going sideways.
5. The public buys the most at the top and the least at the bottom.
6. Fear and greed are stronger than long-term resolve.
7. Markets are strongest when they are broad and weakest when they narrow to a handful of blue-chip names.
8. Bear markets have three stages—sharp down, reflexive rebound, and a drawn-out fundamental downtrend.

9. When all the experts and forecasts agree, something else is going to happen.
10. Bull markets are more fun than bear markets.

We’ve been having a ton of fun in the stock market in recent years but it’s now time to realize that even Fed excesses aren’t permanent.

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IMPORTANT DISCLOSURES