

August 23, 2013

"We all know it's going to end badly, but in the meantime we can make some money."

-JIM CRAMER

POINTS TO PONDER

1. The contrast among a soaring stock market, rising interest rates, and flaccid corporate profits has become more vivid. Excluding financials, S&P 500 earnings are on track to actually decline in the second quarter versus a year ago. (See *Figure 1*)

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2. The US trade deficit has been declining of late, and this is typically viewed as an unalloyed positive. Yet, because the dollar is the world's reserve currency, a shrinking trade shortfall supplies less liquidity to the global economy. Consequently, past financial crises have often coincided with such "good news" episodes.

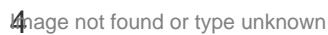
3. Numerous past EVAs have noted the S&P 500 is not nearly as reasonably priced as it superficially appears if present peak profit margins are normalized. Sadly for Middle America, a key reason corporate America's earnings are so lush right now is a result of labor's plummeting share of GDP. (See *Figure 2*)

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4. In another indication that the Fed's multiple QE efforts have failed to sustainably lift consumer prices, its preferred measure of inflation—the price index for personal consumption expenditures (PCE)—has risen by a mere 1.1% over the last year. Core CPI (i.e., excluding food and energy) reveals a similar trend. (See *Figure 3*)

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5. Smaller companies trade at nearly a 30% premium to the blue chip-dominated S&P 500. This leaves them even more vulnerable to a severe decline than the S&P should the present bullish investor attitude become more guarded due to rising interest rates, flagging earnings growth, Fed tapering worries, or all of the above. (See *Figure 4*)

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6. One of the most encouraging aspects of the long-term US economic outlook is that household debt service, relative to disposable income, is at its lowest level in more than 30 years. (See *Figure 5*)

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7. Detroit's travails, combined with the global interest rate surge since late May, have put municipal bonds on their heels. Lost in all the angst over the Motor City is the jump in state and local property tax revenues in much of the country due to the rebounding housing market, thereby boosting credit quality for many municipal issuers. The dark side of this trend is the drain higher taxes pose for consumers.

8. Gold has been stabilizing after its springtime plunge. Barron's recently noted, in an upbeat article on the yellow metal, that commercial participants in the gold futures market (miners, industrial users, etc.) are as bullish on bullion as they have been in more than 11 years. Meanwhile, speculators remain heavily short (i.e., bearish).

9. Silver, similar to its precious metal cousin, is broadly detested by the speculative investor community. (See *Figure 6*)

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10. Overall US employment statistics remain uninspiring. However, per Cornerstone Macro, one of the notable below-the-surface positives is that private sector employment is expanding at a healthy clip while government payrolls have been shrinking. Private payroll gains have averaged 206,000 per month thus far in 2013, the fastest rate of increase since 1999. (See *Figures 7 and 8*)

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11. One of the most exciting developments in the energy sector recently is Mexico's announcement that, for the first time in 75 years, it is opening up its vast oil and gas resources to international capital and expertise. The goal is to reverse a precipitous decline in annual oil production from 3.4 million barrels per day (bpd) to just 2.5 million bpd currently. This nearly 1 million bpd reduction is particularly glaring given that US oil output is on a steep upward arc.

12. It does appear that the eurozone's second recession in the last five years has ended. While this is highly encouraging, Europe's debt crisis and fragile banking system continue to have the potential to destabilize financial markets. (See *Figure 9*)

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13. Another looming hurdle for Europe is that, according to the Royal Bank of Scotland, its banks need to shed roughly \$4 trillion (US) of assets. This requirement must be met to comply with new regulations and is likely to significantly impede the issuance of new loans.

14. One of the most startling statistics about Japan's twenty-year economic stagnation is that its nominal GDP (i.e., including inflation or deflation) is the same as it was in 1992.

15. It does appear China has been successful at gradually letting the air out of its housing bubble. New construction dropped off materially over the last two years while sales have vigorously recovered (up 37% year-over-year in the first quarter). As a result, the prior sizable overhang of unsold properties is contracting. (See *Figure 10*)

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Often wrong but never in doubt. Everyone knows there's never been a stock market bubble like the late 1990s, right? Maybe it comes with almost 35 years of experience in the investment business, but whenever I hear or read "everyone knows" (even in my own newsletter!), I start wondering if what everyone knows *just ain't* so. Thanks to a factoid mined this week by Evergreen's human search engine, Rob Dainard, I think this might be another time when "everyone" is wrong.

Regarding the 1999 market peak, Rob found an interview with Pat English, manager of the \$8 billion FMI Large Cap fund, which carries a Morningstar gold rating. According to Mr. English, the median P/E of the overall stock universe is actually higher today than it was in 1999. Unquestionably, the *average* market P/E, as traditionally measured, was much higher at that time; in fact, the official S&P 500 P/E at the end of 1999 was 32, the highest on record (this excludes the P/E spike in 2009 resulting from huge financial write-offs).

Yet, as Mr. English points out, the nose-bleed average in 1999 was caused by tech stocks like Microsoft, Cisco, and EMC trading at more than 100 times earnings and sporting multi-hundred-billion market caps. In the speculative frenzy of that era, few dared to ask how companies with such massive market values could ever grow fast enough to justify P/Es north of 100—yet another example of the mindlessness of Wall Street group-think. However, their collective multi-trillion size definitely distorted the market's aggregate valuation.

In reality, most of the rest of the stock market entered a bear phase in early 1998 as tech stocks acted like an enormous vortex, sucking in what seemed like all the world's investment capital. Nearly every other investment sector was relentlessly drained of assets during this global mania for anything tech. Consequently, by early 2000 there were bargains galore: small cap stocks,

emerging markets, bonds, master limited partnerships (MLPs), preferreds, and almost all "old economy" stocks (remember that dismissive label from those who had guzzled the dot.com Kool-Aid?).

This period is so vivid in my memory because my clients', and my own, portfolios were loaded up at the time with what "everyone" knew was the wrong stuff. Thus, it was possible to earn decent to excellent returns over the next two years even as the overall market fell hard and the formerly parabolic NASDAQ plunged down the other side of the curve (after all, parabolas do have two sides to them as those who get caught up in bubbles constantly forget).

Today, however, as Mr. English notes, underpriced stocks are hard to come by. In fact, it is the irony of ironies that the sector that was so cheap 14 years ago—namely small cap shares—and what was so dear—large cap tech—have swapped roles. Now, one of the few sectors that still offer an acceptable risk/reward ratio is big tech. For example, you can buy the premier designer and producer of smart phone chip sets, which just reported a 35% revenue increase, at 16 times earnings, or the leading manufacturer of baby clothes at a P/E of 25.

But perhaps the latter entity deserves to sell at such a generous multiple given that infantile behavior always seems en vogue on Wall Street...

I want my QE and I want it now! There are a couple of other things "everyone" knows these days. One is that the economy can't sustain itself without endless QEs. Even hardcore free marketer Larry Kudlow said so on CNBC this week, as did the legendary Byron Wien earlier this month on the same channel. (What a sad commentary that Wall Street needs to whine for constant Fed suckling four years into an expansion!)

Undoubtedly, some *EVA* readers feel I have been unduly critical of the Fed's multi-year and multi-trillion-dollar campaign to create a Lance Armstrong-effect in the US economy. In my defense, I would like to cite a just-released study contending that the \$600 billion QE2 created a mere 0.13% boost to real GDP, and that even this miniscule stimulus evaporated over the next two years. Additionally, real median income has *contracted* by 5% during this so-called recovery.

By the way, the source of the QE2 "boost" analysis was produced by two senior economists working for an organization you may have heard of—the Federal Reserve. And one of its co-authors hails from the San Francisco Fed, which happens to be the stomping ground of Janet Yellen, a leading contender to replace Ben Bernanke and one of the chief architects of QEs 1.0, 2.0, and 3.0.

Another thing "everyone" seems to know is that the end of QE, or even the interminably discussed tapering, will cause interest rates to rise. As far as I know, I've never re-run a chart in *EVA* (I'm sure some sharp readers can trip me up on that one). However, I'm now going to do so intentionally to reiterate that one of the most desired goals of the Fed's binge-printing—to lower interest rates—has been an even bigger whiff than the Fed's attempt at economic stimulus.*

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Therefore, to this inveterate contrarian, what would totally flummox the consensus, an occurrence that happens regularly I might add, would be a decline in longer term rates once the Fed does decide to taper. Underscoring just how convinced the pliant majority is that stocks are preferable to bonds, a recent B of A Merrill survey of global money managers found that equities were at their third highest weighting in the last decade, while a grand total of 3% felt long-term interest rates would be lower in a year.

It is often the case, though, that the consensus view is right on a near-term basis and, without a doubt, there is considerable upside momentum to yields presently. Thus, I wouldn't be the least surprised to see rates break above 3% and possibly spike from there to 3.5%, or even somewhat higher, at least briefly. But, if they do, the selling pressure that is already so palpable around the world, and is also becoming apparent in US equities, is likely to hit a fever pitch. If that's the case, we might have one of those September or October stock market surprises that have graced this time of the year so often in the past. If so, be prepared for some serious crying on Wall Street.

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*To be fair, QE1 was, in my opinion, a necessary intervention to prevent a systemic meltdown. The rate rise this triggered was limited to treasury securities with corporate rates falling dramatically after it was launched, which stabilized the financial markets and the economy. QE2 and QE3, however, were much less effective and, arguably, counter-productive.

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