February 15, 2013

"Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria. The time of maximum pessimism is the best time to buy, and the time of maximum optimism is the best time to sell."
-SIR JOHN TEMPLETON

POINTS TO PONDER

1. As our partners at GaveKal have repeatedly shown, US profit margins are in a long-term uptrend, as the chart below, courtesy of John Hussman, makes abundantly clear. However, they remain highly cyclical. It appears that the "new normal" for US corporate after-tax profits is around 8.5% of GDP, about 15% below present levels. If so, then the S&P 500 is trading around 18 times normalized earnings (see the main text for more details). (*See figure 1*)

1

2. The chart above also illustrates how weak profit growth is over the subsequent four-year period after margin peaks. This reality is at odds with the current bullish consensus on future earnings increases.

3. Offsetting such fundamental and long-term concerns, as those expressed above, is the fact that the Fed remains committed to elevating share prices. Once again, however, history shows that such liquidity-driven market gains tend to be fleeting. Conversely, sustainable bull cycles have coincided with periods when real interest rates have been in positive territory. (*See figure 2*)

2

4. Notwithstanding the bubbly multi-year performance of REITs, the underlying fundamentals in two key sub-sectors are underwhelming. In the office area, vacancies remain above 17% while rents increased just 2% in 2012 (i.e., flat, net of inflation). In the retail space, vacancies are near 11% while rents have failed to rise for two straight years. Even in the long-vibrant apartment realm, multi-family giant Avalon Bay is warning of deteriorating conditions.

5. In another illustration of how much the Fedâ??s money manufacturing is driving the stock market, as opposed to actual corporate vitality, over 75% of S&P 500 constituents that have given forward earnings guidance are lowering estimates. (Admittedly, less than a quarter of the companies in the S&P 500 actually provide this projection.) Of course, in the surreal world in which we now live, this could be construed bullishly as it enhances the odds that the Fed will leave its liquidity spigots wide open.

6. Underscoring what a daunting liquidity drain lies ahead for the Fed, Charles Plosser estimates that it will need to reduce its balance sheet by $1.8 trillion once money velocity returns to typical levels. As chairman and CEO of the Philadelphia Fed, Mr. Plosser is certainly not part of the lunatic fringe. Yet, he notes that should the Fed fail to materially shrink what will likely be nearly $3 trillion of bond holdings (by the end of this year), consumer prices will triple.

7. Because junk bonds have stock-like attributes (such as a much higher risk profile than traditional debt securities), it is reasonable to compare their valuation to stocks. On the basis of

prevailing junk bond yields versus the earnings yield on the stock market, they look extremely pricey. Even after adjusting profits down to account for peak margins, sub-investment-grade bonds would be toward the high end of their relative valuation range. (*See figure 3*)

3

8. Attitudes in the housing sector have quickly morphed from despondent to euphoric. Yet, nearly all the improvement has occurred in the rental-related market. Actual new home sales remain exceptionally subdued (though clearly improving). (*See figure 4*)

4

9. Echoing one of the main themes from Matt Ridleyâ??s best-selling book, The Rational Optimist, Donald Boudreaux and Mark Perry, writing in the Wall Street Journal, assert that Americaâ??s middle class has fared much better over time than popularly believed. Spending on essentials such as food at home, clothing, housing, utilities, and even autos, is 32% of disposable income versus 53% in 1950 and 44% in 1970.

10. Canada continues to break away from the rest of its developed world peers when it comes to fiscal integrity. Its latest effort in this regard is a bonus plan for senior public officials tied to permanent spending cuts.

11. A recent government-sponsored study of Franceâ??s eroding competitiveness noted that the country has lost 750,000 jobs in the last decade. It cited high payroll taxes and rigid work rules as the prime culprits. Other countries with socialist traditions, such as Norway and Sweden, have effectively reformed their welfare states. Thus, itâ??s possible France will as well. However, even the governing Socialist party is admitting it has excessively relied on massive tax hikes in a vain attempt to shore up its finances.

12. The contrasting performance between the German and French economies is becoming even more pronounced. Moreover, in a shocking admission of his countryâ??s plight, French labor minister, Michel Sapin, conceded in a recent radio interview that the government is "totally bankrupt". (*See figure 5*)

5

13. For all those who believe European Central Bank chief Mario Monti has solved Europeâ??s most existential problems, consider this statistic: The European Union has 7% of the worldâ??s population and 50% of its social spending.

14. Supporting the bullish view of companies involved in shipping LNG, Shell Oil is projecting LNG demand to double by 2020. It is also forecasting that China will be the destination for 10% of the increased volume; however, based on its horrific pollution problem that may be low.

15. Although Chinaâ??s torrid economic expansion of the last 30 years is unquestionably cooling off, growth may nevertheless experience a near-term spurt. Inventories have been materially reduced, setting the stage for a replenishment cycle. (*See figure 6*)

6

Could it be dÃ©jÃ vu, 1982 all over again? Ah, yes, August of 1982. How well I remember that fateful month. My investment career was barely in its fourth year and, just as I was wondering if I had chosen the right profession, the stock market came alive after 16 years of imitating the EKG of a cadaver. I still remember sitting at my desk the day the Dow exploded 38 pointsâ??an almost unprecedented 4.9%â??as the Dean Witter "squawk box" system played the theme from *Rocky*. 1000 on the Dow, so long a ceiling for the market, was decisively broken and the monster bull market of the 1980s and 1990s roared to life.

From a liftoff point of 777, the Dow would eventually top out at 11,722 in January of 2000, an increase of 1,410% not counting dividends. Meanwhile, the overall market P/E ratio rose from a miserly 7 to a lofty 28.

Then, as is always the case when valuations become overly generous, reality bitâ??and with a ferocity worthy of *Jaws*. The broad market, as measured by the S&P 500, has gone through one of its longest zero-return stretches as it is essentially unchanged from where it was trading 13 years ago. Yet, lately, there has been a growing amount of chatter that the S&P is poised to decisively break above the threshold that has been a resistance level for all these years (the Dow, made up of only 30 stocks, exceeded its 2000 high back in 2007).

Therefore, itâ??s reasonable to relfect on how likely it is that stocks are primed for a 1982 breakout. Letâ??s consider the conditions then versus now.

In addition to much lower P/E ratios in 1982, interest rates were nearly 14% on government bonds. However, they were beginning to fall, as was inflation that had also vaulted into double digits. The Fed back then was headed by a man who was determined to vanquish inflation and he was beginning to succeed. The administration at the time was on a mission to reduce the regulatory burden and simplify the tax code (though the latter would take six years to accomplish). Additionally, profit margins were at a recessionary trough and ready to explode.

Today, these critical supporting elements are inverted. Itâ??s fairly obvious that interest rates are unsustainably low and that inflation isnâ??t likely to remain muted given current Fed policies. And, anyone who runs a business is acutely aware of the mushrooming cost and complexity of government regulations.

However, the reason I led off with the chart of profit margins as the first Point to Ponder in this issue is that I donâ??t believe this topic is getting the attention it deserves (despite the efforts of folks like John Hussman). Rather, the incessant chant we hear on Wall Street is how cheap stocks are relative to interest rates.

While my team and I have sympathy for the argument that stocks are the Least Bad Option, we do believe it is imperative for a long-term investor to adjust for margins that are unquestionably unsustainable. (Yes, that really is a double "un".) Itâ??s not often you can use phrases like that in the investment game, but it is simply axiomatic that profitability cannot continue indefinitely at these levels.

Long-time EVA readers will remember I made this case back in 2007, and it was just as unpopular to the raging bulls then as it is today. Of course, profit margins six years ago soon not only reverted to the mean, they went far below in what was one of the meanest earnings meltdowns ever seen.

Consequently, when stocks had fallen almost 60%, some alleged market experts were saying equities were overpriced because profits had collapsed even more, leaving the P/E at that time much higher than it was when the market was at its zenith. But, when viewed on the far more meaningful normalized earnings basis, the market was inexpensive. That was an argument I strenuously tried to make at the time. Yet, there werenâ??t too many buying my reasoning since panic was overwhelming logic, as it does so often when stocks are free-falling.

Therefore, what is a plausible adjustment to "normalize" earnings and come up with a P/E for the market that is more accurate? John Hussman believes that profit margins are 60% to 70% above their historic mean. However, as much as I respect Johnâ??s analytical skills, I think that is too negative. The reason is that, as noted in Points to Ponder 1, profits as a share of GDP have been trending up for 30 years. Nevertheless, they remain highly cyclical and any prudent stock investor should adjust for the ups and downs.

For last year, the overall earnings on the S&P 500 appears as though they will come in around $100 (a fair amount lower than had been optimistically projected at the beginning of 2012). With the S&P trading a bit above 1500 now, that means stocks are being valued at 15 times trailing earnings. They are even cheaper if you use this yearâ??s earnings estimate of roughly $110, making the "forward" P/E about 13Â½. That sounds so reasonable, almost bargain-like, right?

But if we assume that the new mean for profits is around 8.5% of GDP (again, referring to the chart in Points to Ponder 1), that would be about 15% lower than last yearâ??s record-breaking level. Thus, instead of $100 as a trailing earnings number, it actually should be more like $85. Then the marketâ??s P/E would be nearly 18, a far cry from 13Â½.

Robert Shiller, who warned of both the tech and the housing bubbles well before they burst, has devised a P/E methodology that smooths out earnings over a 10-year period. Presently, that P/E is 22 versus a norm closer to 17. The really key part is that whenever the Shiller P/E has been this high, future stock returns have only averaged 1% after inflation over the next decade. Valuations such as we see today, combined with nosebleed high profit margins, are not the stuff breakaway bull markets are made of.

In my 34-year career, Iâ??ve seen a number of liquidity-driven markets, though never one as flagrantly juiced as what weâ??re experiencing now. Theyâ??ve never ended well. As a result, Iâ??m wondering if the dÃ©jÃ vu year might be more like 1987 than 1982.

October, 1987, is another month Iâ??ll never forget. Watching the market fall almost 23% in a day and over 30% in a month was quite a book-end for what had happened just over five years earlier. It was the original flash crash. While there were various causes, including spiking interest rates and a plunging dollar, portfolio insurance played a leading role. The belief among institutions using this tactic was that it protected them from major declines--not unlike the prevailing attitude today that the Fedâ??s QE-forever has eliminated material downside. In reality, portfolio insurance helped turn a correction into a collapse.

Astute students of the market know that, despite that epic cliff dive, stocks actually finished 1987 in the plus column and another multi-year rally started from the post-crash trough. However, interest rates began falling sharply and the economy was growing vigorously, two circumstances that are nearly impossible to recreate today. Should the abiding faith in the Fed be shattered at some point, itâ??s difficult to envision what would come to the rescue.

Yet, I do have an idea in that regard, something that the Fedâ??s constant monetary heroin fixes are preventingâ??real reforms of fiscal, tax, healthcare, and regulatory policies. Next weekâ??s full-length EVA is going to examine a group of countries that were nearly destroyed by socialistic sclerosis and how they unclogged their economic arteries.

David_Hay_Signature

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