May 31, 2013

*"Just because a reversal of something unsustainable hasn't happened yet, doesn't mean it won't."*
-SUPER INVESTOR, SETH KLARMAN

**There they go again!** Don't get me wrong—I'm a regular reader and avid admirer of The Economist. It has a uniquely global perspective but whoever chooses its cover graphics does have quite the knack for star-crossed timing. It was just a month ago, in our last guest *EVA*, that I noted *The Economist's* remarkable ability to run a feature story not long before real-world events almost completely contradict their theme of the week.

The latest case in point was its cover on Japan from the May 18th-24th issue, as shown below. Incredibly, the very next week, the Japanese stock market fell 12% over two days. After a brief rally, it has withered further, bringing its cumulative tumble to 15% (equivalent to a 2300 point plunge in the Dow!) Therefore, it may not bode well for the continuation a country's bull market when its leader is shown in Superman garb on the front of a major financial publication.

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Accordingly, *The Economist's* cover from a week earlier on the US stock market should raise a few eyebrows (and, perhaps, stop loss orders). The good news, as you can see below, is that it didn't feature President Obama changing clothes in a phone booth or leaping over tall buildings in a single bound.

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Despite the caution these glowing cover stories raise in my mind, as do numerous other measures of excessive ebullience, this issue of our monthly guest *EVA* is dedicated to the bull case. In our business, you learn a lot of humility as markets have a funny way of making your most confident predictions come a cropper. Therefore, it's wise to consider the arguments of those who disagree with you.

Four weeks ago, at his Strategic Investment Conference, John Mauldin introduced Anatole Kaletsky as the most widely read financial journalist in Europe. It's not an exaggeration to say that I am honored to be associated with Anatole through our partnership with GaveKal Research and Capital, which he co-founded.

Besides being wicked smart, and having attained celebrity status on the Continent, he is also a very nice man (he didn't even utter a word of complaint when he was forced to share the backseat with our American bulldog, Whitey, when we drove him to dinner while at the Mauldin event).

Anatole recently authored an essay with the delightful title shown below. Although he is too polite to say so, I think one of the Ten Bears he is referring to is yours truly. Certainly, he is addressing a number of the concerns that I've shared in these pages over the last few months. Yet, as longtime readers know, I am a temporary bear, having been a lonely bull when the market was doing "the Tom Petty" (that would be free falling) in late 2008 and early 2009.

One of the best parts of working with GaveKal is that we can agree to disagree (and if you saw our internal emails, you'd see how often we're at loggerheads) but still respect each others' views.  And I'll be the first to concede that Anatole has been right and I've been wrong about the market over the last six months.

Who knows?  Maybe I'll be giving Anatole more kudos come next fall.   If so, I'll also have to admit that this time *The Economist* got at least one of its May cover stories right.

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**GOLDILOCKS AND THE TEN BEARS**
Anatole Kaletsky

Two weeks ago, as the S&P 500 soared out of the trading range in which it had been trapped for 13 years we suggested that this break-out could mark the start of a secular bull market in global equities. This idea provoked derision and even outrage from many clients. While we cannot do justice to all of the objections we received, it seemed helpful to summarize the main criticisms and offer a defence of our bullish position. The counter-arguments we heard most often can be grouped under ten headings. To put things more colorfully, Goldilocks in the fairy tale faced only three bears, but our views are under attack from at least ten bears, with plenty of others lurking in the shadows.

**Bear #1:** There is no convincing evidence yet that the US will avoid another summer slowdown and the global economy has not yet improved sufficiently for a bull market to take off.

**Goldilocks:** The US economic indicators are looking increasingly healthy, the slowdown in March and April seems to have been an aberration, maybe due to cold weather. Europe is still very weak but it is no longer that important and the rest of the world is in decent shape. Because of the rapidly increasing weight of fast-growing emerging markets in the global economy, the 3.3% global growth forecast by the International Monetary Fund this year is only a little slower than the average of 3.6% from 1995 to 2004. And even if the US and the world economy do run into another summer soft-patch, this will merely mark a pause in the post-2009 recovery and act as the launchpad for the next powerful leg of the bull market, to judge by the experience of the past four years. In any case, the economic outlook is never clear in the early phase of a bull market. If evidence for global economic recovery were unambiguous and undeniable, then equity prices would already be much higher.

**Bear #2:** In that case, how can you say that this is the start of a new bull market? This rally started in April 2009. This isn't a frisky young bull with lots of upside potential but a geriatric ready for the knacker's yard.

**Goldilocks:** The gains of the past four years were merely a recovery from one of the worst bear markets on record. Many investors were convinced that this was a dead cat bounce, to be followed by another slump once the losses of 2008 were retraced.

If the S&P 500 had recoiled from its 2000 and 2007 highs, bears would have hailed this as proof that equities were still stuck in a long-term trading range, with a serious risk that the lower half of the 13-year range was re-tested. But the S&P has now risen 6.5% above its previous all-time high. In the past 100 years each time US stock prices have broken decisively through previous record highs, large further gains have followed—ranging from 20% to 900%. Of course, past performance does not prove anything, but it does remind that equity prices generally break out of previously established ranges for good reasons; because bullish forces are gaining ground in the world economy, even when analysts do not yet detect them.

**Bear #3:** But this break-out has nothing to do with economic fundamentals. It is totally dependent on monetary stimulus—mainly from the Federal Reserve but now also from the Bank of Japan.

**Goldilocks:** That may or may not be true, but who cares? As long as the stimulus continues equity investors will keep making money. And we now know that the stimulus will continue until the US economy is growing fast enough to get unemployment to 6.5%. So either the central banks will succeed in stimulating stronger growth (at least in nominal GDP)—or they will keep on printing money. Either scenario is bullish for equities. As the Roman Emperor Vespasian remarked when he taxed public toilets to raise money, pecunia non olet ("money doesn’t smell").

**Bear #4:** But what happens when central banks stop expanding their balance sheets or interest rates start to rise? If economic growth and equity prices are powered by monetary stimulus they will collapse once the stimulus is withdrawn.

**Goldilocks:** But we now know that central banks will NOT withdraw stimulus until they are absolutely sure that growth is strong enough to keep going even in the face of tighter monetary conditions. That is the main difference between the situation today and a year ago. The central banks are now committed to continue stimulating without limit until growth reaches what Mark Carney calls "escape velocity". Of course, the central bankers may miscalculate. They might start to withdraw stimulus too early—but in that case they would reverse course at the first signs of economic slowdown, redoubling the stimulus and giving asset prices an even bigger boost. More likely, the central banks will keep stimulus going too long, creating inflation. But higher inflation would generate higher nominal GDP growth—higher growth in corporate revenues and profits. So even an inflationary outcome to the present monetary experiments would be quite positive for equities, especially in relation to bonds.

**Bear #5:** But structural fundamentals are still as bad as ever. The world economy cannot move into a sustainable phase of growth and corporate profitability with unsustainable debt burdens, on-going deleveraging, worsening demographics, slower productivity growth, widening income inequality, and health and pension liabilities out of control.

**Goldilocks:** Some of these structural factors have improved more than is generally acknowledged, especially in the US. The budget deficit is down to 4% of GDP and is on track for 2%, even without further tax hikes or spending cuts. Household balance sheets have improved dramatically and corporates are flush with cash. Productivity growth was actually very strong in 2009 and 2010—the recent slowdown in US productivity growth is mainly a payback for two years of extremely aggressive cuts in corporate employment. The demographic situation will probably improve with the immigration reforms and there are even signs that healthcare inflation may be slowing. Most importantly, there are plenty of structural forces pointing to faster growth and sustainably high corporate profits; for example, the US energy revolution, spectacular advances in automation and the potential for Pacific and Atlantic free-trade talks. In any case, structural issues do not, by definition, change much from year-to-year and most of the negative structural factors must by now be discounted. Is any investor in the world still unaware that our societies are aging and that unfunded health and pension liabilities will need to be reduced? Meanwhile, the cyclical factors are moving in a more positive direction and it will be the changing factors that dominate market movements, since prices are made at the margin.

**Bear #6:** But negative real interest rates, maintained for many years by irresponsible central bankers, will lead to mis-allocation of resources and do further damage to productivity growth.

**Goldilocks:** This may happen in the long-run, since sound capitalism certainly requires capital to be properly priced. For the present, however, there is no evidence to support the "austerian" claims about mal-investment, since investment all over the world is clearly too low, not too high—with the notable exception of China. Mal-investment can certainly become a danger in the boom phase of the cycle, but it is hard to see how low interest rates can do much damage to productivity in the bust phase when investment is clearly too low, rather than too high.

**Bear #7:** But the market leadership is all wrong. If the world were really moving into a sustainable growth phase, leadership would be coming from cyclical stocks, not consumer staples and healthcare stocks. And look at weakness of emerging markets—this hardly suggests improving prospects for global growth.

**Goldilocks:** Stock market leadership has reflected the widespread view among investors that the 2009-13 rally was essentially a dead cat bounce and that the world economy would NOT break out of the "new normal" of weak growth and high unemployment. But in the past few weeks, the leadership has begun to change with technology, cyclicals and financials all starting to outperform. This suggests that the "new normal" may turn out to be not so very different from the old normal after all. The weakness of commodities is due to specific issues connected with over-investment based on wild speculation about dollar debasement and insatiable demand in China – and equities in commodity-producing emerging markets may now be paying the price. Meanwhile, Asian emerging markets have been spooked by yen devaluation, but they should soon start to outperform if the structural bull thesis turns out to be right.

**Bear #8:** This rally cannot last much longer because equity valuations are already too high. Equities only look attractively priced because bond yields are totally distorted and investors are calculating valuations based on unsustainably high profits, instead of using cyclically-adjusted Shiller PEs.*

**Goldilocks:** Bond yields of 2% are surely unsustainable and distorted, but when we plug in ten-year bond yields of 3.5% into most valuation models, equities look about as cheap as they were in the early 1980s. As for the Shiller PEs, they are an absurdly distorted measure since the 10-year averaging period now encompasses two recessions, including the longest and deepest on record. For the Shiller PE to make any sense, you have to believe that 2012 was near the top of the global economic cycle. We believe that 2012 was nearer the bottom of the cycle and there is a much higher probability of the global cycle accelerating in 2014 and beyond than going into reverse.

**Bear #9:** Even if it’s true that the economic background is conducive to further equity gains, sentiment is all wrong. Investors are far too bullish for the start of a secular bull market.

**Goldilocks:** This is simply untrue. Investor sentiment is actually still surprisingly cautious, despite the fact that equity prices have more than doubled in the last four years without any really large drawdowns. As our friend Ed Hyman of ISI notes in his latest comment: "ISI’s hedge fund survey increased last week, but to just 51.3; i.e., just over 50.0, suggesting that many funds are defensively positioned. During 2004/06, the survey regularly hit 60.0." Ed’s view is supported by the latest State Street Risk Appetite Index, which at 93.6, is lower than it was last summer and much lower than for most of the period from March 2009 until late 2011.

**Bear #10:** But share prices cannot keep just keep rising. A correction is inevitable - and it could start as soon as this week.

**Goldilocks:** On this we finally agree. The S&P 500 has risen by 23% in the six months since 15 November, with a maximum drawdown of 3.5%. The Nikkei has, of course, been even more spectacular. There is no knowing when a correction will happen, but sooner or later there will be a drawdown of at least 5% and maybe even 10%. The issue, however, is whether equities will fall back into the trading range of 700 to 1550 on the S&P 500 where they have been stuck in the 13 years since March 2000. We think this is now unlikely. Of course all the bearish arguments above – and many others – make us seriously worried about the outlook for the world economy and for corporate profits in the years ahead. But let us not forget that bull markets always climb a wall of worry; the time to get bearish is when we see prices sliding down the slope of hope. That, by the way, now seems to be what's happening to gold—the last refuge of the perma-bears.

*Based on the average of inflation-adjusted earnings for the S&P 500 over the prior decade.