Investment Perspective

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WILL THE CICADAS WAKE THE BEARS? **July, 2013**

The buzz is back

After six months of steady stock market gains and relative calm, volatility suddenly reawakened like the cicada, creating quite a buzz. Stock and bond markets both sold off late in the quarter. The main cause of this renewed angst? Fears that the Federal Reserve may be ending the era of free money.

Judging from the markets' reactions, many stock and bond traders were apparently shocked by the notion that ultra-low interest rates cannot persist indefinitely. (By the way, if they did, that would not be a good sign — see Japan.) Traders rushed for the exits, selling higher-dividend-paying stocks, longer dated bonds, and other instruments of yield.

The 10-year Treasury closed the quarter at 2.52%, up almost a full percentage point from early May. That represents a sizable move and is certainly unwelcome news for owners of long bonds. The drop in value from the spike in rates just overwhelmed the incremental coupon one was receiving over a short-term security. From a broader standpoint, however, it is critical to recognize that interest rates remain very low. And as such, they are not at odds with an improving economy or higher stock prices.

No cold turkey for a drug like "zeroin"

Markets have become addicted to easy money. As with any addict, they must be gradually weaned from this dependence for their own good. Hence, Bernanke's running dialogue laying out the conditions under which the Fed would begin this process. Since the 2008 credit crisis, Fed policy has been extraordinarily accommodative. Most recently, the central bank has been soaking up $85 billion of bonds per month, helping keep down long-term rates.

Such *quantitative easing* has been about putting a floor under the economy. The latest focus has been on supporting job growth and insuring against downside risks such as those from restrictive fiscal policy. As the economy has slowly regained some traction, the Fed understandably has begun to talk about "tapering" its bond purchases.

Many pundits seem to suffer from the misguided view that the shift away from aggressive monetary policies denotes the end to the cyclical bull market in stocks. They are overlooking the reasons such policies were necessary in the first place — the credit meltdown, implosion of the housing sector, massive job cuts, collapse of consumer net worth, and reluctance of businesses to take risks. In short, an extremely ugly and precarious backdrop.

A good economy means a good stock market

Moreover, it is erroneous to equate *tapering* with *tightening*. Reduced bond purchases by the Fed would still represent monetary easing, just at a slower pace. The impact on the real economy should prove minor. And note that this is a separate tool from the Fed's (zero-) interest-rate policy. They appear to be in no hurry to allow short-term rates to move up, implying that the overall monetary policy will remain stimulative for the foreseeable future.

Should not a return to a healthier economic climate — allowing for the normalization of monetary policy — ultimately be bullish for stocks? Assuming inflation is contained, the answer will generally be affirmative. Well, some might counter, without the crutch that is Fed policy, the economic tide will shift against us again.

Perhaps that view partially explains the virulent reaction to Bernanke's June 19th press conference. Inferring that the brakes were about to be stomped on, stock and bond markets convulsed. In reality, the Chairman did not change his basic tune. He stressed that Fed policy would continue to depend on the economic outlook and ultimately would provide any "necessary support." Importantly, core inflation remains at low levels, so policymakers still have plenty of flexibility.

Uncertainty abounds

But uncertainty about the future path and structure of interest rates has stoked market anxiety. The Fed's balance sheet has tripled in size since 2008 to $3 trillion. It consists mostly of Treasury, agency, and mortgage-backed bonds. The counterpart to these assets is the cash that has flooded the banking system — most of it not circulating, instead residing on banks' balance sheets.

When and how will these holdings be unwound? Will the Fed sell the securities, thus pressuring interest rates upward? Or will it simply allow the bonds to mature, which would take years? No one, including the Fed itself, has a good sense for what the exit will look like. So it is apt to be a bit messy. And as markets are wont to do, the instinct is to shoot first and worry about the aim later.

By driving down the returns on bonds, quantitative easing has had the desired effect of inducing some investors to shift their capital elsewhere. Like many asset classes, stocks have benefited from this tailwind. Analogies to 1999 have begun to surface. That year marked the last in a tremendous string of up moves and the approach of a long-term, or secular, bear market.

A different picture this time

The comparisons have been prompted by the prolonged rise by stocks since the March 2009 lows, along with investors' gravitation back toward them. To us, however, the backdrop today is dissimilar on many fronts, whether one considers sentiment, valuation, or corporate fundamentals.

Remember Bill's Barber Shop, the subject of a front-page *Wall Street Journal* piece in March 2000? It was a gathering spot for Cape Cod locals who traded technology stock tips and apparently minted money. They were not alone. Like many, they had complete faith that the party would continue unabated. The premise seemed to simply be that stocks would keep moving up because they had been moving up. And indeed, the trend *is* your friend — until it isn't. In hindsight, that article encapsulated the hubris and recklessness of stock investors at the time.

Today, such unwavering optimism towards stock is absent. As a group, investors are no longer pessimistic, but one still senses quite a bit of skepticism. That wariness flows from the experience of the last two deep bear markets, acting as a governor on investor appetite for risk. Interestingly, the prevailing mood is again borne out at Bill's. The *Journal* returned to the barber shop this past March and reported that many of the protagonists have gotten entirely out of the market.

Broad, solid and strong

So in 2013 we do not have anywhere near the level of speculation evident in 1999. Also, consider the nature of the stocks that propelled the market forward during the respective periods. In the late 1990s, the market was dominated by a narrow band of companies in the technology, media, and telecommications complex. Some even had positive cash flows. Today, the stock market is led by the blue-chips, companies with high profits and solid balance sheets. Some sectors have performed quite a bit better than others, but most have still participated in the rally. In other words, it has been broad-based.

And contrary to the meme that easy money is the primary reason for higher stock prices, most of the move of the past four years is justified by sharply higher earnings. Compared to their counterparts in 1999, stocks today in the S&P 500 have twice the earnings and dividends for *half* the price-earnings multiple. We are not arguing that stocks are cheap now, but valuations are nowhere near those of the inflated late 1990s. Therefore, the comparison to 1999 is not valid.

OK, so stocks are not in a bubble, but after a 150% gain from the 2009 lows, is this cyclical bull not gasping for its last breath? The backdrop suggests that the cycle has further to run. First of all, consider that these gains have followed a decade in which investors confronted two severe bear markets, each producing declines of more than 50%. Stocks sharply underperformed bonds and to this day are still below their long-term trend line.

Early stages of recovery

Additionally, bear markets are typically preceded by monetary tightening. The yield curve often inverts as short rates exceed long ones. An inverted, or negative-sloped, yield curve commonly signals a recession as well. Today, the yield curve is steepening as short rates remain anchored near zero and long rates rise. This implies that monetary policy is stimulative and that the economy should strengthen rather than weaken. BCA Research points out that it would be unusual for a major bear market to develop with a positively-sloped and steepening yield curve as we have now.

And, in fact, the U.S. economy has been regaining traction that should persist. Many of the more cyclical areas are actually still in the early stages of recovery. In other words, they have a ways to go just to get back to normal levels. Also, there has been a disconnect between public and private sectors, with slashed government spending dragging down overall growth. As public spending stabilizes (i.e., stops being cut), GDP growth should pick up.

A mixed globe

Outside of the United States, the macro environment remains mixed. The euro zone, in the aggregate, is still stalled but apparently not worsening. Meanwhile, in Japan, Prime Minster Abe's program to reflate that economy out of its long funk is producing some green shoots. Loan growth has picked up, and surveys of consumers and businesses point to rising confidence. Inflation expectations have increased, suggesting an accelerating economy around the corner.

China is generating the most heated debate among market observers. After two decades of rapid growth and development, the country's economy seems to be at a transitional or even *tipping* point. Fortunately, the new leadership team recognizes the need to carry out structural reforms to address the imbalances that have emerged as a byproduct of that growth. One immediate challenge: Reining in the *shadow banking system*, a nebulous network of private trust companies and wealth management vehicles that have lent trillions of yuan, some to finance questionable projects. Reformers also need to dismantle state monopolies as well reduce the country's reliance on huge capital projects in favor of more consumer spending. Easier said than done.

During this transitional period, China's growth rate should continue to slow. So perhaps it is 6% to 7% instead of 8% to 10%. However, the odds of a hard landing with a U.S.-style *subprime crisis* are still low. Banks may be overextended, but the central bank could quickly move in to stabilize the system if required. And for the banks (shadow or otherwise) to really get into trouble, there would have to be a collapse in asset (real estate) prices. Most household borrowers are underleveraged; they have significant equity in their property thanks to large down payments. Private sector businesses also tend to have low amounts of debt compared to their capital. The main problems lurk with the state-owned businesses. So, while noisy and far from benign, the global backdrop does not appear to represent a clear and present danger to the U.S. stock market.

The Fed is going long

That said, the market strength this year has been a bit surprising, although obviously not unwelcome. Until the late-May through mid-June period, the S&P 500 had not had a meaningful pullback in many months. And the recent sell-off amounted to "only" about a 6% drop (7.5% using intra-day extremes) before reversing. Stocks have been due for some choppiness, and the concerns about rising rates proved a timely catalyst. We do not expect volatility to burrow back into the ground and go dormant. But we think that Fed policy will continue to be accommodating to stocks for awhile, and that it may well be a future shift that prompts the next cyclical downturn.

— Christopher J. Singleton, CFA, Managing Director

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