Investment Perspective

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SPRING FORWARD AFTER FALLING BACK

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This spring marks the five-year point since the lows of the seminal 2007-09 stock collapse. The road back has been littered with economic and financial challenges. For many investors, it may not feel like a significant bull market, because they have been focused on just clawing back to even. But, in fact, the broad stock market averages are up 175% since March 2009, finally surpassing the previous highs.

Some have questioned how stocks could have performed so admirably with the overall economy struggling to move into the 3% GDP growth zone. Is there a disconnect between Main Street and Wall Street? The short answer is that corporate profits have grown substantially faster than the overall economy since the depths of the recession. Profits dropped sharply but then experienced a "V-shaped" recovery, quickly moving back up to record levels. The rise in stock prices has simply reflected corporate America's return to profitability.

How tough is our toro?

How resilient will this bull market continue to be? We have no doubt that its endurance will be tested. It is the nature of bull markets to get ahead of themselves and require a pause from time to time. And indeed, there are increasing signs of exuberance, most notably illustrated by the IPO market.

During the first quarter, nearly seventy companies went public in the U.S., raising over $10 billion of capital. According to the IPO advisory firm Renaissance Capital, that is double the pace of last year's first quarter. It is also the largest number of new offerings since 2000, an ominous year for investors. A number of pending IPOs stand in the queue, many sponsored by private equity firms looking to cash out. Major European exchanges are witnessing similar trends.

Half of the IPOs this year have involved the health care sector, primarily biotech. The other big chunk was technology, many of them in the sizzling hot cloud-based space. As was the case with the offerings of the late 1990s, a number of these companies are losing money or have dubious long-term prospects.

Sweet sanity crushes hype

But perhaps there is still some sanity out there. King Digital Entertainment, the maker of the popular smartphone game Candy Crush Saga, went public with much hype in late March. Glance around at persons glued to their phone or tablet, and chances are some are playing the addictive Candy Crush. King Digital's IPO raised $500 million, valuing the firm at $7 billion. The company had a decent level of earnings in 2013, but virtually all stemmed from that one game. The stock's debut proved underwhelming, with the opening day price ending up 15% below the subscription price.

Beyond the IPO market, other signs of excess exuberance have emerged. Ned Davis Research has been pointing to several measures of sentiment that suggest investors are overly optimistic at the moment. For instance, margin debt has been rising at an elevated rate. Also, mutual fund cash balances are low. Such measures are not particularly useful for timing market moves, but they do give a sense of the balance of the risks.

Cloud-based silver linings

And indeed, some of the high flyers have begun to fall back to earth — and that is a good sign. As the IPO trends suggest, for a number of months, biotechnology and Internet-related stocks, small and large, have led the way up. They are now leading the way down. The NASDAQ stock indexes for those two industry groups have been almost mirror images of each other. Since early March, both have corrected by 20%. But while a number of stocks have been under pressure lately, the *pronounced* weakness has been largely contained to those issues that had been surging. Investors who had not been chasing the hot money probably do not understand what all the hair-pulling is about. Broader measures, such as the S&P 500, are off their highs, but only modestly so.

But that begs the question: Will a contagion develop, spreading to the broader market and "old economy" stocks? Only the chattering pundits on the financial networks seem to know. But whom to believe? The fact is, the S&P 500 has not experienced a correction — defined here as a drop of 10% or more — since 2011. Moreover, the robust gains of 2013 may need to be digested a bit. It would be typical for stock market averages to pull back temporarily without signaling an end to the bull's run.

According to Joshua Brown, a well-known market observer and blogger, over the post-WWII period there have been 27 corrections of 10% to 20% that did NOT turn into an all-out bear market; that is, a drop of more than 20%. And actually, since the beginning of the current rally in 2009, there have been three such episodes. But again, not in a while.

Dot-com bubble trouble

Still, warnings of a stock bubble persist, as do comparisons to the late 1990s market. One can certainly find similarities; however, we believe they are outweighed by the differences. The 1990s stock market surge was at first propelled by emerging technology companies tied to the Internet. Because many had little or no profits, analysts had to create new metrics to support the prices. "Website clicks" and "monetizing eyeballs" justified the froth. But the mania later spread to include much of the old guard, so it was not just the dot-coms that traded at nose-bleed valuations. For example, by 2000, General Electric was trading at a P/E multiple of over 40, while Wal-Mart was trading at 50 times earnings. Wal-Mart — really?

The landscape today is different, particularly as it pertains to stock valuations. At the bubble's peak in 2000, the S&P 500 was priced at 26 times earnings, and the dividend yield stood at 1%. Currently, the index trades at 15 times earnings and with a dividend yield of over 2%. Today's stock multiples are further supported by the low inflationary environment. One could reasonably argue that stocks are moderately expensive, but where's the bubble? Unlike the mid-to-late 1990s period, the current melt-up in stocks was preceded by a market collapse. Stocks have moved to new highs because earnings have.

Rather than the *late* 1990s, what if the better parallel for today's backdrop is really the *mid*-1990s, when the bull market went from adolescence to maturity? With painful memories of two fairly recent and debilitating bear markets, not too many folks are asking *that* question. BCA Research points out that bull markets do not typically end until short-term interest rates move above long-term rates; in other words, not until monetary policy becomes tight. Given the Fed Funds rate of 0.25% and the 10-year Treasury near 3%, there is plenty of cushion before the yield curve will invert. And the Federal Reserve seems to be in a holding pattern, at least as far as the policy rate is concerned.

From bonds to stocks

The maturing stages of a bull market tend to contain the most dynamic price gains. Stock market strength broadens out, and the gains begin to engender some complacency on the part of investors. Retail accounts move back into the market, reinforcing the price trends. Critically, judging by mutual fund flows, the retail channel has just begun to move out of bonds and into stocks. Sir John Templeton famously noted that "Bull markets are born on pessimism, grown on skepticism, mature on optimism, and die on euphoria." In other words, we have likely not seen the market cycle fully play out yet.

Meanwhile, interest rates remain low, and the economy should reaccelerate this year after a winter weather-induced slowdown. If so, consumer spending should continue to perk up, and corporate profit growth will improve. So the economic and financial backdrop could prove similar to that of the back half of the 1990s. Then, as we now know, rising profits and expanding multiples in a brew of easy money policies propelled stocks, later leading to an asset bubble.

A Ukraine headache

Investors should always consider what may go wrong, and there are a number of threats that could derail the stock market. In recent months geopolitical events have rattled stocks, most notably the Russia-Ukraine crisis. If Putin follows his annexation of Crimea with a military foray into eastern Ukraine, global tensions will really flare up. Without being cavalier, it's not that the Ukraine itself is economically critical to the West. Instead, it is that country's symbol as a proxy in a potential new Cold War struggle. Europe's reliance on Russia to meet its oil and natural gas needs both raises the stakes and limits the West's near-term options.

Whatever the outcome, this is not a one-off challenge that can be quickly remedied. As former CIA director (and Russia/Soviet scholar) Robert Gates argued in a *Wall Street Journal* opinion piece, Putin has a "dramatically different world view" than the leaders of the West. His goal is to restore Russia's sphere of influence in the region, and he won't be playing by our rules. The West will not be able to overwhelm him with kindness. Gates also noted that constitutionally, Putin may remain in power until 2024, so the U.S. and her allies must be prepared to play a "long game."

China treats its hangover

We have repeatedly cited China and its leaders' move to reform their unbalanced economy as an ongoing risk to the markets. China's growth in recent years has been propelled by debt creation, which must be reined in. The current challenges stem from the Communist Party's decision in 2009 to order banks to flood the economy with credit. Lending surged by 30% and 10 trillion yuan, supporting GDP growth in the midst of a global recession. The ultimate cost, however, was waste, over-investment, and sour loans. Policymakers have since moved to curb credit expansion and reduce the profligate lending on real estate and other fixed investments.

Some warn that a cascade of troubled debts may cause China's financial system to implode. But those doomsayers are viewing the issue through western lenses. China will not have a *Lehman moment,* as the U.S. and Europe did in 2008. That summer, credit became frozen because financial institutions doubted the solvency of their counterparties. So they refused to lend to each other, even on a very short-term basis. The Chinese banking system is dominated by the state. In effect, the state is the counterparty. Any credit stresses — and there will be some — can be quickly relieved.

China's GDP growth has slowed from a 9%-10% pace to somewhere around a 7% rate — to the extent one can believe the numbers. Due to the sheer size of the Middle Kingdom, the impact from this deceleration in growth has been rippling across the globe. Producers of commodities and other raw materials have taken it on the chin. Many capital equipment manufacturers have also faced some pressure, after having previously benefited from China's strong appetite for their exports.

The country's premier is already backtracking on the official target of 7.5%. Whatever the near-term growth rate, the global economy needs China to pursue structural reform and move to a more sustainable model. The transition will ultimately be beneficial for stocks, but in the interim could lead to some hiccups in global markets.

Spread out to catch spring winds

But absent some major external shock that alters the economic landscape, stocks should continue to have a tailwind, even if it does wax and wane. We do recognize that as we enter what is sometimes a seasonal slow time for the markets, stocks are a bit frothy. In such an environment, it is particularly important to be diversified, while being prepared to step in and buy high-quality companies when their stock prices drop.

— Christopher J. Singleton, CFA, Managing Director

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