Investment Perspective

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How quickly things can change. A healthy dose of fear began to grip the stock market as summer turned to fall. This comes after an unusually calm period, at least for the broader averages. During much of the spring and summer, trading remained light and volatility was subdued, as stocks pushed higher. The mood changed in mid-September.

Let's face it: Given stocks' sharp move up in 2013 — with stock prices rising much faster than underlying revenues, earnings, or cash flows — it should not be surprising to experience some digestion (or rather, indigestion) this year. And though not pleasant, such backfilling is necessary from time to time to sustain an upward trending market.

Aging bull

The current bull market is 5½ years old, and the S&P 500 Index has not experienced a 10% dip since October 2011. Of course, market cycles do not follow a calendar, but it is reasonable to expect the uptrend to start showing some age. And actually, a deeper look reveals that the market's purported strength has masked some underlying shifts.

For instance, while the overall U.S. stock market is within striking distance of record levels, half of NASDAQ stocks have dropped 20 percent from their 52-week highs. Meanwhile, not only are small-company stocks off their highs, but as a group they have produced a double-digit negative return this year.

Rising pressure

As stock prices rise, they often become more susceptible to pressure from negative headlines. Investors *are* confronting a number of cross currents, but most have actually been evident for a while. So it is not clear whether these issues are causes of the recent selloff or merely excuses for it. The sound bites and snappy headlines that pass for financial journalism demand neat and tidy explanations for the day's events. But financial markets' complexity often does not allow such a luxury.

What could be concerning investors these days? In the United States, economic activity picked back up after a winter-weather-induced slowdown. Second-quarter GDP rose at a 4.6% annual clip after slipping 2.1% in the first. The labor market, in particular, has really gained traction. Employers have added jobs at an average monthly rate of 225,000 so far this year, which, if it persists, would mark the fastest pace since the late

1990s. The unemployment rate has moved down to 5.9% although, admittedly, adding in the underemployed moves the dial to 11.8% of the labor force.

Finally, capital steps up

In addition to this new hiring, U.S. businesses appear to be stepping up their capital spending. New orders for nondefense capital goods have risen at a double-digit pace since February. Investment in plant and equipment by the large companies of the S&P 500 rose by 10% during the first half of the year. Smaller firms are also showing signs of shifting focus from cost-cutting to expansion. A late summer *Wall Street Journal* survey of small company CEOs indicated a large number planned to increase CAPEX over the succeeding 12 months.

A resurgence in capital spending has been the key missing ingredient in the current economic recovery. As a group, businesses have been pushing out the replacement cycles of their machinery, computers, office equipment, trucks, etc. The average age of all fixed assets stands at around 22 years, the highest level since the mid-1950s. Moreover, executives have been reluctant to *expand* their existing capacity. With pools of cash and more confidence in their order books, corporate America is hopefully back to an inflection point of greater spending. And then we'll finally see that virtuous cycle unleashed, whereby capital spending leads to more hiring; hiring to more consumption; consumption to more production, and so on.

Europe lags behind

Of course, the recovery has experienced a number of false starts, and business confidence can prove fickle. Which brings us back to what is ailing the stock market these days. In contrast to the rather bright outlook here in the States, the economies of other major players are sputtering. In essence, the global economy is beset by a two-speed recovery.

The euro zone, in particular, is back on the radar screen as a source of concern. The problem is no longer contained to the small countries on the periphery. The three largest economies (Germany, France, and Italy) are growing barely, if at all. With 28.5% of the zone's output, Germany represents a bellwether for the region. Until recently, that country had been a pillar of strength. But officials there just reported that industrial production and exports both dropped sharply in August. Global stock markets sold off on the news. It turns out that the contraction was partially related to the unusual holiday timing of some large factory shutdowns. So the declines may have been overstated; but they still imply a sluggish backdrop.

The wrong moves?

The Ukraine crisis arose at a tenuous point of the European "recovery." It has damaged business confidence, and Germany's mighty industrial sector has suffered. Many critics argue, however, that the real barrier to recovery has been the euro zone's reliance exclusively on monetary policy to cure what ails it. On balance, the member states have not pursued structural reforms to improve competitiveness and remove barriers to growth. Nor have they adopted expansionary fiscal policies to drive domestic demand; in fact, quite the opposite — fiscal moves have been debilitating to growth.

The Germans have been the most dogged in this regard. Under Chancellor Angela Merkel, the government's top economic priority is to deliver *schwarze Null* ("black zero"), a federal budget that is in the black, or fully balanced, in 2015. Many officials on the outside argue that instead, the government should be channeling resources to public investment. So far, those admonitions have fallen on deaf ears. And the International Monetary Fund now expects German GDP to expand by only 1.4% in 2014, followed by 1.5% in 2015.

Bond rates too high or low

Compared to the Federal Reserve, the European Central Bank (ECB) has been behind the curve in the post-crisis period. But the bank seems to be following a similar playbook, albeit more tentatively. ECB President Mario Draghi famously pledged two years ago to "do whatever it takes" to save the euro. This stance calmed financial markets and began to drive down the onerous yields on sovereign bonds. Struggling governments could then refinance public debt at more manageable rates of interest.

However, a glance at current European sovereign yields reveals some striking figures. A benchmark for the continent, the 10-year German bond yield hovers below 1%. Meanwhile, the corresponding yields for two troubled nations in southern Europe — Italy and Spain — are barely above 2%. These low rates are not signals of economic vitality. And they are not boosting the demand for credit. The implication is that the euro zone needs a multi-pronged policy approach to get out of the muck.

Exporting lower currencies

In Europe, Japan and much of the world, it seems as if the plan is to drive one's currency down via aggressive monetary easing to stimulate exports and restrict imports. In other words, to rely on external rather than domestic demand to drive a growth recovery. Sounds reasonable, but the problem is that all currencies cannot simultaneously weaken. And a nation cannot increase exports unless a counterpart is increasing its imports. This is a zero-sum game. Fortunately for the rest of the world, the U.S. has so far proven willing to accept the brunt of the currency adjustment, and the dollar has moved up.

But the weakness overseas could spread to U.S. shores, as a stronger dollar and lower exports potentially crimp the domestic economy. And this eventuality explains some of the recent stock market turmoil.

Some Federal Reserve officials expressed such concerns at their mid-September policy meeting, the minutes of which just became available. The Fed has been winding down its bond-buying program, with the next policy shift being an increase in short-term interest rates. While the job market has regained momentum sooner than Janet Yellen & company had anticipated, uncertainty about global growth could delay their interest-rate decision.

U.S. consumers in charge

It is too early to say, but fears of a stronger greenback stifling U.S. growth could well be overblown. Yes, the dollar has moved up sharply in recent weeks. But from a longer perspective, it is still hovering near 20-year lows in trade-weighted terms against a basket of currencies. Furthermore, the export intensity of the U.S. economy is fairly modest compared to others. Our exports account for only about 13% of GDP. In other words, the key driver for U.S. growth will continue to be domestic spending by consumers and businesses.

But at the margin, an appreciating dollar would be headwind for growth. It would also tend to push down inflation at a time when the Fed obviously prefers the opposite. At the corporate level, the foreign earnings of U.S. multinationals will be translated into fewer dollars, so we should see some lowering of earnings expectations. And if Europe fails to grow or, more ominously, slips back into recession, that would further pressure the profits of U.S. companies with sizable European operations.

A new season

Stocks have obviously moved up sharply from their 2009 lows. And multiples have expanded to a point where stocks, while not necessarily expensive, are no longer cheap. Investors may have become a bit complacent this summer, ignoring the fact that many global challenges will continue to persist for a while; or said another way, that headlines will still be negative from time to time.

If the stock market is in fact transitioning back to a more volatile period, there will be a huge bull market in the number of opinions coming out of the woodwork. Keep in mind that your time horizon is likely different from the pundit pontificating in the financial media. Stock prices will ebb and flow and with selloffs come opportunities. Our view is that the U.S. economic recovery has momentum and, while earnings could be pressured in the near term, corporate America is in fairly decent shape.

— Christopher J. Singleton, CFA, Managing Director

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