Sunday, April 3, 2016

RISK ON, BUT FOR HOW LONG?

- Given the decline in corporate profits in Q1 2016, the recent stock market correction was not deep enough to ring out valuation excesses.
- The stock market is mildly overbought; the pace of ascent must slow from here.
- It would be consistent with Election Year tendencies for the stock market to correct as investors become more uncertain about new fiscal policies from a new President, only for prices to bottom before the general election and then to rally into the year end.

We wish the stock market correction this winter was even worse. Well, in retrospect that's true. Going through that 15% drop in the stock market was painful. Even when it is a temporary drop that we should all be used to by now given its natural and common occurrence, it is painful. But we needed that pain. Stocks are not in late 1990-like bubble territory, but they aren't that cheap. Well, at the least, they aren't cheap enough for us to ring the proverbial all-clear bell for the stock markets.

At its recent low, the earnings yield of the S&P 500 was about 5% and the P/E (price-to-earnings ratio) was about 20. At the bottom of similar corrections (or crashes, whatever you are comfortable calling them), since 1928 the trough valuations were closer to 9% for the earnings yield and 11 on the P/E. Now, given that the decline was driven by fear of a recession that never came, it is not surprising that the market reached its bottom with a relatively shallow drop (well, relative to the twenty percent drop that has been conspicuous by its absence for some time now). A shallow drop doesn't ring out valuation excesses. When bear markets have occurred independent of recessions, they end with less severe losses and higher valuations.

As an honest aside, we don't want to be overly cavalier about the economy in Q1 2016. While the Q1 GDP is tracking flat-to-plus – which is unusually positive given the quarter's problematic seasonality – corporate profits were most certainly negative on both a quarter-over-quarter and a year-over-year basis. So, we're not exactly taking a victory lap on the "I told you there would be no recession" track.

So what? Well, in our 2016 Economic Outlook we wrote:

> "Here's the bottom line: BMM is positioning clients for a high single-digit return in the stock market return in 2016, and expecting up to a twenty percent correction, likely from July through October. "

So the question becomes, do we STILL expect a stock correction to occur later this year, consistent with election year uncertainties? Yes. Yes we do. Stocks did not get cheap enough to make investors feel comfortable with the unknown of new Presidential election policies. Compounding the problem, even though the RNC and DNC conventions are held in July, typically by now the candidates are known. So not only do we expect buyers to be scarce based on not knowing who will be President, we expect buyers to be scarce based on not even knowing who the candidates will be.

The phrase "buyers will be scarce" was carefully selected and repeated for emphasis on purpose. The prices of stocks are based on the laws of supply and demand. More demand, prices go up. Less demand, prices go down. While selling pressure is expected, a lot of investors who might have sold mid-year have already sold. But ***we don't expect a lot of buyers to step up and improve demand in stocks until a) prices exhibit better value, and/or b) some uncertainty has disappeared.***

So what? With less selling pressure than we might have otherwise expected, a twenty percent drop in prices now is closer to a maximum drawdown than an expectation. 10%? Probably. Most likely. 15%? Maybe. Definitely maybe. 20%? Well, with high valuations it is possible, but not nearly as probable as it was a few months ago.

The rally from the February lows caused the market to move from being heavily oversold, to lightly overbought. So some level of consolidation from here, a struggle to materially break above previous highs, is likely. But the positive breadth thrusts experienced during that rally suggest that any additional heavy price drops for the major markets (if a correction does actually materialize) will be of the second-half-of-the-year variety as opposed to being imminent. An encouraging sign of stock price support at this level for some time has been a broadening advance, with stocks of companies of different sizes and industries participating in this rally, and with a stocks breaking above moving average lines, and Advance/Decline Lines improving.

The bullish and improving breadth suggests that with risk appetite improving, bullish pessimism moving positively toward optimism (but not yet so good that it's bad), improving economic data, and monetary policies that remain positive for equities, that a quick resumption of the correction is unlikely. For the last year or so, the stock market has been characterized by short periods of "Risk-On", when growth oriented stocks were benefitting most, and "Risk-Off", when more defensive strategies worked. ***Risk is back on, but for how long?***

Some quick historical observations. The S&P 500 was down about 5.5% year-to-date through February. That was the 19th year since 1929 that the index fell in the first two months of a new year. During those years, the market remained volatile (on the upside and the downside) then ultimately rallied by year end. During election years, like 2016, the year end rally was stronger (a median gain of 13.1% from the low). However, the lows were more pronounced (sometimes revisiting the year's earlier lows).

Now some fun math. In Election years when the first two months were negative, the February-December gain was 6.5%. That would put the S&P 500 at 2,058-points at year end. The median aforementioned 13.1% year-end rally from previous lows would put the S&P 500 at 2,069-points at year end. That's about a zero gain in capital appreciation for the rest of the year from current levels. Given that the markets are currently, at best, fairly valued it is hard to argue strongly against that historical assessment without some really positive earnings surprises. This argues for patience, some defensive positioning if the markets get clearly overbought (they are only mildly overbought now, and that's pretty normal), and the acceptance of some dividends or interest payments.

So, why bother staying in the market if history suggests that there may not be many gains for the rest of the year? Well, because history also suggests that a) the market could go up from here, even if in a choppy fashion, b) any additional correction this year will be quick (but, yes, painful), c) the efforts of timing the market's movement to be defensive without solid recessionary evidence is, at best, inconsistent and unreliable (and, at worst, nonsensical).

We get it. Taking little to no action appears as if we are looking at things through lenses of the proverbial rose-colored glasses. We might still adjust portfolios at the margin; we do that from time to time, in good times and bad. ***But there just isn't enough evidence to suggest that the smart play is a wholesale change to a defensive stance***. ***Stocks go down. It's what they do. It's our job to figure out if they'll go back up, too (well, in a timeline that is consistent with achieving or maintaining your goals). We think if the market goes down in the next couple quarters, it will go back up fairly quickly.***

That doesn't mean we don't have changes targeted for your portfolio – it just means that the smart play is some portfolio rebalancing as opposed to selling everything. I am often tempted to sell everything and to try to buy in again at cheaper prices. So maybe writing about how bad an idea that is ends up being a bit of therapy to me – I admit that. But the tools just don't exist to time the market. In 2002 and 2008 we went to mostly cash based on US economic concerns and we were right. In 2011 we went heavily to cash based on European economic concerns and we missed an incredible eight trading days. The historical lesson we should have applied then and are applying now is that while portfolio allocation changes should always be considered, ***getting solidly defensive without the real risk of a US recession is pretty much always the wrong investment decision***.

We should spend some time supporting why we believe there is no US recession upon us. The stock market correction in the beginning of the year was accompanied with all sorts of the-sky-is-falling-and-the-recession-is-coming rants. True, a falling stock market can be a sign of coming economic stress. Heck, a falling stock market could cause a recession by both manipulating consumer sentiment (which is important since consumer spending is about two-thirds of US GDP) as well as causing a significant negative wealth effect. But even if the stock market does drop back to recent lows in the coming months, we believe that the negative wealth effect will be offset by positive developments in housing, employment, wage increases, and household balance sheets.

Additionally, at some point the lower energy prices will positively affect consumer spending, but right now the cost benefits have been finding their way to a 12-month average personal savings rate of 5.1%, well above the 3.9% average of the prior expansion. A higher savings rate does typically mean a slower pace of spending growth, but the stronger household balance sheet provides a cushion against shocks that could tip the US economy into recession. Should consumers feel the urge to pick up spending, they have that power. Employment has been strong, wages have been advancing, and both credit conditions and debt service benefits the ability to spend. The latest Senior Loan Officer Survey of Bank Lending Practices shows that banks continue to ease standards for all types of loans. And the Household Debt Ratio is near a record low at ten percent, which means that if consumers decide to go shopping they can use more of their disposable income for discretionary spending.

On the subject of strong employment, the facts do not agree with a lot of the negative spin we have heard on the matter. For example, we keep hearing complaints that the jobs being created are of the low paying variety. True, in the beginning of the recovery most of the gains were in the lower paying retail and hospitality areas. But in more recent years the gains have been across all pay scales. Recently some of the job losses (because even when there are net gains, some losses can occur) have been in the higher paying energy and trade-sensitive industries, but much of the gains have also occurred in higher paying sectors, like health care, financial services, and information technology.

Another negative spin on the job growth has been the accusation that they are mostly part-time jobs. While the number of part-timers jumped during the Great Recession, that number has not changed much since then. And of those current part-timers, an increasing number of them are those that are doing so by choice; the number of part-timers looking for full-time work has declined significantly.

Bottom Line

The indicators from the markets' February 11 low suggest that the US equities have entered a cyclical bull market, supported by secular tailwinds. The rally has the possibility of breaking recent highs. However, new highs in stock prices are likely be challenged by a combination of being fully-valued, some mildly overbought signals, election uncertainties, and renewed conversations about monetary tightening. This could set the stock market up for a decline back to its 2016-lows, leading to an opportunity to increase equity exposure and/or increasing beta (i.e. increased risk).

A quick resumption of the correction is unlikely. After some consolidation from current levels, the bullish and improving breadth suggests that with risk appetite improving, bullish pessimism moving positively toward optimism (but not yet so good that it's bad), improving economic data, and monetary policies that remain positive for equities should push the market to marginally higher highs. Because of these points, any correction in 2016 is expected to be followed by a strong year end rally.

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The Knowledge and Experience to Build Your Wealth

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Questions?	Call 888-232-6072 or go to www.berkshiremm.com

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