BERKSHIRE MONEY MANAGEMENT

March 25, 2015

DON'T FLINCH

Surprise!

- The heightened level of analyst optimism felt at the beginning of the year has proved to not be warranted.
- Corporate earnings have disappointed this quarter.
- The direction of the US dollar was predicted, but the pace of the ascent has been surprising.

The economic news this year hasn't been that good, but the stock market absorbed it with two tiny corrections (five percent in January, and three percent in March). The Citi Economic Surprise Index (ESI), which essentially tracks expected economic numbers versus actual numbers, keeps on showing us that the heightened level of analyst optimism felt at the beginning of the year was not warranted. The ESI recently reached its lowest level since July 2012.

We're not too surprised at some of the surprises. For example, in our 2015 Economic Outlook, we wrote "BMM has found that analysts are not very good at predicting earnings per share, but we are confident in our ability of figuring out how much consensus estimates will move… Consensus estimates for S&P 500 operating EPS growth will grow from around 9.3% in 2014 to 13.7% in 2015…(but we think that) EPS growth will probably be in the low-eight's to high-nine's for 2015." So that earnings have been disappointing this quarter wasn't news to us.

The good news is the potential for new upside surprises in regards to earnings. A calculation called the "guidance spread" measures the difference between the percentage of companies raising guidance and lowering guidance. The spread for the most recent quarter has come in at its lowest since the final two quarters of 2008, at the end of the financial crisis. Admittedly, we may be relying as much on hope as we are on data, but the proverbial bar has now been set low enough for actual corporate earnings to begin hurdling over expectations in a quarter or two.

What was news to us was the pace of the dollar's increase. In our 2015 Economic Outlook, we argued that "with much of the developed nation in an easing policy, a normalization of U.S. interest rates should continue to drive the U.S. dollar higher due to interest rate divergences." So the direction was obvious to us. The magnitude and pace, however, was outside of the range of any forecast we saw or considered.

The strengthening dollar can be a blessing, and it can be a curse. On the plus-side, a stronger dollar pushes down the price of oil and other commodities, helps keep inflation in check, and improves terms of international trade. On the minus-side, US corporate profit margins could be squeezed as they cut the price of their products abroad.

That list could get a lot longer for both pluses and minuses, but they are also technical and we'll spare you from that here. The point is that arguments can be made for the desire of either a strong or a weak dollar. However, our analysis indicates that it is not only the value of the US dollar that matters for growth, but also the pace of appreciation. Against major currencies, the dollar value has increased over thirteen percent over the past six months, the most since February 2009. Historically, such fast increases have been associated with below-trend economic growth. The bulk of the negative impact comes from export-oriented manufacturing, which has actually contracted in the past when the dollar has appreciated so quickly.

The dollar's strength comes from growth and interest rate differentials between the US and the rest of the world. Given that we don't expect those differences to abate, we expect the strength to continue. The strength of the US dollar will weigh on net exports this quarter. Since 1980 there have been eleven cases of the dollar appreciating by at least five percent over six months. On average, net exports were not a big subtraction from GDP growth in the first two quarters, but increasingly subtracted from growth in the third to sixth quarters.

No Recession Means Only Short-Duration Corrections

- Job gains span almost industries, regions, and pay scales.
- Neither households nor businesses are overleveraged.
- The banking system is strong.

So far this year, the price of oil has sunk, earnings have disappointed, the dollar has rocketed, and it seems like the Fed may raise interest rates sometime this year. In isolation, any of these events could cause problems for the stock market. But they are not occurring in isolation – they're all happening at the same time; all while valuations could be argued as stretched (not lofty, but stretched) and optimism has been increasing (often a contrary indicator). Given all of this as a backdrop, the risks of the biggest correction since 2011 seem more than plausible. But don't flinch – the market remains far from the bubble conditions that could be expected at the end of a secular (i.e. long-term) bull run. Any correction that occurs – whether it is big or small – will only prove to be a cyclical occurrence that will reset valuations and ultimately refresh the secular bull.

Following the advice of "don't flinch" will be hard for any of us if a stock market drop of any meaningful magnitude does occur. That's not a commentary on the next correction; it's a comment regarding any and all corrections and the human reaction. A drop in stock market prices often triggers an emotional response, and that response is panic in the form of selling. But the more appropriate reaction might be to switch from bonds to stocks, or, to be more nuanced, from one asset class or sector of stocks to another.

The point is that any pullback should be short-lived. Like the five-percent pullback in January, and all the other pullbacks since March 2009, the next correction of any magnitude will likely be forgotten merely months after an eventual bottom. Corrections in non-recessionary times happen in the matter of months (often too quick to make a meaningful defensive change to a portfolio) and typically bounce back in a time period that mirrors about twice the duration of the decline (so not that long). However, during a recession, market declines grind on much longer and also take a lot more time to recover in price. A recession would make us flinch. But don't flinch, because we just can't make the case for a recession.

At six years, the current U.S. economic expansion is already longer than the average expansion since World War II, and is yet to show signs of deterioration. In fact, the likelihood is that this will be one of the longer economic expansions in history. The breadth of job growth is rarely ever as strong; aside from the energy sector, job gains are occurring in all industries, regions, and pay scales. But as robust as hiring has been, the labor market still has slack. That slack is good news, for now, as expansions typically end when the economy overheats (i.e. the labor market is at full employment and businesses are running beyond capacity), inflation pressures develop and interest rates become high, thus exposing overleveraged households and businesses. This expansion is far from that; this expansion has room to run.

Core inflation, as measured by the Consumer Price Index (CPI), is rather flat (and not likely to pick up, given the drop in oil prices and the rising dollar). And although the Fed will likely raise interest rates this year, it is seen as more a process of "normalization" and it will be a long time before rates get back to anything looking familiar. Not to mention that weakness in Europe's economy and their responding version of quantitative easing will pressure down US interest rates.

Also, there is no indication of households or businesses being overleveraged. Households owe about $1 trillion less today (or almost 10% less) than they did at the peak of their indebtedness in 2008. Less debt combined with lower interest rates has significantly reduced household debt service burdens. In fact, the share of disposable income that households must pay to make debt payments is as low as it has been since the Federal Reserve started tracking that measure in 1980. As you would suspect, as a result, delinquency rates on household debts are about as low as they get in the best of economic times (which, in turn, helps keep businesses flush with cash).

Now, it is important to note that households are still borrowing, and still spending (which is important to keep the economy moving). But the borrowing is more cautious than it was prior to the Great Recession – for example, auto and student lending is strong, but credit card and home equity lending is softer.

And corporate profitability has never been stronger, and businesses' capacity to service their debts is excellent. The quick ratio (the ratio of liquid assets to short-term liabilities) is almost fifty percent, about double its long-term average. And the interest coverage ratio (the ratio of interest payments to corporate cash flow) is still falling even though it's already near record lows. Businesses are borrowing more aggressively than households, and that's a good sign. Corporate bond issuance has been robust and commercial & industrial (C & I) lending by banks is expanding at a double-digit pace. C & I lending is among the most reliable lagging indicators. And while we obviously prefer leading indicators, that amount of lending is proof that the economic expansion is solid.

The pace and ascent of the US dollar's rise is not something to disregard. An argument can be made for the desire of either a strong or a weak dollar. However, our analysis indicates that it is not only the value of the US dollar that matters for growth, but also the pace of appreciation. Historically, such fast increases have been associated with below-trend economic growth. The bulk of the negative impact comes from export-oriented manufacturing, which has actually contracted in the past when the dollar has appreciated so quickly. For quite some time large-cap stocks have been favored over small- and mid-capitalization stocks. This may be the trigger for some reallocation from large-caps to something a bit smaller.

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The Dow Jones Industrial Average (NYSE: DJI, also called the DJIA, Dow 30, INDP, or informally the Dow Jones or The Dow) is one of several stock market indices, created by nineteenth-century Wall Street Journal editor and Dow Jones & Company co-founder Charles Dow. The Dow average is computed from the stock prices of 30 of the largest and most widely held public companies in the United States. Clients of BMM may have portfolios that differ substantially from the composition of the DOW and therefore, their performance may vary significantly from that of the Dow. The Dow is used for illustrative purposes only, as one indicator of the overall US economy, and its past, present, or future performance should not be viewed as an indicator or comparison point for BMM client performance.

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BERKSHIRE MONEY MANAGEMENT

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For joint marketing with other financial companies	NO	WE DO NOT SHARE
For our affiliates' everyday business purposes— information about your transactions and experiences	NO	WE DO NOT SHARE
For our affiliates' everyday business purposes— information about your creditworthiness	NO	WE DO NOT SHARE
For nonaffiliates to market to you	NO	WE DO NOT SHARE

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

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