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2015 Mid-Year Update

Economic Expansions Do Not Die of Old Age

- The U.S. economic expansion is entering its seventh year, and while that may make it old, it is aging well.
- Economic expansions do not die of old age.
- While the expansion may be closer to the next recession than to the beginning of the recovery, the unusual nature of this expansion suggests that not only could it age differently than previous recoveries, but that its best growth is still ahead of us.

While the expansion may be closer to the next recession than to the beginning of the recovery, it is important to remember that economic expansions are getting longer. Over the decades, expansions have lengthened due to such things as better management of inventories from technological advances and the rise of a more stable service economy. The current expansion is six years, or 72 months, old. The three expansions prior to the Great Recession lasted an average of 95 months, much longer than the 58-month average for all expansions since 1945. Interestingly, the average expansion between 1860 and 1945 was just 26 months.

So while this expansion may be, as they say, long in the tooth, expansions don't die of old age. Expansions normally end when the economy overheats. For example, the last few expansions have ended about three years after the economy reached full employment, as full employment leads to acceleration in wages and inflation and tighter monetary policy. The Congressional Budget Office (CBO) puts the natural rate of unemployment at 5.5%, which is where we have been for the last six months. Assuming some continued connection to recent correlation, the current expansion could last until sometime in 2018, making this one among the longest expansions on record.

However, it is unclear to us what the real natural rate of unemployment (the unemployment rate that is consistent with full employment) is. Given the absence of a noticeable acceleration in wages, it is possible that the natural rate is closer to five percent. (Though it is important to note that per the employment cost index of private wages, wage growth is accelerating.)

A lower natural rate doesn't necessarily buy the expansion a meaningful amount of additional time, but it could push the possibility of the next recession all the way out until 2019. But historical patterns are simply hints, and should be interpreted carefully, particularly given that

this expansion has been anything but normal. We don't want to focus too much on when the expansion may end because a) we want to be conscious of leading indicators that could suggest a quicker turndown, and b) we do not want to overlook how the economy changes as the expansion matures, especially because it could be much different than a historical analog would suggest.

The "anything but normal" nature of this expansion may cause it to age differently; better, stronger. Typically, real Gross Domestic Product (GDP) growth slows as the expansion matures since the economy runs into capacity constraints and monetary and fiscal policy move from being accommodate toward more restrictive. The way expansions usually mature is unsurprising; capital spending contributes less to growth as the expansion phase of the business cycle matures, consumption is larger in the first third of the expansion as lending costs are low, and then wages and population growth are stronger in the final third. Generally, the best times for expansions occur early. But this time, history may not repeat itself.

In addition to the US economy still waiting to see the windfall from low energy prices, this expansion does not exhibit the same signs of wear and tear as previous ones. While this expansion may be entering its final third, this could be its best yet. Real GDP has accelerated this expansion, which is not the typical situation. But the recession of 2009 was not typical. We emerged from a financial crisis that did not allow the US economy to find its rhythm as quickly as previous expansions. Both households and businesses had to deleverage, which added to pent up demand. Also, availability of credit had been a problem. Usually bank credit is readily available after a recession, but due to new regulation and bank concerns the flow of credit has only more recently recovered. So there is still a sizable output gap. Therefore, the economy won't run out of spare capacity soon and this will keep inflationary pressures at bay, which is why the Federal Reserve plans to tighten monetary policy at a slow pace.

Even as the Fed begins to raise rates, the process will be more of what has been called "normalization", as they move from a zero interest rate policy (ZIRP). This process will not be designed to slow economic growth, but rather to get monetary policy back to a more normal stance. Monetary policy will remain extremely accommodative, not only because of the slow process of raising low rates, but because the Fed's balance sheet is still being used in a manner to keep longer-term rates lower than they otherwise should be, a form of stimulus that we didn't see at the tail end of past recessions.

China

- We expect renewed outperformance from the Chinese stock market, post final capitulation.
- An accommodative People's Bank of China, signs of property market improvement, and bank stock resilience are encouraging signs.

We expect renewed outperformance from the Chinese stock market. The significant run up in prices until April left the Chinese stock market vulnerable to a market sell-off due to extreme overbought conditions. Chinese stocks have sold-off recently (and significantly), and this is becoming a buying opportunity, for those without exposure, within a longer-term uptrend that remains well intact. An accommodative People's Bank of China, signs of property market improvement, and bank stock resilience may be further encouragement to foreign investors.

Now that China has experienced / is experiencing a much needed correction within its longer term uptrend (and with global uncertainties surrounding Greece likely to fade over the weeks / months ahead), the global equity advance will likely reassert itself, with China being a relative winner in response to the continuing central bank accommodation and increasing evidence of global economic improvement.

Better than the Alternative

- Based on data going back to 1925, 2015 was the first year in which both the DJIA and long-term Treasuries fell during the first six-months of a pre-election year.
- With the market being led higher by a narrowing number of rising stocks, there could be little support, relative to recently abnormal levels of low volatility, to hold prices up should selling begin to expand.
- A high-probability prediction is that while the S&P 500 will mostly likely not decline much more than ten percent in 2015, it will break 2,000 points in the second half.
- The strength in the Financial sector has been occurring in tandem with relative weakness in Utilities, and that's a sign that the market wants to go higher, as opposed to turning more defensive.

"Frustrating" may be the appropriate word to describe the current market environment, given that stocks have spent 2015 essentially going nowhere. However, while the sideways price action of the S&P 500 Index and the Dow Jones Industrial Average (DJIA) has frustrated us, frustration is better than the alternative offered by other market indices that have damaged some investors. For example, the DJ Transports and the DJ Utilities are both down about ten percent for the year.

While it would be natural to have concerns that the deterioration in these two indices foreshadow an imminent end to the bull market, the performance of select industry groups by themselves does not provide sufficient evidence to draw conclusions regarding ongoing

performance of the broader market. Nonetheless, there has been some deterioration in the broader stock market. The selectivity evident throughout the S&P 500, and the fact that many stocks are already in their own individual bear markets, likely has some potential for a short term correction in the months ahead. With the market being led higher by a narrowing number of rising stocks, there could be little support to hold prices up should selling begin to expand. This lack of support creates the potential for a deeper sell-off than what has occurred in recent memory (an event that really is not uncommon in the stock market).

From about seven months back, the S&P 500 index has gone pretty much nowhere. The increased pessimism that has grown is serving as a stock market correction of time, as opposed to a correction of price. A high-probability prediction is that while the S&P 500 will mostly likely not decline much more than ten percent in 2015, it will break 2,000 points in the second half, then allowing the market to reenergize and reassert its cyclical advance.

The stock market will regain traction. In addition the expectation of continued, and greater, economic growth, we are encouraged by the continued momentum of sectors like Financials, Technology, Consumer Discretionary, and Health Care. Most notably, the strength in the Financial sector has been occurring in tandem with relative weakness in Utilities, and that's a sign that the market wants to go higher, as opposed to turning more defensive, in the wake of expected higher interest rates.

The global advance does not depend on the strength of Utilities (Utilities represents 3% of the S&P 500; Financials represents 15%). In fact, Utility outperformance often acts as a warning, especially when accompanied by diverging Financials. While Financials are currently benefitting from relatively high earnings yields, increasing loan demand, and the positive bank profit implications of rising interest rates and steepening yield curves, Utilities are anticipating the negative effects rising interest rates for the sector, especially the competition for investing dollars among yield-oriented investments.

With Financials making up 15% of the S&P 500, the aforementioned three other sectors with positive momentum (Technology, Consumer Discretionary, and Health Care) comprise some 60% of the index. This is important as we try to decide whether the weak start of the year will be a dangerous omen once negative seasonal tendencies start in the third quarter, or whether it is a sign of resiliency. And make no mistake this was a pretty bad start to the year, even taking into consideration that stocks historically have a weak first half in pre-election years. The S&P 500 managed to barely go positive for the first half of the year with a gain of 0.2%. This was the index's worst start to a pre-election year since 1947. The Dow Jones Industrial Average declined 1.4%. Bond investors got hit worse, with long-term Treasuries dropping 4.7% (based

on the Barclays Capital Long-Term Treasury Index). Based on data going back to 1925, 2015 was the first year in which both the DJIA and long-term Treasuries fell during the first six-months of a pre-election year.

Given that a majority of sectors, by number and by weighting, are showing relative strength and positive momentum as well as resilience to a negative US GDP rate in the first quarter, evidence supports a continuation of the long-term uptrend, likely after a long-overdue correction finally allows investors a better price to reenter the stock market.

Growth becoming a better value than Value

- For the last fifty years, the average median price-to-earnings (P/E) ratio of the S&P 500 is 16.8. As of the time of this wring, the median P/E ratio is 21.5. Excluding the late 1990's bubble period, the market has been unwilling to push the median P/E much higher than 21.5.
- The highest dividend yielders, whose P/Es have been well below the market historically, currently have the highest P/E's.

Valuation of stocks, especially a group of stocks, is trickier than you might figure it should be. Companies take write-offs that may (or may not) be one-time events. Past earnings are not necessarily a prolog to future earnings. And future earnings projections even by analysts who are in the mix of things rarely seem to get it right. Given these difficulties, often times it is consistency of measurement types that is the most important application. Going back to 1964, the median P/E ratio of the S&P 500 is 16.8. As of the time of this writing, the median P/E ratio is 21.5. Excluding the late 1990's bubble period, the market has been unwilling to push the median P/E much higher than 21.5.

The natural assumption would be to suspect growth-oriented stocks, especially the "high-flying" type, as those most responsible for offering some sort of skew that has pushed valuations so high. However, currently it is the highest dividend yielders, whose P/Es have been well below the market historically, are among the biggest culprits. The fact that the highest yielding stocks are more expensive (also by P/E Price/Book, shareholder yield, and cash flow yield) than their counterparts is rare. This isn't because the lowest yielders are especially cheap. While said counterparts' median P/E is above their long term average, the highest yielders P/E is two standard deviations above its average.

While overvaluation is one of the reasons for caution toward dividend stocks, valuation is rarely a timing signal. That is to say, while the move from Value to Growth is on our proverbial radar screen, making the move isn't necessarily imminent. While we are on watch for how a monetary tightening cycle by the Federal Reserve will negatively impact dividend / interest paying investments over the longer term as that increases competition for yield, due to their lower betas, dividend payers generally experience less volatility during market declines, offering some greater protection. Still, it is worth nothing that companies who have lower dividend yields tend to withstand tightening cycles better than the highest yielders. A correction could come sooner than the start of monetary tightening cycle.

BOTTOM LINE

While the expansion may be closer to the next recession than to the beginning of the recovery, it is important to remember that economic expansions are getting longer. The unusual nature of this expansion suggests that not only could it age differently than previous recoveries, but that its best growth is still ahead of us.

The stock market is expensive, based on a nominal price-to-earnings (P/E) ratio. Going back to 1964, the median P/E ratio of the S&P 500 is 16.8. As of the time of this wring, the median P/E ratio is 21.5. Excluding the late 1990's bubble period, the market has been unwilling to push the median P/E much higher than 21.5. The highest yielding stocks are more expensive than low paying stocks, as the highest yielders P/E is two standard deviations above its average. This warrants a favored allocation of Growth stocks over Value stocks.

While overvaluation is one of the reasons stocks may correct, valuation is rarely a timing signal. That is to say, while the move from Value to Growth is on our proverbial radar screen, making the move isn't necessarily imminent. Due to their lower betas dividend payers generally experience less volatility during market declines, offering some greater protection.

A high-probability prediction is that while the S&P 500 will mostly likely not decline much more than ten percent in 2015, it will break 2,000 points in the second half, then allowing the market to reenergize and reassert its cyclical advance.

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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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