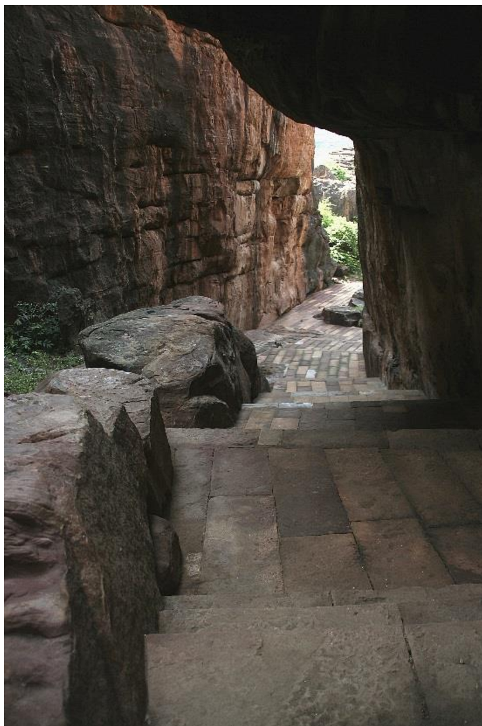
April 20, 2015

Passages

Our economic theme for 2015 has been "Smoke From a Distant Fire." The theme highlights the view that economic and capital market risks (and opportunities) abound overseas. In addition, our theme states that the global economy will face a transition this year – a central bank leadership transition. After years of the Federal Reserve being the world's monetary stimulus agent (through repeated quantitative easing (QE) actions, other central banks will pick up the baton and start their own QE actions. This action has occurred as the European Central Bank (ECB) has launched its own QE policy.



In our annual outlook, we also stated another transition would take place. After a number of years where capital spending drove marginal economic growth in the United States, 2015 will be a year where the economic growth baton will pass from capital spending to a new growth driver – an upward push in consumption. We are seeing the first portion of that transition occurring. With the decline in oil prices, capital spending growth is slowing. However the second part of that baton pass, an increase in consumption, has yet to come around.

We suggest the global economy, and specifically the U.S. economy is experiencing an economic passage – a period of time when these transitions are occurring which will eventually lead to a different growth driver in gross domestic product (GDP) (and corporate profits). While the economy is moving through this passage, growth will be subdued. We believe the current downward shift in global GDP growth will prove transitory as economic growth, and the benefits of lower oil prices, will spur overall consumption patterns as 2015 unfolds.

That being said, the durability of the economic passage the world is going through has serious ramifications to the future direction of stock prices. If we are wrong regarding the temporary nature of the current growth slowdown, what will the ramifications be on global capital markets? Is the

downward move in economic growth going to persist for a period of time? If it does, corporate profit growth rates may be further adjusted downward, bringing on risks or declining stock prices.

To understand the potential ramification on asset values, we need to understand the nature of the passage. Current valuation levels of stock prices and several other factors need to consistently be monitored to measure the durability of the passage.

The Nature of the Economic Passage

It is instructive to think of economic transitions akin to moving from one room in your home to another, via a hallway. That hallway looks nothing like the room from which you came, nor does it look like the room to which you are heading. ***Walking through that passageway is what the global economy is currently experiencing as economic growth shifts from capital spending to increased consumption.***

With this passage, capital spending cuts have come into full force, but the new "room" which the economy is heading is not yet in view (increased consumption). In the meantime, investors should expect a period of economic and stock market chop.

We expect first quarter U.S. GDP growth of less than 1 percent. Weather and weaker export growth, due to the strong dollar, hurt economic growth by roughly 1.4 percent. Our confidence level is high that the U.S. economy (and global economy in general) will see a renewed growth push as lower oil prices, higher consumer confidence levels and lower levels of unemployment all weigh positively on consumption growth rates as the year continues to unfold.

The Nature of the Monetary Passage

The other passage, or type of transition, the global economy is experiencing is the monetary transition. This transition is in bloom and is driving asset preference by global investors. With the ECB and the Bank of Japan (BOJ) now driving QE actions in their own right, foreign stock markets have outperformed the U.S. market this year as global investors have moved their focus from the United States to other economies and markets. (Data below is provided by Capital Economics.)

Market	YTD Price Change	1 Year Price Change
S&P 500 Index (U.S. Large Cap)	+1.12%	+11.60%
Russell 2000 Index (U.S. Small Cap)	+3.91%	+10.01%
DAX Index (German Stocks)	+19.20%	24.22%
Nikkei Index (Japanese Stocks)	+12.62%	+36.21%

All price changes noted are in local currencies. As can be seen, the noted foreign equity markets have rallied hard over the last four months as the ECB and the BOJ have been flooding their markets with cash, which has led to sharply higher stocks prices and sharply higher stock valuation levels.

Current Valuation Relative to Historical Norm

Considering the recent overall global growth slowdown, do stocks offer investors a safe haven due to low valuations from declining earnings estimates? Hardly. As witnessed above, the European and Japanese markets have had a major upward move in value over the last four months. Investors in mature equity markets tend to believe a 10 percent average annual return is a reasonable return to expect from these asset classes. ***As can be seen, Germany and Japan's***

equity markets have generated one or two years of good performance – all over the last three and a half months!

Until this year, the U.S. equity market has been a standout performer in relation to other global markets. Once considered cheap, a number of foreign equity markets have entered the realm of normal historical valuation due to the recent rapid price increase in these markets. Consider the following data, which shows current trailing P/E ratios as compared to 20-year historical valuation levels.

Market Segment	P/E Ratio	20 – Year Average
U.S. Stocks	20.0x	19.2x
European Stocks	19.6%	16.7x
Japanese Stocks	17.2x	31.0x
Emerging Markets	13.7x	14.1x
Global Markets – Weighted Average	**19.2x**	**18.5x**

Looking at the data above (supplied by our friends at Ned Davis Research), it's hard to make the case that global stocks markets are outright cheap based on trailing earnings. Now, it is true that stock prices are discounting mechanisms, taking projected earnings into account. We need to look not just at trailing earnings, but also look at expected earnings and build that data into a valuation statement. That is fine, but here is the rub***: If earnings disappoint, there is little undervaluation room to cushion downward moves in stock prices because of lower-than-expected earnings. We sense the risk of a market price correction is now higher than was the case a few months ago.***

This isn't to say we are becoming more critical of current stock allocations in portfolios, but rather this is to say our call for higher levels of price volatility is still in force. Additionally, it is becoming more apparent that a downward shift in stock prices may indeed occur if economic (and consequently corporate earnings growth) fails to recover as 2015 unfolds. But will earnings gains disappoint?

Factors to Monitor – Into the New Room

Where does this leave our outlook? As the world's economy moves, from one room into another, what are the factors which we will focus upon to give us solace that the world's economy (and markets) are succeeding in this transition period?

- **Lower oil and gasoline prices.** As all know, oil and gasoline prices have declined dramatically over the last 12 months. Oil companies are slashing their exploration and production budgets, which is lowering overall capital spending in the United States. Rig count, i.e. operating oil/gas drilling rigs, have declined by a whopping 48 percent over the last 12 months. Additionally, layoffs due to low oil/gas prices have come into full bloom. The negative economic impact expected due to the decline in oil prices is happening. On the other side of the coin, consumers by and large are major benefactors as gasoline prices have come down. So far, consumers haven't shifted discretionary spending dramatically due to this windfall, and apparently are either increasing savings or paying down debt. This is not unusual. U.S. consumption patterns take time to change. ***We***

continue to expect a change in consumer discretionary spending patterns as 2015 unfolds. We will be monitoring retail sales and discretionary spending patterns.

- **Unemployment.** The rapid upward trend in job creation slowed in March. Over the previous three months (November – February), the U.S. economy created more than 1 million new jobs. Why did this upward march recently slow? It is probably due to the increased level of layoffs in the oil patch (see above) and an overall stalling of growth during the first quarter. We believe this recent slowing in the employment picture will prove temporary as overall economic activity starts to rise back to the 3 percent neighborhood. ***We will be monitoring the weekly jobs report.***
- **Consumer sentiment.** The recent release of the University of Michigan Consumer Sentiment Index was at 95.9, up 3.1 percent from the previous release. Consumer sentiment, driven by many factors including employment trends, remains robust. Various ***consumer sentiment data needs to be monitored closely going forward for hints of altering consumption patterns.***
- **Currency trends.** We believe the majority of the upward move in the value of the dollar to the Euro may be behind us for this portion of the cycle. The 21 percent upward move in the dollar to the Euro over the last 12 months is practically unprecedented. If we see stabilization in the value of the dollar, one impediment to higher growth (slower export growth) should be altered. ***We will continue to closely monitor variables (growth and monetary policies) which impact currency movements.***

Bottom Line

With global equity market valuation levels being raised over the last few months, combined with recent economic weakness, we need to understand what needs to occur for the world's equity markets to continue their upward ascent. It has become more clear that valuation, in and of itself, may not push equity prices substantially higher. Our view is ***the upward push in equity prices will need to be accompanied by an upward push in corporate profits, which will be supplied by a reasonably strong global economic and central banking environment.***

This year, we have been calling for an ***increase in asset price volatility***, driven by uncertainty. So far there have been 73 trading days in 2015, 41 of which have seen the Dow Jones Industrial Average rise or fall by at least 100 points (56 percent of observations). This level of volatility is reflective of investors' nervousness about the uncertainty the markets currently face.

At this time, we believe the global economic environment is passing through an economic passage… moving from one environment with specific economic drivers towards a new environment with different growth drivers. If we are correct in our assessment, the world's equity markets will continue their upward tilt as the year continues to unfold. During this period of transition, price volatility in global asset markets may continue to be rather high.

If we indeed witness a period of concentrated stock price weakness, we would use that period as an opportunity to increase equity exposure, rather than run from current positions, as we remain convinced that the global equity bull market remains sustainable.

We will be back next week.

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