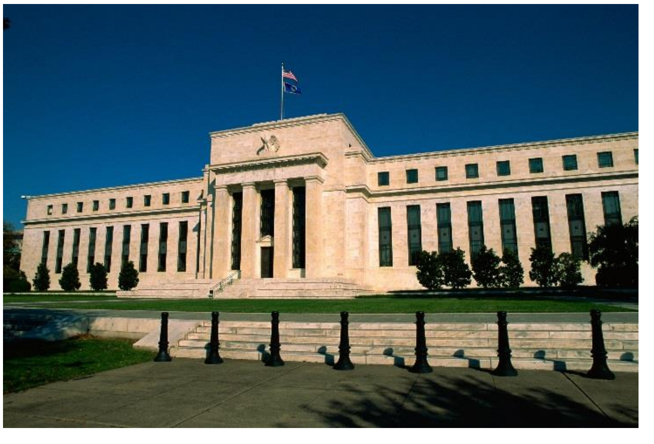
May 11, 2015

Asset Valuation – Expensive or Cheap?

Last week, Federal Reserve Chairperson, Janet Yellen, gave a speech at the Finance and Society conference. The U.S. market declined somewhat following her speech, as she commented:

> "I guess I would highlight that equity market valuations at this point generally are quite high. Now they're not so high when you compare the returns on equities to the returns on safe assets, like bonds, which are also very low. But there are potential dangers there. ***And in interest rates, obviously not only short but long-term interest rates are at very low levels. And that would appear to embody low term premiums, which can move and can move very rapidly.*** We saw this in the case of the taper tantrum in 2013 where there was a very sharp upward movement in rates and you do have divergent monetary policies, potentially around the world."



It appears by these comments, that Chairperson Yellen believes ***both*** stock and bond values to be high by historical standards. She goes on to say (through her comments regarding the taper tantrum and term premiums) that when interest rates start to move, we should expect rather rapid movements in capital assets – both stocks and bonds.

Valuation Levels - Stocks

Should we pay attention if the Chair of the Federal Reserve – arguably one of the most powerful people in the financial world – believes asset values are high? Some would say we should pay close attention because the Federal Reserve Chair has the capability to do something few people in the world can. She can do something about valuations (raising interest rates) for an entire banking system.

It has been rare for the Fed Chair to make comments concerning stock market overvaluation levels. Probably the most famous comment recently by a Fed Chair as to asset valuation occurred when Alan Greenspan was making a televised speech on Dec. 5, 1996. In that speech, Chairman Greenspan said:

> "Clearly, sustained low inflation implies less uncertainty about the future, and lower risk premiums imply higher prices of stocks and other earning assets. We can see that in the inverse relationship exhibited by price/earnings ratios and the rate of inflation in the past. But how do we know when ***irrational exuberance*** has unduly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the past decade?"

Did Greenspan's irrational exuberance comment have an impact on the world's stock markets? Immediately following his speech, Japan's stock market traded down 3 percent. Markets around the world swooned. But, following the immediate impact, the U.S. stock market (as measured by the S&P 500 Index) continued its upward march. From December 1996 until March 2000, the S&P 500 rose by 102 percent! Greenspan was eventually vindicated as the S&P fell in value by 41 percent from March 2000 until October 2002. While eventually right in his call, warnings from a Fed Chair regarding stock market valuations didn't prove to be a reliable timing tool.

Indeed, it has been my experience that valuation by itself is a very poor market timing tool.

It is not new information to us that stock values are high, based on historical averages. I have been writing on this subject for the last year. Valuations, in and of themselves, normally don't push asset values higher or lower. ***A catalyst is normally necessary for that valuation disparity to be erased. Economic contraction (recession), or a significant change in central bank policies, are needed for the overall tenor of the equity market to make a meaningful correction (price decline of 20 percent or more). We don't see either precondition on the immediate horizon. We wouldn't, however, be particularly surprised to see stock prices correct by 5 - 15 percent sometime in the not-too-distant future. If that were to occur at this time, we would view that type of correction as a buying opportunity.***

Valuation Levels - Bonds

Janet Yellen's comments focused not only on stock valuation levels, but also on bond valuation levels (interest rates). Interest rates, by and large, have been declining over the last 30+ years. Some of us can remember when the 10-year U.S. Treasury bond was yielding 15.8 percent (September 1981). Currently, the 10-year is yielding 2.23 percent, up from a low of 1.45 percent reached in June 2012. Foreign sovereign yields are much lower than our government yields in the United States.

Today, the 10-year German Bund (their wording for "bond") is yielding 0.55 percent. On April 13, 2015, the 10-year German yield was 0.08 percent (that's not a misprint). That doesn't seem like a big deal, unless you were the investor (ahem, the poor soul) who actually bought the German 10-year at a yield of 0.08 percent. From April 13 to May 11, the 10-year German bond has lost 4.56 percent of its market value! That loss (unrealized, of course) ***represents 57 years of yield of the initial purchase price! Let's take another example – let's say that the 0.08 percent yield bond is held for the next five years, and interest rates rise to 3.0 percent - not an outrageous assumption. The bond would then be selling at a loss of 13.5 percent from initial purchase price – after five years! This is an example of how vicious buying long term, low interest rates bonds can be.***

In our weekly piece from March 9, 2015, (Nega-Coups) we highlighted what we believed to be the folly that currently is the European bond market. Since the launch of our piece, other more well-known investors have made the following comments regarding the German bond market:

> *Bill Gross (legendary bond manager at Janus): "German 10-year bunds are the short of a lifetime. Better than the pound in 1993". – April 21.*
>
> *Jeffrey Gundlach (Chief Executive Officer, DoubleLine Capital) on "shorting" the German bond market: "It seems to me there's almost no way to lose. I wonder why people don't leverage up negative yield bonds".*

So, there are two very highly respected bond managers of international fame who are concerned about the European (specifically the German) bond market.

Let's consider an example of bond-market risk a little closer to home. The U.S. Treasury 10-year bond is now yielding 2.22 percent. Over the next five years, 10-year government bond yields rise to 4.40 percent (assuming average inflation of 2.7 percent and a normalized term real-interest rate structure of 1.7 percent). The 10-year bond purchased at 2.22 percent yield would have generated an average annual return of 0.82 percent.

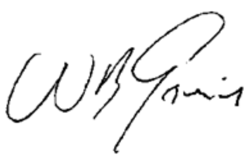
If your financial plan is calling for a "needed" return of 5.0 – 8.0 percent per year (typical for many investors), you can't have many assets in your portfolio and achieve your financial goals with assets generating an average return of 0.82 percent per year! The rest of the portfolio has to do some real heavy lifting for you to meet your financial goals.

In April 2013, we launched our "Shifting Sands" theme. This was an investment theme which highlighted our view that bond investors needed to consider alternative strategies to traditional long-term fixed income investing. Since that call, the 10-year U.S. Treasury bond has risen in yield from 1.6 percent to 2.2 percent. ***The total return of investing in the 10-year Treasury since the launch of "Shifting Sands" in 2013 has been -1.18 percent.***

Eventually longer term yields will rise to a point where the Fed will be compelled to act. When they "act" enough, capital risks in markets – both stocks and bonds – will intensify.

We currently harbor stronger concerns about global bond markets than equity markets.

We will be back next week.



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