FirstPoint Financial

WEEKLY MARKET THOUGHTS

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Questions

Due to the newly increased volatility in the capital markets, I thought it appropriate to summarize our thoughts on asset prices. Many of these thoughts have been recently published.

Today's piece takes a question and answer narrative. The following is a conversation I can imagine having with a client.

Bill: Thanks for coming into our offices today – it is always a pleasure to see you.

Client: Bill, I have questions that you may or may not be able to answer. I am getting a little nervous at all I'm seeing in today's world. The global geo/political environment is unstable. Our economic growth remains lackluster, and now the world's stock markets have picked up volatility. What do you think of the current risk-based asset price weakness?

Bill: First, from a fundamental perspective, my view is very positive over the intermediate/long term for most risk-based equity assets. However, as you remember, I was suspecting we would see some type of pullback in prices – the table was set for the market to show some degree of short-term price weakness due primarily to extreme levels of investor complacency and bullishness.

Additionally, stock valuation levels were becoming disturbingly high. As an example, small capitalization U.S. stocks, as measured by the Russell 2000 Index, were priced at 26x trailing operating earnings about a month ago and 1.4x sales. Both of these metrics register in the top 10% of historical valuation levels for this index. Due to these valuation levels, we suggested small capitalization stocks may struggle for a period.

Stocks rallied nicely last Friday. We can't predict what the market may do on a daily basis – the drivers that spurred the markets downward recently were political, in nature, not economic. But, we don't believe the current downturn will be long-lasting, nor particularly ugly, in its magnitude.

Client: I hope you are right. Can you provide some deeper thought as to why you don't think the current downturn will turn into something more ugly, like a cyclical bear market?

Bill: The definition of a bear market for any asset is a 20% or more decline in prices – from peak to trough. Here is a short list of asset indexes and the declines they have experienced, so far, from their recent high prices.

Index	Price Change From Recent High
S&P 500	-3.0%
Russell 2000	-6.8%
EAFE (foreign stock index)	-6.3%
Emerging Markets	-3.1%
Barclay High Yield Index (bonds)	-2.9%
CRB Index (commodities)	-6.7%

As you can see, we are a long way off from 20% declines. Since the end of WWII, the U.S. stock market hasn't declined by more than 20%, unless one of the following conditions was met:

1. **We are heading into a recession –** The best work I've seen on this issue suggests the U.S. economy is a long way off from an outright contraction in economic activity. Unfortunately, I can't say the same for Europe. In the United States, most economic momentum measures are pointing toward increased economic strength, rather than less.
2. **The Federal Reserve is contracting money supply –** While we firmly believe the Fed will continue its tapering of Quantitative Easing (QE3), followed eventually by a rise in interest rates sometime next year, we also know M2 (broad-based money supply) has increased by 6.1% over the last 12-month period. Nominal (real + inflation) GDP growth has been 3.9% over the same period. Consequently, the Fed has grown money supply by a higher rate than the economy needs that extra money to grow. The excess money supply has to go somewhere – bank reserves or the capital markets. Take your pick; either way this is stimulative to economic activity and asset values.
3. **Extreme asset valuations –** While P/E ratios are high by historical standards – and we have frequently made note of that issue – they are not high enough to trigger an outright bear market, based on historical standards. Currently, the S&P 500 is selling at 18.3x trailing GAAP earnings, which is about one standard deviation above the multi-decade average. Compare today's valuation levels to those we saw in the 1999-2000 era. During that time, valuation levels rose to two standard deviations above the normal level. While not cheap, today's markets aren't priced anywhere near those old frothy high levels.
4. **War –** I don't know if we are going to war, but I doubt it. Others may carry that ball for a while, Russia, for example.

The catalysts that normally precede a cyclical bear market do not currently appear to be on the horizon.

Client: Ok. Then, what fundamentals are currently driving the market? What is creating this higher level of volatility in prices? What fundamentals can I monitor to give me some clues as to how much lower, if at all, the current decline will go?

Bill: Good questions. Initially, I thought much of the current decline was due to increased concern that the Fed would start raising interest rates sooner than most had expected (I still believe this to be the case). But, the activity in the market over the last few days has mirrored news reports about

Russian military activities in Ukraine. On a day-by-day basis, the market has turned into a "rumor" market, making it difficult to deal with, at least over the short-term.

As an example, on Friday the Dow Jones Average rallied by 185 points when a Russian official said, "Russia will continue to make all efforts for a very fast de-escalation of tensions." Stocks continued to surge on Friday when the Russians said they were preparing to end military exercises. Is the Russian experiment with Ukraine over? I obviously don't know, but somehow I doubt it.

Consequently, volatility may remain elevated for a period of time as the issue is sorted out. What is the end-game of Russian activities? I don't know, but I have made statements in earlier writings regarding Putin and his actions (see our piece *The Consequences of Slow Growth and Leadership Vacuums*, *March 3, 2014).* Remember, at the end of the day, ***corporate earnings tend to drive stock prices over the intermediate to long-term. I am seeing more evidence that earnings growth rates for U.S. corporations should be reasonably strong over the next 6-12 month period of time.***

Client: Ok, you have convinced me to stay the course and not sell in this current volatile market. I understand the unpredictability of the current environment, from a political perspective. But, how weak do prices need to become before you suggest putting additional risk capital to work?

Bill: Market timing of that sort is a guessing game, at best. I will let the market talk to me and let me know when it is safer to deploy capital. How does the market talk to me? Technical analysis is a reasonably good tool in this type of volatile environment. I liked what I saw on Friday, as the markets rallied. The upward move was rather broad, which is a good sign that investors' attitudes are becoming a little bolder.

It appears the Russell 2000 Index is acting as the canary in the coal mine as to overall risk-based asset temperament. As you remember, the Russell was the first index to crack on the downside. The peak in the index occurred on July 1st, as compared to the S&P Index, which peaked three weeks later on July 24th. The downward move in the Russell 2000 is more mature and deeper than the swoon in the S&P 500. I am watching the Russell closely for hints of a bottom or for further weakness. The Russell closed at 1,131 on Friday, after trading at a high of 1,213 last month.

Stocks are cheaper today than a few weeks ago. In select markets (foreign developed markets), valuations are reasonable and economic momentum is positive. With the problems in the Ukraine, many of the major indexes in Europe have contracted rather harshly in value. The German DAX Index is down 10.2%, the London FTSE Index has contracted by 4.5%, and the Paris CAC Index is down 9.7% from its recent high.

It makes sense for investors to use the current market swoon to put cash to work in the developed international markets, but ***we urge you to get in touch with your wealth advisor to discuss the advisability of putting additional capital into the foreign equity markets. Your personal wealth advisor knows your particular situation well and can give you solid advice on these ideas.***

Client: You have been saying that the U.S. stocks have started a new, secular bull market. Do you still believe this to be the case, with all the socio/political strains in the world?

Bill: Yes, I do. ***The vast majority of the evidence available suggests that this is the case. While equity prices take both price and time corrections during secular bull markets, over the long-term, a secular bull is an environment where owning stocks is a very rewarding financial experience. Remember, the last secular bull market started in 1982, during a time when the Cold War was very intense. The USSR didn't collapse until six years after the start of the secular bull. Socio/political strains are normally present. People are people and somewhere in***

the world political strains exist.

The bottom line regarding my thoughts is, if I'm right about the long-term secular bull environment, buying stocks when they swoon, as is currently the case, will prove a profitable exercise over the long-term.

Client: Thanks for your time.

Bill: I appreciate your visit – and we appreciate your continued business.

We will be back next week.

William B. Greiner, CFA
Chief Investment Officer
Mariner Wealth Advisors

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