ISSUE 10 | VOLUME 2 | APRIL 2014

Cadence *clips*

FOCUSED ON WHAT MATTERS MOST.

A Strong Economy May Not Equal Strong Stock Performance

It seems that these days we jump from one economic report to the next looking for clues as to the true health of the economy. While some contend that things are on the mend and the economy will be picking up speed this year, others feel that we may be on the verge of an economic stall. To make matters more confusing, the unusually cold and snowy weather across a good portion of the country this winter has made some of the weak economic reports unclear as to their true tone. There's no question that a strong economy is good for Main Street, but why is Wall Street so obsessed with every little rise and dip in the economic data? Maybe it shouldn't be.

Stocks tend to perform well when the economy's healthy and growing. As the economy grows, there's more money in people's pockets to be spent leading to more corporate and business profit, which can lead to more employment, which in turn leads to more money in people's pockets - and the virtuous cycle continues. But the correlation starts to break down when we start to get away from the middle of a healthy economy and focus instead on either side of it – the beginning or end. In other words, as we start to see hard evidence in the numbers that the economy is weak, the stock market may be starting to look forward to better times and the underlying economy may already be healing. On the other hand, when an economy has been growing for a period of time and is showcasing its strongest economic data toward the end of a cycle, we may start to see stocks markets react less positively. It's this discounting nature of markets that tends to stay one step ahead of economic news that is just starting to reflect what most have already experienced first-hand. Markets tend to think about what's coming rather than what currently is.

Take recent counter-intuitive reactions of the stock market to rise in the face of disappointing economic headlines as an example. The market is betting that the weak data will lead the Federal Reserve to extend its accommodative "easy money" policies in an effort to get things turned around. It's thinking 6-12 months down the road. So as investors, it may be more profitable to be less concerned about the current state of the economy and more concerned about what stock markets are currently reflecting. If they've already run up quite a bit in anticipation of strong earnings in the future, then there's probably a good possibility that the market suffers losses should those earnings not fully materialize. On the contrary, if the market has recently taken it on the chin because it expects horrible corporate profits going forward, it may be primed for launch should those earnings turn out not to be so bad.

As we scribe this letter, it's very clear that the markets have risen over the last 5 years in anticipation of improving economic results. It's also apparent that although the economy isn't where anyone would like it to be, by many measures, it's the strongest it's been since before the financial crisis. What might this mean? Let's take a look at history to see what can be gleaned that might help us stay informed as investors.

Lessons From History

Our number crunchers at Cadence went to work looking into the relationship between some of Wall Streets most adored economic reports and stock market performance. We looked at data going back to 1950 and sought to find out what our 1-year return on the S&P 500 would have been if we invested when the data from these reports were among the best and the worst over a business cycle. We defined the business cycle as a seven year period. We also defined the "best" reports to be those better than 80% of the others over that 7 year period. By contrast, we defined the "worst" as those worse than 80% of the others over the prior 7 years. Here's what we found.

GDP - If we bought stocks when GDP reports were the best, our return on average over the coming year would have been 2.1%. If instead, we swallowed hard and bought stocks when GDP data was amongst the worst, our average return over the coming 12 months would have been 14.2%.

Unemployment - If we were to invest in the S&P 500 when unemployment was low, our return on average over the coming year would have been 7.5%. If instead, we went against the grain and invested when the monthly unemployment figure was relatively high, our average return over the coming 12 months would have been 14.4%.

U.S. Manufacturing – Another very popular economic indicator is the PMI Composite Index, which measures manufacturing activity in the U.S. If the number is above 50, it indicates expansion, whereas a number below 50 connotes economic contraction. The more positive, the better for the economy. So the same should hold true for the market, right?

If we were to invest in the S&P 500 when the PMI Index was high indicating a strong economy, our return on average over the coming year would have been 3.9%. If instead, we invested when the monthly PMI Index figure was uncomfortably low, our average return over the coming 12 months would have been 11.8% - much better.

Across a number of key economic measures, the results are consistent. Strong economic numbers don't necessarily mean that the coast is clear when it comes to investing in stocks. By and large, when the economic data reflect a weak economy, the markets have already declined, and by the time those same figures are looking the best they have in years, the market has nearly completed its journey upward. This suggests we may be better off paying less attention to the daily barrage of economic reports and more attention to what we're actually investing our money in.

Given that our economy is looking as good as it has in years, we may want to weight it less when it comes to our investment decisions. A strong economy should never be the main reason to invest more heavily in stocks. Price always matters.

A Typically Quiet Stock Market Titan Speaks

Seth Klarman, recently ranked as the fourth best performing hedge fund manager of all time and generating annualized returns of 18 percent since 1983, recently issued what equates to a market warning in his letter to clients recently. Here are some thoughts and excerpts we found particularly interesting.

Klarman refers to this market as a "Truman Show" market, where the main character played by Jim Carrey goes about his daily life completely ignorant of the fact that he is operating in world that is a completely manufactured reality. With Bernanke and other central bank heads as the "creators", life under this giant Plexiglas dome of modern markets, almost everyone is happy, skeptics are criticized, and bad news is ignored. In the movie, once Truman discovered the truth, outrage ensued. With this Truman sequel, even though we suspect most investors intuitively know they're operating underneath the dome and it shouldn't be any surprise once it's made clear, anger and outrage will still be in full bloom as it's discovered they're woefully unprepared for reality.

“There is a growing gap between the financial markets and the real economy…and the overall picture is one of growing risk and inadequate potential return almost everywhere one looks…and every Truman under Bernanke’s dome knows the environment is phony.”

“Our assessment is that the Fed’s continuing stimulus and suppression of volatility has triggered a resurgence of speculative froth. Margin debt measured as a percentage of GDP recently neared an all-time high.”

Klarman also comments on how Europe is not fixed. With debt to GDP ratios rising in almost every country and unemployment and social unrest still at uncomfortably high levels, it’s anything but fixed.

"Any year in which the S&P 500 jumps 32 percent and the Nasdaq 40 percent while corporate earnings barely increase should be a cause for concern, not for further exuberance."

"On almost any metric, the US equity market is historically quite expensive. A skeptic would have to be blind not to see bubbles inflating in junk bond issuance, credit quality, and yields, not to mention the nosebleed stock market valuations of fashionable companies like Netflix and Tesla Motors."

"When the markets reverse, everything investors thought they knew will be turned upside down and inside out. 'Buy the dips' will be replaced with 'what was I thinking?'… Anyone who is poorly positioned and ill-prepared will find there's a long way to fall. Few, if any, will escape unscathed.”

In an environment where the main argument in support of stocks tends to be improving economic fundamentals and that they’re the “least bad game in town” (that’s our quote referring to how stocks seem to be a better investment than the low yielding cash and bond alternatives), it may be wise to take Seth Klarman’s sentiments seriously. If you haven’t already done so, consider consulting with an investment adviser who has a good understanding of market history. If you’re reading this letter as a client of ours, you’re already well aware that we’re taking precautions. Remember, future returns are all about the price levels we invest at. The better the price, the greater the opportunity.