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FOCUSED ON WHAT MATTERS MOST.

Markets Are Calm – What's to Fear?

When contemplating whether to trek up the snowy slopes of a mountain, more should be taken into account than just the observable weather conditions above the ground. Although it may be an absolutely perfect day for a climb, conditions under the snow's surface may tell a different story.

Based on observable conditions alone, investors would most likely choose to trek right into stocks. Although we've seen some ups and downs in the market this year (in the absence of greater specificity as to which market, we're referring to stocks), things have remained relatively calm when looking at the major indices - the S&P 500 and the Dow Industrials. Both have remained within fairly tight trading ranges since early February with the highs and lows only separated by about 4.5%. In addition, the VIX - a popular gauge measuring the amount of volatility investors expect to see in the coming weeks and months - is among its lowest levels in history. According to this volatility measure and a host of investor sentiment readings, investors on average are very bullish and extremely complacent, viewing the range-bound market as a healthy and temporary departure from its upward trajectory. The plan to summit remains intact.

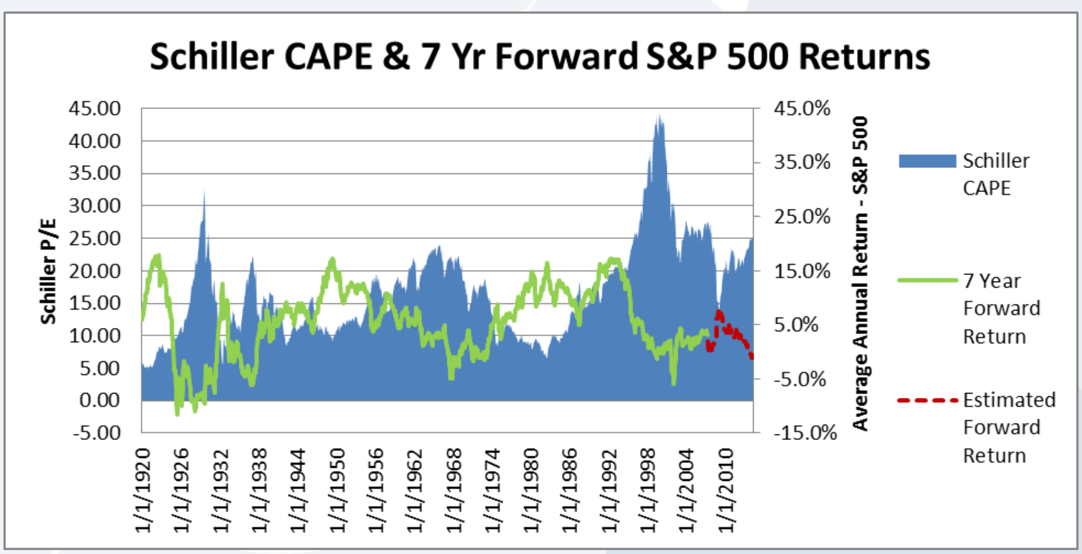
We've also observed some interesting movement in bonds recently. Some of the hardest-hit categories from last year such as longer dated U.S. Treasuries are up over 10% since Jan 1, exactly the opposite scenario than the pundits were calling for coming into the year - a classic case of the crowded trade or consensus phenomenon. When too many people start thinking the same thing, the opposite outcome may be in the offing - and potentially in a dramatic way as everyone starts to realize that they were leaning in the wrong direction at the same time. But still, investors favor stocks to bonds and are chalking up this drop in interest rates (rise in bond prices) to short-covering amongst those who were betting too big on higher rates, as well as a limited supply of government bonds for purchase due to lower budget deficits/financing needs. Both of these things put upward pressure on bond prices and downward pressure on rates. Although both of these points are likely true, there's a good possibility that there may be other factors at work in bonds. A slowing global economy and a growing sense of discomfort around the stability of stock markets may also be contributing to lower rates.

Calm, sunny conditions always bring out the optimists, and when it comes to the stock market, optimists are generally referred to as Bulls. The Bulls rest their optimistic case on the fact that corporate profits are at record levels and balance sheets are as strong as they've ever been, the latter of which haven't yet been unleashed on the economy by way of capital expenditures on things such as technology upgrades, R&D, infrastructure, say nothing about hiring actual people to do things that ultimately help drive innovation and additional profitability. A logical argument no doubt. The consumer is also looked at as further fuel for economic expansion. The idea being that once confidence comes back to the average Jack and Jill, spending will ensue, which everybody knows is the secret sauce making up 70% of our national economy. With home prices continuing to rise and debt being paid down incrementally, and of course unemployment coming down to 6.3%, this return of confidence is almost certain. Oh, and the markets aren't that pricey when looked at against expected corporate profits for next year which are running at record highs. And those events that cause markets to drop like big bank failures or world wars? The Bulls don't see any of those on the horizon, so it looks like the coast is clear for now.

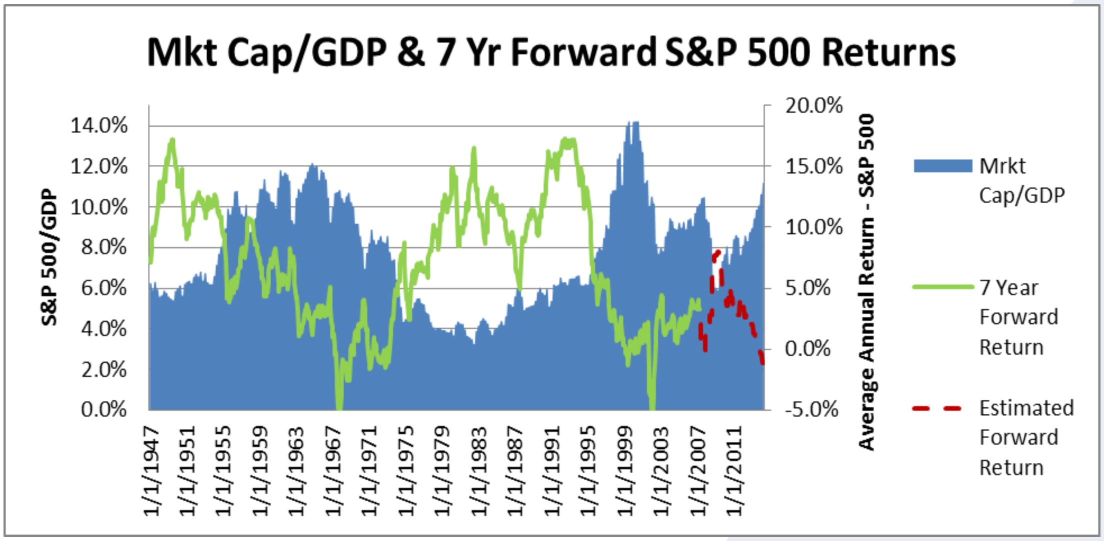
Let's just say, we far prefer being bullish to bearish, optimistic to pessimistic, we prefer sun to clouds, etc. We all know people who have a tendency to dwell on the dreary, which may or may not work for them, but we're guessing not. In the world of investing, we believe that basing our positions and outlook on reality is more effective than on general dispositional preferences. That reality isn't static and will change over time, which in our opinion helps us view a slightly less rosy outlook with optimism as at some point, market turmoil turns into tremendous opportunity. In any case, according to our research and a healthy respect for history and human nature, our feeling is this…

Markets have only been more expensive than they are now a handful of times over the last hundred years depending on the valuation approach used, and that doesn't bode well for expected returns over the next 5-10 years. Based on the Schiller Cyclically Adjusted Price to Earnings (CAPE) method, the stock market has only been this expensive three other times in the last 100 years and on a Market Cap to GDP basis, valuations have only been richer twice in 50 years. When looking at stocks throughout a complete business cycle (good and bad), according to both metrics, they appear anywhere from 45-55% more expensive than usual. Take the biggest bubble in 100 years out of the numbers, and stocks look even further out of whack relative to what we'd consider normal. Schiller's CAPE shows an average market multiple of 15 between 1871 and 1998 compared to the current average of approximately 16.5 when we factor in the last 16 years, a period that we'd argue has harbored three market bubbles – two in stocks and one in real estate. Cutting this period out probably more realistically implies that today's market is closer to 67% overvalued. Same concept when looking at Market Cap to GDP – given that the largest bubbles in history wouldn't necessarily be considered normal and affect the mean more than the median, a more conservative estimate as to what price the market can bear over time may be warranted.

What's more is that these two valuation metrics have been incredibly consistent throughout history at predicting returns over the following 5-10 years. In the charts below, you'll notice the inverse relationship between both the CAPE and Market Cap to GDP models and the average annual returns of the S&P 500 over the following seven years. Simply put, the higher the valuation of the market, the lower the returns over the coming seven years. If you look at every point in history where markets were valued as richly as they are today, investors would have had to settle for much lower returns than normal. Some would argue that interest rates have never been this low, making it possible for stocks to be more expensive than usual for longer. Although this may be true, we witnessed U.S. rates well below their long-term averages in the mid 1960's with forward returns being below average. We also witnessed Japan's interest rates at historic lows beginning in the mid 1990's after their markets began an adjustment from the biggest stock and real estate market bubble in their history. The argument then could have been that low interest rates can support higher stock market values. Almost 20 years later, interest rates are even lower and the stock market is roughly 75% of what it was then. We have to be careful about evaluating one investment's appeal based on the relative unattractiveness of another.



When we assume a reversion to the average relationship between the S&P 500 and both the CAPE and Market Cap to GDP models, we see market losses of between 30-40%. If we assume this reversion takes place over a full economic cycle of 7 years, we see returns averaging just below zero before inflation given that the economy continues to grow at roughly 4% over that same period of time. If history's any guide, it would be reasonable to expect that we not only revert to average, but poke beneath it for a while since markets tend to overshoot – the pendulum swings both ways. This would make for a pretty nasty outcome and would put market prices well below where they are now even 7 years down the road. That doesn't necessarily mean however, that there won't be opportunities along the way.



Profit margins are another factor allowing the markets to appear deceptively attractive. After-tax corporate profits currently account for 11.4% of total economic output (GDP), whereas they've averaged 6.5% over the last 67 years. One could argue that globalization has made for a new environment where the economy can support a bigger slice of the pie going toward corporate profits. With greater global competition, businesses may be able to better control costs leading to higher profit margins. As true as this may be, globalization has been taking place since long before profit margins started soaring in 2004. In addition, any costs cut as a result of people being paid less, no matter where they live, makes for less money in the hands of potential customers. A global economy works both ways – it means corporations can hire and outsource overseas, but it also means your customers can come from overseas. Ultimately, an economy that depends on consumption needs healthy customers. If corporations keep hoarding too big a slice of the economic pie, it's just a matter of time before those buying their products buy less.

We feel record corporate profit margins are more a function of incredibly easy monetary policy by the Fed coupled with an exceptionally agile corporate environment that's willing and able to cut costs more quickly than ever to drive shareholder profitability. The easy money policy by the Fed has made it a cinch to refinance debt and reduce interest expense, while additional cost savings have been made through reduced capital expenditures (yes, it's true they've been suppressed) and employee cuts. This employee cutting gets to the heart of the matter for us. As we just mentioned, an unhealthy consumer makes it very difficult for margins to stay high. Ultimately, the natural ebb and flow of economic events will likely cause profit margins to revert back to a more "normal" level in the near future. Without any change in the P/E multiple being placed on the market right now, this would lead to a 43% decline in the S&P 500. Assuming a reduction of the current trailing 12 month P/E multiple to its long-term average of 15.5, that would leave the S&P 500 53% below its current level.

And what about the argument that there's no catalyst on the horizon to knock the market off its lofty perch? Well, there never is, that we see coming anyway. It's rarely something knowable because if it was, it would have already affected the market negatively. Rather, it's the tiny incremental input or variable that starts an already unstable, vastly complex system down a dangerous path. It's not about the variable at all, but rather the system and its current state. Is it simple or complex? Is it stable or shaky? Does its success depend on external and artificial inputs? These are the questions we need to ponder in order to accurately assess the inherent riskiness of markets today, not whether we can identify that thing that will lead to the next correction. When the forest is dry, it doesn't take a lightning bolt to set thousands of acres ablaze, but rather a tiny ember. Likewise, an avalanche is often triggered on a clear sunny day with no obvious indication as to what caused it. It doesn't matter. What matters is that the mountain is inherently unstable and dangerous, and the decision whether to climb it should be made on that basis.

So with markets at record high levels and valuations, and projected returns over the next 5-10 years likely very, very low, are we optimistic about the future? Absolutely. If we look at things realistically and without prejudice, with history as our guide, we can choose to focus on risk management and wait for better conditions. There's never been a period in history where similarly over-priced markets haven't provided tremendous opportunities to create wealth. This one won't be any different. We're looking forward to it. In the meantime, we tread very carefully in an increasingly unstable market, and prepare to seize those opportunities when they present themselves.

Key Takeaways:

- A low VIX (measure of expected volatility in stocks) and bullish investor sentiment readings indicate complacency and a general disregard for risk among investors. History shows that this is very common toward the end of bull markets, when risks are the highest.
- Based on current market valuation metrics, returns over the next 5-10 years are likely to be much lower than investors expect. It has less to do with economic prospects and everything to do with the current price of stocks.
- History very consistently suggests that when stocks are purchased at current valuation levels, returns will be lower going forward as market forces bring things back into balance. This can create tremendous opportunity to buy stock from those who didn't heed history's warning. We're very optimistic about the opportunity this will create and would much rather be a buyer in that rebalancing period than a panicked seller!

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