January 2015

INVESTMENT PERSPECTIVES

New Year's Resolution: Patience

It's January, a time when we say good bye to the prior year and look ahead to the new one. It is also the time of year when a slew of annual market outlook pieces will vie for your attention on popular media outlets. According to a recent survey by Barron's, there appears to be an expectation among market strategists that stocks will rise roughly 10% in 2015 which would imply a price target on the S&P 500 of 2,265. Ironically, a 10% return is also very close to the average market return since the early 1900's. At HCM, we place little value on the predictive power of Wall Street. Danish physicist Niels Bohr said it best that "prediction is very difficult, especially about the future." This is not to insinuate that those making the predictions do so with dubious intentions, it's just that the historical record of accuracy tends to be quite poor. Quite frankly, as it relates to our portfolio construction and investment process, we would prefer to focus on the underlying business and purchase a stock only when one can do so at significant discount to the value of the corresponding business. Famed value investor Benjamin Graham termed this "margin of safety" and it allows an investor to build uncertainty into his or her estimation of where a stock should be priced.

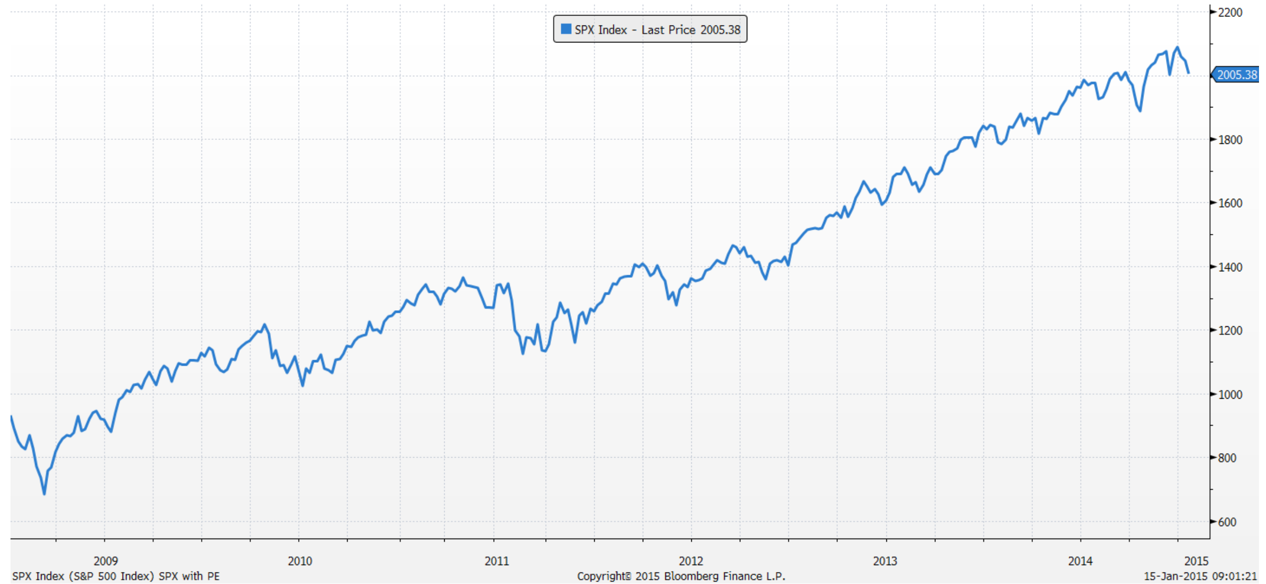
So now that most strategists have shifted to the bullish camp, we on the other hand believe that this is a time for the prudent investor to exhibit patience and wait for potentially better opportunities. This reasoning is rooted in our belief that an investor has a far greater probability of success if committing new capital for investment when values are attractive (more often than not when prices have declined) as opposed to chasing markets higher following several years of gains. The thought process is particularly useful when valuations have risen higher as they now have. This view remains in line with our core tenet of preservation of capital and growth of client portfolios over the long term.

So what are the proverbial elephants in the room that may spook the markets? We see valuation, elevated sentiment, global deflation, US interest rates, and falling commodity prices (oil) as among the list of possible suspects.

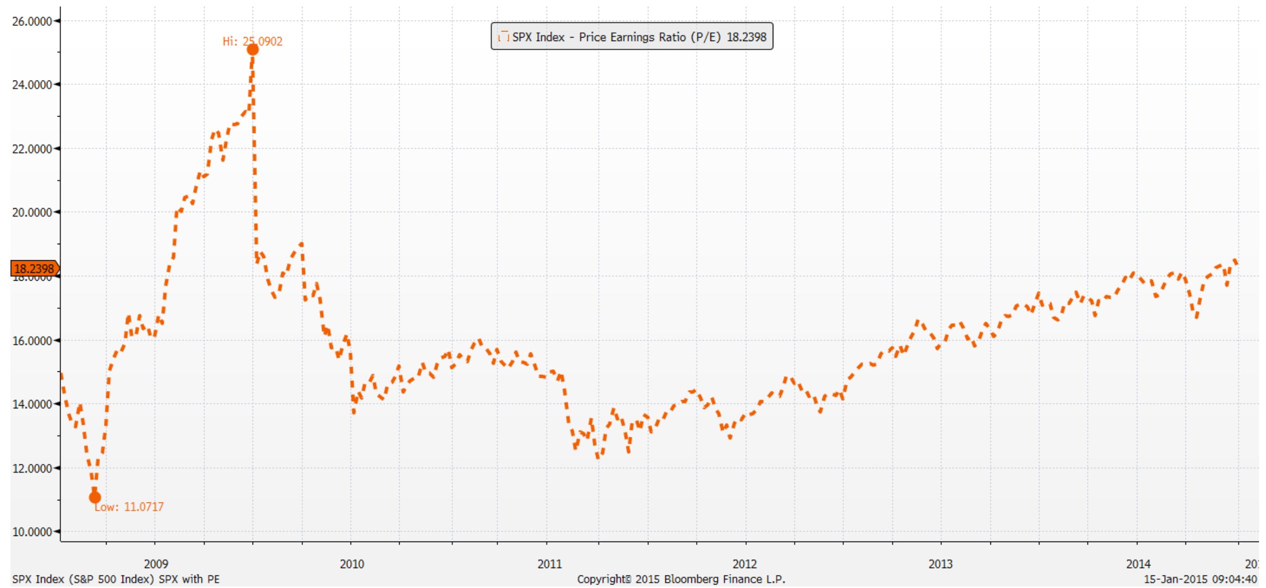
Valuation

The chart below shows the price return for the S&P 500 since 2009. As the reader can see the market has enjoyed a very nice run since 2009. The current bull market is almost at its six year

mark and is the fourth longest since 1926, with cumulative returns for the S&P from March 2009 of 212%.



Additionally, the second chart shows that the price to earnings ratio (P/E), a measure of valuation, has also increased over that time period to its current ratio of nearly 18x based on trailing 12 month earnings. This compares to the longer term average of approximately 15x and a low of 11x at the start of the bull market in 2009.



Sentiment

Our assessment of investor sentiment is another factor that gives us pause and reinforces our call for caution and patience in the macroeconomic and market environment at the start of 2015. As mentioned previously, the consensus among Wall Street's strategists is that the S&P 500 will advance 10% in 2015.[1] Further gains this year would be remarkable given the 13% increase last year on top of a stellar 32% advance in 2013. We would note that Wall Street strategists as a group are universally optimistic: since 2000 the average forecast has called for higher stock prices, failing to predict the tech bust in 2000-2002 and the financial crises in 2008-2009.[2] Consumers are also feeling optimistic with consumer sentiment in December hitting it highest level in eight years, according to the Thomson Reuters/University of Michigan survey. Individual investors are also bullish on the outlook for the stock market. The January 1, 2015 sentiment survey of the American Association of Individual Investors (AAII) showed that 52% were bullish, 29% neutral and only 19% bearish. Historically, individual investors have represented a good contrarian indicator because there is a natural human tendency to extrapolate recent trends into the future. So what does all of this mean? Our crystal ball is not any clearer than anyone else's but we simply point out that attitudes toward risk border on complacency and that a bullish outlook for stocks is certainly not a contrarian investment viewpoint.

Deflation or Inflation?

A current concern of some economists is the potential for global deflation. These economists point out extraordinarily low global interest rates as a predictor of impending global deflation. Deflation is a decrease in the general prices of goods and services. On the surface, this issue seems like a good thing, as who doesn't like for something to be cheaper tomorrow? Unfortunately, deflation wreaks havoc on economic growth as consumers hold off from buying which inhibits economic growth as many economies require consumption for a large component of growth. Central bankers fear deflation because it's very hard to control and difficult to use monetary and fiscal policies to limit or stop it.

Current fears surround the Euro zone, Japan and even China's ability to sustain economic growth strong enough to keep their economies from entering a deflationary spiral. Japan has struggled with this for decades and has recently embarked on a large quantitative easing program to try to stem deflations grip. Many point to Europe's incredibly low interest rates (see chart below), highlighted by Germany recently having negative interest rates as a sign that deflation is taking hold. Spain and Italy, once the most feared countries to default, currently have interest rates lower than the United States, as can be seen in the next chart.

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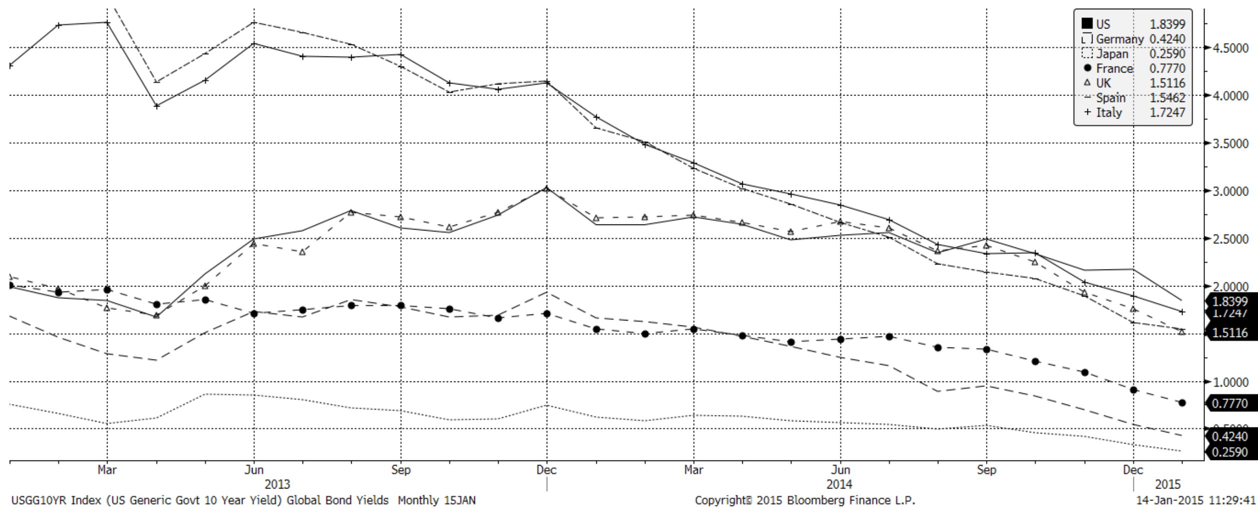
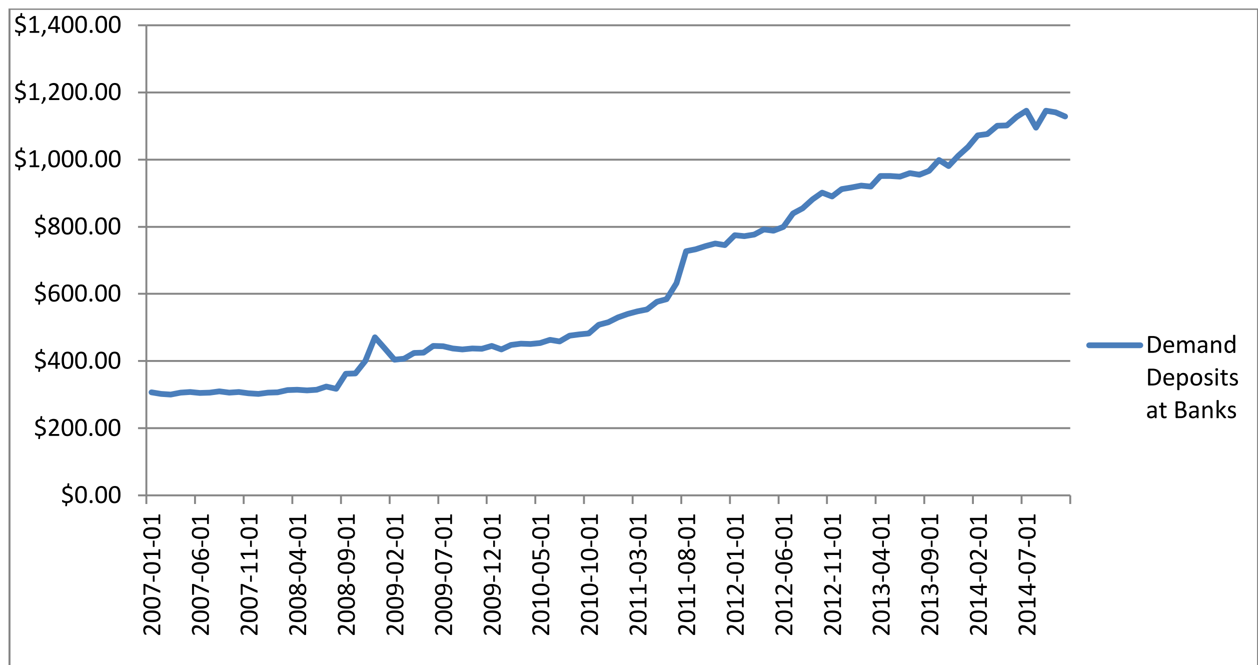
[1] Barron's, December 15, 2014 p. 33.
[2] Wall Street Journal, January 5, 2015, p. C1.



On the other side of deflation is the concern that the U.S. may finally face inflationary pressures in 2015. Inflation has been mild for a mix of two reasons. First, the *velocity of money* has been very low. The velocity of money is how fast money changes hands in the economy. This relates to the fact that while money sits on bank balance sheets, banks are not making the necessary loans for the money to enter the money supply. As banks lend, there is a money multiplier effect that causes inflation to rise. Banks complain that businesses are not requesting the loans or aren't credit worthy. Businesses complain that the bank's lending standards are too high. Most likely both are partially true. As businesses and banks become more confident, they will tend to borrow or lend more and this increases velocity of money which in turn creates inflation.



Source: St Louis Federal Reserve

The other reason inflation has been low has been the lack of wage inflation. While the US economy has been recovering, employers have been reluctant to hire due to the long term commitment and cost and wage inflation has remained very low. We have seen employers spend on equipment and even acquisitions (which tend to shed jobs) but reluctant to hire due to uncertainty about the future outlook for the economy. With confidence in economic growth returning, we are starting to see a brisk pick up in hiring which may lead to wage inflation in 2015.

While we have no predictive powers over either deflation or inflation, even the fear but not the reality of these two events can have consequences for the stock market.

Commodities (Oil)

Oil has dominated the headlines in recent months amid the more than 50% decline from $107/barrel in July to the recent price of $46/barrel. Like all commodities oil trades based upon expectations for supply and demand. With U.S. oil production at its highest level since 1986, concerns over excess supply have driven oil prices to the lowest level in six years. Oil market participants were caught off guard in November when the Organization of Petroleum Exporting Countries (OPEC) decline to curb production to prevent prices from declining further. Oil prices have continued to decline not only as a result of OPEC's inaction but also related to concerns about weak global growth negatively impacting demand.   Due to its importance, oil remains a critical proxy for overall global economic activity. Although the drop in oil prices is a negative for oil producers, markets nonetheless seem to be shrugging off the positive implications for energy users. Many businesses will benefit from lower raw material costs and consumers will see savings from lower gas prices at the pump, which could translate into more discretionary spending in other areas. We would not be surprised to see a financial shakeout in the energy sector as high cost producers and highly leveraged companies face increasingly dire scenarios. Should prices hover near current levels for an extended period we could even see bankruptcies.

Excess supply is putting downward pressure on the prices of other commodities as well. Iron ore, for example, was down over 50% from its high last year. Overall, commodities were one of the worst performing asset classes in 2014 with the Goldman Sachs Commodity Index (GSCI) declining 33%.[3]

The fluctuation in oil prices the past six months is indicative of how quickly the tides can shift. Significant price swings in oil (or other key commodities) could contribute to market dislocations and heightened investor concern.

Conclusion

Given the factors mentioned, the reader may be asking if the best action would be to sell equities. Quite the contrary, this is a time for portfolios to be reviewed and prepped for the range of possible outcomes. It is certainly within the realm of possibility that markets can continue to march higher in 2015. However, having some cash available at this time is not only prudent but also advantageous should any of the prior mentioned factors (or others) cause a sell off. We plan to review portfolio holdings and likely will conclude to reduce and/or sell positions that do not offer a favorable risk/reward outlook. At the same time, however, given the many companies we are currently monitoring, should favorable entry points become available, we will be able to take advantage with cash on hand. We believe investors who can exercise patience and avoid anchoring to extremes of being fully invested in equities or being overly conservative and going entirely to cash, while maintaining a disciplined investment process, stand to increase the odds of favorable, longer-term investment results.

[3] Bloomberg