

## Investment Commentary—January 2014

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In a speech a decade ago Ben Bernanke famously conjured the image of dropping money from helicopters to fight deflation<sup>1</sup>. As Helicopter Ben (as he is now sometimes called) ends an eventful tenure as Fed Chairman, we have to wonder whether he has been dropping something else—crates of rose-colored glasses targeting lower Manhattan perhaps. Whether aided by tinted spectacles or of its own accord, Mr. Market has embraced the notion that we live in the best of all possible worlds.

Yes, the Fed has begun to taper its bond purchases, but it has promised to maintain rock-bottom interest rates as far as the eye can see. The U.S. economy finally seems to have made the transition from 2% growth to something in the neighborhood of 3%. But with credit still constrained, the prospects of overheating are dim. That old bugaboo inflation is low, low, low, but higher growth will keep any threat of deflation at bay. Political polarization remains deep but the budget deal struck by Congressman Ryan and Senator Murray suggests the food fights in Congress are on hold. Equity valuations are somewhat high but when you consider those rock-bottom interest rates and the bundles of cash on corporate balance sheets, they're not *all that* high.

It's a good thing that Wall Street types have short memories, else all of this happy talk would remind them of the so-called "Great Moderation," a notion popularized by the very same Ben Bernanke and intended to suggest that 'round about the late 1980s policy makers had finally tamed the business cycle and would henceforth and forever be able to maintain developed economies on an even keel. A mere two years after Bernanke's Great Moderation speech the subprime mortgage market experienced the first tremors of what would become the Global Financial Crisis/Great Recession, the recovery from which is still in process.

It's oversimplistic but one could say that belief in the Great Moderation led to a great complacency, which led to a great debt bubble, whose collapse led to the Great Recession<sup>2</sup>. It is the notion of complacency that echoes uncomfortably in the wake of 2013's thirty percent rise in U.S. equity prices.

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<sup>1</sup> The image was borrowed (with credit) from Milton Friedman.

<sup>2</sup> Had he been alive, Hyman Minsky would have foreseen all of this. Minsky was an economist of modest repute but keen insight who proposed the "Financial Instability Hypothesis." One of its essential tenets was that lengthy periods of prosperity almost necessarily lead to the rapid accumulation of excessive, speculative debt, whose collapse ushers in a period of financial instability.

We don't mean to sound overly skeptical about the prevailing optimism. On the whole things *do* look quite good. We've been encouraged by the U.S. economy for a while now, noting in these pages that the chief reason growth had been stuck at a roughly 2% pace was the fiscal drag from various congressional actions. That drag seems to have ended over the summer and second half GDP appears set to clock in north of 3%, perhaps substantially so. If anything we think expectations for 2014 GDP may be low, and that has us just a wee bit nervous.

Recall last spring when the first hints of Fed tapering sent shockwaves through capital markets. Bonds were hit hardest, but equities, especially in emerging markets, did not go unscathed. Chastened, Bernanke and pals worked overtime making nice with the bond market, repeating emphatically that there was likely to be a loooong time between tapering (slowing bond purchases) and tightening (raising the fed funds rate). To underscore this point, the Fed changed its "forward guidance," which had previously anticipated possible tightening when the unemployment rate reached 6.5%. The new guidance delays tightening until "well after" the 6.5% rate has been crossed. So we'll have rock-bottom interest rates for a long, long time, right?

Most forecasts—including the Fed's own—suggest tightening won't begin until 2015 at the earliest, maybe as late as 2016. The idea seems to be that while the economy has gotten over the hump of 2% growth, thereby allowing the Fed to begin tapering, growth will remain tepid enough to avoid creating significant inflationary pressures. Given the considerable slack in the economy that's plausible. But it's also plausible that 2014 surprises to the upside, perhaps significantly. Based on respectable consumer spending, healthy growth in construction and increased spending by states and municipalities, most economists seem to be penciling in growth around 3%. But if "animal spirits" were to kick in and push consumer spending and business investment into a higher gear, GDP significantly above 3% is a possibility. In that event inflationary pressures may build more quickly than anticipated and the Fed's hand could be forced. Or worse yet, the bond vigilantes could take over and leave the Fed behind. Whether driven by the Fed or the bond market, interest rates could climb sharply, putting a damper on housing and jolting a stock market that seems to be counting on a protracted period of historically low rates.

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In the wake of 2013's 30% runup in stock prices and the possibility (but by no means certainty) of surging interest rates putting pressure on the stock market, it's worth spending some time on the question of valuation—i.e., have share prices generally reached unjustifiably high levels? Interestingly, the answer depends greatly on the sector one looks at. Focusing just on the seven large sectors<sup>3</sup>), three seem to us to be considerably overvalued, one seems to be pretty close to fair value, and three (with one huge asterisk) seem to be on the inexpensive side. The huge asterisk refers to the fact that a small number of tech stocks, especially those having to do with

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<sup>3</sup> The three smaller sectors--Utilities, Telecom and Materials--comprise less than 10% of the S&P 500, so for present purposes we leave them aside.

social media, are in a full-on bubble, as exemplified by Twitter being priced recently at nearly forty times forward revenues (not earnings, mind you!) In general though, tech valuations are quite reasonable, as is the case with financials and energy. On the other hand, consumer cyclicals, consumer staples and industrials appear in general to be considerably overvalued, while healthcare sits in the middle. The market seems to think that banks, insurance companies, oil and gas producers and mature tech companies are stuck in low-gear while industrial and consumer companies alone will reap the benefits of an accelerating economy. It all seems strange to us, but then we've never subscribed to the view that markets are rational. The good news is that, while it's hard to find screaming buys these days, there are plenty of attractively priced stocks in the sectors that have been left behind.

Looking at valuation for the market overall, price-to-earnings ratios look pretty reasonable, especially in light of low interest rates<sup>4</sup>. Many market observers, however, have questioned the E in the P/E ratio, arguing that with corporate profit margins at record highs earnings are due for a tumble. While we don't disagree that margins are a bit stretched, the situation may not be as bad as it looks. The fact is that over the last thirty years we've outsourced a lot of low-margin manufacturing to places like China. More and more of the companies that remain are in intellectual property rich industries like pharmaceuticals and technology where net margins can be double or even triple that of a widget-maker. In other words a large part of the growth in margins in recent decades is probably here to stay. In further defense of the rationality (more or less) of current market valuations, it's worth noting the massive amounts of cash on corporate balance sheets. It earns nothing (those low rates again) and therefore gets no credit in a price-to-earnings analysis but it does contribute to the value of the enterprise.

All in all, valuations are on the high side but not so high that a near-term decline is inevitable. Certainly we're overdue for a pullback, but it's entirely possible that the bull market will nonetheless march on for some time. Whether it does will depend to a great degree on whether the acceleration in economic growth underway is gradual enough to accommodate the Fed's plans to hold off on tightening for at least a year and perhaps significantly longer. We shall see.

*January 15, 2014  
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<sup>4</sup> Lower rates tend to be associated with higher price-to-earnings ratios, no doubt because lower rates make stock investors more tolerant of the lower dividend yields that come along with elevated P/E ratios.