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Investment Commentary—July 2014

As we began composing this commentary, the S&P 500 Index stood a whisker shy of 2,000, nearly triple the Great Recession low of 666.79 reached on March 6, 2009. The steady and steep climb in share prices raises the question: what will it take to topple the bull market, or at least to usher in an extended correction?

Perhaps a crisis of some sort will come along and knock the wind out of the stock market's sails. After all it was the end of a crisis (at least the beginning of the end) that ignited the market five years and four months ago. Policy makers had responded with swift and vigorous action to the September 2008 collapse of Lehman Brothers, with central banks flooding the global financial system with liquidity and Congress enacting the controversial but ultimately successful TARP. Six months later though, a cloud still hung over the U.S. banking system, with many pundits asserting that it would take trillions to recapitalize the large commercial banks. Speculation that Citigroup and/or Bank of America could be nationalized ran rampant. Then on March 9th Citi released an upbeat projection of first quarter operating results. Analysts crunching the numbers inferred that TARP would have sufficient funds to keep it, and by extension all of the large banks, solvent. The stock market rallied and never looked back.

If the resolution of a crisis triggered the bull, will the eruption of another crisis end it? Of course that's possible, but let's acknowledge how durable the bull has been in the face of a series of financial, fiscal and geopolitical calamities. A look back yielded the following list: the Greek debt crisis that led to fears of a breakup of the euro zone, the messy Arab spring, the tsunami/nuclear disaster in Japan, the U.S. debt ceiling standoff of 2011, the fiscal cliff, a failed banking crisis in Cyprus that resuscitated fears of a euro zone split, last spring's bond market/emerging markets panic over the initial talk of Fed "tapering", the U.S. debt ceiling standoff of 2013, the ongoing crisis in the Ukraine, the seeming disintegration of Iraq, and persistent fears in many quarters that corruption, overbuilding and an unregulated shadow banking system in China may precipitate a collapse of the Chinese economy. Perhaps for bears, the twelfth time will be the charm, but we're inclined to look elsewhere for the end of the bull market.

Market analysts have worried for some time about the elevated level of profit margins. Will earnings roll over and take the bull with them? We're pretty sympathetic to that idea, truth be told, but our guess is that they won't. To be sure, margins are fat: the recovery from the Great Recession has certainly been slow, but corporate CFOs could be forgiven if they hadn't noticed. After about three decades of ranging between 5% and 9% of final

sales[1], U.S. after-tax margins climbed sharply from 2002 to 2006, crossing the 10% threshold for the first time in almost 40 years. Profits declined after the financial crisis but not dramatically[2], with margins bottoming out around 7%. They climbed rapidly from there and have been hanging around the lofty 12% mark for the last couple years, very close to their post-World War II high-water mark.

How the heck did *that* happen? There are a myriad of reasons but most important is the forty-odd year transformation of an industrial economy into a services/intellectual property economy. (Yes, there has been something of a revival in U.S. manufacturing of late due to lower energy and labor costs, but thus far the impact has been modest.) Manufacturing businesses tend to be cyclical. When margins are strong, companies invest too much in plant and equipment which leads to overcapacity, lower prices and collapsing profits. Reducing factory footprint is slow and costly compared to the simpler (from the employer perspective at any rate) process of reducing headcount in a services business. As manufacturing has waned, profits have thus become less susceptible to the ups and downs of the business cycle.

In addition to being shielded from boom and bust cyclicality, those companies that depend heavily on intellectual property (think pharma and tech) have another big advantage. With the benefit of patents and/or trade secrets, they are able to generate profit margins that an auto manufacturer or steel producer could only dream of[3]. When a significant chunk of corporate America is able to drop 25 cents or more of every dollar in sales to the bottom line (after taxes no less!), that has a significant impact on the overall statistics.

Does this mean that profits as a percentage of sales can be sustained at 12% indefinitely? No, but (a) in light of the transformation of the economy, 12% isn't as high as it might seem, and (b) it's not obvious what would drive that number materially lower in the near future – which isn't to deny that a pause in profit growth is a legitimate concern. At current multiples, the market is probably pricing in some meaningful increase in earnings over the next couple of years. If earnings come in flat or slightly down this year or next, that could take a toll on the market. But it's not clear what would cause earnings to collapse in a way that would cause major damage. After all, the economy looks quite strong (notwithstanding what turned out to be a dismal first quarter GDP number).

In fact, if anything, the bigger risk to profits is that the economy becomes too strong. *Say what?* One of the reasons margins have been so buoyant is that companies have been very cautious about investing for growth. In part, that caution accounts for the so-so nature of the recovery. Companies are hiring—that's clear from the fact that we've had five straight months of 200,000+ job creation—

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[1] For this discussion we use Bureau of Economic Analysis data for after-tax corporate profits divided by gross-value added, excluding financial corporations in each case. In doing so we follow the suggestion of the anonymous blogger at Philosophical Economics. He or she makes a thorough and compelling case that this is the right metric and that other measures, some of which have been touted by market bears, are problematic at best. See *http://philosophicaleconomics.wordpress.com/2014/03/30/foreignpm/*.

[2] Remember that we're excluding financials—the picture looks much worse if AIG, Citigroup, Bank of America et. al. are included.

[3] It goes without saying that the lines here are a bit blurry. Auto companies have IP too, but because it contributes relatively little to product differentiation, it has a negligible impact on margins.

but no one is placing large bets on future demand. Getting ahead of the curve on hiring means accepting lower profits today for the sake of future growth. That's not a tradeoff most mid- and large-sized companies have been making. By discouraging companies from betting big on growth (not to mention keeping interest rates low), the heretofore tepid economy has curiously helped to keep margins in that lofty 12% range and bolstered the stock market.

The modest nature of the recovery has helped stocks in a more significant way: by keeping interest rates at rock-bottom levels. To set the stage, let's return to our history lesson. Following the market's determination in early March of 2009 that the large commercial banks were sound, the S&P 500 shot up 75% in the ensuing ten months. Stocks then bounced around for seven months or so, declining slightly over that period. This was to be the longest pause in the bull market outside of the debt-ceiling crisis in the summer of 2011. The 2010 pause ended with Fed Chairman Ben Bernanke's famous Jackson Hole speech on August 27th of that year in which he laid the groundwork for a second round of quantitative easing (bond purchases). Since then Bernanke and his successor at the helm of the Fed, Janet Yellen, have been steadfast in maintaining rock-bottom interest rates.

If it's low rates as far as the eye can see, it's easy to justify a lofty price-earnings multiple. At around 19x trailing twelve months earnings, valuations are rich by historical standards. On the other hand with the ten-year Treasury yield around 2.5%, an earnings yield over 5% looks rather juicy. So, is it low rates as far as the eye can see? We're dubious. We examined the question in detail in these pages three months ago, so we'll be more cursory here. Consider simply this: the unemployment rate is 6.1%. We are creating over 200,000 jobs a month but need no more than 100,000 a month to keep up with growth in the 155 million strong labor force. Simple arithmetic then tells us that the current rate of job creation should push the unemployment rate below 5.5% (the level the Fed deems to be equilibrium) by the spring of 2015. In which case, if consensus forecasts are correct, Fed tightening won't begin until *after* equilibrium unemployment has been reached, whereas past tightening cycles have begun *well before* that point. In other words the Fed appears to be behind the curve. If and when the bond market joins us in this opinion, interest rates will spike. And if we had to place a bet on what might topple the bull, that is where most of our chips would go.

Of course one of the lessons of the last several years is that optimism on the economy hasn't paid off. To a first approximation, the recovery has chugged along at around 2% GDP growth for nearly five years now. If it continues at that pace or slightly higher and employment growth fades a bit, the U.S. economy may continue for quite some time to provide a very attractive backdrop for the bull market: tepid growth, high margins and low interest rates. If GDP over coming quarters turns out to be significantly better than that, and monthly job numbers head in the direction of 250,000, interest rates could soar, and a bout of market turbulence could be in the offing. We shall see.

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