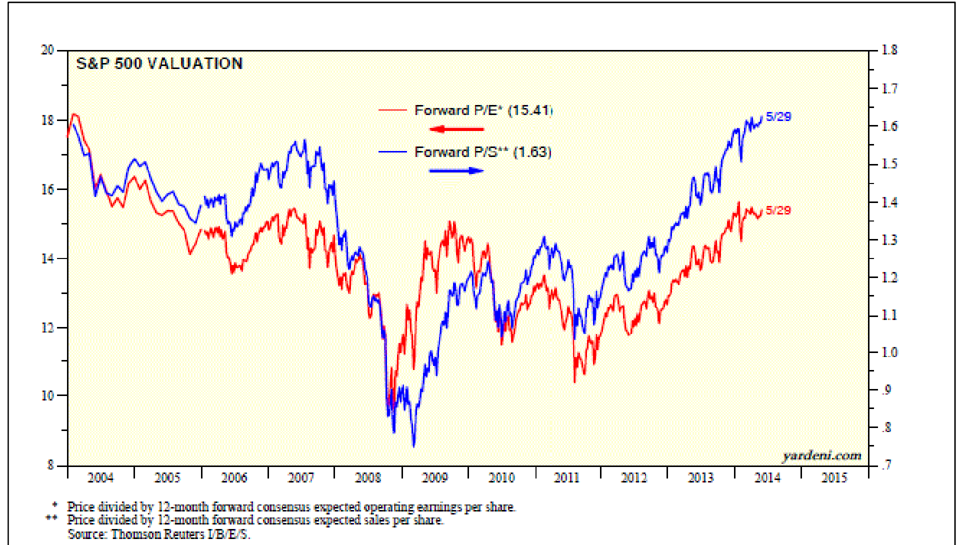
The Long & Short of It
Quarterly Newsletter
Second Quarter 2014

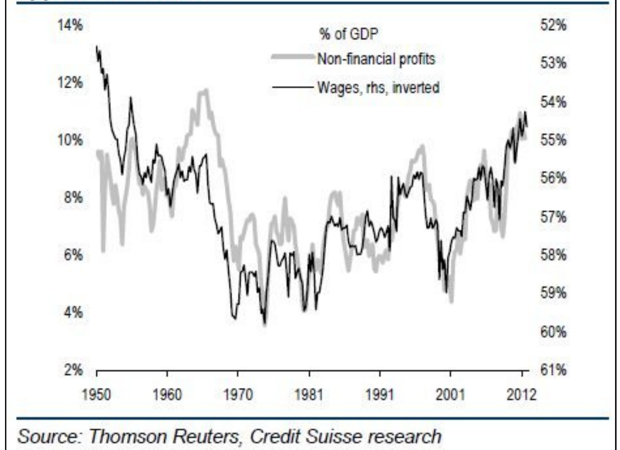
Stocks are Hot
Lately, there's a growing consensus in the media: *Stocks are best*. With cash yields currently near zero and bonds not much better, the Federal Reserve's easy money policies compel investors to take greater risk as they hungrily search for yield and return. It's no surprise that among pundits and asset allocators, the recent favorite is foreign stocks, especially those of emerging countries. We hear, "Emerging markets have outperformed domestic equities for the last five years; surely, they are a safe place to be now?"

Owning stocks is an easy answer, one with which we agree for the long term. However, being long stocks today feels too easy. It is moving toward a dangerous consensus along the lines of, "Only the truly clueless would not be fully invested." These people are the ones currently loading up on creative plays, particularly illiquid small-cap and emerging foreign exposure. Our "Old Reliables" lag behind as they would near most market tops. It gives us good reason to carefully review our commitments and perhaps strengthen the defensive posture of our investment choices.

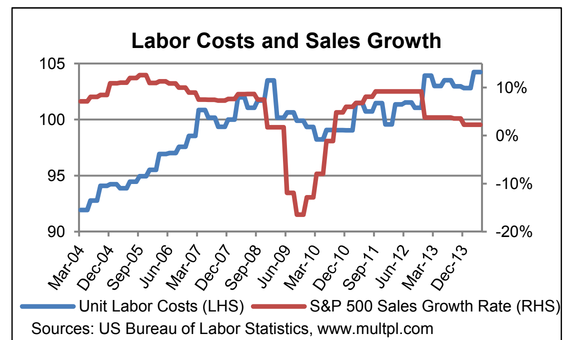


Looking at recent stock market performance, we find that stocks have risen 189% from their 2009 lows, 25% from 2007 highs, 30% in 2013, and 5.2% this quarter. All this came despite low labor force growth rates, little capital investment, and disappointing productivity gains. It is impressive for the market to climb so high without much fundamental support.

Looking at valuations, we find that 2008's compelling valuations of 10 times earnings have risen to over 15 times earnings, well above the highs of 2007.



Looking at profitability and margins, we find that underlying these multiples are earnings margins that are currently at all-time highs. We have heard it argued recently that, "This time, it is different" because margins should actually expand from here—an opinion we find particularly disturbing in its detachment from reality. Much of the same was said in 2000, when bricks and mortar were supposedly dead and "price-to-eyeballs" would be the new valuation metric for up-and-coming equities. We say, "Watch out for rising wages putting pressure on these lofty margins."

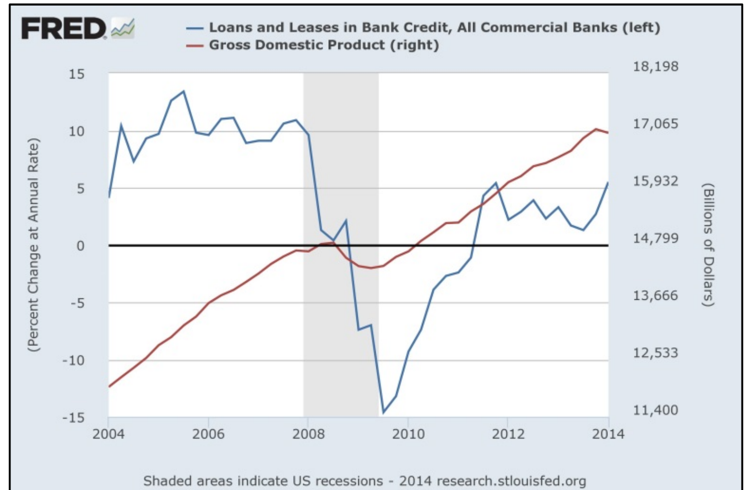


We also find that unit labor costs (which factor in productivity as well as employee compensation) have now surpassed pre-recession levels while unemployment rates have remained little changed. This suggests that margin expansion has come from aggressive cost-cutting, not increasing revenues. With the recent

pickup in hiring, unit labor cost may finally begin to rise more rapidly, forcing margins to reverse their gains of the last three years. This would mean tougher times lay ahead for stocks.

Looking at revenue growth, we find that revenue growth of S&P 500 companies has declined steadily from 9.4% at the end of 2011 to 2.2% at the end of 2013.

Looking at debt expansion (perhaps the only thing left), we find Federal Reserve data showing that loan and lease growth is on the rise, demand for credit is rising, and banks are beginning to meet that demand by easing their lending standards. So, again, it appears that the stock market has reached a stage where little is driving its rise except for the expansion of debt (think 2005-2007). If interest rates drop still lower, it could promote further debt expansion, and even justify higher stock prices so long as earnings growth remains stable-to-rising. We will keep an eye on credit expansion and give you a detailed update next quarter.



Midterm-Midpoint

Last year, the stock market advanced briskly as real growth expectations rose and inflation expectations declined. Will this bullish environment for stock prices continue? It is possible in the short run, but unlikely over the long term. The greater probability will be for flat growth and rising inflation expectations—a less than ideal environment for equities.

With primaries now in full swing and the stock market seeing an unusual summer rally, we will look for any holdings that are approaching fair value and exit or cut back those positions. We will seek companies with more defensible valuations, perhaps ones whose price has recently dropped as the media has expounded on a morsel of temporary bad news. We will also reassess those companies with a tendency for their stock prices to peak relative to the stock market in early summer.

Again, "stocks for the long run" still makes sense. In fact, after nearly 12 years (2000 – 2012) of stock returns going nowhere, the decade to come should be good for stocks. One very good year in 2013 will not change that fact. In the short-term, we must be a bit more careful. In light of this an unusual run up, it is even more important to adhere to our disciplines and embrace our value-oriented, somewhat contrarian approach.

Fade the emotion, follow the research. Enjoy your summer.

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