MID-CONTINENT CAPITAL

CONSILIUM*

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*advice; judgment; resolution; wisdom

Be Careful What You Wish For

Why does the stock market go up or down? What are the sources of the returns earned by investors? In the short run, the simple interaction of buyers and sellers – demand and supply – determines the level and direction of stock prices. As with commodities and pari-mutuel wagering, when buyers are persistent and sellers are reluctant, higher prices are likely. Gauging the intentions of buyers and sellers is the realm of technical analysis, a discipline that can be helpful in understanding the market's daily or weekly gyrations.

But what *justifies* higher prices over time? Why *should* the market go up? This is the realm of fundamental analysis, and here only two factors matter: earnings and valuation. A company's stock price will be a function of its earnings, and the valuation that the market places on those earnings. If earnings rise, all else being equal, stock prices will rise. And if valuations rise, all else being equal, stock prices will rise. Thus, the only environment that is unambiguously positive for stock prices is one of rising earnings and rising valuations. All other possibilities have outcomes that are either unclear (rising earnings can be offset by falling valuations, and vice versa), or negative (falling earnings and valuations). We know what makes earnings rise or fall – revenues, profit margins, and capital management – and the reasons these inputs might change are straightforward and somewhat predictable (economic and/or market growth, the character of the business, and management decision-making). But what causes valuation to change, and is it predictable?

The two main factors affecting valuation are interest rates and risk perceptions. Interest rates affect stock valuations because fixed-income instruments represent a readily available alternative to stocks. When rates rise, bonds become more competitive with stocks for the marginal investable dollar, unless stock valuations fall to compensate – and generally, they do. Risk perceptions also affect valuations in a direct way – higher perceived risk levels (or "risk premiums") result in lower valuations.

Since the S&P 500 index hit its lows in March 2009, the market has risen in price by 145% (through the end of August). Earnings for the S&P rose 70% over that same span, and the market's valuation rose 44% (as measured by its price/earnings ratio). The increase in valuations is quite understandable, rising from an extremely depressed level as fears of another financial calamity faded, and as interest rates declined. But a closer inspection reveals a change in the character of the market during its 30% price rise since the end of 2011: earnings have risen by just 3.7%, but the market's valuation has expanded by 25%. Interest rates have risen notably over that time – but risk perceptions have declined so sharply as to completely overwhelm their effect on stock prices.

The interest rate effect on stock market valuation is a matter of simple arithmetic: if you tell us where interest rates are headed, we can tell you how that should affect the market. But determining the correct risk premium, we have found, amounts to pure guesswork. It is easy to determine when they are high, as in the fall of 2008 – but that does not prevent them from going even higher, as everyone learned by the spring of 2009. Between January 1995 and November 1996, valuations rose by 25%, similar to our recent experience – but that did not prevent them from rising another 60% by June 1999.

[1]Confirming the arithmetic: 1.70 * 1.44 = 2.45 or 145%

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History has shown that market cycles driven solely by changing perceptions of risk can be very powerful, but they are not sustainable. Ultimately, earnings must carry the day for the long-term investor, who today faces a conundrum: can earnings growth resume? That would appear to require a stronger economy, as the period of slow earnings growth has roughly coincided with notably more sluggish business conditions, both in the US and elsewhere.

We noted in our last issue of Consilium that, as of its June 18 Open Market Committee meeting, the Federal Reserve clearly was anticipating just such a return to sustained and stronger economic growth. Chairman Ben Bernanke indicated that the Fed could begin tapering its bond-buying program if economic conditions warranted. But we also noted that housing activity and consumer spending needed to withstand the higher level of interest rates that had emerged for that forecast to materialize. In actuality, nearly all measures of economic activity weakened to varying degrees over the summer. Despite strong market expectations to the contrary, on September 18 the Fed announced that it would not be reducing its bond-buying program.

That the stock market rose sharply in response to this development is actually somewhat concerning: the Fed indicated that it finds the economy disappointingly weak, and stock investors, who should be hoping for better growth and rising earnings, considered that a reason to cheer. Does the market "want" the economy to remain sluggish? If so, only still-higher valuations can provide meaningful returns – and as we have demonstrated above, this does not represent a sustainable path for investors.

With the third quarter now closed, the S&P 500 index has generated a 19.8% total return in 2013, a stark contrast to the -1.89% return for the Barclays Aggregate Bond Index. After the stock market's strong advance in the absence of a strong economy, the stakes for the Fed and for investors have become fairly high: the bond-buying will not end until it is beyond doubt that the economy has been rejuvenated. The Fed will not want to find itself having to reverse course again. For the stock market to withstand this, investors will have to adjust their thinking about what is good and bad for stock prices. We believe they should have little to fear from a return to a more normal interest rate environment – but based on recent market behavior, the arrival of that moment is likely to be volatile and unsettling.

Source: *Baseline; Barclays*

150 S. Wacker Drive, Suite 400 ♦ Chicago, IL 60606-4101 ♦ Tel: 312.551.8200 ♦ Fax: 312.551.8780 ♦ www.mccllc.com