Observations and Outlook

October 2, 2014

Year to Date Recap/ Ongoing Concerns/ The Most Important Chart in the World

It has been an interesting year to say the least. Small cap stocks continue to gyrate and currently are negative by about 6% on the year and more than 10% off their highs. Large cap/dividend paying stocks have done much better ending the third quarter higher year to date. The most surprising (to most people) development so far this year is the decline in long term interest rates while the Federal Reserve tapers its bond buying program. This has been referred to as both a 'conundrum' and a 'mystery' in the Wall Street Journal. There was no mystery here as I indicated early in the year rates were near a multi-year range top and the US economy isn't going anywhere fast.

Percent Change	Quarter	2014 YTD
S&P 500	4.86%	6.59%
Rusell 2000 (small cap IWM)	-7.65%	-5.32%
Emerging Markets (EEM)	3.42%	-.57%
30yr Yield	-3.82% (from 3.34% to 3.21%	-18.94% (from 3.96% to 3.21%)

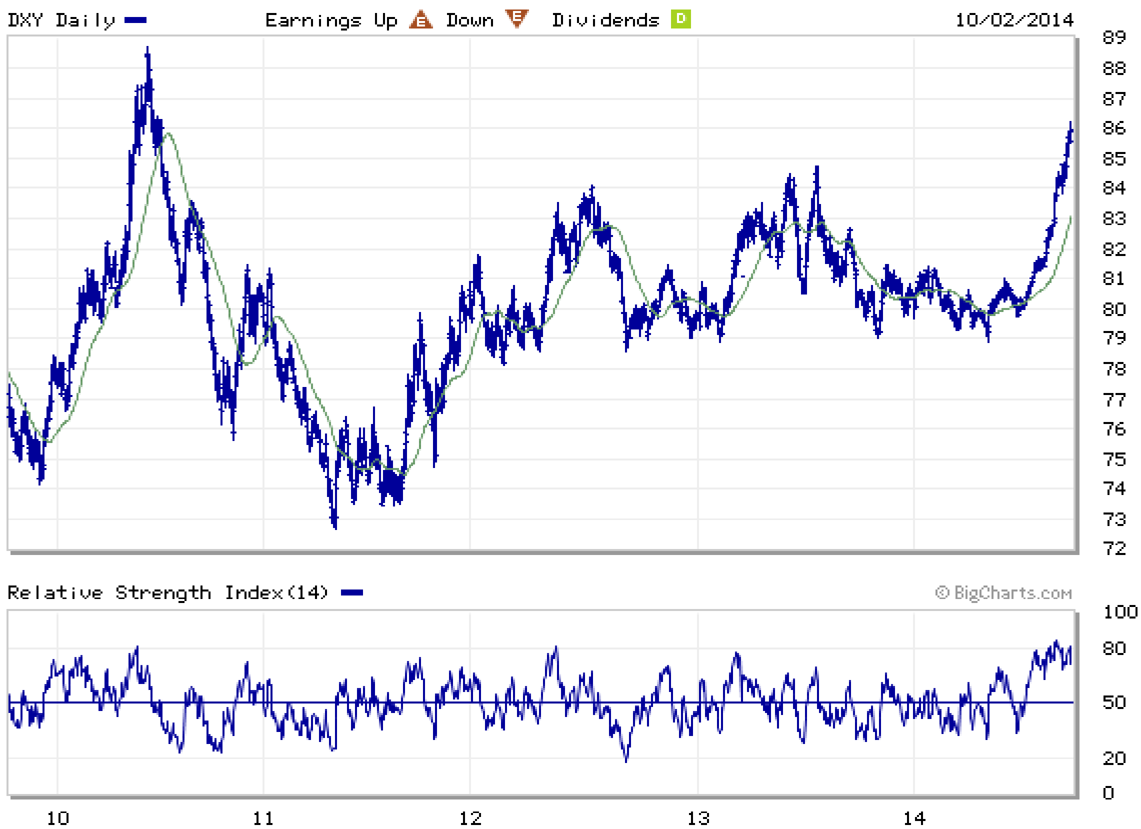
If we look under the hood at some other relationships that have been developing through year, the continued recession and deflation concerns in the Eurozone; China's slowing economy and slowing real estate market and the more recent fantastic climb in the US Dollar, we can perhaps see where financial markets may be headed in the future. Additionally, the ongoing excessive valuations in many areas of the US stock market and the end of QE have some likely, and potentially large implications for US markets.

Europe is between the proverbial rock and a hard place. They are desperate for growth and believe that lowering the cost of government debt is the way to achieve growth, which is usually referred to as inflation. If this method worked, I would think after 6 years of doing so, it would have begun to work by now. Unfortunately several European countries are looking at a third dip into recession while at the same time staring at potentially higher energy prices (due to shortage of Russian gas) in the coming months. No growth and more debt, regardless of interest rate does not appear to be a viable solution to me.

China's real estate market is seeing slightly lower prices across the board (-3% year over year) and substantially slower sales, -10% in the aggregate. Additionally, 'land sales', from local governments to developers have collapsed down to 50% of last year's levels. I say 'land sales' because in China the government owns the land, other parties simply get to lease it for a long period of time. I am not a China Real Estate Expert, but generally, when sales slow, it means there are fewer buyers; and fewer buyers puts downward pressure on prices. This process can continue lower in a vicious cycle lower, undermining developers' ability to pay bonds back. This larger issue may be some time off still, as the psychology that real estate in China never goes down wears off. Furthermore, a general slowdown in the world's largest consumer of raw materials causes great strain on raw material exporters like Australia, Brazil, and Canada. So while China's economy may 'sneeze', several other economies catch the flu.

Second Most Important Chart

US Dollar Index (DXY)

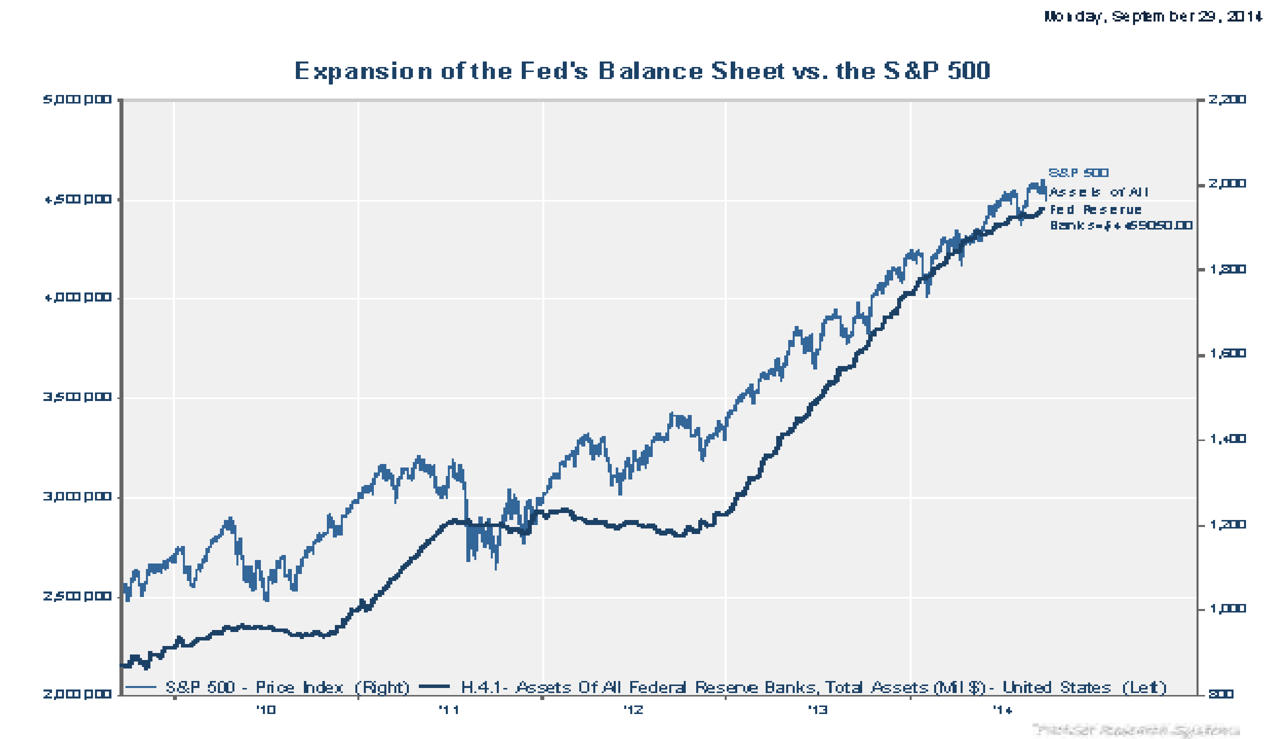


This very dramatic climb in the US dollar is not to be taken lightly. I have seen a few reports where a strong dollar is good because it makes dollar-denominated stocks and bond attractive. While this makes sense, it does so only in the past tense. If one is a euro-based investor, one HAS SEEN a gain relative to the euro since owning dollar-based assets. Going forward, one has to assume this trend will continue.

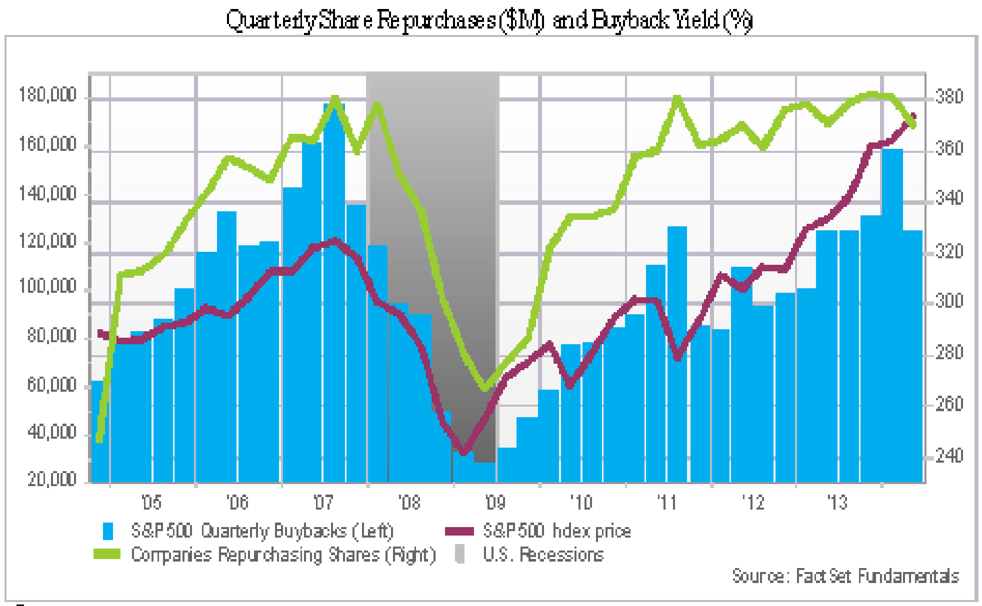
I think the more important implication is how this will affect the profits of US companies. Given that 40% of revenues of companies in the S&P 500 are derived outside of the United States, a stronger dollar will lower the value of earnings in other currencies, in dollar terms. Very approximately, if 40% of revenues are now worth 8% lower in dollar terms, the aggregate value of total revenues in the S&P 500 could turn out to be 3.2% lower. Furthermore much of the marginal change in the top line of an income statement can flow directly to the bottom line, creating the potential for a net zero change in bottom line earnings, in the aggregate for companies in the S&P 500. Some companies hedge foreign exchange risk, most will claim forex fluctuations are a ‘one-time’ occurrence and will be added back to non-GAAP earnings.

The change in the value of the US dollar can take some time to show up in reported earnings, which are reported months after they occur.   Comparing the last time such a substantial change in the US dollar occurred with earnings in the following two quarters, late 2012 and late 2010; we can see a major slowing in 2010 and a reversal of earnings in 2012.   If such a reversal were to occur late in 2014, current fundamental valuations (Price/Earnings) would be even more expensive than recent readings or readings of the last two periods.   I expect much discussion, and general dismissal of this observation, that is until early in 2015 when complete earnings history for our current period is known.

Now for the **Most Important Chart in the World:**



Given the drastic, massive, and continuing (until October 2014) direct market intervention by the Federal Reserve we can clearly see a relationship between the size of the Fed balance sheet and the value of the SP500. While the causation may not be as direct as this chart indicates, the liquidity the Fed has created has found its way into equities via corporate balance sheet leveraging (stock buybacks with borrowed money), and risk/yield seeking actions by investors suffering from 0% interest on their savings. There are two periods where we see the balance sheet stop increasing, or outright decline. Both periods coincided with very volatile equity market performance. Today we are at much more elevated levels and significantly further along in the current business cycle.



Over the course of the year, equity valuations as seen in the P/E (price to earnings) ratio have been flat. That is, we have not seen prices increase faster than reported earnings. In 2013, prices rose much more rapidly than earnings, leading to a P/E expansion. If, going forward, earnings cannot grow due to a stronger dollar and fewer stock buybacks, and a cessation of the expansion of the Feds balance sheet, US stocks and other ‘risk assets’ should see a significant correction.

As always, what an investor should do or not do, is predicated on an investor’s individual goals, risk tolerance and time frame. For a year now, I have been advising investors to truly reflect on their own goals and risk tolerance and to seek advice on how to take action regarding their own investments so that their portfolios behave in a manner that fits the investor’s profile. There are many instances in the past where equity prices seemed to disconnect from past fundamentals, sometimes for years at a time. But over the slightly longer periods, equity prices always come back to a level (after over-correcting) that reflects the long term earnings growth prospects.

Adam Waszkowski, CFA
awaszkowski@naplesam.com
239.410.6555