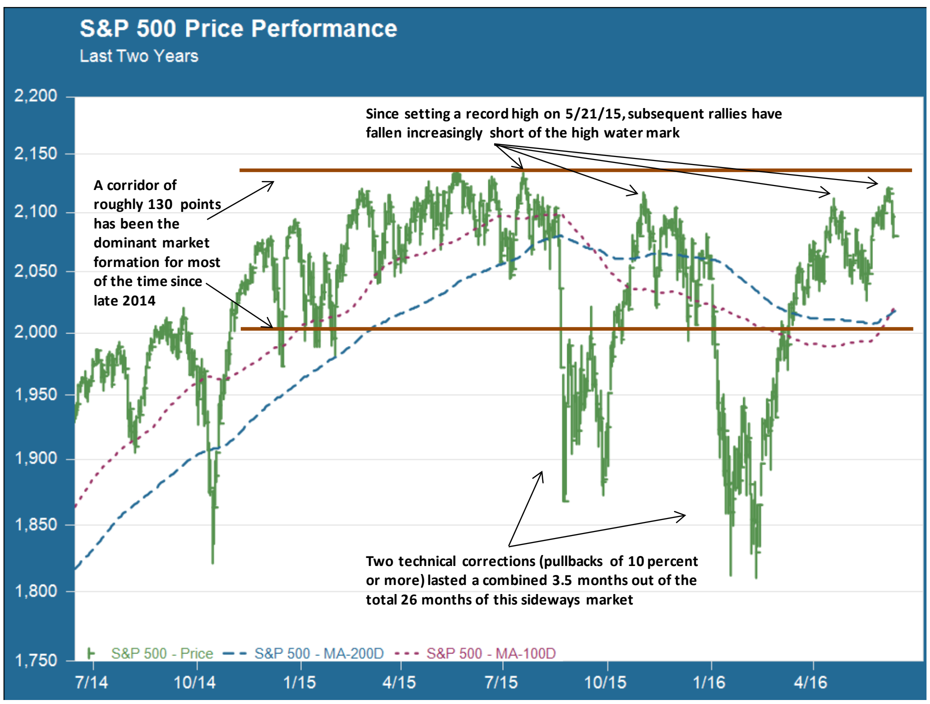
MVF Research Team Comment

2016 Halftime Report

June 15, 2016

The Glass Is Half-Empty, and also Half-Full

We all know the old trope: optimists see the glass as half-full, pessimists as half-empty. This year – and indeed for more than a year before that – the Cassandras and the Pollyannas seem to be as close to equilibrium as possible. Since November 2014, the S&P 500 has traded in a relatively narrow corridor between a floor of 2000 and a ceiling of 2130 – a spread of about 6.5 percent. That's a 26-month sideways market, punctuated twice on the downside with the technical corrections of August 2015 and January 2016, while thus far failing several successive attempts on the summit price of 2130 reached in May 2015.



Source: MVF Research, FactSet

We can look at this sideways market through the lens of that metaphorical glass of water. On top you have the "valuation ceiling", where the glass-half-empty crowd stands guard. By traditional metrics such as price-to-earnings (P/E) and price-to-sales (P/S), stocks are more expensive than they have been at any time since 2003. If you are not fully invested in the market, goes the thinking up here, what's the point of taking on exposure at these rich price levels? Earnings growth has been negative for four quarters in a row and is projected to be modest for the rest of this year. The overall US economy is doing okay, but other parts of the world from Europe to China and Japan are question marks at best. A clear upside catalyst seems to be missing.

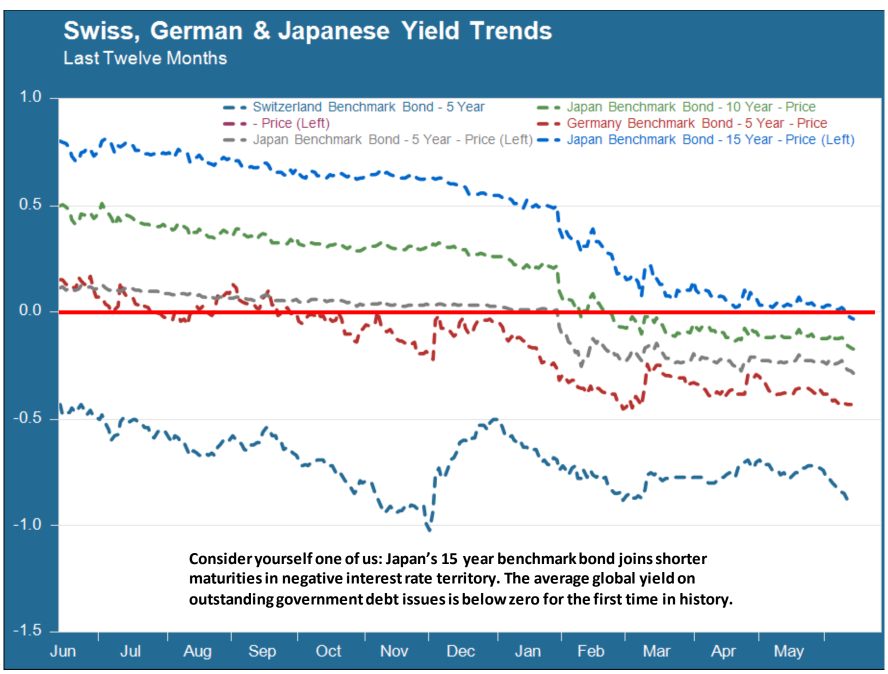
At the bottom of the corridor range is the "policy floor", where the glass-half-full folks congregate. Look at those two corrections in August and January, say the Pollyannas. Lots of signals flashed red in both cases – the VIX "fear gauge" went crazy, intraday spreads widened and prices crashed through technical support levels like long-term moving averages. Yet – as with literally every pullback subsequent to the 2008-09 market crash – the damage was relatively contained and a V-shaped recovery got prices back into the corridor fairly quickly.

There may be any number of plausible reasons why the corrections bottomed out where they did. But policy – namely, the willingness of central banks to do anything in their power to prevent asset markets from falling too far – is the most likely explanation for why nothing that has happened in the world for the last eight years has had more than a fleeting impact on asset prices. Why go ultra-defensive if the Fed has your back? What makes next time different from last time, and the time before that, and…?

History would tell us that this sideways market will, at some point, turn into a sustained directional trend one way or the other. But now may not be that time. The Cassandras at the valuation ceiling and the Pollyannas at the policy floor make near-equally compelling arguments, in our opinion, as to why the breakout could be forestalled for some time longer.

Curiouser and Curiouser

Stocks have nothing on the bond market for sheer logic-defying weirdness. Want proof? Consider the yields on a range of maturities from five to 15 years in the chart below.



Source: MVF Research, FactSet

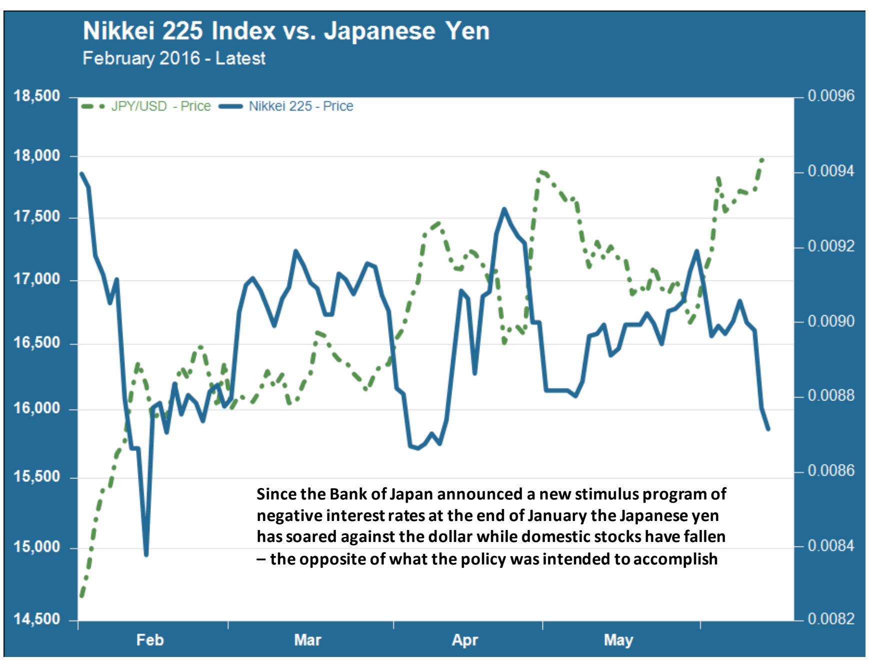
This week's headlines in Wonderland include: the descent of the 15-year Japanese Government Bond into negative rate territory, the German 10-year following close behind, and the fact that the *average yield of government debt on all outstanding issues around the world is less than zero*. Think about that for a moment. The average government bond investor is willing to accept a locked-in loss for a period of time spanning from overnight to 15 years. Why would anybody want to do that? Today's excuse (as we write this on June 14) is Brexit; in just nine days the good citizens of Great Britain will decide whether or not they want to be in the European Union. So, to follow the logic here: ahead of something that may or may not happen, and for which the practical economic outcome would be unclear in either case, the right investment move is to…lock in a multi-year guaranteed loss? Really?

If there is a reason to be truly worried about what the market is going to do for the second half of 2016 then it would seem to be this: there is something awfully strange going on in asset markets if more than $10 trillion of investment capital sees securities with a guaranteed loss as an acceptable portfolio allocation. Negative interest rates continue to become the rule, not the exception, even while the practice continues to defy logic and the basic core assumptions of modern financial theory. NIRP does not appear to be doing any favors to home-country stock markets, with most European bourses as well as Japan down by double digits for the year to date – once again trailing US equities.

Greater Fools

One explanation offered for negative interest rates is that investors have come to see bonds less as fixed income instruments with a defined schedule of cash flows, and more as commodities in a Greater Fool market. What matters is not the bond's own intrinsic characteristics, but simply how much the next fool is willing to pay for the asset some time down the line. Of course, Greater Fool markets have a familiar end game when there are no fools left; arguably, this was how both the dot-com and the real estate bubbles crashed last decade. This time, though, the game has a twist. The ultimate fools in the global bond market are the central banks at whose behest negative interest rates exist in the first place. The thing about having a central bank as the greatest fool is that it can pull other rabbits out of its hat if need be to extend the game for longer. Perhaps nowhere is this more evident today than in Japan.

The Bank of Japan got into the negative interest rate policy (NIRP) game later than Switzerland of the European Central Bank (ECB), but it has been diligent in its implementation of NIRP since earlier this year. So far it's fair to say things have not gone as planned: the yen is up and stocks are down from where they were when the BoJ went NIRP.



Source: MVF Research, FactSet

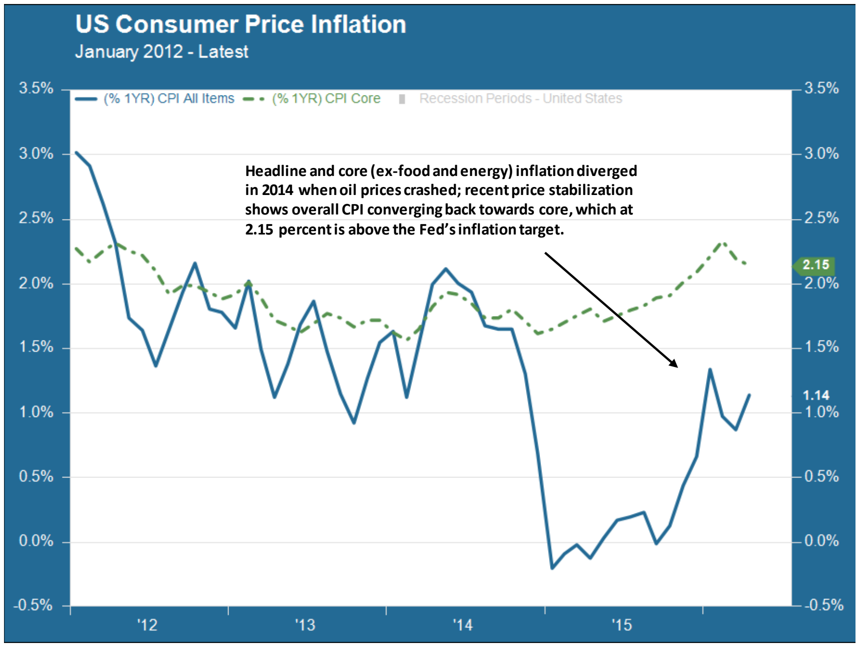
Not to be deterred, the Bank of Japan is doubling down on Greater Fool. The central bank is now the largest shareholder of record in Japan's domestic stock market. Direct intervention into the domestic equity market, mostly via exchange traded funds (ETFs), has made the central bank a top 10 shareholder in 200 out of the 225 companies in the Nikkei 225. The thinking, such as it were, appears to be that if ordinary private investors are not impressed enough by other stimulus programs to jump into the stock market, well then the BoJ will do the heavy lifting itself. The bank has even ordered a handful of bespoke ETFs to be designed around specific policy goals such as higher employee wages and a greater allocation of cash to new capital investment. Companies that comply with these initiatives (whether they are economically beneficial to the company or not) will be rewarded with inclusion in the central bank's new ETFs, potentially favorable for their share prices.

Negative interest rates, central banks designing their own ETFs to prop up stocks…these are trends sure to give support to the glass-half-empty crowd. As noted above, next week's Brexit vote in the UK is driving market sentiment towards the negative side of the dial, even though polls continue to suggest that it will be a close margin either way. China is never far from the top in lists of reasons to be worried, with its economic rebalancing still up in the air and persistent questions about its debt overhang. More recently, the end of primary season in the US means that attention is fully fixed on the incipient general election contest between Hillary Clinton and Donald Trump. General bemusement at the circus-like nature of Campaign 2016 thus far is giving way to deeper concerns about longstanding US commitments to its role in the world, and how those may change depending on the outcome in November.

Two Cheers for Jobs, Wages and Prices

What about the Pollyannas? Are there any reasons other than the "policy floor" for investors to not be overly fearful of a sustained market reversal into bear country? We think there are, and most of them are part and parcel of the continuing story of economic recovery in the US. Specifically, there are no clear and present signs of a recession on the horizon. Of course, it is not out of the question that any of the multitude of risks outside the US could wind up triggering a recession, and that would be a recipe for a more protracted market downturn than what we have seen since 2009. But we see little reason to bake such an outcome into the equation for this year. On the contrary, there is some good news recently where it has been missing for much of the recovery thus far: in wages and prices.

Tepid wage growth has puzzled economists for some time now, with the labor market racking up month after month of payroll additions and a decline in the unemployment rate. Finally, though, wages do appear to be ticking up. Year-on-year average hourly wage growth is tracking around 2.5 percent currently, and that appears to be giving renewed support to consumer prices. The chart below shows inflation trends (headline and core) over the past four years.



Source: MVF Research, FactSet

The takeaway from the most recent jobs report released on June 3 was mostly negative, as observers focused on the lower than expected gain in payrolls and downward revisions to previous months' payroll gains. We think the improvement in wages is worth paying attention to, though. Bear in mind that the current string of positive monthly payroll gains is a record, ever since the Bureau of Labor Statistics began keeping track of this statistic in the 1940s. It is not necessarily surprising that this year's pace would lag that of the past two years. But higher wages are a sign of less slack in the job market, which in turn should translate to a continued uptick in consumer prices.

This wage-price correlation should not be confused with the destructive spirals of the 1970s which resulted in so-called "stagflation." Higher wages and prices will give the Fed room to maneuver the gradual rate hikes it very much wants to implement, to bring interest rates at least somewhat closer to historical levels. With other central banks continuing to flirt with the unintended consequences of negative rates, the Fed's ability to continue its intended program of tightening will, in our opinion, be an important weathervane for confidence in continuation of the positive economic story.

Earnings and the Dollar

While there are plenty of other forces at play, the other major trend we believe holds a key to what the second half of the year may bring is the US dollar, and in particular the dollar's impact on corporate earnings. The strong performance of the dollar against the currencies of major US trading partners has had a pronounced negative effect on top line revenue growth in particular. The phrase "FX headwinds" has become a staple of quarterly earnings calls and also is arguably the key explanatory factor for the very rich price-to-sales (P/S) ratio we discussed earlier in this report. Currency is normally seen as a transitory variable, as the losses from a strong currency one year should be compensated by gains from a weaker currency the next, and over a full business cycle everything evens out. But when the currency trend is in one direction for a multiple year period, the transitory becomes somewhat more fixed.

The chart below shows that the dollar's strength has ebbed this year against some (not all) major currencies.

Source: MVF Research, FactSet

Against the euro and the Australian dollar, the greenback has had some ups and downs over the past twelve months but the net trend has been more or less non-directional. Businesses with a high level of trade with Japan stand to benefit from the strong yen – an outcome, unintended as we noted earlier, of the Bank of Japan's negative interest rate policy decision. Among its major partners the dollar has been strongest against the pound sterling, largely due to heightened volatility around Brexit.

Overall, the last couple months have been somewhat more forgiving for dollar-based financial statements than the previous two years have been. In the first quarter earnings calls we have been tracking since April there is a higher incidence of raised revenue guidance than in previous quarters – i.e., management teams expect the negative impact from currency to be milder than they had previously communicated. To the extent that an improved currency outlook translates to a pace of earnings growth above current projections, that would be a potential tailwind for stocks to break through the valuation ceiling we described earlier.

Of course, there is nothing remotely certain about how the dollar will trend this year. In fact, if the Fed does continue to gradually raise rates while the rest of the world pursues more monetary stimulus then, all else being equal, economic theory would say the dollar should be expected to appreciate relative to its soft-money trading partners. But all else rarely is equal, Exhibit A being our oft-referenced yen response to NIRP. Given the multiple variables at play, a default assumption of "anything goes" is probably as reasonable as any other currency view.

Conclusions

- US equities have spent most of the last 26 months in a relatively narrow corridor bounded by a "valuation ceiling" providing resistance and a "policy floor" of support. While a directional breakout is likely to happen eventually, there is a strong case to make for continuation of the sideways corridor for some time to come.

- Negative interest rates have become the rule, not the exception in global markets outside the US. The unusual nature of negative rates and the apparent willingness of investors to accept securities with locked-in losses is a sign that overall market conditions are highly unusual and potentially volatile.

- The next stimulus frontier appears to be direct intervention by central banks in equity markets, and the Bank of Japan has already crossed that line. The question as to where prudent monetary policy ends and where potential confusion and conflicts of interest begin is increasingly blurry.

- Despite the "strange times" theme that hangs over this calendar year, the economic recovery story in the US appears to be on track. Recent strength in wage and price data, alongside continued positive jobs numbers and modest GDP growth, may give the Fed the room it needs to gradually raise rates.

- The US dollar has eased somewhat in recent weeks as compared to its strong bull run of the past couple years. While there is no clear case to make for a sustained trend in dollar weakness, we see evidence from more corporate management teams that a milder FX impact is forecast than previously expected. An upside surprise in sales and earnings could help stocks push further against the valuation ceiling.

- Overall, we expect to see no shortage of surprises in the second half of the year. The exact nature of the surprises and how they will affect asset markets, however, is not clear. We would go back to our initial comments in this piece about the relatively stable equilibrium between the optimists at the policy floor and the pessimists at the valuation ceiling. That to our mind is as good a metaphor as any for recommending neither a strongly aggressive nor an overly defensive position. It is, however, a good time to be fully engaged and on top of developments as they factor into overall market direction.

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