# MV Capital Management Weekly Market Flash

## Pondering the "Big Melt"

### *January 3, 2014*

Temperatures in much of the northern U.S. are well below freezing, so it would seem that melting fears are not weighing on the minds of our citizenry. In the climate-controlled offices and trading floors of investment houses, though, the topic is very much in the discourse. The new buzzword is "melt-up", as in a market that goes into a frenzy of speculative buying and pushes assets into bubble territory. Of course, the logical result of a melt-up is that which we know all too well, the meltdown. As 2014 gets underway, the punditry wants us to consider whether this will be the year of the Big Melt – first up, then down.

*What the Numbers Say*

We prefer to study the data before arriving at any conclusions about what the market might, or might not, do in the near future. What the numbers are telling us now is that equities are expensive at current levels, but not in bubble territory. The twelve trailing months P/E ratio is 16.5, which is higher than it has been for more than three years, but still nowhere near record highs.

The Case-Shiller P/E ratio, which presents the data on the basis of cyclically adjusted earnings, is currently around 26. That level shows equity markets to be overvalued – but again, it does not make a definitive case for a clear and present bubble. It's not a great time to be scooping up underpriced stocks, as there aren't many bargains to be had, but in our opinion there is nothing particularly compelling out there to say that the market is ripe for either a melt-up or a meltdown in the immediate future.

*Mean-Reversion Metrics*

One indicator we focus on in our research is Return on Equity (ROE). ROE is a good metric because it tends to show mean reversion over long economic cycles. What ROE measures is a company's earnings over a period of time relative to its average net book value (assets minus liabilities) over the same time period. Think of equity, or net book value, as what the company has invested in to make money (net of its debt and other obligations). So ROE tells you how productive those investments have been.

Now, in any given industry, a company earning a high ROE will attract competitors eager to get in on the action. The rational expectation would be for average ROE to go down as the total pie gets sliced into smaller pieces. Eventually some competitors will go out of business, and those left behind will enjoy higher ROEs from the spoils they grab…and so the cycles go.

What's the point of this digression into financial statements analysis? Simply that, at present, the ROE for the S&P 500 is about 15.4%. That's a bit higher than its historical average of about 14.9%, but lower than the 16% level it breached two years ago. In a word, inconclusive. It leaves us drawing the same conclusions as the P/E analysis: namely that the market is expensive, but not inordinately so.

*The Earnings Season Catalyst*

We do believe, though, that the upcoming earnings season will be an extremely important factor in influencing the market's near to medium term direction. In particular, we will look at top-line sales numbers as a barometer of whether the recent promising macroeconomic data points are showing up on income statements, or whether the recovery may be on shakier ground than the current consensus holds. That – along with what the tea leaves reveal as the new Yellen Fed gets underway – could hold clues about whether some variation of the Big Melt will become a reality.

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