MV Capital Management Thought Leadership

Learning to Ride
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Remember what it was like learning to ride a bike? Most of us went through a similar experience. First came the tricycle – safe, sturdy and close to the ground. Then the training wheels – now we were further off the ground, and maybe Dad was a little further away as we rode, but it still felt comfortable. Finally came that day when the training wheels came off and we took those first wobbly, uncertain steps on our own. Would I make it? Am I going to fall? Dad's too far away to catch me now. These thoughts raced through our panicky minds – until we finally noticed that we were riding all by ourselves. From there it was one short step to "look Mom, no hands!"

Now – imagine that on your first big-kid bike ride, in those first tentative pedals, you had to dodge a car speeding around a blind curve, the neighbor's dog yapping at your heels, a spilled bag of groceries falling all over the street in front of you and the whole junior high track team running in the road alongside you. That is a good way to describe the US economy's path since June, when the Fed took the training wheels off the US economic recovery. Playing the role of the tough-love Dad, Fed Chairman Bernanke announced that quantitative easing – QE2 – would end on schedule at the end of June and the economy would be on its own two wheels. What a time to be learning to ride – one day Greece is in default-ready meltdown, the next sees the rating agencies getting ready to downgrade US government debt, then our political leaders insist on making an unnecessary crisis on the debt ceiling as hair-raising as possible, and all the while GDP growth is stuck in neutral, household budgets are frugal and record corporate profits don't seem to be moving the unemployment needle off 9%, where it's been stuck seemingly forever.

It's no secret that risk assets have been under an enormous amount of pressure over the past two months. The S&P 500 has turned negative for the year to date, and most world markets are in varying degrees of the minus column. Commodities have been a wildly fluctuating mixed bag – oil and other energy commodities are down, gold and silver are in the stratosphere and agricultural futures reflect expectations that the price effects of severe droughts here, Biblical floods there, who knows what somewhere else, will be showing up soon in a supermarket close to you. Quite naturally, many investors look nervously at their portfolios and wonder if it's time to get out, or at least reduce risk exposure.

You have heard us say these two words before many, many times; *patience* and *discipline*. There are times when it makes sense to change asset class exposures in a major way, but we do not believe this is one of those times. As of the time these words are being written the S&P 500 Index is trading around 1230, its lowest point for the year and just around its 300-day moving average. Just about a year ago the index reached a 52-week low just above 1040 (so it is still more than 20% higher than where it was this time last year). The 12-month forward P/E ratio on the S&P 500 is 13.2, whereas a year ago it was at 17.2. How can the P/E ratio be so much lower today when share prices have gone up so much since then? Simple math – the "E" of P/E, corporate earnings, have been spectacular. In the latest round of earnings announcements over 70% of S&P companies reporting to date have beaten their estimates.

It's worth remembering from time to time that share prices are nothing more than a composite data point of investors' best-guess estimates of the value of a company's future cash flows. That's it. Share prices are not mathematically linked to the price of Greek sovereign debt or the current value of the Swiss franc. They simply reflect what a company's financial health and prospects are seen to be. The trick, of course, is that the farther you peer into the future the harder it is to figure out what those earnings could be. See – you may say – the price of Eurozone debt really does matter because if the Eurozone goes bust then Company XYZ may lose a big chunk of its export market. And that is certainly a possibility – but only one possibility out of a near-infinite number of alternative scenarios. You cannot say with a high level of conviction what specific impact Eurozone debt problems, or another Japanese recession, or some future political debacle in the US, will have on the cash flow prospects of Company XYZ.

But when Company XYZ's current-day earnings, its revenue and earnings forecasts for the next twelve months, and its current cash position all seem remarkably healthy, and its P/E ratio is quite modest by historical standards, you can say with a plausible degree of conviction that the shares Company XYZ seems like a reasonable investment, all else being equal. Now, we are not trying to be glib about this, or paint some kind of hopelessly rosy scenario amid the turmoil we see in the markets. There are serious issues afoot, and we write about these issues very often. But we also believe it is precisely when the short term environment gets into these irrational fits that we have to remain disciplined, patient, and mindful of the facts that we can discern from actual data rather than prevailing flights of fancy.

There is another variable at play that urges us to maintain discipline, and that is the decidedly fragile state of the so-called safe haven investments, notably US government debt. The yield on the 10-year US Treasury bond has dipped below 2.5%, its lowest rate for the year to date and seemingly at odds with all the negative news surrounding Uncle Sam's balance sheet. We have expressed before our concern with the seemingly inflated value of government bonds, and those concerns are ever more so today. As we wrote about in a recent post "Safe Haven Economics 3.0" we think the entire nature of safe haven investments is undergoing a tectonic shift that will result in a more diversified basket of assets to which investors turn on "risk off" days. We are studying this closely and will have more to say in the weeks ahead.

Finally, let's go back to the image of our tough-love Dad in the form of Fed Chairman Bernanke. He may have let the economy take off on its own two wheels, but that doesn't mean that he still won't sprint over to catch it if a bad fall seems likely. Bernanke has not committed to any kind of QE3, but he has been very deliberate to not rule it out. With policymaking gridlocked everywhere else in Washington the Fed is the only place where any emergency stimulus can be enacted. This US Fed has shown itself time and again to not stand by idly as the clouds of crisis gather. In our opinion it would be unwise to make some kind of market-timing bet against the likelihood of a QE3 if the economic picture gets much worse.

So while we will continue to monitor conditions very closely we believe that for now the best course of action is to maintain our allocation discipline and keep the empirical facts separate from the emotions of short-term volatility. Sometimes that's hard to do – but it is absolutely necessary.

With warm regards,

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