Verity Asset Management

Commentary

Core Model

3rd Quarter 2013

# Paying Attention

Tucked into the later stages of a very odd year, 3rd Quarter seemed comparatively "normal". Though the U.S. equity market continued its rather surprising surge, it did not during this stage do so alone; it was joined by other asset classes of various types, and our broadly diversified Core Model had a similarly strong quarter.

While it is tempting to hope that 3rd Quarter could represent a step toward normalization of markets, we cannot allow hope to interfere with careful observation. If we are paying attention at all, two things are clear:

- Despite positive appearances on the surface, market conditions are somewhat vulnerable.
- The whole investment process continues to play out under the dominant specter of the Federal Reserve's quantitative easing program (known as QE).
  [For more on QE, see the June 30, 2013 Market Commentary and Outlook]

I can easily imagine regular readers glazing over at another mention of QE. Unfortunately, no legitimate conversation about markets in this second decade of the 21st century can ignore it. It is the proverbial elephant in the room – and it is the biggest elephant anyone has ever seen. No matter how tiring the subject may be, it has become the context within which everything else plays out. As a consequence, it is critical to have a reasonable appreciation of its impact and the nature of the risks it introduces into the investment environment.

While QE has seemed to have little *identifiable* effect on the economy, it has pretty definitively boosted domestic equity markets. What is more important to understand is that it has, by its sheer magnitude, created deep distortions in financial markets – among them, holding interest rates artificially low. The danger of severe distortions is twofold: (1) they are rarely sustainable, and the ultimate snapback can be sudden and traumatic; and (2) the longer distorted conditions persist, the more they may come to be regarded as rather innocuous, leading many to relax their defenses.

An insight into the degree to which QE has distorted conventional thinking can be gleaned from a November 8 headline posted on the Yahoo Finance website: "Dow and S&P 500 Plummet on News of [Unexpectedly] Higher GDP." When it has become commonplace for the market to react poorly to "good surprises" and positively to "bad surprises", one must think long and hard about the kind of alternative reality we have entered.

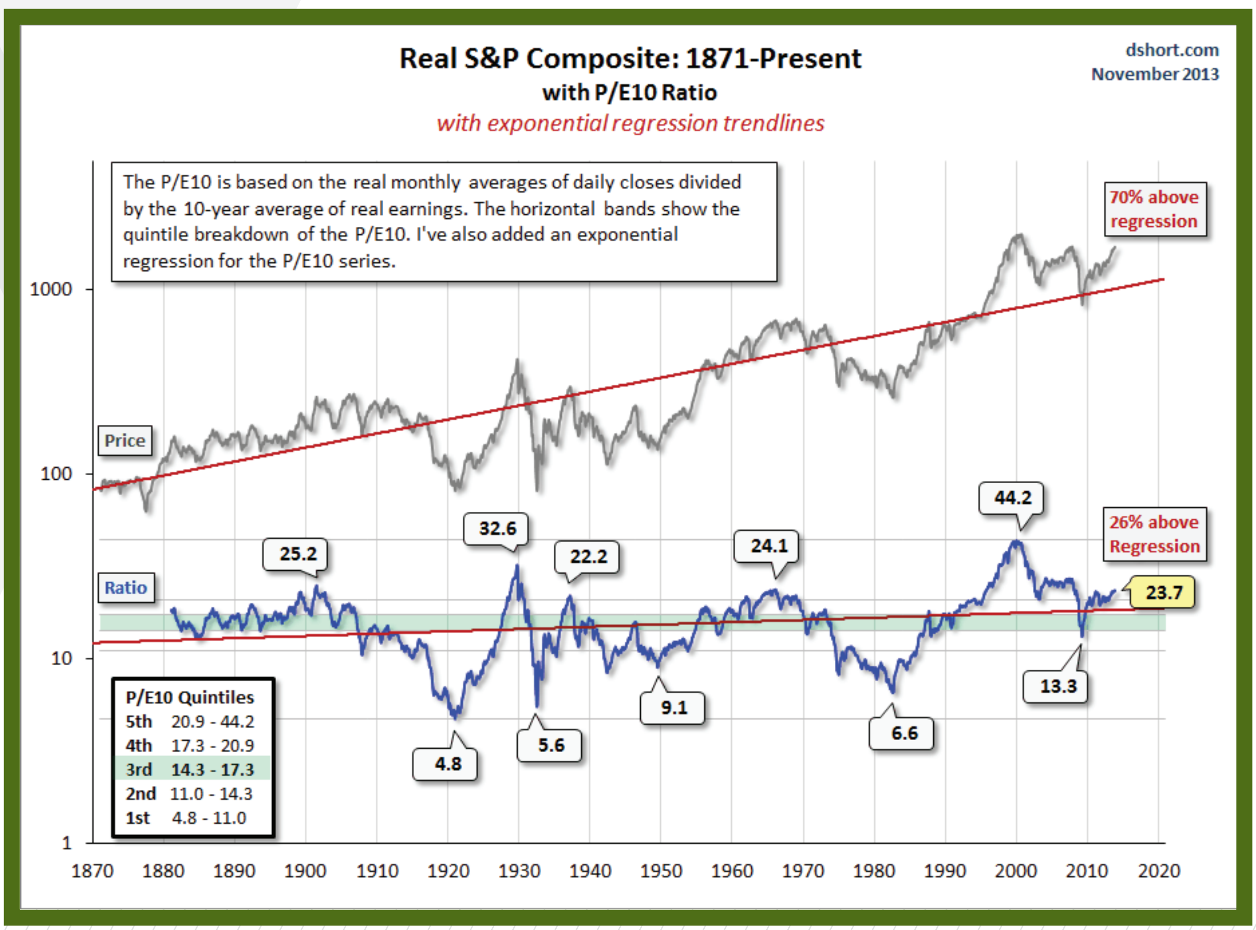
The U.S. equity market's sharp 2013 rise has produced some talk of market bubbles, but I would strongly argue that little or nothing since 2008 has yet approached true bubble territory – including the U.S. stock market at current levels. However, I would posit that any extreme distortion in financial markets is the effective equivalent of a bubble in its ability to generate the preconditions for significant and sometimes violent market reversals.

Ultimately, under conditions of severe distortion, the question is not whether markets will correct – it is *when*, in what manner, and to what degree. And, should markets materially falter, prices could cascade far more quickly than most imagine.

This is not offered as a prediction. Predictions are a tool for gamblers; observations are the more proper tool of choice for investors. Predictions – if they are to be actionable - require not just the "what", but also the "when". The "when" is rarely predicted with any degree of consistency in the world of economics and investing, and predictions in the current environment are perhaps more suspect than ever. Observations, alternatively, permit informed and thoughtful preparation for a broad array of the most likely outcomes.

In the realm of observations, consider a *partial* list of current market vulnerabilities:

- Valuations –By many critical measures, U.S. stocks have over the course of 2013 become rather expensive. Stock prices have risen rapidly despite very limited growth in earnings, which means investors are paying higher and higher prices for future earnings. Historically, the growth outlook from these valuation levels has been very weak, and downside risk considerable. The point should not be overstated - this is not 1999/2000 - valuations have not approached levels of sheer insanity, and some will debate whether they are particularly high at all. *But it is hard to consider current prices reasonable unless one accepts the premise that corporate earnings will expand significantly moving forward.* In simple terms, stock prices are "priced for perfection" in what is – to put it mildly - a very imperfect world.



- Earnings – Despite (or perhaps, because of) an economy that has struggled to gain momentum, corporate profits have been built to near record levels in large measure through cost cutting, with particularly significant cuts to labor costs. Yet growth in earnings has been weak over the past two years. With earnings as a percentage of GDP near all time highs, one must be quite an optimist to expect further gains in profit margins. As a consequence, *if 2014 earnings expectations are to be met, top line revenue growth will likely need to be significant, a material challenge in a still weak economy.*

- Corporate stock buybacks - On a related note, artificially low interest rates have provided an incentive for corporations to borrow funds and by back their own stock. And a significant part of growth in earnings per share over the past two years has been the product of precisely such buybacks. By removing shares from circulation, earnings per share are pushed higher independently of actual growth in overall corporate earnings. This tailwind for stock prices could be quite susceptible to a rise in interest rates.

- The economy – Economic data continues to show *sporadic signs of progress amidst persistent weakness*. As examples, mildly positive employment numbers are tempered by the recognition that a disproportionate number of the new jobs are part time; and unemployment rates tick down partly because so many people have simply dropped out of the work force. Though there was a positive recent GDP surprise, predictions for material growth in GDP in the near term appear to reflect hope more than reliable hard evidence.

- Interest rates – A vital component of the economic recovery is in housing, which, because of mortgage financing, is tremendously sensitive to interest rates. With interest rates so artificially low, there has been uneven but encouraging progress in housing. If there is one clear economic advantage to the Fed's QE program, this may be it. But *when the market began to believe the Fed would taper its bond buying beginning in the fall, the rate on 10 year Treasury bonds nearly doubled from May to September, leaping from 1.63% to 2.98%, with immediate negative effects on the housing market*. (When the Fed in fact did NOT taper at their September meeting, rates moved back down somewhat, but only into the 2.50-2.70% range.)

- Taper sensitivity - It is abundantly clear that the market is aware of these issues, because it has demonstrated repeatedly its belief that the economy is not prepared to stand on its own. As a consequence, *it reacts almost pathologically to practically every utterance of the Fed*, clearly in fear that the Fed may begin reducing (or "tapering") the scope of QE. The logical impact of tapering cascades directly through the sequence of issues above, undermining the factual and philosophical underpinning to current stock prices. In other words, tapering would almost inevitably affect interest rates, which could weaken housing, in turn undermining the economic recovery, weakening earnings, and ultimately exposing deceptively high market valuations.

Of course, the market, already aware of the manner in which these dominos are neatly aligned, recognizes all of this in an instant, and reacts accordingly. So – with apologies to those who are understandably tired of the subject – at present, all roads lead through QE. The paradox is that the stock market may be dangerously unstable at current levels precisely because of the very factor that has provided it with at least a temporary *appearance* of stability.

This all puts investors in a tough situation. The risks are real, and they are significant. And in one way or another, we are all passengers on this journey, whether we choose to be or not.

For us, paying attention to those things which are obvious and some which are not, the question we continually answer is singular: In an environment such as this, how can we reasonably and effectively position a client's most crucial investment assets to weather those conditions which may come while maintaining a sound focus on enduring opportunities for growth?



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