

January 23, 2012

Insight into Equities A Break in the Clouds for Stocks

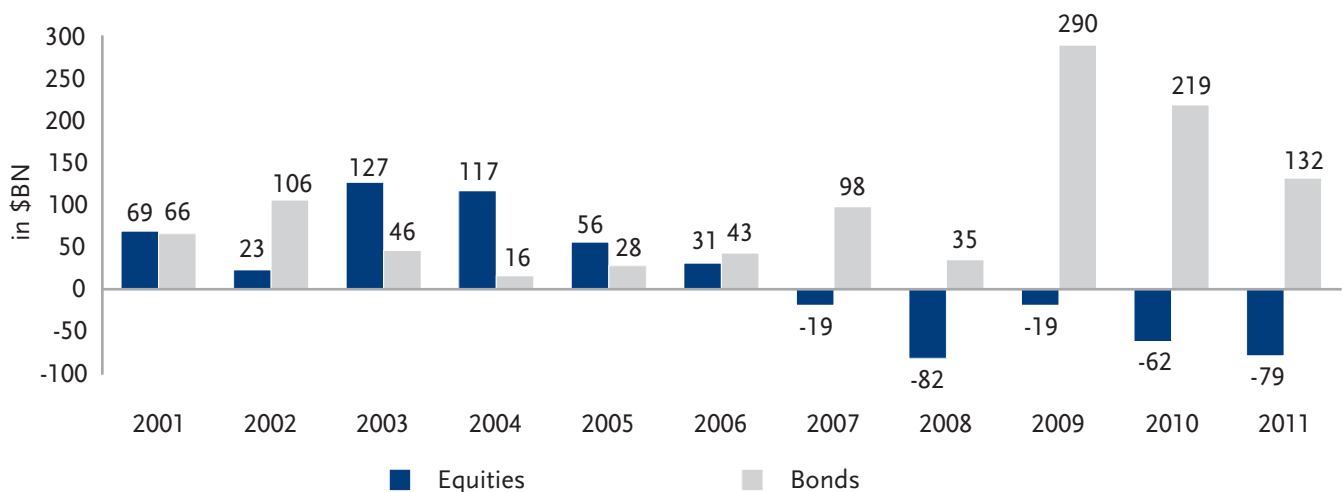


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“All these storms falling upon us are signs that the weather will soon clear and that things will go well for us; for neither good nor bad can last forever, and from this we can deduce that since this bad spell has lasted for a long time, a good one cannot be far away.”

– Don Quixote de la Mancha (Cervantes – 17th Century Spain)

Figure 1
Mutual Fund Flows Express Risk-Off Mentality



Source: Morningstar, TCW Equity Research

Given the persistent flows out of U.S. stock mutual funds over each of the past five years (Figure 1), one can hardly assail equity investors drawn by the allure of Don Quixote’s *very* old-school reversion-to-mean argument. Yet, even without resorting to tilting at windmills, a dispassionate examination of the case for investing in stocks suggests several compelling factors that augur well for a gradual change in the weather.

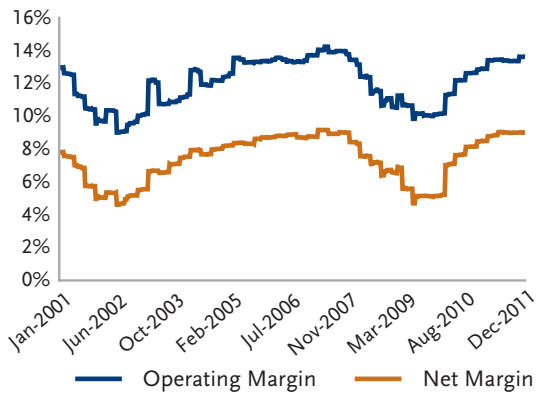
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A Break in the Clouds for Stocks (cont'd)

Fundamentals

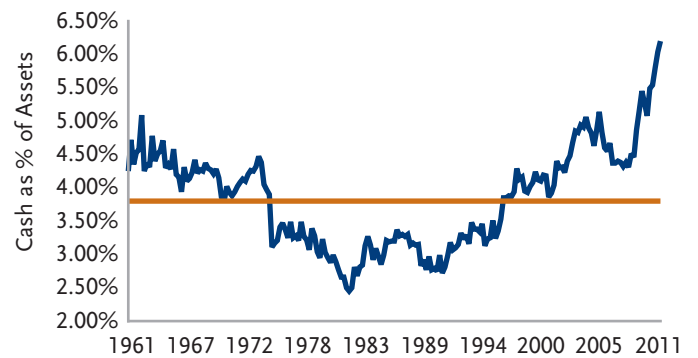
Less than three years on from the trough in the equity markets, corporate America's resilience continues to impress. Despite the myriad macroeconomic headwinds, corporate profit margins have essentially recovered to their pre-crisis levels (Figure 2), with cash levels in excess of \$1.8 trillion among U.S. non-financial companies (Figure 3).

Figure 2
Profit Margins Reaching New Highs



Source: Strategas

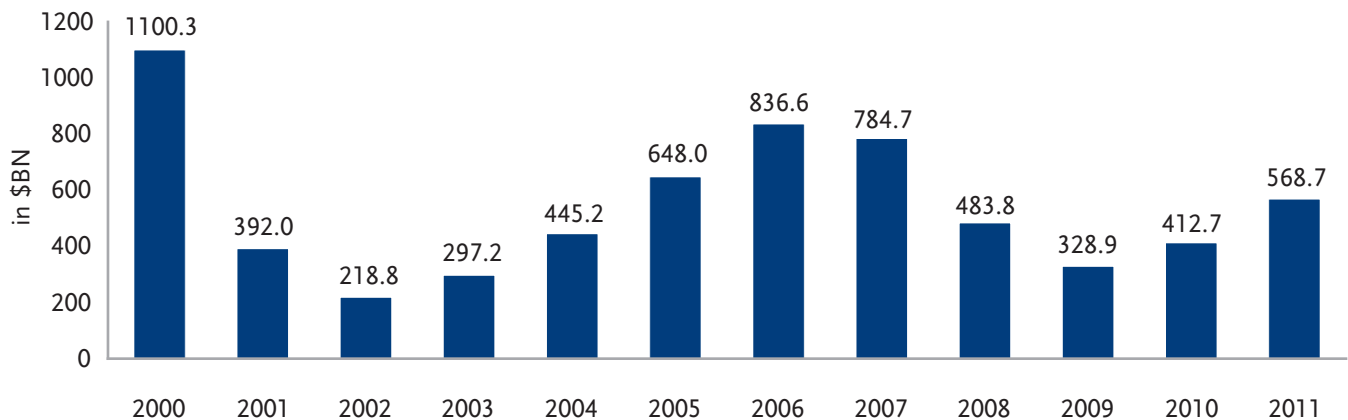
Figure 3
Corporate America is Swimming in Cash



Source: Factset

While corporate earnings growth is set to decelerate from the mid-teens pace witnessed each of the past two years, mid single-digit and perhaps even high single-digit earnings growth is achievable this year against a likely 2-3% real GDP growth backdrop in the U.S. At the same time, we should expect to see M&A activity continue unabated (Figure 4), as attractive valuations encourage companies to deploy their cash hoards on acquisitions that can be expected to complement organic growth.

Figure 4
M&A Activity Continues Unabated



Source: Strategas

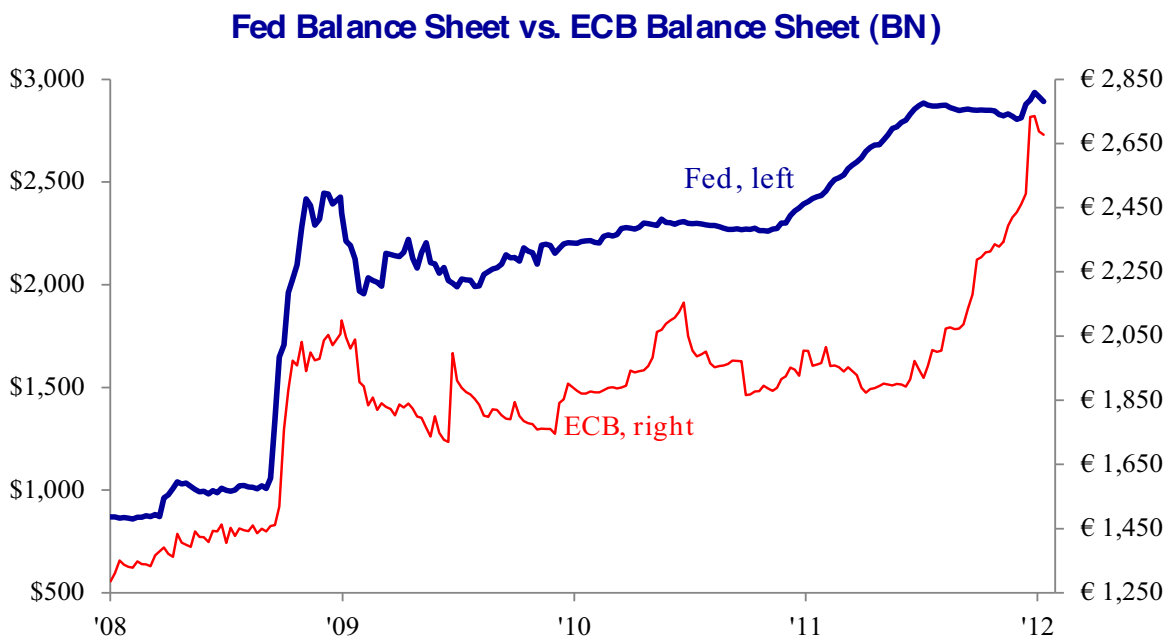
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A Break in the Clouds for Stocks (cont'd)

Over the past several years, corporate earnings have indeed faced real macroeconomic challenges, ranging from depressed spending by weakened consumers still in the midst of an unrelenting deleveraging process, to the well-articulated systemic risks inherent in a European monetary union that continues under siege. Throw in fears about a “hard-landing” of the Chinese economy and doubts about the durability of the U.S. economic recovery, and it’s no wonder that investors have flocked to the safe-haven of U.S. Treasuries. Yet, in a very real sense, investors have heavily discounted many of these risks, so it’s instructive to consider where we stand at present.

First, with respect to Europe, by all accounts Greece is insolvent, yet the greater good of the Eurozone monetary framework has demanded ever-greater liquidity-oriented responses and a drive toward an “orderly default” by Greece in order to stem the contagion potential and forestall the ultimate day of reckoning. While U.S. corporate earnings can absorb the impact of recession in Europe, the fear remains of a *disorderly* resolution to Europe’s woes, which is not discounted in U.S. equity price levels. Perhaps vastly underappreciated, though, is the massive commitment to backdoor quantitative easing already embarked upon by the ECB, with the 3-year LTRO (Long Term Repurchase Operation) proving highly successful in terms of easing the liquidity squeeze faced by European banks.

Figure 5
Aggressive Monetary Response Eases EU Liquidity Concerns



Source: Strategas

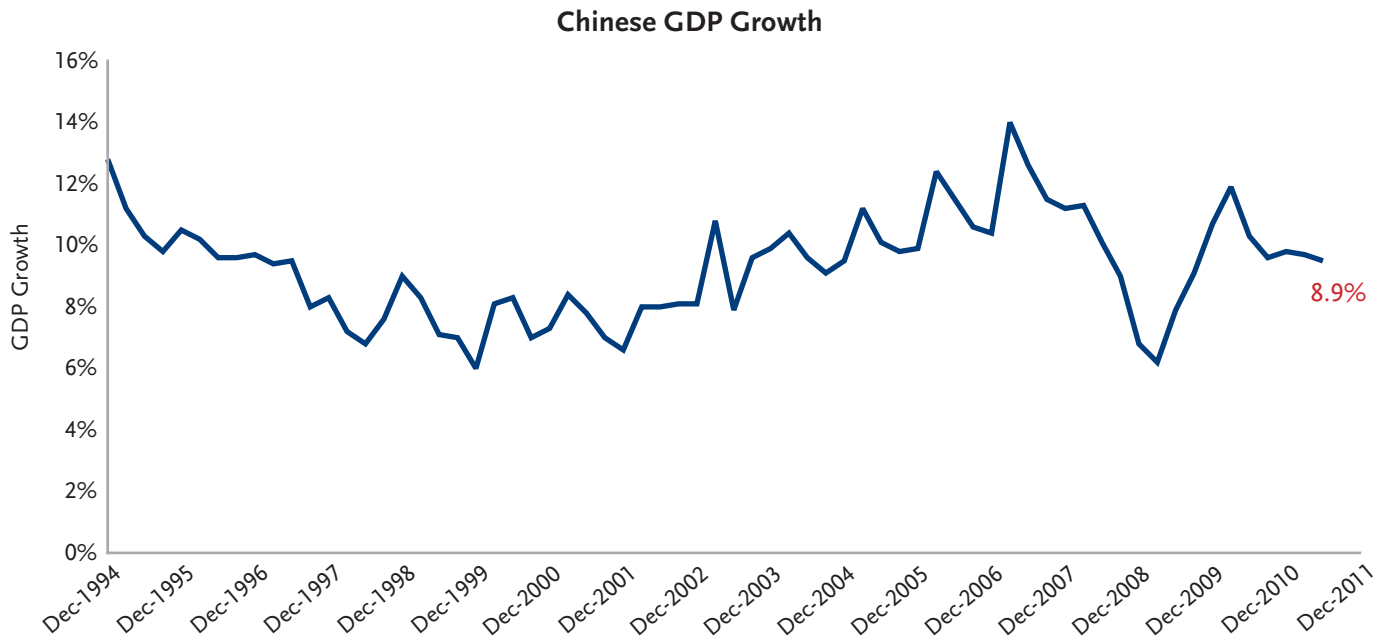
And, undoubtedly, the Fed stands at the ready to reinforce its own commitment to support Eurozone stability, as was witnessed as recently as November, when dollar liquidity swap arrangements were extended through early 2013. So while there will not be a neat, definitive resolution to the Eurozone crisis, quantitative easing will prove to be a similar palliative there, as has been the case in the U.S., with German politicians protesting each and every step along the way.

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With respect to China's economy, there is already evidence of a "soft-landing" in progress, with heightened bank reserve requirement ratios having helped produce a gradual slowdown in real GDP growth to 8.9% year-over-year in the fourth quarter (Figure 6). There now appears to be scope for reductions in the reserve requirements.

Figure 6
Soft Landing for China in Sight



Source: Bloomberg

The latest foreign currency reserve figure out of China was \$3.18 trillion as of the end of 2011, which gives the People's Bank of China unrivaled flexibility to manage the economy's pace of growth while contending with the impact that lower real estate prices are likely to have on banks' non-performing loan balances.

With respect to the fragility of the economic recovery here in the U.S., the risk of a "double-dip" has largely abated, with the most recent data points (job growth, auto sales and consumer confidence) largely positive. Importantly, the Fed has telegraphed, not so subtly, that it won't hesitate to unleash QE3 should the recovery falter. Setting aside dogmatic views as to the advisability of the Fed's policies—and the implications for inflation over the longer term—the Fed "put" remains decidedly intact.

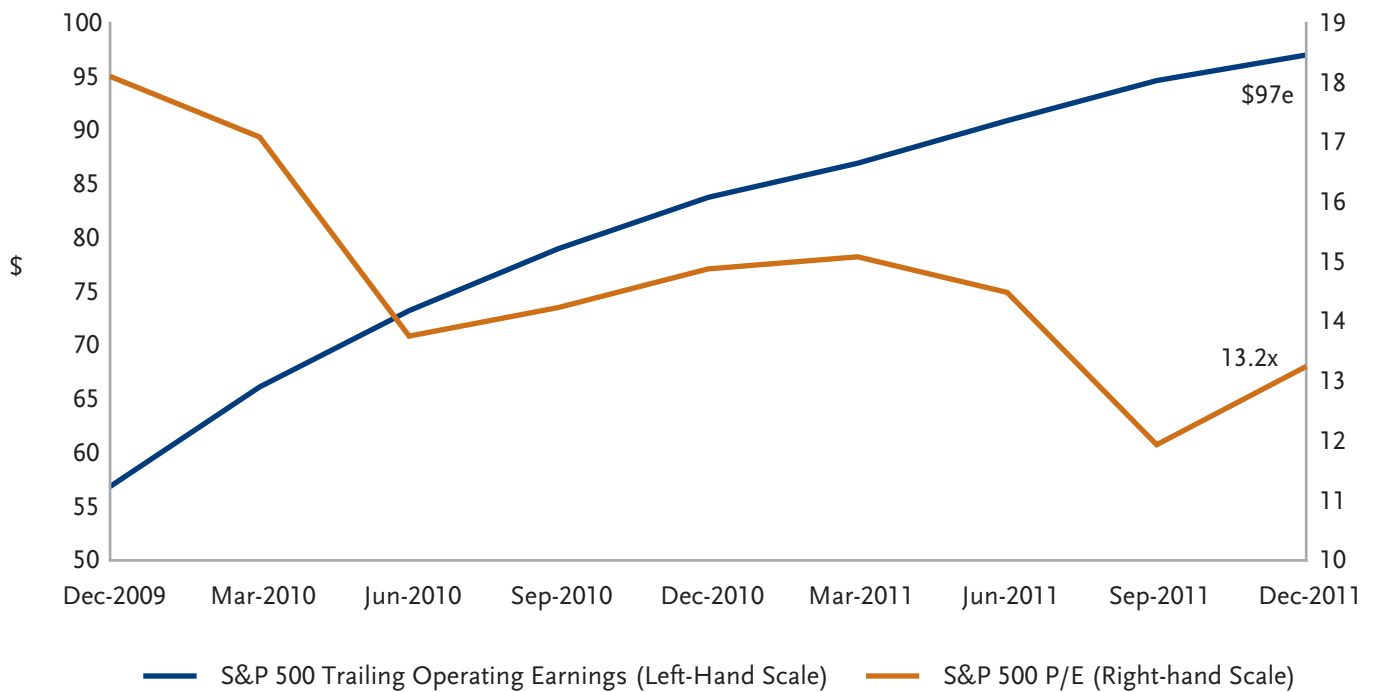
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Valuation

The story of last year's equity markets was the continued de-rating of the strong earnings growth registered over the past few years. In rough terms, corporate earnings have grown a cumulative \$40 over the past two years, yet the *trailing* price/earnings ratio has collapsed from 18.1 to 13.2 (Figure 7) over that period (and is now 27% below the 18.1 average of the past three decades), while the *forward* P/E has compressed from 14.1 to 11.8, nearly 21 % below its 30-year average.

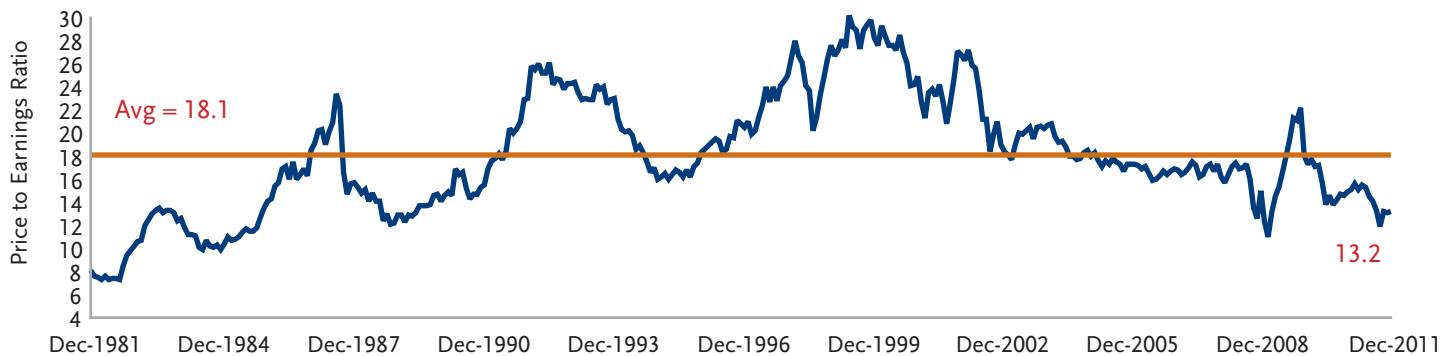
Figure 7
Profits Have Kept Growing Yet Market P/E Multiple Has Compressed



Source: Strategas, Bloomberg

Stocks Look Cheap on Both Trailing and Forward Basis

Figure 8
S&P 500 Trailing P/E

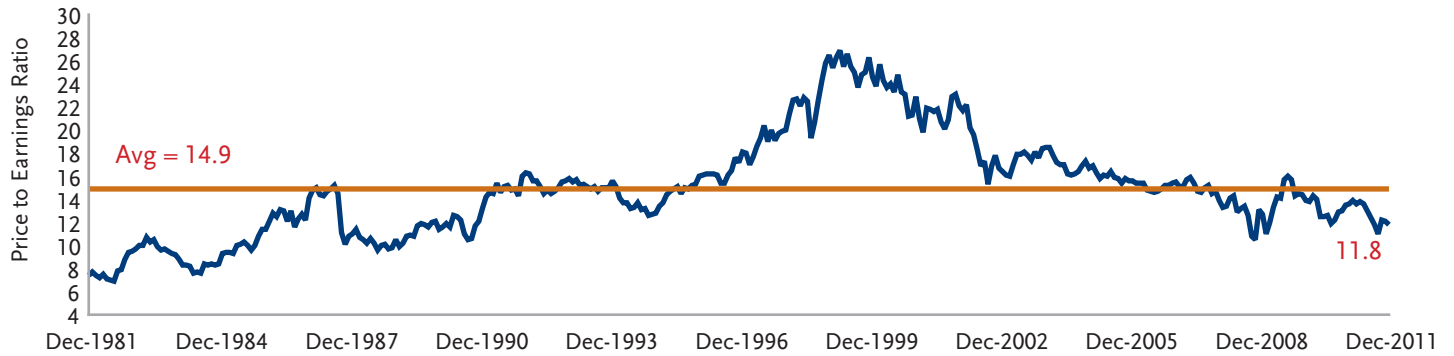


Source: Bloomberg

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Figure 9
S&P 500 Forward P/E

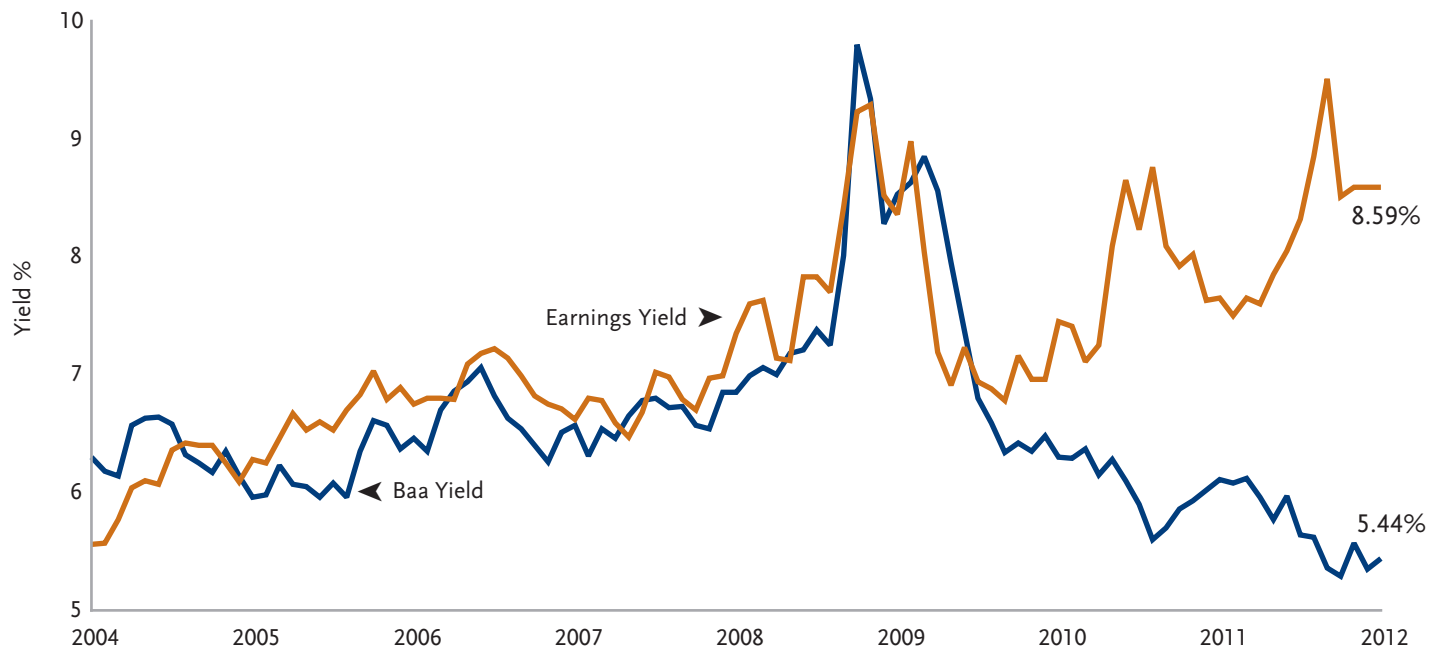


Source: Bloomberg

Investors' pronounced risk aversion has exacted a great toll on market multiples and, barring renewed recession in the U.S. or a calamitous meltdown of the Eurozone, it's difficult to envision a multiple compression repeat of this magnitude.

Not only are stocks inexpensive compared to their own history, but also in relation to bonds, as evidenced by the 315 basis point spread between the earnings yield on equities versus the Baa Corporate Bond yield:

Figure 10
Earnings Yield on Stocks Signals Attractive Relative Valuations



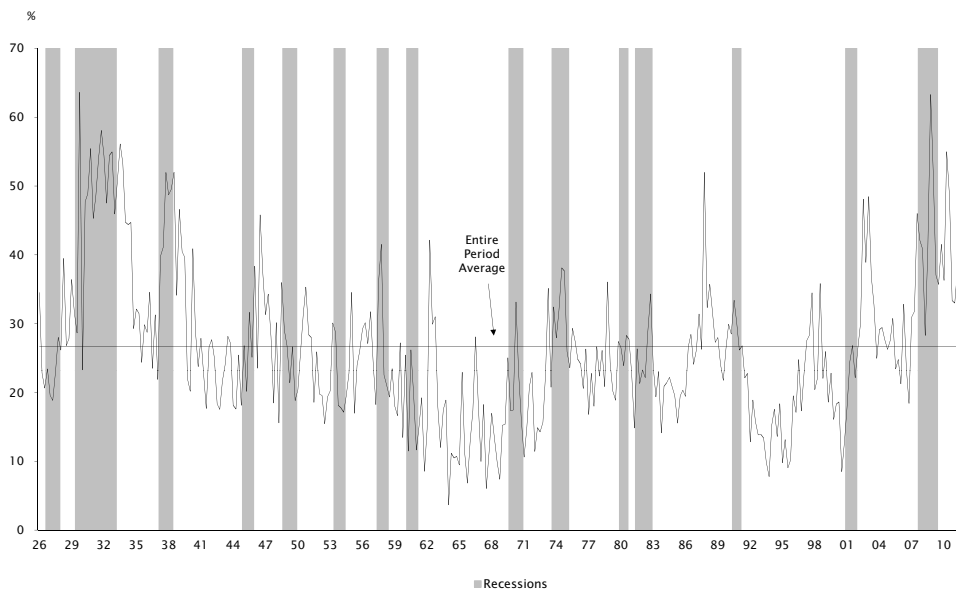
Source: UBS

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To be sure, historical benchmarks such as this one have been rendered less helpful as reference points, given the vast distortion of interest rates engendered by the Fed's massive intervention, but the fact remains that stocks offer an attractive earnings yield — 8.59% at present — with the S&P 500's 2.04% dividend yield, alone, roughly matching the 10-year Treasury yield.

Figure 11

Large-Capitalization Stocks Average Cap-Weighted Return Correlation Among Stocks¹ 1926 Through 2011



Source: Empirical Research Partners Analysis.

¹ Computed using daily data, averaged over a quarter.

Conclusion

Stock fundamentals and valuation metrics didn't much matter last year, as evidenced by the record high level of stock correlations, which even eclipsed the peak witnessed in 2008.

Yes, "risk-off" sentiment has trumped all else as investors have sought refuge from the unrelenting macroeconomic storms. As the Spanish sage reminds us, the storm clouds will dissipate, with hints of bluer skies already on the horizon. At some point investors will no longer be content with the negative real yields offered by U.S. Treasuries, and "risk-on" assets will regain their appeal. When this occurs, stock fundamentals will matter once again, and investors will prize those companies where shareholder value is being created through innovation, disruptive technologies, superior business models, value-additive restructurings, and the like.

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