Time for the After Party

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By Carl Scholtz

Through the first half of the year, the S&P 500 is +13.83% and the party has continued into July. The relentlessness of this rally has caused capitulation amongst many of the pundits who preferred to view the glass half-empty, but some still hold on to some sort of doomsday scenario. We do not see it. While much of the "easy money" may have been made this year, the US stock market does not appear to be overvalued in any way and remains one of the most attractive investment options relative to the alternatives (re: bonds, global equities). The second half and early 2014 will likely not be as exciting and wild, but a more subdued, slow rise for the US equity market.

From a macro perspective, the first half played out much as we had prognosticated allowing equity markets to perform well. First, the US economy held up on the back of housing, weak commodities, and continued Fed stimulus. While the aggregate GDP growth remains in the modest 2% range, we feel that the results are solid in light of increased taxes and fiscal cutbacks. This is especially apparent when you look at the private sector growth which has been 4%. For instance, year-to-date, private sector employment has increased over +200K/mos while government employment has fallen. When viewed in this context, the private sector, which is the real engine of our economy, is really starting to perform and the government headwinds (i.e. layoffs) should begin to abate. Second, we thought that the EU would remain weak, but not likely derail the US recovery. This has largely been the case. Except for a brief panic over Cyprus in March, Europe has not been able to move the needle too negatively despite the fact that most of its nations remain in recession. Third, we projected that Japan would begin to pick up some of the slack of other economies. "Abe-economics" has been one of the most exciting, most aggressive economic policy shifts that any developed nation has seen, ever. After decades of GDP growth near +0-2%, Japan accelerated to 4.1% in Q213 after being down 2-3% in the second half of 2012. Just as exciting, Japan may finally be escaping the deflation which has plagued it. People don't talk about Japan enough.

Our final thought was that China growth would begin to pick up aided by fiscal and monetary stimulus from the newly anointed regime. This has not been the case and has been surprising to us. We missed it. The new administration is determined to control property prices which have skyrocketed into the stratosphere and risk the eventual unwinding of a massive bubble. Despite numerous measures being put in place, property prices are still rising +8-10% across almost all cities. In June, the results even accelerated and many believe the bubble will pop soon. As such, the Central Bank is beginning to pull the reins in and even allowed SHIBOR rates to explode in what amounted to a warning shot across the banks' bow regarding shadow lending and overextending credit. Growth is slowing, not improving.

So, what do we think the second half will look like? From a macro perspective, I think many of the first half trends continue. The US is clearly on track, but I don't think it is about to take off. As I discuss below, the Fed will be there if we need it to continue providing plenty of liquidity. In the meantime, employment is slowly moving higher and I do not think housing will be derailed by rising rates, but perhaps, slowed on the margin. The one area that I am watching closely is gasoline prices which have accelerated upward in recent weeks on the back of rising oil and refinery shutdowns. Oil shocks have in the past caused some big problems, but we aren't there yet. On Europe, political and economic mediocrity abounds, but they should be able to divert disaster again. In times of imminent crisis, sound decision making seems to prevail.

Furthermore, the ECB has implied that further stimulus could be at hand. In a recent policy meeting, the ECB made the bold step of providing forward-looking rate guidance saying that rates will stay at current levels or lower for “an extended period of time.” The ECB is ready. Japan may be set for another boost from the fiscal side of the equation. In June, President Abe had unveiled some preliminary fiscal/regulatory measures as the third part of his three-part plan that was met with some apathy. With his coalition’s victory on 7/21, many predict a far more aggressive game plan to be implemented beginning in the early fall including lowering the corporate tax rate and giving employers with bloated payrolls the ability to make cuts more easily. I agree with this premise and expect positive announcements coming over the next few months. Lastly, China (and other emerging markets) does not appear ready to re-accelerate, and another leg down seems likely. The new regime has publically stated in recent weeks that a slowdown below 7% GDP wouldn’t be a big deal (although they recently tried to back track). This is a meaningful change and portends a China growth story in the 3-4% range for the near and intermediate term. They are clearly trying to lower expectations because there is little hope for meeting existing ones. While cooling a spiraling housing and credit market may be ultimately the “right thing to do,” the slowdown of an $8 trillion economy is not going to help GDP growth.

I also wanted to discuss the Fed and many of the fears permeating the marketplace. For many, the Fed’s seemingly unlimited, unending bond buying program has been the primary driver of equity returns. This is probably somewhat true. The logic is thus that when the Fed begins to step away, the whole market unravels. I would disagree. The Fed will step away when the economy is strong enough to stand completely on its own. Strong economic growth will ultimately be a far bigger driver for the markets than holding down rates and gobbling up bonds. Markets can and do rise in rising rate environments (re: 1994). Moreover, the fact that the government deficit is rapidly shrinking only emphasizes the point that the Fed is providing ample liquidity to the market as fewer bond purchases can achieve a similar result. My personal view is that there may be one last hurrah for bond bulls in September as I think the consensus belief of tapering in September is far from a certainty.

In looking out over the next 6-mos (and especially 12-mos), we think that US equity markets continue to grind higher. The main difference from our commentary 6-mos ago, is that it truly will be a “grind” with ups and downs along the way. Modest earnings growth and perhaps modest multiple expansion will lead to upward movements in equity markets, but hardly the breakneck pace of the first half. During this time, our investment focus will be in several areas. From an asset allocation basis, we continue to prefer equities to bonds. The rising yield story is at the very beginning of its cycle, not the end. So despite the possibility of “one last hurrah” in September, rates will generally be going in one direction. For this reason, we continue to position our bond portfolios to the short-end of the curve, waiting for better reinvestment options down the road. On an equity basis, we are focused on sectors with early-cycle exposure (i.e. Consumer Discretionary, Technology ex-CAPEX) and beneficiaries of a rising rate environment (Banks). We are also positive on Healthcare which remains a growth area regardless of economic outcomes and have been able to find selective Energy positions. Additionally, we continue to prefer stocks with more domestic exposure. This is both due to the global growth headwinds and earnings pressure multinationals will see from FX translation. Inevitably, we will therefore be seeking more small and mid-cap names. Finally, we remain excited about Japan for the reasons I laid out above. We continue to play the country through the DXJ which is a country ETF focused on exporters, giving investors a modest, indirect hedge against further Yen depreciation.

The stock market is at all-time highs which does warrant some caution. For those putting new capital to work, I recommend going slow. There will be dips and/or significant sideways action. But make no mistake about it, over the next 12 mos. and beyond, the primary risk investors should be focused on is the risk of “not owning” stocks, not the other way around.