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Where is the Bottom?

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Finding a bottom in the stock market may well be a fool's game, but that does not stop us fools from trying. A strong rally last week accentuated by a surprisingly weak jobs report on Friday allowed the stock market to successfully retest its initial August correction low for the second time. This show of technical strength has buoyed expectations of a coming year end market rally.

While equities may be finding renewed upward momentum in the current quarter, our guess (and it is just that) is the stock market correction is not yet over. In our view, a quick recovery back near all-time highs would leave the stock market with many of the same vulnerabilities that started the correction. Consequently, we would not be surprised if the stock market tests its correction low yet again and perhaps even fails before reaching a final bottom.

Vulnerabilities need to be addressed

While anxieties surrounding China and collapsing commodity prices may have been the impetus for the recent break in stock prices, they were not the primary cause. Due to a steady advance in recent years, the U.S. stock market has developed numerous vulnerabilities and these were recently exposed because the U.S. recovery finally reached an important juncture. Wall Street is at the crossroads of full employment which has exposed vulnerabilities and until the challenges presented by its new path are addressed, financial markets are likely to remain under pressure.

Up till now, the U.S. bull market has been supported by the ability of the economy to grow without producing negative financial market consequences. The economic recovery has simply absorbed unemployed resources made abundant by the last recession. Persistent economic slack kept the recovery from aggravating inflation pressures or eroding profit margins. Nor has it necessitated a rise in interest rates, delaying any challenge to the valuation level of the stock market. And it has allowed the Federal Reserve to remain an outsized and prolonged liquidity friend for the financial markets.

Despite the weak jobs report last week, the U.S. unemployment rate remains poised to fall below 5 percent within months. Consequently, even modest economic growth can now produce wage and price pressures, mandate higher interest rates, lower both stock and bond valuations and force Wall Street to finally wave goodbye to its great liquidity friend. Simply reviving Chinese economic growth or bottoming commodity prices may not end this stock market swoon. Today's turbulence is more about correcting market vulnerabilities built up over the past six years, and finding a new foundation that will allow this bull market to resume as the U.S. economy moves toward full employment.

In our view, the stock market faces four major challenges. First, in recent years investors have become more calm and confident than at any time in this recovery. Undoubtedly, investor confidence has cracked a bit during this correction. Some quantitative measures of investor sentiment now suggest bearishness (a positive for the stock market).

However, while debatable, our current qualitative assessment of investor mindsets is that they remain fairly constructive about the future. Most media stories are not preaching the end of the world and most Wall Street strategists have maintained bullish year end targets. Moreover, financial market action is not consistent with real fear. There has been no huge and sustained rush to the safe haven U.S. treasury, U.S. dollar or gold. Finally, cyclical stock sectors have done as well or better than traditional defensive sectors in the last couple months. Industrials, consumer discretionary and emerging market stocks have been outperforming in the last couple months. Since its start, the premise behind this bull market has been "climbing a perpetual wall of worry". Today, though, rather than a risk, most seem to perceive the current correction more as a buying opportunity in an ongoing bull market. Once this correction finds its final bottom, we suspect many more investors will likely fear a full-fledged bear market and a heightened risk of recession.

Second, at its recent peak, the trailing price-earnings multiple on the U.S. stock market reached almost 19 times earnings and is still about 17.6 times today. Trading at 19 times earnings in a recovery with a zero interest rate, low and stable inflation and no cost-push pressures is not problematic. However, the stock market is likely to go searching for better valuation support if the normal tensions associated with a recovery nearing full employment begin pressuring the financial markets.

Third, after six years, the U.S. earnings recovery is showing signs of aging. Profit margins are near all time record highs and compared to the last few years, earnings are likely to grow much more slowly during the balance of this recovery. Since profit margins cannot rise much higher, should sales growth remain tepid so will earnings results. Alternatively, should sales growth accelerate, pressures on profit margins are likely to intensify nullifying much of the positive impact of stronger economic growth and keeping earnings performance tepid.

Finally, whether it is this year yet or in 2016, the U.S. is imminently headed toward an interest rate reset. Does the current relatively high price-earnings multiple, an investment community which mostly perceives the correction as a great buying opportunity, a recovery with amazingly weak productivity and an aging corporate earnings cycle represent a good foundation for stocks to withstand a rate hike?

Some guesses on the near term outlook

Most likely, the contemporary bull market is not over. However, the current correction may prove deeper and longer than most now expect. Should the stock market quickly return to its recent highs, the vulnerabilities that produced this correction will remain challenging.

Currently, most fear the global recovery is fading. Foreign economies have been sluggish in the last year and recently even U.S. growth seems to have slowed. However, for perhaps the first time in this recovery, economic policy stimulus during the last year has been synchronized and this should result in a synchronized global economic bounce in the coming year.

Beginning last summer, significant fiscal and monetary stimulus was introduced about the globe. Consumers everywhere are currently enjoying the equivalent of a massive global tax cut in the form of a halving of energy costs. Additionally, due to fears of slower economic growth and collapsing commodity prices, sovereign bond yields have declined significantly around the world. Finally, outside of the U.S., most foreign economies are also benefiting from a devalued currency vis a vis the U.S. dollar. While many seem to expect sluggish economic growth in the coming year with deflationary overtones, these synchronized and sizable economic policies suggest accelerating global economic growth is more likely.

Stronger economic growth virtually anywhere but the U.S. will likely be bullish for stock markets. Most foreign economies are a ways from the crossroad of full employment and still enjoy the luxury of growing their economies without producing negative financial market consequences. However, in a more fully employed U.S. economy, stronger growth may accelerate the challenges currently facing the domestic stock market. Should improved U.S. economic growth finally aggravate wage and price pressures, curtail profit margins and force interest rates higher, the stock market may continue to struggle until it finds a lower level with stronger valuation support.

Maybe the S&P 500 declines below 1800 before this correction finds a final bottom. A second break below the initial crash low in August would produce widespread fears of recession and calls for the end of this bull market rather than the popular " buy on the dip" mentalities recently evident. Moreover, and perhaps most importantly, near 1800, the S&P 500 would be selling about 15 times trailing earnings (close to its long-term 145 year historical average), which represents a much more sustainable level in an economy facing slower earnings growth, somewhat higher inflation and rising short-term and long-term interest rates.

Because the U.S. economy is now near full employment whereby further economic growth likely comes only with some price inflation and interest rate pressures, the days of price-earnings multiple expansion (which has been a large part of this bull market) are likely to be far less common. However, the stock market should be able to maintain a lower price-earnings multiple near about 15 times even if inflation and interest rate rise some during the rest of this recovery. That is, from a more sustainable valuation level, the U.S. bull market may be able to resume with stock prices simply following earnings higher. Assuming a modest 4%-5 % annualized earnings growth rate during the rest of this recovery and adding a current dividend yield of about 2 percent suggests the possibility of a buy and hold total return of about 6% -7%. These longer-term returns could prove even better if the U.S. can resurrect some solid productivity growth. Productivity is the elixir of a fully employed economy. Healthy productivity gains would dampen inflation and interest rate pressures and could allow the price-earnings multiple to expand again as it did during the last solid productivity era in the latter half of the 1990s.

Admittedly, there is nothing scientific about 15 times earnings. Perhaps, the stock market will find good support at 16 times or maybe it will need to fall to 14 times? Who knows? It is guesswork at best. However, we think the stock market still faces some vulnerability and until it achieves a better fundamental footing, it is not likely to sustain a meaningful advance.

Investment Recommendations?

Perhaps the current strong rally will persist and ultimately return the stock market back toward highs reached earlier this year. However, we suspect further struggles for the stock market and probably still lower lows before this correction finds a level which is supportable given the new economic environment the U.S. faces now that it is near full employment. Thinking not only about the next several months but also the next few years, we offer a few investment recommendations.

First, while the stock market correction may not yet be over, we would not tilt significantly away from equities. Cash offers a zero return and bonds also exhibit significant risk in the intermediate term. Moreover, we continue to believe the bull market is most likely pausing but not ending. While buy and hold may prove difficult in the next several months, it may still prove profitable over the next few years (particularly if U.S. productivity is resurrected). Still, some cash reserves when the S&P 500 Index is above 1900 appear warranted. Near the initial correction low of 1867 or below however, we would return portfolios to near maximum equity exposures.

Second, stock portfolios should be maximally tilted toward international equities – both developed and emerging stock markets. The U.S. is in an almost unique position facing the crossroads of full employment. Most other economies across the globe are still in full policy accommodation mode. Should global economic growth soon bounce as we expect, while the U.S. stock market may struggle with escalating inflation and interest rate pressures, improved economic growth would be bullish across the emerging world, Europe, Japan and Canada.

Third, we recommend using contemporary stock market volatility to slowly position portfolios for the next leg of this bull market. As discussed in a recent note (see the September 17, 2015 Economic and Market Perspective), we think a shift in economic pricing power from consumers to producers is likely to unfold during the balance of this recovery. This suggest a leadership change in the stock market may be forthcoming from U.S. stocks to foreign stocks (since the U.S. economy is much more consumer centric relative to most foreign economies) and from consumer stock sectors to industrial or producer sectors. Relative stock price performance tends to follow relative economic pricing power. Consequently, we would use periods of strong stock market rallies to lessen the portfolio exposure toward U.S. stocks and toward consumer sectors (e.g., consumer discretionary, consumer staples and health care). Similarly, periods of

significant market weakness should be used to add overseas exposure and to accumulate industrial and capital goods sectors (e.g., industrials, materials, energy and technology).

Fourth, we believe the U.S. dollar is peaking and will likely move lower in the next year. This year, the U.S. dollar has strengthened significantly against emerging market currencies but has been essentially flat since early January against most developed world currencies. We expect a bounce in global economies to close the growth gap between the U.S. and the rest of the world resulting in a bid for foreign currencies and a sell of the U.S. dollar. While U.S. yields will likely rise, better economic growth abroad should also increase foreign yields, keeping yield spreads from widening materially. The likelihood of a weaker U.S. dollar is another reason investors should consider lifting exposure toward international assets.

Fifth, consistent with a weaker U.S. dollar is an expectation that we are near a bottom in commodity prices (see the August 25, 2015 Economic and Market Perspective). After collapsing last year, commodity prices have trended more sideways this year. Indeed, the WTI crude oil price is currently about $46.25, a price it was first at in mid-January of this year. A bounce in global economic growth combined with a decline in the U.S. dollar could produce the best year in commodities since early in this recovery. Overall, if foreign economies finally experience a synchronized recovery (even if growth is still only modest) while the U.S. crosses over into full employment, real assets in general may do much better during the rest of this recovery.

Finally, investors should remain underweighted in fixed-income assets. With most global policy officials now simultaneously and robustly attempting to boost economic activity, with the U.S. moving closer to policy tightening and with bonds currently priced for expected weak growth with deflationary overtones, the upside risk for global bond yields remains elevated. We would focus bond allocations away from the U.S. and toward lower credit quality, which has recently become much more attractively priced.

Summary

The strong stock market rally during the last few days has pushed the S&P 500 near its highest closing level since the correction began in late August. This has boosted optimism that the recent selloff may be ending. While this could certainly prove to be the case, we remain less sanguine that the vulnerabilities, which initially produced this correction, have yet to be resolved.

Ultimately, we expect a more fearful investment culture suggesting a final capitulation and more importantly, a lower stock market valuation level able to withstand a less hospitable recovery as the economy nears full employment.

Thanks for taking a Look!!

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