

Light a Candle

or Just Smile and Wave

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10 months.

That's not how long it's been since we last printed a formal commentary.

❖ *Economic Activity* ❖

Ten months is the remaining term for the Skipper responsible for most of the boats in the water, Ben Bernanke. There's still plenty of time for us all to screw this up, but our Chairman of the US Federal Reserve will be wise to step away in January 2014 while the benediction might still be largely well received. His congregation may come from the ranks of Wall Street more so than Main Street, but regardless, we'll light a candle and remain at the mercy of an exalted economic Skipper.

We've been concerned since a January 2011 commentary about the dissimilar results of our Skipper's monetary policy on Main Street and Wall Street. We penguins on Wall Street have continued to march right along. As for the economy, that progress has been more of a waddle. The U.S. remains in a longer term retrenchment or compression of growth in our view.

Much of Europe remains in a recession with overall Eurozone unemployment in the 11-12% range, and this excludes those who are no longer able to apply for benefits. All of this is pretty well known, and a reversal of these issues could be quite bullish for the globe, but that prospect seems distant. The debt issues we've discussed remain extremely challenging, in the U.S. and Japan as well, but the current consensus is these issues are not a problem until interest rates go up.

There were a number of signs that the domestic economy began to contract in the middle of last year. Those signs then moderated, but interestingly that view has not entirely gone away despite the upward march of the financial markets. Nominal retail sales have progressed nicely but that conclusion is quite different when adjusted for population growth, gasoline prices and retail price inflation. Consumer spending activity is very important (comprising about 2/3rds of the US economy) and is quite correlated with consumer confidence, which in turn is quite correlated with the financial markets. That fact is not lost on our Skipper.

More promising is a much improved level of activity in the housing market over the last two or three quarters, which helps consumer confidence as well. Housing is probably the brightest candle we have at the moment to improve economic momentum. Not to throw water on every flame, but let's keep in mind that much of the housing improvement is investor-oriented rather than new young home buyers.

U.S. political and media focus is on the unemployment rate and it has improved somewhat, but labor participation rates and the shadow economy complicate that statistic. A jobs report will be released in the morning, but as noted below we think the more important information will be the earnings reports and associated commentary which begins late next week. While the unemployment rate may be statistically challenged, huge growth in the number of food stamp recipients must be acknowledged and one could light a candle for concerns about large segments of our economy.

Demographics helped push labor force participation and household income much higher from the early 1980s through late 1990s. Household income, adjusted for inflation, peaked in the late 1990s and again about 6 years ago. Real household income then dropped like a rock in 2008 and 2009, continued to drop and recently simply leveled off. This is a bizarre and worrying trend during a presumed economic rebound. This is important. Real household income is a more robust expression of labor participation, demographics, unemployment and underemployment, confidence and spending power. This measure of economic capacity remains below levels that existed a dozen years ago and has hardly rebounded since 2009-2010. It represents our Main Street.

To our eyes the US economy needs some further catalyst to ignite a more robust recovery which can reach escape velocity beyond marginal growth. A great number of the economists and strategists I read do project significant improvements in GDP this year... let's root for that, knock on wood and light that fuse. The common theme is "it hasn't been that great, but 2013 will be much stronger." Let's hope we can reach that escape velocity soon before the stimulus of monetary policy becomes increasingly ineffective. Investors today must seriously reflect on that.

To this point, while monetary policy actions of the Federal Reserve have quite encouraged the upward march of us Wall Street penguins, why has it not been as helpful to Main Street?

❖ *Inflation, Commodity Prices, Currency* ❖

Velocity. The efficacy of monetary policy is somewhat dependent upon the velocity of money. If it's not moving, if participants aren't as interested in using money, then the effectiveness of added liquidity is obvious. The velocity of money increases when it moves through the economy – businesses are borrowing, consumers are spending. That quicker turnover can also allow increases in the money supply to contribute to higher price inflation for goods and services. However, to the extent this velocity or economic activity is muted, serious increases in the rate of inflation are avoided. Under those circumstances, our Skipper's plans are not hindered by immediate inflation problems, but the financial markets respond to his stimulus more than the general economy.

I'll digress a bit, but the degree to which the financial markets and the general economy can move on somewhat different paths, the degree to which the P/E multiple on stocks can expand, is the question we've puzzled or worried over for some time now. It is easy and natural to react to the positive feedback of an uptrend, to just smile and enjoy the ride... but worry we do. Light a candle.

So the velocity of money, economic activity, will dictate the influence of this aggressive monetary policy on inflation. Meanwhile, the commodity markets have a separate influence on inflation rates. In our commentaries of May and September of 2011 we noted that 2011 represented a change or inflection point and that we were bearish on most commodities and increasingly bullish towards the US dollar. In retrospect, the CRB commodity index peaked in the first quarter of 2011 and by last summer had dropped some 25%. We don't think this theme is over and continue to point especially towards continued weak markets for the base metals, grains, oilseeds, proteins, fibers and raw soft foods. These trends are increasingly beneficial to a number of companies, including consumer stocks.

Under our scenario, grade 1 copper cathode moves below \$3 per pound this year, winter wheat moves to \$6 per bushel, corn approaches \$5.50, raw cane world sugar moves below 16 or 15 cents per pound, and so on. So those are the type of moves we've envisioned, and we're getting closer. One might draw some conclusions about our global economic outlook from this, but this influence on low inflation is largely based on supply/demand dynamics of each individual market. Our view is apparently

at odds with the consensus because I understand the levels of bullishness towards commodities amongst large position trading firms has increased significantly, even in just the past few weeks.

Gold prices have continued to drop as well, but having approached chart support at \$1550 we will position ourselves as being neutral. Moving below \$1500 would open up new downside targets. It will be easier to be bullish of natural gas as the LNG market opens up more and the Panama Canal rework is complete...2014-2015. For now, we see nat gas as a sloppy market, and that leads us to the biggie: crude oil, a major influence on the cost of transport and most products. Refined product, gasoline and jet fuel prices have almost always rallied into an April-June peak and I don't know why this year would be different. But drivers in the U.S. are actually traveling fewer miles. That statistic of "vehicle miles traveled" dropped for a short period of time in the '74 recession, a short period of time in the '81 recession, then peaked in 2008 and has not come close to recovering since then. Again, this is an interesting statistic in the midst of a presumed economic rebound. We see gas prices dropping later this summer, and spot propane prices have actually remained under \$1.00. Crude oil has become boring, consolidating into a triangular price structure between \$80 and \$100. If it breaks out of that triangle to the upside, it will be for a bad reason and one that is hard to predict. Otherwise, crude supplies are ample and one would expect prices to remain under control.

Some of the influence on declining commodity prices is simply some appreciation in the foreign exchange value of the US Dollar. On a secular basis we've been bullish towards the US Dollar for a few years (long before the other penguins thought it was cool). In the September 2011 commentary we emphasized that an important time had arrived for the dollar to make good on that prospect. It did, and we've seen somewhat consistent improvement in the value of the dollar since then. (The true bottom was actually back in 2008.) So for a number of years we've been bullish towards the US Dollar on a secular basis. Having said that, I will say we are doing some deeper work which suggests that our longer term view of the dollar might change ... but for now we think our currency can still appreciate on at least a cyclical basis relative to a number of our major foreign trading partners.

So, given this commodity and currency outlook, and given a continued weak velocity transmission of monetary policy into inflation, one might be wondering about deflation. We'll save that for next time, for now let's anticipate inflation remaining under control.

Inflation is important to the valuation of every investment and forms a base from which we collectively and freely arrive at current rates of interest acceptable to the market.

Wait a second, where did that sentence come from?

We have a Skipper.

❖ *Interest Rates* ❖

As investors, we don't invest our capital without thinking of the expected rate of return and volatility risk. Or that was the theory I read somewhere. Capital has a cost. If one is borrowing money, that interest rate is the cost of debt capital.

Many of the significant economic issues in the world revolve around insufficient revenue and deficit spending, funded by ever increasing debt loads. Low interest rates, low costs of debt capital, are especially important because these potential problems are more manageable or delayed so long as interest rates don't rise.

A year ago we wrote "there remains a huge divide between those who expected bonds to become increasingly valuable and those expecting quite the opposite," but that statement isn't really true. There's not much of a divide, as best I can tell an almost uniform agreement developed that bonds will be a terrible investment. The logic is understandable, we had experienced a long period where conservative bond investing actually provided superior returns to riskier stock investments (unless one was fortunate enough to be invested in stocks which outperformed the market by a wide margin). With interest rates so low, there seems to be upside in bonds and too much risk. We also became more sympathetic to that argument, and commented last year:

The question from here is whether we have moved far enough through the cycle for our expectations on fixed income returns to change. Our answer is that we are getting closer. We don't foresee sleepless nights, but after this nice move in bonds, it seems logical that any thesis of continued gains in fixed income securities will increasingly become the underdog.

This perspective still seems fair to us. Interest rates generally moved lower following those comments last year, bottomed in late July, and have risen somewhat since with the yield curve now at roughly the same levels as a year ago, if not lower.

So the bond market has not inflicted pain, but here's the issue so many strategists are talking about. With the stock market marching higher, we have finally attained levels where the performance of stocks is better than the performance of bonds – a normalized state which one typically expects. The talk therefore is of a move of assets by frustrated and fearful bond investors away from these hellish interest rates and into the heavenly returns of the stock market. That sounds great to me as well, I wonder if that will happen, let's light a candle.

❖ **Common Stocks** ❖

The pattern of that scenario is that the cost of debt capital will rise, long-term bond prices will drop, money moves into stocks and enjoys strong future returns in stocks with earnings growth and/or price multiple expansion.

This rhymes with our Skipper's intentions to boost the economy by forcing investors into riskier assets. We have called it a significant tax, or a transfer of wealth, from retirees and moderately conservative investors to those investing more heavily in public stocks, private equity, real estate, or commodities.

There is a cost of capital – a required rate of return – for every investment. For stocks, it's a function of the P/E multiple, dividend yields, projected growth rates, we won't debate the formulas here. Real estate investors have their own lingo, cap rates and escalation rates and appreciation factors. I won't venture too far from my comfort zone, but cap rates for real estate are moving much lower just as the P/E multiples on stocks are rising. So presumably the cost of equity risk capital is declining, which leads us to an important question. Let's say most of the penguins are correct, that interest rates rise, and bond investments decline in value.

Will the cost of equity capital continue to decline if the cost of debt capital rises?

We want the answer to be “yes” and I think the answer is “yes, but only if...”

❖ **Earnings** ❖

Investors tolerate higher P/E multiples and declining cap rates if or when inflation remains under control and earnings or operating incomes are rising sufficiently.

Profit margins had expanded nicely into 2012 but within the dataset we study there was evidence of peaking in the first quarter of 2012, and those improvements in profit margins certainly seem to have flattened. If we get further commodity price declines, that will continue to help certain industries, but earnings have not grown much over the past couple years. Earnings per share have gone up partially with leverage and stock buybacks reducing the number of shares outstanding.

Profit margins reflect the massive cost-cuts, employee layoffs, and impressive efficiencies implemented by corporate managers over the last 5 years. These companies are dressed up and ready for revenue growth. If we get meaningful top line sales growth, the stock market will be a whole new ballgame. The great majority of companies have not experienced good revenue growth, but here again the common theme is “it hasn't been that great, but 2013 will be much stronger.” Top line sales growth encourages

job growth and employment. Bottom line EPS growth can be a function of cost cutting and encourages investors. Projected earnings by analysts are strong for 2013. We need it. Technically, on the charts US stocks look like they can still move somewhat higher, but we've reached levels where fundamentals must improve. Light a candle.

Investors will be satisfied with good earnings even if lacking something which would seem essential in the long run (stronger revenue growth).

Penguins are an interesting bird, they function well in a sea of liquidity, despite lacking something which would seem essential in the ability to fly.

Earnings season is here, we start to find out next week.

❖ *The Island* ❖

Investors are increasingly swimming to the same island, and we would define that challenging island of circular reasoning as:

- Global top-line economic growth has been difficult to define, but stock investors may need top line growth to produce both employment gains and earnings gains given that profit margins are already wide.
- Investors believe bonds are increasingly risky because interest rates will rise, but most major global economic difficulties are avoided or delayed until interest rates go up.
- Stocks are the professional consensus investment of choice partly because there seems to be no decent alternative, but if the bond alternative is truly that bad, there is genuine risk that fear spreads and the cost of capital rises for stocks and commodities and real estate as well.

I have more, and was going to try to work this up in some sort of circular flow chart, but imagination and artistic ability prevent that. Now this scenario may work out just fine, but it is a delicate dance of moderation in all things. That's not unexpected at this phase in the credit cycles we've discussed so much in recent years, but this is a very difficult environment in which to invest.

So for the moment we are on this island, looking for escape velocity, and eager to see what companies have to say about the first quarter and 2013 as earnings season begins over the next few weeks.

And so I thought of the fun quote from the original 2005 DreamWorks animated movie *Madagascar*:

Private the Penguin: Skipper. Don't you think we should tell them that the boat is out of gas?
Skipper the Penguin: Nah. Just smile and wave, boys. Smile and wave.

Keep a candle burning,
and enjoy the ride while it lasts.

-Brian

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