

All Hat

All Foam, No Beer

September 27, 2014

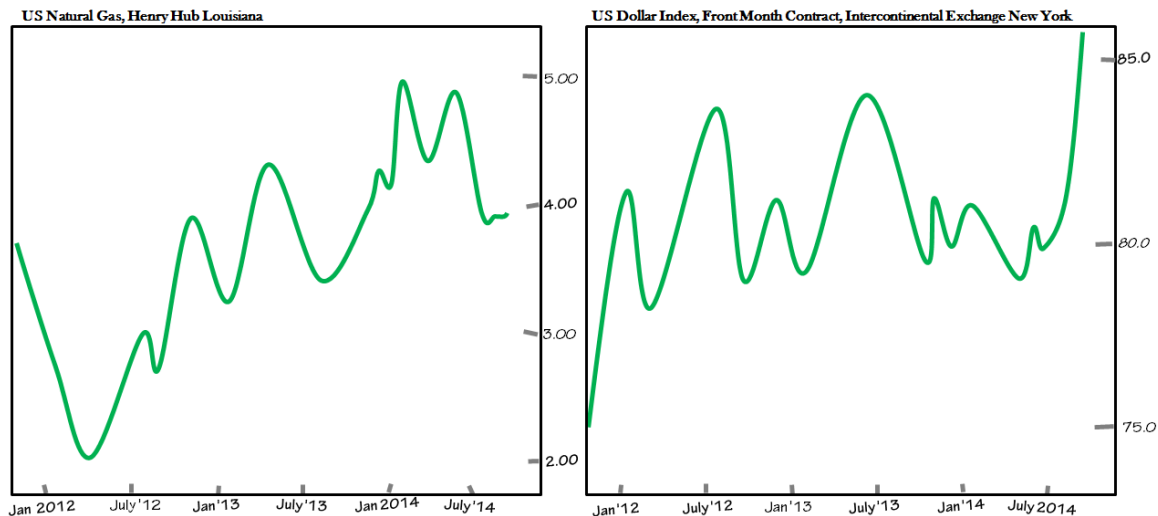
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Our previous written comments from mid-May had us mindful of several factors.

- Watchful of a return to a full monty of valuation, sentiment and technical structures consistent with periods as 2007, 2000, 1987, the late 1960s.
- Central banks of developed economies continuing to compete for low-cost capital to finance structural problems of demographics and accumulated debts.
- Though certain technical requirements for a US market peak were satisfied at that time, for business cycle reasons thinking it more probable that the US stock market would still move higher over the summer months.
- Suggesting the subsequent stock market correction can be more significant than just a "correction" – as a multi-stage affair forcing a progression of uncomfortable issues to be addressed, including a still unresolved credit cycle vulnerable to any increase in interest rates.
- A more positive view towards most Asian markets rather than European financial assets.
- A strong probability of gold making yet another low in its 3-year bear market prior to any meaningful or sustained rally.
- Concerns for investors "reaching for yield" in a market of unjustifiably thin credit spreads.
- A sloppy and rough near-term environment for natural gas prices.
- And little respect for temporary strength in the overall CRB commodity index, largely because of – the prospect of strength in the US Dollar.

Each of these thoughts remain a part of our view, with a couple of adjustments. First, natural gas did indeed go through a rough period, dropping close to a full dollar per mmBtu from the spring highs to the summer lows, basis the November futures contract. We'll probably still see another stab down in that market, but at that point our stated longer-term bullishness towards natural gas could slowly reassert.

In the opposite direction, the US Dollar (which has strengthened quite sharply in recent weeks) may still have one more quick stab higher, but then foreign exchange rates should take a breather and retrace a portion of this brisk rise in the US currency value. Longer term we remain optimistic that the Dollar can trend higher.



With those updates, we would not change any of the previous mid-May comments.

The Texas phrase “All Hat, No Cattle” or “Big Hat, No Cattle” has come to mind while observing the financial markets in recent weeks. For some reason, I thought the phrase traced back to a quote by the humorist Will Rogers, but I have not been able to confirm its origin.

Regardless, it fit our perception that so many on Wall Street are basing pretentious optimism on a fragile Main Street global economy. Such sentiment was a key topic in our May commentary.

Indeed, it is reported that investment advisor sentiment is now extremely optimistic (per the Investors Intelligence Advisors’ Survey), with less than 14% of investment advisors bearish on the US stock market...fewer than the summer of 2011, or the summer of 2007, or any time since 1987. The importance of this can be debated I suppose, but any investor wise to historical tendencies of reversion to the mean has to perk up upon hearing we have the fewest number of bearish investment advisors in almost 30 years. We note major Wall Street firms suggesting economies can easily expand through the end of the decade, or that we are in the 5th year of a 20 year bull market, and we must acknowledge there is a lot of impressive talk about current prospects and a lower level of prudence in many circles.

*We do more talking progress
than we do progressing. – Will Rogers*

In Texas, such confidence seems well-deserved. It’s not “All Sizzle, No Steak.” This region has contributed meaningfully to the national economic growth figures over recent quarters. The valuation of our global companies obviously requires a more panoramic perspective.

Confidence today, or any change in sentiment, is very important. To paraphrase comments from German Finance Minister Schaeuble in August, the effectiveness of monetary policy is ending and may be insufficient to fight deflation in the Eurozone, so the critical ingredient is maintaining sufficient confidence by suppliers and consumers to expand productive capital investments. Yet, triple dip recessions in Italy, France, Spain may be defining an economic stagnation in Europe reminiscent of Japan, and a concrete assessment of global economic growth measures certainly appears lackluster. With all the talk and bullish commentary, one can paint the picture of a stock market that is ahead of

itself, and any turn away from such positive sentiments can develop into broader problems, as suggested by his comments (and realizing there are some politics in his comments).

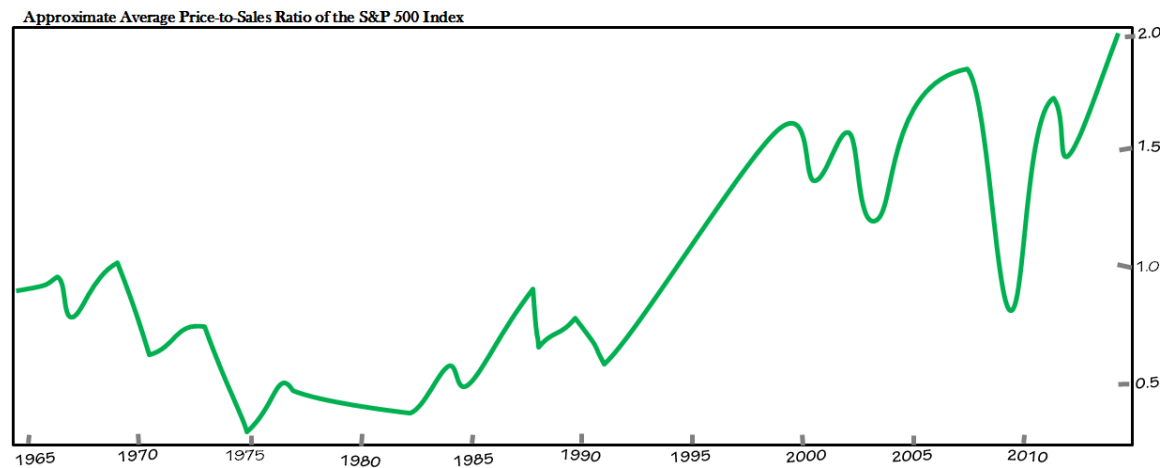
Of note, the breadth or number of stocks advancing within the rally, the participation rate if you will, has been narrowing since the spring, particularly among less liquid stocks and smaller sized companies. The herd is getting smaller.

*If you're ridin' ahead of the herd,
take a look back every now and then to make sure it's still there. – Will Rogers*

To complete a different thought on where we are in the market cycle and sentiment as opposed to the economic cycle and monetary policy, one might be concerned that so much monetary stimulus has been incurred by the developed economies during a period of economic recovery. If a recession were to develop over coming quarters (and we have a thought about that to be discussed at another time), we may look back fondly on these times when institutions possessed both the ability and the earnestness to address such problems independent of fiscal policy and elections. It's worth thinking about these next few years.

*If Stupidity got us into this mess,
then why can't it get us out? – Will Rogers*

We mentioned valuation in our May comments, and received some questions about that. It is fair to debate, as Price/Earnings ratios today are not quite as high as they have been in some previous cyclical stock market peaks...but the P/E ratio is but one valuation metric. Just as we noted it would be a mistake to label the high P/E ratios of the year 2000 as the only relevant benchmark comparison for all future cycles, it would also be a mistake to solely label the P/E ratio as the only relevant valuation metric. Consider the following view of historical Price/Sales ratios:



Ok, the first glance at this chart is an easy one, but it is still debatable because some upward trend in this measure is logical: secular advances in productivity, efficiency, technologies replacing labor, all translating into greater operating potential per sales dollar and justifying higher business valuations. Cyclical changes in tax policy, raw materials inflation, leverage (share buybacks), and costs of capital should also be drawn in, and these things tend to cycle over time in our view.

As a side note, much conversation today focuses on the large discrepancies between executive pay and average worker pay. In some ways the same factors explaining changed relationships between P/S and P/E ratios can also explain the changing relationship between the value of executive management or company ownership and the value of labor. The ability to exploit technology, build productivity, optimize capital structures, and so on is much more valuable. That difference has grown over time, and it is especially true in a challenged economy.

So these factors can help explain why valuations might seem high on a Price/Sales basis and somewhat less so on a Price/Earnings basis. In effect, earnings per share are more efficient and “higher” relative to lackluster sales demand. Then, one needs to lean back in the chair and consider how these factors might change moving forward in time. That might be a long conversation, but that process leads us to conclude valuation metrics are on the high side.

For those companies able to produce meaningful sales demand growth, these efficiencies drop straight to the bottom line and those stocks should prosper. On an aggregate macro level however, the attractiveness of the broad stock markets may be different. Most observers will say that the current market P/E multiple is only somewhat higher than normal, and higher levels could be justified based on current interest rates. Therefore, stock prices could be suggesting that interest rates will rise in the future or that secular growth prospects are not as attractive as previous points in history. That may be. The market may also be pricing in an observation that current profit margins and efficiencies are abnormally high relative to longer term trends, leading one to wonder if the price/sales ratio provides more information on valuation. Neither of those logical paths have us expecting a rising stock market riding the back of rising valuation metrics.

As an “all-in” foam-to-beer ratio, there’s a little too much foam relative to the amount of beer right now.

We’ve had the summer rally that was a part of our script, we have “The Full Monty” of conditions described in the previous commentary (May 15, 2014), and we have credit risk spreads beginning to widen. At this time, it is probably no longer appropriate to “Just Smile and Wave” in the terms of our 2013 comments (April 4, 2013). Selective selling of appreciated securities is warranted, and we are banking some profits. It can be a difficult process, because so many of our individual stock holdings still look capable of achieving higher price levels. So this is a managed process, and higher prices would be welcome during this rebalancing. We are still finding some equities which look attractive, but there are many more which seem quite fully priced. Such changes may be more substantive with aggressive portfolios, less substantive in portfolios with more conservative investment objectives, and are always subject to change as we process the ongoing flow of information.

The stock market may just take off like a rodeo calf from here, and we might look really dumb with hat in hand at that moment, but we do like our performance this year and our positioning relative to the broad market indices.

*You’ve got to go out on a limb sometimes
because that’s where the fruit is. – Will Rogers*

So we are making some changes in our holdings... because this beer has a lot of foam on it right now.

-Brian

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