

Exit ... Stage Left

or go to Abilene?

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We had planned the timing of these comments for the week leading up to the 4th of July – to align with some technical market barometers we'll discuss, a backdrop of peculiar economic data in key economies, and the beginning of second quarter corporate earnings reports. My normal plodding progress was further distracted by the rapidly changing events with Greece, China, and Puerto Rico in this busy week.

Our working presumption includes the thought that U.S. equity markets may continue to trot along in a tightening pattern for somewhat longer before likely breaking down, and that spreads among fixed income sectors should increasingly widen and diverge. Events of the past few days may or may not accelerate this process, but our conclusions are not changed.

As a reminder, our comments reflect our analysis. Portfolio decisions are more complicated and rightly consider other realities, including the prospect of an incorrect analysis. Like the Federal Reserve, our actual trades are "data dependent."

First, before discussing the drama of Puerto Rico, China, or Greece, I want to talk about Abilene.

This 1974 story begins with a married couple entertaining the in-laws with a game of dominoes under the fans of the porch at their Texas home. It's July and 104 degrees in the small town of Coleman and the talk has gotten a little slow, so the father-in-law puts down his cold glass of lemonade and casually suggests they drive to Abilene for dinner. You need to know that Abilene is an hour from Coleman. Each way. The younger couple, unable to quickly think of another idea and wanting to seem in-step with the spirit of the suggestion, then say it sounds like a great idea, if it's ok with her mother. The mother-in-law says, "Of course I want to go, I haven't been to Abilene in a long time." And so, they drive an old Buick for a long, hot dusty hour to Abilene, only to find that the restaurant food and service ended up being as bad as the drive. After this four hour round-trip adventure, they arrive back home exhausted, but having gotten exactly what they all said they wanted.

Except the mother-in-law then admits that she would actually have preferred to stay home, but just went along since the other three were so enthusiastic. The young couple then admit they just went along to be in harmony with the group, and the father-in-law says he only suggested it because he thought everyone might be bored.

And so they sit down, rather confused and bemused, realizing they had decided as a group to do something that none of them wanted – something that indeed turned out to be a bad idea.

*The Abilene Paradox by Jerry B. Harvey, [http://dx.doi.org/10.1016/0090-2616\(74\)90005-9](http://dx.doi.org/10.1016/0090-2616(74)90005-9)
Organizational Dynamics, Vol 3 Issue 1, Summer 1974, pgs 63-80.*

Business Equity Values

As of this date, over the trailing year U.S. equity price indices are up 4 to 6+% in looking at the S&P500 or DJIA or Russell 2000 -- an upward slope interrupted by a sharp decline in October and becoming increasingly compressed or boring this year.

Since our comments of May and September 2014, <http://rahlfscapital.com/updates.html>, we've been building on a case of high valuation in the U.S. stock market, which coupled with investor sentiment measures, is reminiscent of such periods as 2007, 2000, 1987, the late 60s, and so on. I consistently view financial news broadcasts in the offices, and thoughts of high valuations in the U.S. stock market have certainly been a minority view over the past year.

We don't want to be the only ones not going to Abilene, and have probably stayed somewhat close to the main pack. We have sold some stocks and added other stocks at points in the past year, and have recently added to some fixed income positions. We have certainly been poised to make changes that are more significant but being "data dependent," market actions have yet to confirm such an opinion.

Recently, a number of respected professional investors have expressed concerns about stock valuation levels. Carl Icahn voiced concerns on a June 24 CNBC broadcast about great risks in stocks and high-yield debt, to name one. Julian Robertson was interviewed the following Tuesday suggesting the stock market was overvalued with a serious credit bubble. As that list has grown, it starts making it easier to say no to Abilene.

We do not know where equity valuations and the stock markets are headed. If they are headed much higher from here, the dwindling possibilities include either truly alarming valuation metrics, or we are about to see a most-welcome acceleration of revenue growth which will magnify corporate earnings given the lean cost structures and high margins.

Second quarter earnings reports begin this next week, so the market will instruct those of us who are data dependent.

Technical Picture

Timing is difficult and technical analysis or historical price tendencies can be ambiguous. We look at everything we can, and in terms of cycles, our commentary of May 2014 suggested that while some technical requirements for a high turn were present, for cycle reasons we thought it more probable stocks could still move higher last summer. It did, reaching a high point in mid-September. So, our commentary of September 27, 2014 was timed, in part, to correlate with the cyclical influences peaking at that time -- but the subsequent sharp sell-off was over very quickly. There was no continuation and stocks promptly trended higher, and in retrospect, I don't know how helpful that was to us.

These comments are timed, in part, to coincide with some peaking technical influences plus the typical seasonal tendency of a rally into the 4th of July holiday. For what it's worth, these sequences suggest rough markets through mid-October. There is a weak seasonal tendency that moves lower into October as well...part of the old saying of "sell in May and go away."

Separately, in terms of algorithmic and some quant strategies, further weakness likely triggers larger sell volume...partly because the volatility of the markets became rather muted this year as prices converged into a gently rising wedge pattern. That process tends to "bring in" the trigger points of mechanical systems regardless of the algorithm, and explains why one often sees short-term spikes in volatility once the market creeps outside of the wedge.

Sort of a computerized version of deciding to go to Abilene...just because a "system" told us to. Or possibly more broadly, because "there is no alternative" or we all follow the same general rule-

set like the developing “robo-advisors.” An early experience with program trading (dynamic hedging/portfolio insurance) was the role of such trading in the Black Monday October 1987 crash. The Abilene Paradox cited by Professor Harvey is somewhat different from “group think” (and I’m not at all suggesting a Black Monday is in our future), but there has been a very one-sided view of the U.S. stock market for some time.

Back to the “wedge” idea, the following graph is of the 5000 stock U.S. Wilshire Index.



Such wedge patterns are often “ending patterns” and culminate in sharp retracements. While this chart pattern seems well defined right now, it is almost humorous how often such constructions evolve into something entirely different.

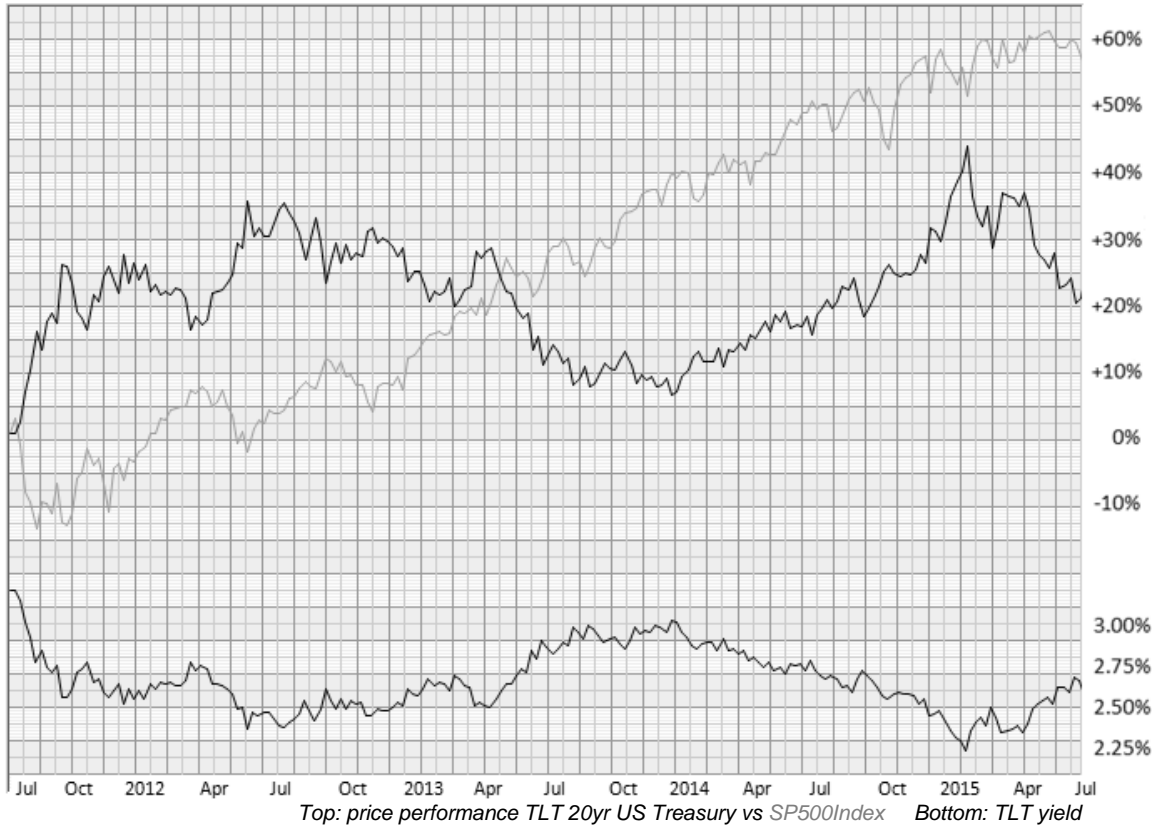
Traders use all sorts of technical indicators, many of which are arbitrary. As investors, we prefer metrics that root back to understanding investor behavior or systemic triggers.

With the barometers we monitor, we sense a turn at this juncture, but the accuracy of most technical indicators is not particularly great, perhaps as bad as corporate earnings projections and economic forecasts! Weather forecasts are useful.

Interest Rates and Investment Cashflow

Like the weather, investor behavior cycles back and forth, and one version of this thought is termed “mean reversion” – a strong influence in investment finance and markets. If thoughts on equities have been largely one-sided, thoughts on bonds and interest rates have oscillated as demonstrated by the following graph. It compares the cumulative price returns of the S&P 500 and the Treasury bond, excluding income, although the Treasury yield is shown at the bottom of the chart. This chart is for the trailing four-year period back to July 2011.

The 2014 bond market rally (declining interest rates) reversed this year, and for the last 6 months, there has been much talk of the Federal Reserve wanting to raise short-term interest rates. We have made some purchases recently as there was room again for a reversal in those thoughts, at least a partial reversion to the mean.



This is not a convergence trade. Our thought was that the Federal Reserve might find it difficult to begin a process of raising interest rates. The International Monetary Fund has now twice requested the U.S. Federal Reserve to postpone such a decision. What would cause short or intermediate interest rates to rise? Answers to that question may not be as strong as has been thought this year. Key commodity prices are declining, and signs of global economic distress continue to challenge other signs of global economic recovery. Frankly, there is some merit to arguing that the Federal Reserve may have missed an opportunity to raise short-term interest rates when both stocks and bonds were rising together last year. The September comments touched on this, first, that the effectiveness of monetary policy was likely diminishing. More broadly, it is somewhat concerning, as stated at that time,

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.

Our recent additions to fixed income securities have targeted particular sectors. We anticipate spreads among fixed income sectors to increasingly widen and diverge. Specifically we are prepared to see investors assign greater risk premiums to duration, greater risk premiums to credit, and greater focus on liquidity and taxation. If so, interest rates on many securities will be rising.

On a spread basis, corporate paper is not particularly attractive, and it's true across the spectrum from high-grade and investment-grade to high-yield junk credits. The combination of thin spreads on a relative basis, and low interest rates on an absolute basis, contribute to a difficult environment for income investors. An unprecedented period of "zero interest rate policy" from central banks has contributed to corporations issuing an unprecedented level of sub-investment grade debt. We hope that all the buyers of that debt know what they are doing, or a lot of them are in an old Buick headed somewhere they didn't want to go.

Quality municipals have looked somewhat more interesting; to the point that we have, in fact, amazingly placed some select tax-free paper in tax-free accounts. That is a rare occurrence, and admittedly only in cases where we felt the offering was favorably away from the curve. In recent days, Puerto Rico has admitted their efforts have failed and they will be unable to pay their debt. We obviously have no exposure there, and perhaps similar comments apply to Illinois, California, or elsewhere. These are example reasons of why we think credit spreads will trend higher, to the advantage of the performance of quality paper.

Another recent opportunity in our eyes has been the utility sector, or utility stocks. Utility stocks fell 11% in the first half of this year anticipating “obvious” harm once the Federal Reserve starts raising interest rates. We’ve questioned that premise, and we’ve questioned the impact of one or two ¼% increases in short-term interest rates on stocks with 4-5% dividend yields and growing cashflow. So that income sector has become more interesting to us.

Over coming quarters, interest rates may or may not rise, but we have confidence that the oscillation between stocks and bonds shown in the chart will continue, providing some relative opportunities for investors who’d rather stay on the front porch instead of driving to Abilene.

Moving Economic Pictures

It seems all the world’s a stage these days, and it is not entertaining, it is unsettling.

Upstage Left

There are subplots to the Greek drama and the impending moves to remove the euro currency from Greece. We noted several years ago our suspicion that ultimately the euro does not survive. The politics are interesting to watch. Current Prime Minister Alexis Tsipras and his left-wing populist Syriza party are oil and water with Germany. The Greeks have voted and apparently said they wish to Exit...Stage Left. Our key conclusion is that any resulting strength in the euro (without Greece) may prove to be temporary as there are larger issues than just Greece:

Downstage Left and Right

The rate of unemployment in Spain remains almost as high as in Greece. Unemployment in Italy continues to climb, along with France. Any increase in interest rates will amplify the debt struggles across Europe, and there are anti-austerity movements growing in each of these countries. These are sources of stress. We look at the Five Star Movement in Italy and the far-right wing National Front party in France as examples of growing sources of discord. The “Greece issue” is not related to the size of its economy in 2015, it is about the euro in 2017. The next French presidential election is in April/May 2017 and the (very) early frontrunner is none other than Marine Le Pen of the National Front Party – eager to exit the euro. Not Portugal, France. The rhetoric precedes the election, and current actions with Greece precede that rhetoric. The European Union is in a deep crisis. This is a very delicate thing, and these factors influence what we do not invest in, rather than what we do invest in.

Centerstage

There is a growing dissonance in economic reports and quarterly corporate reports. Either an unprecedented period of extremely low interest rates has partly obscured deep weaknesses in global economies, or deep weaknesses in global economies have continued to require an unprecedented period of extremely low interest rates.

Economic reports have been sporadic recently, particularly with China, though U.S. growth should have returned to 2% in the second quarter from the negative slump in the first quarter. Six weeks ago, one could have looked at declines in wholesale sales, exports, new factory orders, retail sales, inventory-to-sales ratios and almost concluded the U.S. was heading into recession. At this writing, data reports have bounced back some, and frankly, this economy has been very frustrating for all of us. It’s unsettling, to feel like we are teetering into recession, then not, to

assume the Fed will not be raising interest rates, then will, and now maybe not. We are all data-dependent, and there is no robust trend in the data.

We expect both sales and earnings reports for this 2nd quarter to decline rather than grow, as do most analysts, and company projections for the second half of the year will be very important. What is not known is how eager or apathetic investors will be to exit the stage or tolerate possible disappointments with the corporate sales and earnings picture. This has been a very tolerant market, eager to remain in-step.

We are surprised there seems to be much agreement, many sentiment extremes, amongst investors holding various assets when the major global economies are dealing with significant and unsettling issues – implementing almost experimental, yet highly consequential, macro policies.

One hopes those sentiments are right, and one hopes the crucial policy decision makers are correct. The Federal Reserve said it wanted to follow a zero interest rate policy, the European Central Bank said the same thing, but Greece has voted and “said” they want to Exit...Stage Left. We will see what happens in the next 18 months.

It is easy to imagine investment committee decisions being made, to invest in assets or sectors where each participant harbored personal reservations, in this era of zero interest rate policies.

It is easy to imagine retirees collectively investing in securities they hadn't really planned to be involved with, because there seemed to be so few alternatives in this era of zero interest rate policies.

Corporate decisions to issue debt and buy back their own stock or acquisitions, even when board members harbored different personal thoughts, are possible in this era of zero interest rate policies.

The Abilene Paradox develops, at least for our purposes, when the players involved agree to do something that they actually had reservations about or in some cases privately disagreed with. On the front porch, the backdrop or umbrella sentiment influencing that situation was the desire of the young couple to accommodate the in-laws. In today's investment markets, the atmosphere influencing so many decisions is an environment of low interest rates and unprecedented central bank policies.

Such decisions can last a long time. Another feature is that people will only begin to reveal their reservations when the results start to go bad, and be surprised to learn that so many others were thinking the same as them all along...revealing that there was perhaps actually more agreement to exit the decision than to enter the decision.

I confess some unprovable suspicion that “Exit, or go to Abilene” is the essence of some financial decisions that many people on the planet are faced with.

-Brian

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