Positioning

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It's the Economy, Stupid

With stocks relentlessly rallying the past six months, skepticism about the sustainability of such a move is starting to build. There are also some cries about interest rates rising too fast relative to the fundamentals and that 10-year Treasury yields will have a hard time pressing far above 3%. Our view remains that stocks and yields are rising because the economy is getting better. Many people are having a hard time with the idea that the economy can grow with so much debt still weighing us down.

The fact of the matter is that real GDP grew north of 4% in the third quarter of 2013. While some of that growth was due to excessive inventory build, we are still likely to get fourth quarter real GDP growth above 2%. Not bad for an economy that is still feeling the effects of a 2% payroll tax hike a year ago and mandatory government spending reductions due to the sequester last April.

The bottom line is that the economy has been better than expected. In fact, Exhibit 1 (see page 2) illustrates just how much the data has been surprising on the upside relative to the consensus. Stocks like faster growth, bonds do not. It's that simple—and it's a big reason why we continue to recommend equities over bonds.

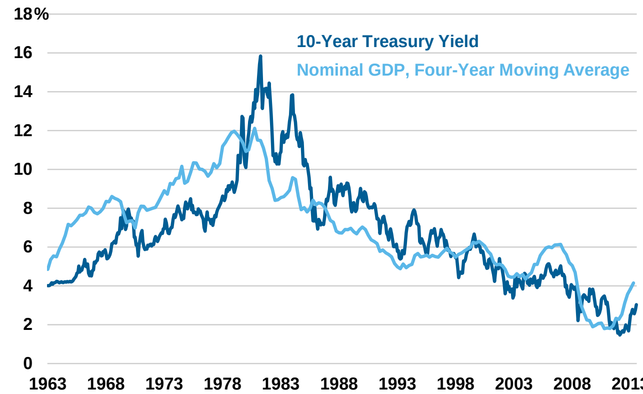
What could go wrong? These surprises have been led by activity in the labor market and housing, two of the hardest hit areas in the aftermath of the financial crisis. However, last Friday, the December employment report came in weaker than expected. The markets responded accordingly, with stocks falling and bonds rallying sharply. Some of the weak employment report can be explained by the severe weather during the month and seasonal trends around the holidays, but there is no sugar-coating the facts—the report was disappointing. We believe the data will turn positive again and prove the December jobs report as a pause rather than a change in direction, leaving us with a mild correction in stocks and interest rates that don't fall much further from here.

Ironically, the more significant risk to stocks could be if the data reaccelerate too sharply. So far, the market is taking the Fed at its word with respect to its forward guidance on when it will actually raise rates—at least 18 months from now. However, if the data continue to surprise on the upside, I would expect the bond market to challenge the members of the Federal Open Market Committee and raise rates for them. While that does not necessarily have to kill the economy or the stock market, it could create

Exhibit 1: US Economic Data Have Surprised to the Upside

Source: Bloomberg as of Jan. 10, 2014

Exhibit 2: Historically, US Treasury Yields Have Tracked Nominal GDP



Source: Bloomberg as of Dec. 31, 2013

significant volatility and a deeper correction in stocks than we have seen in quite a while as investors assess the impact of higher rates on growth. It appears that the economy can handle higher interest rates and, based on how stocks have traded during the past six months, the equity market can handle them, too. However, it's the speed of the rise in rates that concerns me more than the level. Therefore, the weaker-than-expected jobs report and subsequent decline in interest rates may help keep stocks on the right track.

How Important Is QE?

One of the comments I hear frequently from advisors and clients is that the only reason interest rates are so low and stocks so high is because the Fed is engaging so aggressively in Quantitative Easing (QE). Once QE comes to an end, their thinking goes, so will the rally in stocks and interest rates will shoot up. I beg to differ and continue to believe rates are determined primarily by economic growth while stock prices are determined by earnings.

Let's start with bonds by looking at Exhibit 2. This chart shows the 10-year Treasury yield plotted against the four-year moving average of nominal GDP for the past 50 years. As you can see, Treasury yields follow nominal GDP quite closely and have a hard time moving too far away for any meaningful period of time. Interest rates have been falling for 30 years because nominal GDP has been falling for 30 years. Most of this decline was due to falling inflation while more recently, it was due to subpar real GDP growth, not QE. After all, if rates are driven primarily by QE, then why did they bottom two months before QE3 even started?

For the past year, we have been saying that interest rates would rise because the global economy was healing. Notice how interest rates began to move higher in the summer of 2012 just after nominal GDP began to accelerate from very depressed levels. Furthermore, nominal GDP remains well above 10-year Treasury yields, suggesting there is little reason to expect declining rates. In fact, if we are correct about growth surprising on the upside during the next six months, we are likely to see more upward pressure on interest rates. That is why we continue to be underweight fixed income and recommend shorter-duration* maturities. Keep in mind that due to the deleveraging cycle in which we still find ourselves, it is unlikely that nominal GDP is going to reach 5% in the next several years. We think this will put a lid on the rise in rates just as it put a floor under them in 2012.

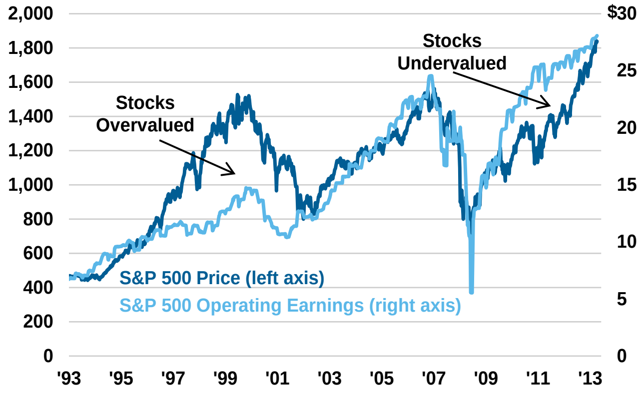
Now, let's talk about the stock market, where the belief in QE as the primary driver of prices is even more pervasive. As already noted, I believe the primary driver of stocks is earnings, both the absolute level and the growth rate. Exhibit 3 (see page 3) shows just how closely the S&P 500** has followed the absolute level of earnings. This is why Wall Street spends so much time and money trying to forecast them.

Notice how there is only one period during which stocks moved materially away from the earnings—during the tech boom. Otherwise, they have tracked closely. We now know that this period was definitely a valuation bubble. That bubble burst in March 2000, and the S&P500 fell 50% before bottoming in

For more information about the risks of Duration, please see the Risk Considerations section beginning on page 5 of this report.

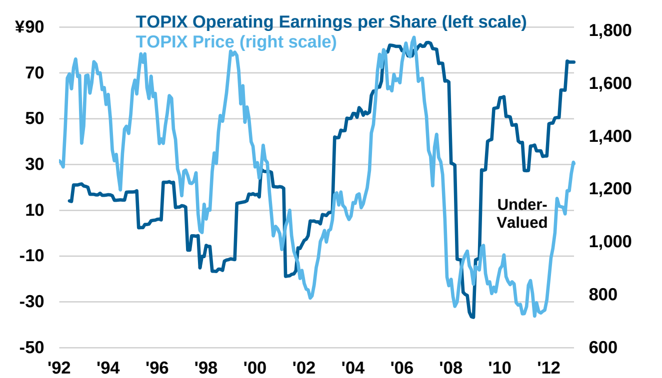
*****Please reference page 5 for index definitions.***

Exhibit 3: US Equities Appear Fairly Valued Relative to Earnings



Source: Bloomberg as of Jan. 9, 2014

Exhibit 4: Japanese Equities Have Underperformed Earnings Gains



Source: Bloomberg as of Jan. 9, 2014

September 2002, a price decline that was far greater than the downturn in profits. Stocks then got back in line with earnings in 2002 and tracked them closely. As earnings collapsed during the financial crisis, the S&P 500 traded lower by 50% for the second time in less than 10 years. Earnings recovered quickly and robustly, but given the two bear markets of the prior decade, investors went through a period of disbelief. This led to a period of undervaluation between 2010 and 2012, which has since been closed. At this point, stocks appear to be trading rationally and in line with the fundamental earnings picture.

Therefore, with stock prices supported by earnings, the question becomes what could derail the earnings outlook? Given our economic outlook, we think earnings should continue to grow and may even accelerate from last year's pace of 6%. Without an economic recession, it seems very unlikely that earnings will contract. One wild card, however, is that profitability of US companies is at a record high currently and may be peaking.

In order to determine if profitability is peaking, we need to determine what has been driving that profitability. For the past 10 years, the primary drivers have been lower interest rates, low capital spending and lower, or at least contained, labor costs. First, if interest rates rise from here, it is likely to have little impact on corporate profits in 2014 or 2015 because companies, over the last few years, have taken advantage of low interest rates to extend the maturity of their debt. Second, given the significant excess capacity in most industries, companies are likely to remain frugal with capital spending in the foreseeable future. Recent commentary from company management teams on earnings conference calls confirms this view. Finally, while the labor picture continues to improve gradually, there is still much slack in the jobs market. This is one reason why wage growth has been so anemic since the financial crisis—running about 2% per year, or about 2% lower than normal. We suspect hiring will remain positive but gradual, leaving labor costs well under control.

The bottom line is that profitability is likely to remain elevated until the next economic recession, when revenues fall short and operating leverage cuts the other way. For the record, Morgan Stanley & Co. Adam Parker's S&P500 earnings growth forecast for 2014 is 6% to 7%, depending on 2013's final tally. That's not exciting, but it's not negative either. We expect US stocks to appreciate more in line with earnings growth, with more dispersion across sectors and companies at this stage of the recovery.

In Japan, earnings are leading the stock market upward, but investors remain skeptical of the recovery, much like what happened in the US during 2010 and 2011. Japanese stocks have significant potential upside if they make gains in line with earnings (see Exhibit 4). This is one reason we remain overweight Japanese equities in our tactical asset allocation.

Are We There Yet?

We have been recommending shorter-duration fixed income for the past 10 months given our view that interest rates are on the rise. However, 10-year Treasury yields are now up almost 100% in the past eight months, which begs the question, are we there yet? We think 10-year yields are headed to 3.5% this year, so it's still a little early. However, it is time to start thinking about it because the move toward 3.5% could be fast and one needs to be ready to act if that happens. There is also a chance that longer-term interest rates don't rise much this year because of the strong demand coming from pension funds looking to lock in returns now that they are fully funded—one of the numerous positive side effects from the incredible stock rally of the past five years. Many companies and organizations with defined-benefit pensions are reaching fully funded status for the first time in 13 years and deciding to reduce their risk by matching their investment assets with liabilities via long-duration fixed income instruments.

As a result of this strong bid for longer-duration securities combined with a reduction of new supply, we are witnessing a sharp compression of the spread between 30- and 10-year yields even as interest rates rise. Normally, in a rising-rate environment, they would both be moving up at the same pace. This suggests that bonds with maturities of 15 or more years may be getting closer to fair value and therefore we think investors may start considering a barbell approach of very short-duration securities, say less than two years, and very long-duration securities. Many institutional investors have adopted a barbell strategy, which is why maturities in the middle, three to seven years, have underperformed during the past month. This is likely to continue, which is why we still recommend investors stay short duration with an eye toward some long-duration bonds as we start to approach 3.5% on 10-year Treasuries. However, given last week's strong rally in bonds—falling yields—on the back of the weaker jobs data, patience is warranted in pursuing the long-duration part of the barbell strategy. ■

Index Definitions

CITI ECONOMIC SURPRISE INDEX This index measures actual economic surprises relative to expectations. A positive reading means that data have been stronger than expected, while a negative reading means that data have been worse than expected.

S&P 500 INDEX Regarded as the best single gauge of the US equities market, this capitalization-weighted index includes a representative sample of 500 leading companies in leading industries of the US economy.

TOKYO STOCK EXCHANGE PRICE INDEX (TOPIX) This free-float-adjusted index tracks all domestic companies of the exchange's First Section.

Risk Considerations

Duration

Duration, the most commonly used measure of bond risk, quantifies the effect of changes in interest rates on the price of a bond or bond portfolio. The longer the duration, the more sensitive the bond or portfolio would be to changes in interest rates. Generally, if interest rates rise, bond prices fall and vice versa. Longer-term bonds carry a longer or higher duration than shorter-term bonds; as such, they would be affected by changing interest rates for a greater period of time if interest rates were to increase. Consequently, the price of a long-term bond would drop significantly as compared to the price of a short-term bond.

International investing entails greater risk, as well as greater potential rewards compared to U.S. investing. These risks include political and economic uncertainties of foreign countries as well as the risk of currency fluctuations. These risks are magnified in countries with emerging markets, since these countries may have relatively unstable governments and less established markets and economies.

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate.

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