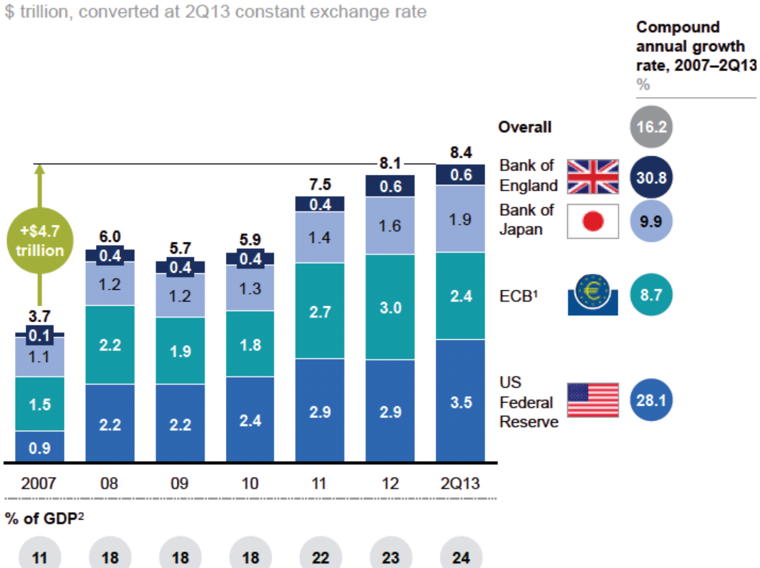
The Pop of the Bubble: Still Far Away

As a result of the Federal Reserve's expansive monetary policy, the US central bank's balance sheets have expanded by $2.6 trillion dollars- increasing at an annual rate of 28.1%.[1] Central banks around the world have followed suit with significant increases in their balance sheets (as illustrated by below graphic) - creating an easy money environment for the world's leading economies. Coordinated expansive policy of this enormous magnitude has not been seen before- and neither have many of the programs implemented by the central banks. There have been endless debates on the effectiveness of these programs. Given the complexities of interactions and factors which influence the markets, it is difficult to clearly and definitely measure effectiveness. However, we do believe you can identify some direct and indirect effects of QE on the markets- especially the support of stock prices.

Central bank balance sheets in the United States, the United Kingdom, the Eurozone, and Japan have expanded by $4.7 trillion since 2007

Total assets on central bank balance sheets (end-of-period values)

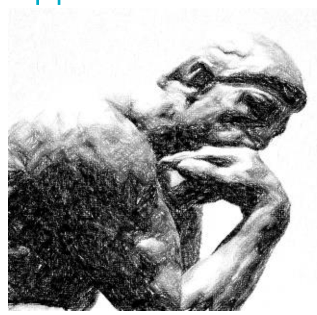
$ trillion, converted at 2Q13 constant exchange rate



1 European Central Bank; excludes gold and foreign currency.
2 Total assets as share of combined GDP.
NOTE: Numbers may not sum due to rounding.
SOURCE: US Federal Reserve; European Central Bank; Bank of England; Bank of Japan; McKinsey Global Institute analysis

A new study released this week by the McKinsey Global Institute states that there is little evidence to show that this easy monetary policy and the Federal Reserve's quantitative easing (QE) program has boosted stock prices. We disagree with the consultancy firm's

The Thinking Man's Approach



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In recent days the S&P 500 Index broke 1800, touching record highs. The S&P 500 is up 28% year to date. With sluggish global growth and mixed economic data many are surprised by this robust performance- and the market seems to keep going higher. An important factor which has helped boost the equity markets is the Fed's expansionary quantitative easing program. In this month's Thinking Man we discuss how – through boosting equity valuations and earnings; and encouraging flows from corporations and retail investors. While we detect the formation of a bubble in stocks, we are still far away from its end.

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1 McKinsey Global Institute, "QE and ultra-low interest rates: Distributional effects and risks" Nov. 2013

position, and believe that the Fed's easy monetary policies have played a large role in lifting equity prices- through boosting valuations and earnings of corporations, as well as encouraging flows.

Valuations of the Equity Markets

We agree with McKinsey & Co. that valuation metrics do not show current valuations as out of line with normal historic ranges. The S&P 500 is valued at 16 times projected 2013 operating profits of $109 and at 15 times estimated 2014 earnings of $120. That means that the "Earnings Yield" of the S&P 500 (the inverse of the P/E) is 6.7%. These are about equal to the long-term averages; however, these metrics look attractive when compared with:

- Short-term rates near zero;
- Inflation running well below 2%;
- 10 year Treasury rates of 2.7%;
- Average yields on Corporate Bonds of 3.9%[1]
- Average yields on Junk bonds of 5.9%[2]
- Equity Risk Premium (ERP): the ERP for large cap US stocks is around 4% (i.e. Earnings Yield minus 10 year Treasury rate). This seems attractive given yield of other assets.

We think that this ERP is highly affected by QE and all expansive global monetary policies. While McKinsey asserts that the ERP is singularly driven by the artificially created low level of rates created by QE (in particular the 10 year Treasury rate), we believe that there are other indirect manners in which QE has been key in supporting equities.

QE Has Boosted Earnings

QE has supported US companies by boosting their earnings- through lowering companies' interest expense and pumping profits in the financial sector

- Interest expense – companies have been able to issue corporate bonds at historically low rates, increasing profitability via a large decrease in their interest expense. Thus, companies are boosting profits in an artificial way. This positive contribution to a company's earnings is highly affected by QE policies.

Sales & Earnings Growth in S&P 500 by Sector

Data Annualized from Jan 1, 2011- November 15, 2013

Sector	Sector Allocation	Sales Growth	Earnings Growth
All Securities		2.1%	2.0%
Financials	16.2%	9.0%	19.5%
Industrials	10.8%	3.9%	6.5%
Telecommunication Services	2.4%	2.8%	4.2%
Utilities	3.1%	-1.3%	3.5%
Consumer Staples	10.2%	3.7%	2.4%
Health Care	13.1%	6.3%	1.6%
Consumer Discretionary	12.5%	3.7%	1.5%
Information Technology	17.7%	4.2%	-1.7%
Materials	3.5%	-1.2%	-11.0%
Energy	10.5%	-9.1%	-11.7%

Source: Bloomberg

- Profits by non-financial companies have been slightly negative since 2011 – if we strip-out the 16.1% representation of financial companies within the S&P 500, the market

[1] BOFA ML US Corporate BBB Effective Yield as of 11/20/13
[2] BOFA ML US High Yield Master Effective Yield as of 11/20/13

has shown no profit growth. The table from Bloomberg on the previous page clearly demonstrates this trend- overall there are lackluster sales and earnings growth in the S&P 500 companies, with the exception of the financial sector. Financials have been driving profits and sales growth in recent years. The sector has been making a recovery after its battering in 2008. Over the last 2 years, banks have been releasing loan-loss reserves in an amount of $112 billion- as a consequence of QE. This goes directly to bank profits – and is a major contributing factor to the almost 20% earnings growth the financial sector has seen since 2011.

Flows into the Equity Markets

The number of companies engaging in both a dividend and a buyback over the trailing twelve month period (as of September 23, 2013) has reached its highest level since at least 2005 (71% of the S&P 500 index).[1] According to Bloomberg, buybacks thus far in 2013 have reached a six year high of $505 billion.[2] What is QE's influence in this? The low rate environment created by QE has encouraged corporations to issue low-cost debt and gives them funds buy back shares. Take Apple for example- in April of this year, Apple was sitting on $145 billion of cash and still chose to raise $17 billion in a record size bond deal (at that moment, the largest deal ever), borrowing money for the first time in almost 20 years. They paid interest rates near the low-cost debt of the US Treasury, and used funds to increase dividends and buy back stock.[3] This strong participation of corporations in the equity markets helps boost stock prices.

Year-to-date the inflows into US equity mutual funds are +$450B - this is more than the combined inflows since the bottom of the S&P 500 in March 2009 until the end of last year. We think we are only at the beginning phase of this phenomenon, and we are indeed in the process of a Great Rotation that slowly but surely has begun to pan-out. These inflows are also being driven by a new market participant- "mom and pop." After years on the sidelines, we see retail investors starting to participate in the stock markets again, after being sidelined for many years, scared off by the 2008 crisis. Why now? Retail investors tend to be performance chasers. With such strong performance of the equity markets, buoyed by QE, investors finally feel comfortable. With plenty of cash to invest, retail investor flows will boost markets higher, and in our view, are early signs of a forming bubble.

Conclusion

While we think we are in a secular bull market in stocks, there are elements of a bubble being formed as a consequence of QE. We think the market multiple can expand to over 20x earnings before there is a market crash. We are continuously discussing the effects and timing of QE. While we feel Tapering will start within the next 3-6 months, the first tightening will come in 12-18 months. However, since 1977, the Fed has hiked rates 5 times to cool the economy. The S&P 500 then took over 3 years to peak gaining on average over 30%. While we can detect the formation of a bubble in stocks, we are still far away from its end. We foresee a day when we will recommend all our clients to hit the exit button. But that day is far away at this point.

[1] Factset, "Buyback Quarterly: S&P 500," September 23, 2013
[2] Bloomberg, "Buybacks to Dividends at Risk With Record-Low Yields Ending," September 3, 2013
[3] New York Times, "To Satisfy Its Investors, Cash-Rich Apple Borrows Money," April 30, 2013

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