A Healthy Correction in the S&P 500

In 2013, global equity markets were up over 23%, and the US equity markets lead the charge with the S&P 500 up over 32%. The S&P 500 only experienced four corrections in the year 2013, none of which exceeded a drop of 5%. There were expectations of a larger correction in 2013, but this never came.

BigSur, along with many other investment houses, started 2014 with a positive outlook on US equities for the year. The start of 2014 has been ugly: in the second half of January, the S&P 500 experienced a correction of 5.8%, a lower drop than at any point last year.

Corrections in the S&P 500 since Jan 1, 2013		
	% Drop	# of Days
May 21 - June 5	-3.6%	10
June 18 - June 24	-4.8%	4
August 8 - August 27	-4.6%	17
September 18 - October 9	-4.0%	15
2013 AVERAGE	**-4.3%**	**11.5**
January 15 - February 3 (2014)	-5.8%	12

Source: Bloomberg

This has shaken some investors, and questions have arisen on whether this goes beyond a simple correction but signifies a change in trend. Below are four risks which face the US equities markets:

1) China: a potential credit crisis?
2) Emerging Markets: another 1990s like crisis?
3) Europe: continuation in the recovery?
4) US Corporate Profits & Valuations: no room for growth?

In this Thinking Man, we discuss and evaluate each of these risks, with a heavy focus on China and its shadow banking system- as this is our #1 concern (due to the usual lack of transparency). Overall, we believe that while these risks do pose some concerns, they are not threats to the bull market and we maintain our positive outlook on US equities. This recent sell-off should be characterized as a healthy correction for US equity markets.

China: More Defaults Likely, Credit Crisis Unlikely

In the second half of January, it was announced that a trust product offered by CCTC (China Credit Trust Co.) was in fear of defaulting on January 31. If it were to default, it would be the largest default of

The Thinking Man's Approach

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We've seen investors concerned about the recent sell-off, wondering if this signifies a change in trend. In this month's Thinking Man, we discuss the broad risks facing the bull market in US equities. We believe that these risks do not pose serious threats, and instead were causes for investors to take some risk off the table and provide a healthy correction for US equity markets.

For more information, including how we are positioning our equity portfolios, please contact your Investment Advisor or inquire at:
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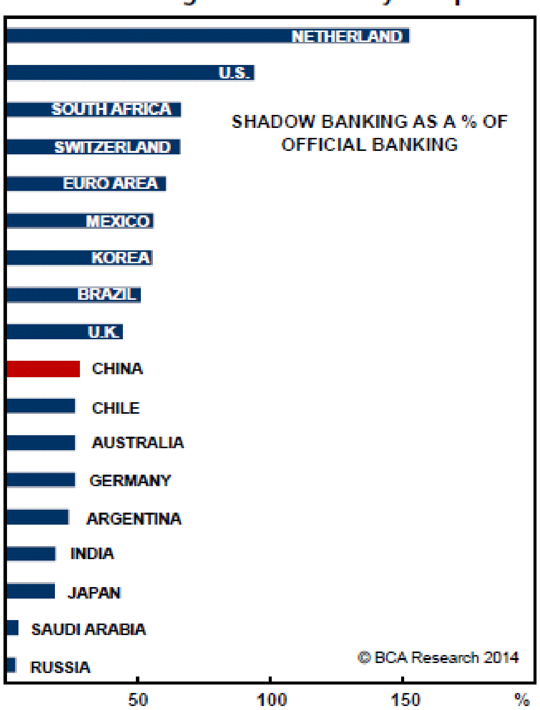
such a product in China, and questions on whether this would set off a credit crisis in China quickly led to a sell-off in US equity markets. Ultimately a bailout of the product was secured, but investors are still uneasy about the Chinese shadow banking system and whether more defaults will lead to a credit crisis or systemic banking problem in China, which could potentially spread across the world.

We can start by defining the Chinese shadow banking sector- it has a similar function to our wealth management industry- it is the system where financial intermediaries transfer savings into investment. Unlike the US wealth management industry, which mostly invests in public markets or financial securities, in China the investments are mostly in real business ventures, including infrastructure, and are often project-specific. The industry firms are also different: instead of numerous private firms (hedge fund, mutual fund, private equity fund firms), in China this is consolidated to 67 trust companies (which are incidentally not allowed to make levered bets). These trust companies manage US $1.7 trillion and they are often jointly owned by private investors, state-owned companies, and in some cases, local governments. The remaining $1.5 trillion of assets that make up the shadow banking sector is managed by state banks in liquid money market like instruments.[1]

The state's role in the shadow banking system is a key point in preventing a credit crisis in China. With so much state ownership of the banking system, it would be very unlikely that the Chinese government would allow a major credit crisis to develop, given that they have more than enough resources to recapitalize the banks. The government could potentially leave some less significant companies to go bust, especially as a control experiment to reduce the issue of "moral hazard".

Shadow Banking: A Cross Country Comparison



NOTE: CHINA AND U.S.'S DATA ARE BASED ON BCA ESTIMATE, AS OF THE END OF 2013 AND 2013, Q3 RESPECTIVELY. OTHER COUNTRIES' DATA ARE BASED ON GLOBAL SHADOW BANKING MONITORING REPORT 2013, FINANCIAL STABILITY BOARD, AS OF THE END OF 2012.

Investors have also questioned the size of the shadow banking system; some fearing that it could be so large that it could quickly spin out of control. In fact, it represents 30% of the formal banking sector, which is substantially lower than most major economies (see chart on the left).

Defaults will most likely continue in Chinese trust products. However, given the limited leverage in these products and that counter-party risk is highly controlled, defaults should be seen as isolated company defaults (similar to a US junk bond default) and not generate contagion risk. Thus, a

[1] BCA Research, "BCA Special Report: On Chinese Trusts and Shadow Banking," February 5. 2014

potential credit crisis should be avoided. In fact, only about 10% of total trust company assets are claims on other financial institutions

EM: Tough Road Ahead for the Weakest

The turmoil EM currencies have been facing in recent weeks and broad sell-off of EM assets has panicked investors into questioning whether we are facing a major crisis in Emerging Markets, similar to that of the 1990s. Our view on Emerging Markets is that they will have a difficult road ahead as the Fed "tapers" its asset purchases and as such monetary policy tightens. But the picture will be mixed- we continue to believe selectivity is an important theme for EM countries (this has been a view we have maintained for months, as highlighted in our piece published in August 2013, "Emerging Markets: Time to be selective"). We continue to like Mexico (as first discussed in our TM #6 written in May 2013). We see bright spots in countries like South Korea, which boasts a healthy current account surplus, large currency reserves and a limited fiscal deficit as well as companies like Hyundai and Samsung which have become strong global players in their markets. We see problems in countries with high with high current account deficits like Brazil and India which are also facing issues with productivity (Brazil) and structural reform (India). Other problems lie in countries with large foreign currency debts, like South Africa and Turkey.

In addition to the fact that a broad EM crisis is unlikely given the differing situations of the EM countries, it is also important to note that the same situations which contributed to the 1990s Emerging Markets crises are not the realities in EM today. Very few countries have pegged exchange rates, making them less vulnerable to the speculative attacks which occurred during the 1997 Asian financial crisis. As a whole, EM countries have less external debt than they did in the 1990s. Emerging Markets only account for roughly 13% of total S&P sales. US profits are much more heavily exposed to the developed world, especially the euro area. This party explains why US profits have been able to increase by 11% since 2012 in the face of EM weakness.[1]

Europe: Recovery Continues

Recovery has been the main story in Europe for the last few months- a theme which contributed to positive performance in both US and European equity markets. Events in the first few weeks in January brought about doubt in some investors on the strength of this recovery- including data which showed that inflation had dropped slightly in the euro zone in January, prompting investors to panic that deflation and lowering consumer prices could derail the recovery. This fear was eased by ECB on February 6- rates were kept the same and ECB President Mario Draghi announced deflation was not a risk for the euro zone currently

Earnings generated by European companies or European units of global companies has been mixed, fueling doubt for some investors, and causing sell-offs in both the US and European equity markets on some days. It is important to remember that companies are reporting for the past quarter, when the recovery was still in nascent stages. We see continued evidence of a growing and stronger European recovery. In January, manufacturing activity picked up across the Eurozone – we saw the

[1] BCA Research, "US Equity Strategy: Risk Repricing," February 3, 2014

highest PMI (Purchasing Manufacturers Index) level since May 2011. Expansions continued in Germany, Italy, Spain, the Netherlands, Australia, Ireland, and for the first time since August 2009- Greece.[1] We do not see a significant pause or change in trend for the European recovery.

Corporate Profits & Valuations

Over the past four years, we have seen a surge in US corporate earnings. With profit margins at very high levels, investors are questioning whether companies will be able to boost profits even higher. The explosive growth in profits over the last years have been fueled by a very specific set of economic conditions including very low interest rates and weak wage growth- but against a very weak global macro backdrop. This backdrop is now one of a global economic recovery, where we could see a modest 3-4% in top-line growth (i.e. Sales), while profit margins can stay flat and as such earnings growth can sustain a 5-6% pace.

At the end of the year, we saw the S&P 500 reaching 1850, a level technically overstretched where valuations topped 16x forward earnings. At that time, questions of an equity bubble were frequently posed by investors and analysts, seeing a market that popped over 30% with very insignificant corrections. After this recent correction, the market is trading at 15x earnings, a level we feel is more close to fair value, helping ease overheating concerns. With a earnings yield of around 6.7% the S&P 500 still offers an interesting equity premium to high grade bonds, to corporate bonds as well as to high yield bonds.

Conclusion

After a year like 2013, when we saw an ever-rising equity market, investors were a little shaken by the negative performance of the markets thus far in 2014. While the questions around China and Emerging Markets were valid, we do not believe they pose a serious threat to the US equity markets. These were justifications for investors to take some risk of the table. The European recovery continues on; US corporate profits are set to benefit from the global economic recovery, and valuations which are closer to fair value help ease fears of an overheating equity market.

We believe that we can continue to see multiple expansion in the US equity market over the next two to three years- to 18x from below 15x where we are today- and we also see US Equity and Europe Equity markets as inexpensive on a relative basis vs. Treasuries, High Grade Bonds and High Yield Bonds. Given these views we see this as a buying opportunity.

[1] Markit, "Markit Eurozone Composite PMI- final data," February 5, 2014

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