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A Hated Bull Market

The market continues to grind higher despite negativity & uncertainty

Analyzing fundamental, global macro and technical factors, we still think the US equity market will continue to grind higher in the short-term, probably finishing 2015 with a 5-8% total return. We call this a "hated" bull market: despite signals that we are still in positive territory for equities, investors are bearish and full of negative sentiment. Just last week there was study published which found that global institutional investors see equity market risk as the single largest risk to their portfolios.

We are cautious about the long-term health of the equity markets, as companies are not taking significant steps towards building long-term growth. CEOs have low "animal spirits" and are uncertain about the future - they don't want tie up cash flows for the long-term – and they are also being pushed to have a short-term orientation by activist investors. However, owners of financial assets are benefitting in the near-term. Equity shareholders are benefitting from companies' strong operating cash flows are going towards buybacks, dividends and M&A activity. Other technical factors, such as fund flows and high cash holdings are also positives for equities. We discuss the factors contributing to the "hated" bull market in this month's Thinking Man's Approach.

Fundamental Factors

Low "animal spirits" favor M&A activity, buy-backs & dividend growth vs. long-term capex

Goldman Sachs calculates that margins on the S&P 500 are about 9%, which in normal times would have sparked a corporate investment boom. This was the hope of policy makers, but it did not happen. In contrast, investment as a percentage of operating cash flows has fallen from 29% to 23% in the last 5 years. On June 24th, the OECD released its "Business and Finance Outlook 2015," which shows that companies see a big risk to capital spending. The "hurdle" rate of return required to undertake new capital spending is very high, despite the historically low interest rates. This is weighing on long-term structural growth. Economic growth is stagnating in many regions due in part to this lack of investment.

CEOs are quite gloomy about the growth outlook in this world of Quantitative Easing (QE). This is because QE spurs supply and not demand and QE keeps non-economic businesses funded (instead of letting them die). Stricter regulations that are a burden for small businesses do not help either.

The Thinking Man's Approach

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Ignacio Pakciarz | CEO
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Investors around the world are feeling a sense of unease about the equity markets and this week's events surrounding Greece does not help build confidence in the markets. Bearish sentiment permeates the investment environment, with retail and institutional investors alike sharing negative views on the markets. Despite the noise surrounding Greece this week, we continue to believe that the market will grind higher and we are not done with the bull market just yet. We have not hit levels that signal serious overvaluation, and equities will be supported by corporations using cash flows to benefit shareholders (via dividends, buybacks and M&A activity) as well as future flows. The market will continue its grind higher over the "wall of worry" as it has done for the last few years.

For more on how we are positioning our portfolios, please contact your investment advisor or email:

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"However (and this is when Behavioral Economics gets into play): CEOs need to find other ways to deploy their increasing cash hoards to justify their compensations. So what are they doing? Buying their own stock, buying other stock or giving back dividends to equity holders: actions that do not promote long-term investment growth, but for the short-term are positive for those who hold equity assets.

Chart 1

Source: OECD. Financial

Record M&A activity: Since the global financial crisis of 2008, profit margins have surged, and one way that companies have been spending cash flows is purchasing other companies. Many companies are not confident enough about the future to put their capex to work and reinvest in long-term growth. They do, however want to do something with their reserves, and given the supportive M&A environment of growing confidence, a stable economy and cheap financing, acquiring quality companies seems like a good option. Global mergers & acquisitions (M&A) activity during the first quarter of 2015 was at its highest levels since 2007. The value of M&A deals was $811 billion, up 21% over the same period a year ago. The US has been at the center of this, accounting for about half of all M&A activity (US: $399 billion).[1] This suggests the market is reaching the latest stage of the bull market, not that it has peaked.

Buy-backs and dividend growth: Blackrock and other investment houses project that combined outlays on dividends and buybacks will exceed $1 trillion in 2015 in USA, more than the expected spending on operations and research. This trend is demonstrated by Chart 1 above, showing that dividends & buybacks as a percentage of sales (of US companies) has increased steadily over the last decade. Companies can afford to pay more dividends and buy back their own stock. Equity holders have been beneficiaries of this trend, earning large dividends and benefitting from a boost in stock prices supported by share repurchases by management. This trend will likely continue, especially as activist investors continue to exert significant influence over US corporations.

The mounting importance of activist investors: Over the last few years, activist investors have become an important force. They have influenced companies to have a strong emphasis on short-term results for shareholders, favoring special dividends, increasing dividends, buy-backs and cost cutting measures.

Who are activist investors? Those who gain the support of other investors and proxy advisors to remove management, to gain influential board seats, and/or to make sure company strategy is in the best interests of shareholders. This may at times add to company efficiency when incumbent management is either idle or pursuing plans that are less sensible or effective when compared to superior strategies of activists. Activist investors are having more and more weight in the market. Companies are even assuring activist investors that they are pursuing their recommended strategies to keep them from taking board seats. The activist way has paid off: activist hedge funds

[1] Arash Massoudi, Joseph Cotterill, and James Fontanella-Khan, "Dealmakers have fastest start since 2007," Financial Times 30 March 2015

outperformed all other hedge funds in 2014 and are on track to do the same in 2015.[1] These results are positive for equity holders in the short-term, but many activist investors are short-term oriented, and tend not to be long-term or strategic focused.

Valuations not yet fully stretched; Peak is still to come based on the current moment in the cycle

Corporate cash flows going into equities via financial investments in M&A, buybacks and dividends is positive for the equity markets in the short term. Two other positive fundamental factors: we believe that valuations can still grind higher before being overvalued, and we are not yet in the time of the cycle which signals the peak of the equity markets.

US equity market valuations are not yet extreme, especially in terms of relative valuations. Our concerns of serious overvaluation would come at a market multiple above 20x (Price/Earnings Ratio, also known as P/E). The S&P 500 current P/E is 18x and the forward looking P/E is 14x. While these figures are slightly higher than historical levels, they are not particularly stretched. Also, it is rare that a bear market would begin at this current stage of the economic and the interest rate cycles. Historically, the equity markets have peaked in a range of 6 to 24 months after the Fed's "lift-off" of rates (with the average peak coming 18 months after the rate "lift-off"). If this trend continues, we still have some time for the markets to continue their ascent.

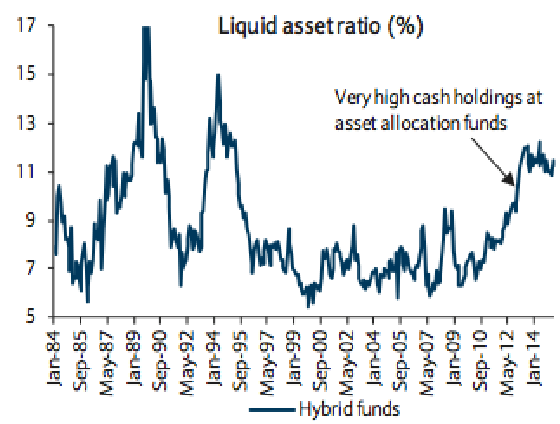
Technical Factors

Fund Flows Favor Equities

The "Great Rotation" (from bonds to stocks) that some analysts predicted when the Fed started to taper, has yet to materialize. While we are now waiting for the Fed's "lift-off" from the existing zero interest rate policy, flows are likely to continue to favor equities over bonds. We've seen signs of this over the past few weeks: as of June 25, there was the biggest three week outflow from all bond funds over the past 2 years ($20 billion redemption). Meanwhile, equities have seen positive inflows from 4 out of the last 5 weeks (last week alone had $4.6 billion of inflows).[2] Cash seems to be "King" (as evident through investors' enormous cash hoards), but investors will be pressured to put money to work in an environment where staying invested will likely outperform. Thus, flows favor Equities.

Chart 2

Cash holdings at asset allocation funds are very high already



Source: ICI, Haver, Barclays Research

Cash holdings at highs and climbing the "Wall of Worry"

Mutual funds that specialize in allocating between asset classes (known as multi-asset class funds, now managing $2 trillion) are "underweight" bonds, "neutral" equities and "overweight" cash. See

[1] Activist Funds (YTD 6.9%) vs. All Hedge Funds (YTD 4.4%) as of 4/30/15. Preqin, "Activist hedge funds continue to outperform in 2015," June 23, 2015

[2] Bank of America Merrill Lynch, "The Flow Show: From Feast to Famine," June 25, 2015

Chart 2 on the previous page which demonstrates the high allocation to cash in these types of funds. Anecdotal data and surveys show that the "underweight" position in bonds is here to stay and funds are deploying gradually into stocks, another technical positive for equity markets.

What about investor sentiment? Both institutional and individual investors have distrusted the rally. Allianz Global Investors published their annual "Risk Monitor" report in mid-June, which surveys 735 institutional investors all over the world, including pension funds, foundations, endowments, sovereign wealth funds, and family offices. The purpose of the survey is to understand their views towards risk, portfolio construction and asset allocation. What did these investors say is their greatest risk? Equity-market risk. This trumped interest-rate risk, credit risk, commodity risk, inflation risk, FX risk, liquidity risk, counterparty risk and event risk.[1] We see evidence of this when looking at net equity buys from Bank of America Merrill Lynch clients (see Table 1). Hedge Funds, Institutional, and Retail clients have all been major net sellers of equities over the last 5 years, despite positive performance of the markets. Hedge Funds and Institutional clients continue to be net sellers this year. Only Corporate clients are significant buyers of equities. While this data is only from one institution, given the size of prominence of Bank of America Merrill Lynch, we believe this could be a good representative sample.

Table 1: Cumulative net equity buys of BofAML clients ($MM)

Client	YTD as of 6.16.15	Last 5 Years (2010-2014)
Hedge Funds	(1,391)	(20,336)
Institutional	(4,509)	(60,621)
Retail	1,180	(121,026)
Corporates	19,004	181,561

Source: Bank of Americal Merrill Lynch

While the stock market is vulnerable to a fall, this has been the case for quite some time and despite this, we continue to climb a "Wall of Worry." Regardless of cautious sentiments and concerns on long-term growth, the markets continue to climb higher.

Conclusion

The effects of QE are positive in supporting and inflating asset prices, but "real" economic growth struggles. QE is making owners of assets rich, but not convincing corporate CEOs to make long-term investments. Rather, they are focusing more on more on buybacks (which are changes to the capital structure as companies borrow cheaply to reduce their dependence on more expensive equity financing); using more of their cash hoards buying other companies' stocks (M&A), and giving back in the form of dividends.

We do think the party will end badly, but we seem to be far away from that point. The history of the latest two market booms and busts shows that cold economic reasoning can take a long time to make itself felt in the stock market, especially with the global central banks' intervention. We believe this hated rally shall continue to grind higher.

[1] Allianz Global Investors, "RiskMonitor Study," June 16, 2015

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