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U.S. Equity Markets:
Don't Ignore the Positives

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As life-long believers that the best means of achieving superior long-run investment returns is through "bottom-up" research on a stock by stock basis, we rarely contribute to the deluge of "Market Outlook" pieces that seem to proliferate in our industry. But given the full-blown obsession with the U.S. fiscal situation that has developed in the financial media (which feels eerily reminiscent of the Y2K hysteria of 13 years ago), we believe it is appropriate to pass along a few observations that highlight some of the more positive underpinnings of the equity market as it moves into 2013.

Consider:

- The Fed's ultra-low interest rate policy has pushed mortgage rates lower, providing a modest lift to house prices and encouraging mortgage refinancing that raises disposable income. At the same time the central bank's action has to some extent enhanced the collateral value of the banks' mortgage book.

- The Fed's monetary policy is clearly directed at moving investors out of low-risk assets such as cash and bonds into higher-risk assets, especially equities. Based on the fund flows we have seen in 2012, this has not yet happened.

- The employment picture is improving with a consistent growth in jobs. Now that the Fed has indicated it will continue its quantitative easing program until the unemployment rate is below 6.5%, it seems likely that the gradual improvement in job statistics will persist.

- Both consumers and corporations have made big strides on the deleveraging front. Consumers have reduced borrowing while corporations, already flush with cash, have taken advantage of low rates to actually borrow more, lowering overall funding costs and extending maturities to the benefit of their balance sheets.

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- On the energy front the surge in domestic oil, and especially shale gas production will have a major impact on the economy: reduced dependence on foreign energy, reduced costs for manufacturers, and positive employment benefits. According to Dow Chemical, U.S. manufacturers have announced more than $90 billion worth of investments in this country to take advantage of its cheap natural gas.

- Even after a strong 2012 for U.S. equities, with the S&P 500 Index rising around 16%, stock valuations still look very reasonable, especially when compared to bond yields. The inflation-adjusted earnings yield of equities is approximately 5% while the inflation-adjusted yield of the ten-year Treasury bond is roughly zero. This partly explains why U.S. companies have invested very substantial amounts in share buybacks, boosting earnings per share and potentially offering support to the stock price. This trend looks set to continue as corporate capital expenditure, which slowed in the third quarter of 2012, shows few signs of recovery at present.

To summarize, we are certainly not blind to the risks facing investors. Chief among these: the dampening effect of higher taxes and lower government spending; the longer-term inflation risks from money printing (probably not an issue in 2013 due to under-utilization of capacity and of the labor force); the risk that current “peak” margins could compress, and other potential challenges from geopolitical risk and natural disasters. It is also worth pointing out that we are almost four years past the last fear-driven market bottom of March 2009, and these “panic attacks” seem to hit the equity markets about every five to eight years.

Yet rather than be paralyzed by these risks, our bottom-up investing approach directs us to make portfolio changes based on company-specific circumstances as they unfold. There is more than ample evidence that investment strategies predicated on macro themes and geo-politics ultimately come up short compared to those which focus on company- level microeconomic considerations. On balance, we continue to see clear signs of economic progress and corporate value creation, and thus remain confident that our approach should yield attractive upside participation in our base case expectation for rising stock prices, while offering substantial protection of capital should market fundamentals unexpectedly weaken.

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