Central Banks Gone Wild

As regular market observers and followers of Tandem Investment Advisors, you all undoubtedly found the first month of 2015 to be as utterly exhausting as I did. Two weeks into the New Year, the Swiss National Bank lifted its cap on the Franc's value, which had been pegged at 1.20 EUR/CHF for the past two years. In the immediate wake of the bank's announcement, the Franc shot up 40% against the Euro before closing the day up nearly 20%. Such a dramatic appreciation is roughly the equivalent of a 20 standard deviation move. To put the statistical improbability of the Franc's rise into perspective, a much lower standard deviation move of 7 would occur only once every billion years. You better believe that with this unprecedented event came devastating casualties, particularly in the FOREX market, where firms and individuals often operate at 50 to 1 leverage – a ratio that lends itself to accounts being wiped out by relatively small moves. For example, FXCM, one of the United States' leading online FOREX trading brokers needed a $300 million bailout from Leucadia National to help meet its capital requirements. Moreover, several retail currency brokerage firms around the world declared bankruptcy. I can promise you that the actions taken by the Swiss National Bank were not some flash in the pan; instead, they represent the beginning of a trend. If you don't believe me, consider this fact: In January alone, 14 central banks cut rates. The race to the bottom has officially begun! Due to this central bank intervention, we now live in a world where negative sovereign yields are quickly becoming the norm. The following are just a few staggering figures that represent my point: In Switzerland, there is a negative yield all the way out to the 10-year maturity. That's right. You now have the luxury to pay to hold a 10-year Swiss bond. In Germany, negative yields are projected through the 7-year maturity, while the 10-year and 30-year yields 0.11% and 0.88%, respectively. In Spain where the unemployment rate is close to 24%, the 10-year yields 1.49%. There have to be unintended consequences of this unprecedented central bank interference, right? More specifically, what effect will their actions have on the U.S. stock market? Quite simply, the answer is more volatility than what we have witnessed over the past year.

For the most part, volatility has not found a place in U.S. equity markets, but since October, it has been slowly picking up, even as the S&P 500 and DJIA were reaching new highs. On July 3, 2014, the VIX hit 10.28, its lowest mark since January 2007. At the time of writing this column, the VIX sits at 20.97, 104% higher than that July point. Volatility is definitely present, even in our equity markets. The following table shows the intraday ranges of the S&P 500 for January 2015 versus all of 2014. Granted, the sample size is small, but the comparison is nevertheless striking.

	JAN 2015 (20 trading days)	2014 (252 trading days)
Intraday range (+/- 1%)	18 days (90% of the time)	78 days (31% of the time)
Average intraday range	1.49%	0.86%

Yet another indication of increased volatility has been the recent non-utterance of the very popular 2014 tagline, "get paid to wait." Throughout last year, you could not go a day without hearing some financial pundit or commentator say or, more likely, simply repeat the phrase on TV when referring to a company's dividend or stalling fundamentals. In a sense, the tagline carried some weight in 2014. Last year, volatility was extremely low, and many stocks or indices as a whole did not experience extreme price fluctuations. So, it is true that in a low volatility world you can "get paid to wait," but this investment strategy gets thrown out the window when volatility increases. Take, for example, the blue chip stocks listed in the table below. I am positive that the tagline “get paid to wait” was used in reference to each one at some point during 2014. For hypothetical purposes, let’s assume that you took a get-paid-to-wait approach to these companies’ stocks, purchasing them before each company released its earnings announcement. I have illustrated below how long it would take for you to recoup the annual dividend for each company, based on each company’s recent low stock price as well as its stock price immediately before its latest earnings announcement. In this hypothetical, your capital loss dwarfs your dividend payment.

- Proctor & Gamble	2.0 years
- Caterpillar	2.5 years
- JP Morgan	2.8 years
- Microsoft	5.4 years

It is easy to lose several years of a dividend payment overnight based on the magnitude of the stock price drawdown. For these reasons, I would warn against using taglines or catch phrases, including "get paid to wait," as investment strategies, especially in today's increasingly volatile environment.

In my column last month, I suggested that volatility was on the rise when pointing out that 2014 saw essentially every other market (i.e. credit, commodity, etc…) disconnect from the U.S. equity markets. I noted that these other markets were signaling some type of slowdown in our economy. In January, we saw a slew of economic indicators slow relative to their prior readings. In addition, the quarterly earnings reports so far have been less than stellar. Companies have pointed to slowing growth overseas and the strengthening dollar as the primary culprits. Below is a table illustrating the direction of S&P earnings estimates for Q4'2014 and 2015.

	Q4'2014	2015
9/30/14	$32.24	$136.07
12/31/14	$30.04	$130.99
Current	$29.51	$121.31

Based on the direction and magnitude of these earnings projections, we at Tandem won’t be rushing out to pay premium multiples for most companies. And nor should you. If you have followed my monthly column or Tandem’s quarterly newsletter over the past year, then you know that these figures don't come as a surprise to our firm. In fact, our quantitative models detected this growth-slowing trend more than a year ago. Based on the accuracy and reliability of our models, we became net sellers in 2014. We were once again net sellers during the first month of 2015, given the continued trend of valuations increasing even in the face of slowing earnings growth. Since growth appears to be decelerating at an accelerating rate, prices will need to fall farther before we would find valuations attractive enough to entice us to be net buyers. In the meantime, cash is not a bad asset to hold. It enables you to preserve your capital until the right time to buy – when fundamentals and prices are more equally aligned.

--Billy Little, CFA

"It requires a great deal of boldness and a great deal of caution to make a great fortune, and when you have it, it requires ten times as much skill to keep it." ~ Ralph Waldo Emerson