The Market Mystery

Party like it's... 2014? After a disappointing January where the S&P fell 3.1%, it followed up with a 5.5% increase in February. If you are experiencing some déjà vu, you are not alone. In 2014, the S&P started with a decline of 3.6% to only be followed up with a gain of 4.3% the next month. If history is any guide, we may be in for another respectably positive year for the U.S. equity markets despite what fundamentals might say. Unfortunately, that is where the similarities end.

Since the start of the year, 2015 S&P 500 earnings estimates have declined 9.7% and estimates for the 1st quarter of 2015 have declined 12.3%. The current 1st quarter estimate would imply a year over year decline of 1.9%. If you recall in the 1st quarter of last year, we dealt with a climate phenomenon dubbed the Polar Vortex. The Polar Vortex apparently caused all business in the U.S. to come to a screeching halt with 1st quarter GDP registering a 2.9% drop. The residents of Boston may argue that the weather this year has been far worse than last year. However, as a whole, the weather around the country hasn't been nearly as severe. With that being said, it is a little disconcerting to see 2015 1st quarter earnings expectations imply a negative year over year growth rate considering the weak weather induced comps from the 1st quarter last year. Some would point to the strength of the U.S. dollar or the sharp drop in oil prices for the decline in earnings expectations. While these two factors will have a negative effect on earnings, there are more issues bubbling under the surface. For starters, greater than 70% of U.S. macroeconomic data points missed estimates in February. In addition, of the companies who have already reported earnings this quarter, 80% of our closely held positions have a lower earnings estimate over the next 4 quarters than they did before reporting their most recent quarterly results. These two facts are absolutely staggering! If economic and earnings growth ultimately leads to higher future stock prices, what could be causing U.S. equity indices to make all time highs practically every day in the face of decelerating growth or outright contraction in some instances? The answer lies in sheer trading momentum and corporate stock buyback announcements.

Trading on momentum can be a very powerful force in the stock market. As prices continue to march higher or lower, buying or selling begets increasingly more buying or selling. Very few people enjoy the feeling of being left out of the party, so they typically will stampede in the direction of the trend. In February, once the equity markets started to move higher, the fear of missing out propelled them even higher.

The second potential reason for record levels in the U.S. equity markets have to do with corporate stock buyback announcements. According to TrimTabs Investment Research, in February buyback announcements for companies in the S&P 500 reached $104.3 billion, which marked the highest monthly amount on record. This news is not shocking to anyone in the industry. As interest rates remain low and the prospects of companies investing in their future growth decline every day as

evident in their declining or at best stagnant capital expenditures, the only thing left for companies to do with their cash generated from operations and cash received from additional debt offerings is to buy back their own stock. For the foreseeable future, these forces will remain in play, driving equity prices to record levels day in and day out. However, I will not be the first one to tell you that this is simply unsustainable. Financial engineering can only take you so far. At the end of the day, if a company is not seeing revenue growth through increasing demand for their products or they don't reinvest in their business to stimulate new demand, long-term expectations for a higher future stock price should be tempered. In the short-term, a company can slash expenses and lever up to buy back stock to give the impression of sustainable earnings per share growth. This may drive the stock price higher in the near future, but there will come a time when there is no one left to be laid off. That, or creditors will no longer want to take the risk of over-extending themselves. It will be at this juncture when investors again realize that fundamentals do indeed matter.

As I have mentioned in past columns, stay disciplined and true to your process. In the end, it never pays to try and be someone you are not. Fundamental data, in particular REAL earnings growth generated from REAL demand, is a cornerstone in how we manage portfolios. This particular information may not matter today, but I promise you that it will matter eventually. In the meantime, we will remain true to who we are.

--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

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