The Long & Short of It

Quarterly Newsletter
Fourth Quarter 2014

Flight to Government

If 2014 were a cake made of things to worry about, the fourth quarter was the icing. Geopolitical concerns ranged from violence in the Middle East, further Russian saber rattling, renewed concerns about Greek government finances, the spread of Ebola, slowing growth in China, and the collapsing price of crude oil reducing Russia to rubles.

Investors in the stock market have now learned that none of this really matters.

During the fourth quarter, the S&P 500 rose 4.9%, bested by mid-cap and small-cap stocks that returned 6.4% and 9.9% respectively, while international stocks posted low single-digit losses. But the more observant bond markets showed that these developments do matter. Bond returns generally varied around zero as a rather dramatic flourish was put on the "Flight to Government" that we discussed earlier in the year ("Centralized Government Wins Again", The Long & Short of It, Third Quarter 2014). To wit: during the fourth quarter, while corporate high-yield and emerging country bonds declined, high-yield U.S. muni bonds were up 2% and long-term U.S. government bonds returned 9**%**.

And for the full year, U.S. Treasuries lined the pockets of investors with a total return of 25%. One would normally refer to this as a "Flight to Safety," but our research leads us to some uncertainty regarding the strength of credit and safety of U.S. government debt. In fact, single A may be a more appropriate credit rating for treasuries rather than the pristine AAA earned through the consistent and diligent efforts of stalwarts such as Johnson & Johnson and Microsoft. Of interest is the fact that the flight to government paper was not limited to just U.S. Treasury bonds. Looking at Morningstar's bond fund categories for 2014, we find that long-term municipal bond funds were up slightly over 10% on average, long-term California bond funds returned 11.9%, and high-yield municipal bond funds returned nearly 14%. When low-quality bonds start outperforming high-quality bonds, and highly leveraged government debt outperforms more conservatively leveraged corporate debt, it reminds us of the extreme rallies sometimes achieved at the end of previous bubbles. All of this leads us to believe we may be in the later stages of another asset bubble. And much like prior bubbles in Internet stocks and housing, the current bubble in government debt could end badly. But in the interim if you need a great rate on a loan, perhaps you might want to call your congressman.

Private Sector Struggles

Looking at common stocks for the full year, the S&P 500 returned 13.7%, winning out over mid-cap and small-cap stocks, which returned 9.8% and 5.8% respectively. International stocks lost 3.4%. It was a decent result for domestic large-cap stocks led by defensive sectors like Utilities and Health Care. But small-cap, highly leveraged, and international companies did not fare so well, and the energy sector was decimated. Most long-term estimates of economic activity continue to underestimate the hindrance to growth and the profound deflationary effect of the U.S.'s aging demographic and falling oil prices. While the domestic economy is now at a good point in the business/credit expansion cycle, surprises will continue to come in the form of slower growth and persistent deflation.

Crude oil prices can stay lower longer than most expect, with downward pressure likely to remain throughout 2015. The effect will be further downward pressure on the Consumer Price Index (CPI) and nominal GDP. Deflation is likely to reassert itself as one of the more significant surprises in our economy over the next year and should continue to do so until about a year after the price of oil stabilizes. The stock market seems happy with slow, sustainable growth and very low inflation. Low inflation rates mean that the real rate of growth is even more attractive than it feels and allows for higher price-to-earnings multiples. We expect slow to moderate growth and lower inflation rates in 2015, with interest rates staying low. The stock market appears a bit overpriced right now, but not in the extreme. Bull markets can easily go to extremes, so we will work to become a bit more cautiously positioned, but not extremely so.

Inflation rates deviating from the 1%-3% band are what can cause the most damage to the stock market. Regarding any potential inflation threat, watch wage rates. The risk to our estimates comes if wage rates move significantly higher. In this scenario, the equity markets would be challenged due to significant pressure on the strong profit margins of companies that enjoyed years of steady sales growth with only moderate increases in labor costs.

On the deflation side, watch CPI. With the drop in petroleum prices, one should expect renewed deflationary pressures. Petroleum is in so many products, as well as in their cost of packaging and transportation. If the drop in the price of petroleum affects the price of other goods sufficiently to drive CPI lower, the Federal Reserve (Fed) may not feel the need to raise rates or launch another round of Quantitative Easing. The Fed’s next announcement should be on January 28. Watch closely for changes in their language.

Perhaps of more relevance to 2015 is the likelihood that the political landscape will reemerge as a more important influence on the stock market than the Fed. Historically, in the years after midterm elections, the stock market has performed very well. In post-midterm years, the environment typically moves from active legislative endeavors to gridlock. Investor perceptions shift from higher risk of change to lower risk of change, which is very good for stocks.

This time around, though, the stock market has performed quite well before the midterm elections, as Congress has been stymied in one of the most inactive postures ever. A functioning Congress might bring a greater sense of uncertainty to markets in 2015. Even if the legislative agenda moves toward a “business-friendly” environment, the result of increased uncertainty may be difficult for current valuations to sustain. Although it is counterintuitive, the worst outcome may be if Congress and the President find that they are able to work together on some large issues, especially if those bills are not sensible and/or prudent. The most benign outcome may be if bills passed are so out of step with the administration’s agendas that the veto becomes routine. Yet, even that outcome will disappoint those hoping for better results from Washington. The reality seems to be that any of these outcomes is likely to feel worse to investors than the last two years, so watch for uncertainty coming out of Washington.

Defensive Posture

However 2015 goes, 2016 will mark the end of another two-term presidency. The stock market tends to struggle with the profound changes involved in the transition to a new administration, as was seen at the end of Clinton’s and Bush’s second terms. The last several years have been very productive for owners of common stocks. Robinson Value will now begin a process of shifting to a more defensive posture. However, with defensive sectors like Health Care and Utilities having led the stock market this year, this drift may not be so conventional. Basic Materials and Energy sectors are where the valuations will first become most defensible. We will be shopping in these areas, looking for low-cost producers with clean balance sheets that have the ability to survive and thrive as they purchase (or lose competition from) firms struggling with high cost structures and too much debt.

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