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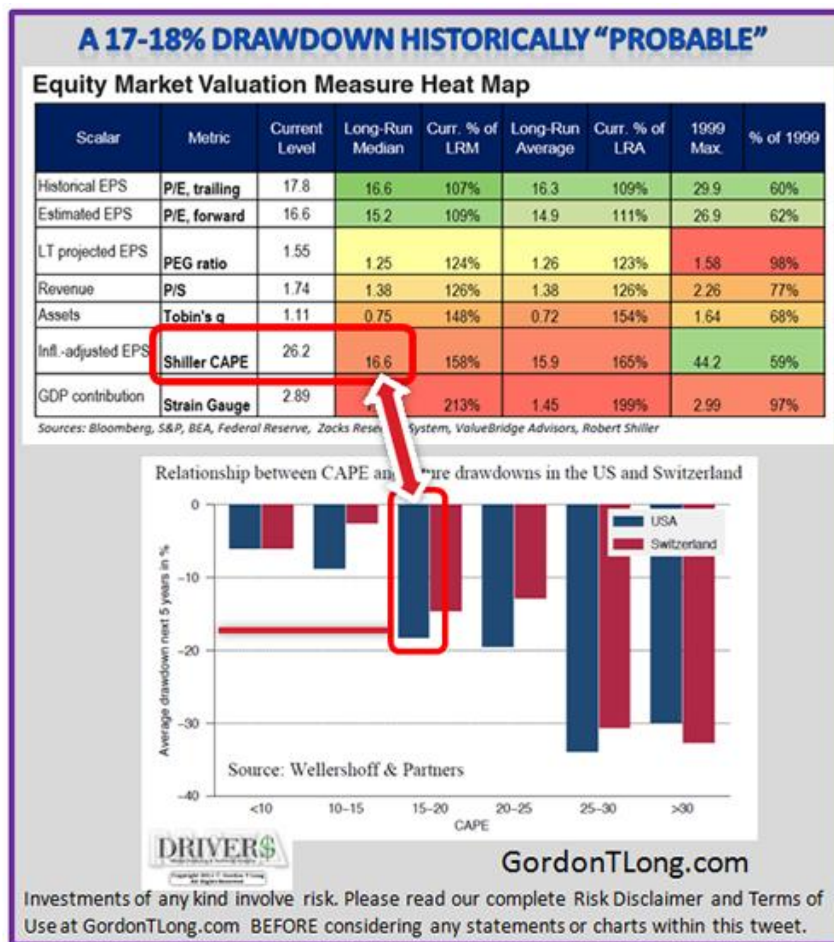
FAILING FUNDAMENTALS

TRIGGER$ - October 2014



A 17-18% DRAWDOWN HISTORICALLY "PROBABLE"

Equity Market Valuation Measure Heat Map

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Estimated EPS	P/E, forward	16.6	15.2	109%	14.9	111%	26.9	62%
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Sources: Bloomberg, S&P, BEA, Federal Reserve, Zacks Rese[illegible] System, ValueBridge Advisors, Robert Shiller

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Failing Fundamentals

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What is it that is troubling legendary investors such as George Soros, Stanley Drunkenmiller, Sam Zell, Carl Icahn and others to be so worried about the markets and to be issuing warnings as they exit? We need to pay attention to these people who each have unbeatable track record but 'en masse' is simply unprecedented.

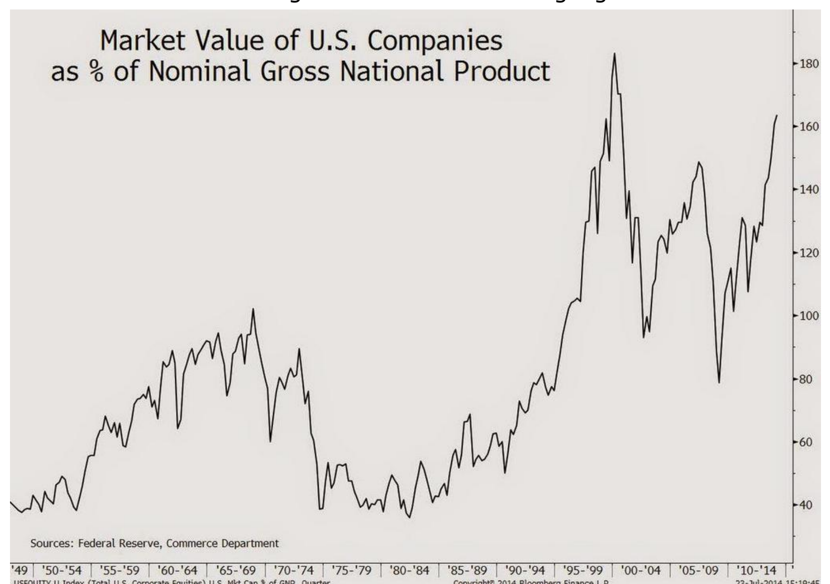
TROUBLING – *Revenue versus Earnings per Share*

They are clearly worried about the lack of top-line or revenue growth that is not occurring. "The stock market is at an all-time, but economic activity is not at an all-time," explained billionaire investor Sam Zell to CNBC in a recent interview, adding that "every company that's missed has missed on the revenue side, which is a reflection that there's a demand issue. And when you got a demand issue it's hard to imagine the stock market at an all-time high." Zell said he is being very cautious adding to stocks and cutting some positions because "I don't remember any time in my career where there have been as many wildcards floating out there that have the potential to be very significant and alter people's thinking."

"This is the first time I ever remember where having cash isn't such a terrible thing."

BUFFETT'S MEASURE – *Market Value of US Companies as % of Nominal GNP*

Even legendary investor Warren Buffett's favorite metric for measuring market risk is showing signs of excess (chart to the right) and has only be higher once before in history.



Earnings per share must rise faster than top-line Sales or Revenues for PE multiples to expand. Contraction usually means falling equity prices.

This is what we have been getting as corporations slashed employment costs. And profits soared to the higher end of Buffett's metric.

Corporate profits have historically seldom been higher as labor costs have been reduced, salary increases avoided, benefits removed or reduced and

tremendous leverage added to the balance sheet (both on and off balance sheet).

But how long can employments costs keep pushing profits higher with real after tax revenues shrinking? This is the question that George Soros, Stanley Drunkenmiller, Sam Zell and Carl Icahn have answered in their minds as they exit. Obviously not much longer!

Professor Robert Shiller

> Even market guru Robert Shiller is concerned about the potential for a crash, even though he doubts the value of his cyclically adjusted price earnings ratio to forecast the timing of one.
>
> "As of yesterday my price earnings ratio - I call it CAPE for cyclically adjusted price earnings - was 26.3. There's only three major occasions in US history back to 1881 when it was higher than that," says Shiller.
>
> "One is 1929, the year of the crash. The other is 2000, which I call the peak of the millennium bubble, and it was also followed by a crash. And then 2007, which was also followed by a crash.
>
> Asked for a worst case scenario, he says: "Well, the price earnings ratio reached its all-time low in the United States in 1921, when it fell under 6. So we're at 26. It could go to 6.
>
> "I'm not forecasting that. It got down very low also in 1982 when it was I think around 7. The last correction, after 2000, I thought it might fall to low levels but it did not. And in fact, after 2007 it got down to 13 - 13.3 I think on a monthly basis. So it was low, but not super low. So I don't know.

Let's look at the fundamentals as summarized by Bloomberg:

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PE

Looking at a traditional price-to-EPS (earnings per share) ratio the 12-month trailing P/E for the S&P 500 is about 40 percent lower than its all-time peak in late 1999 and about 5 to 10 percent above its average since 1954; a chart of the 12-month forward P/E tracks the backward-looking measure relatively closely.

PEG

Other ratios, though, appear less benign, as the table demonstrates (with "heat map" coloring for levels of concern). The widely varying results testify to the difficulty of estimating fair value. For instance, a chart of the Zacks Research System PEG ratio (ratio of P/E to 3-5 year EPS growth rate) for its S&P 500 ETF Composite looks significantly less encouraging than current P/E ratios.

The PEG ratio goes beyond the P/E by incorporating longer-term EPS growth assumptions. In this case, with the Zacks survey current consensus of 10 percent growth as the PEG denominator, the

ratio shows that analyst expectations of lower EPS growth relative to past years have been undermining the rationale for the recent run-up in stock prices.

CAPE

The academically designed Shiller Cyclically-Adjusted P/E (CAPE) ratio assumes that EPS multiples will revert to long-run averages and that the key adjustment to make is for inflation's effects on both stock prices and reported earnings. The Shiller CAPE ratio is well above its long-run average and this week its creator Bob Shiller said it is

"hovering at a worrisome level."

That said, it is still well below its levels during the dot-com bubble.

TOBIN'S Q

A different approach is to dispense with earnings themselves and instead compare market value to corporate assets, a presumptive source of earnings. For instance, Tobin's q compares equity market value to the replacement cost of firm capital (which we calculate using nonfinancial corporate net worth from the Federal Reserve's Flow of Funds data).

This ratio is now at its highest level since 2000, about halfway between the extremes of the dot. com bubble and the mid-2000s, or close to its mid-1990s levels. It remains an open question how much technological innovations in e-commerce and other industries have reduced the asset intensity and increased asset longevity, thus shrinking the denominator of Tobin's q.

STRAIN GAUGE

Another way to frame "the nexus between financial markets and markets for goods and services" (as economists Tobin and Brainard once put it) is what one co- author (Barnier) calls the "strain gauge."

Like Tobin's q and trailing P/E ratios, it is backward-looking, but it focuses on sales, setting aside changes in asset and industry composition trends over time. In its inclusiveness, this ratio raises more concern of frothy equity values. While this macroeconomic strain gauge provides a view of U.S. equity market values compared specifically with the U.S. corporate contribution to GDP, it ignores the full value of U.S.-based companies' overseas business activities.

PRICE TO SALES (P/S)

A simple corporate revenue or sales multiple, the P/S ratio, does incorporate profitable overseas activities, and it shows less strain, although it is still at its highest levels since the dot.com years. That the P/S ratio still shows more strain than the P/E reflects the fact that in recent years, U.S. aggregate corporate EPS growth has been driven by cost-cutting more than revenue growth. Corporate revenue growth, in turn, depends upon broader economic growth, whose prospects have clouded under recent concerns about possible secular stagnation at home and slowing demand abroad.

In sum, measures such as P/S, the PEG ratio, Tobin's q, and the strain gauge encapsulate outstanding concerns about the outlook for capital investment and macroeconomic growth in the U.S. The Shiller CAPE ratio is also elevated.

While demographic and globalizing forces complicate their precise interpretation, these alternative metrics suggest **cause for concern, not complacency**.

VALUATIONS – *Unrealized Hockey Stick Projections Bode Poorly for Following Year Estimates*

The chart (right) shows the change in the growth rates of expected future trailing year dividends per share (a.k.a. "rational future expectations") for each quarter from the present through 2015-Q2 (we'll start getting the data for 2015-Q3 later this month).

As Ironman at Political Calculations, Political Calculations points out:

"What we observe is that at present, investors would appear to be focused on 2014-Q4 in setting today's stock prices, which is a relatively recent development - one that has come about largely as a result of better than expected earnings reported by many companies in the S&P 500 in recent months. Prior to that

development, investors had been largely focused on 2015-Q2, which is the period during which many believe the Fed will begin hiking short-term interest rates.

But the danger in focusing on the fourth quarter of 2014 is such that any shift in focus by investors to another future quarter would be associated with either flat or falling stock prices. And then there is the question of what expectations of the future will replace those of the soon to expire 2014-Q3. Or the next to expire 2014-Q4. Investors can hold their attention on 2014-Q4 through the end of the third quarter of 2014, but that won't be an option for long in the fourth quarter.

It's that kind of scenario with expectations that explains why the month of October is historically feared by investors, because it can come with the greatest downside potential when compared with every other calendar month. If those new expectations are more negative than the ones they replace, then the stock market's reaction will likely be as well.

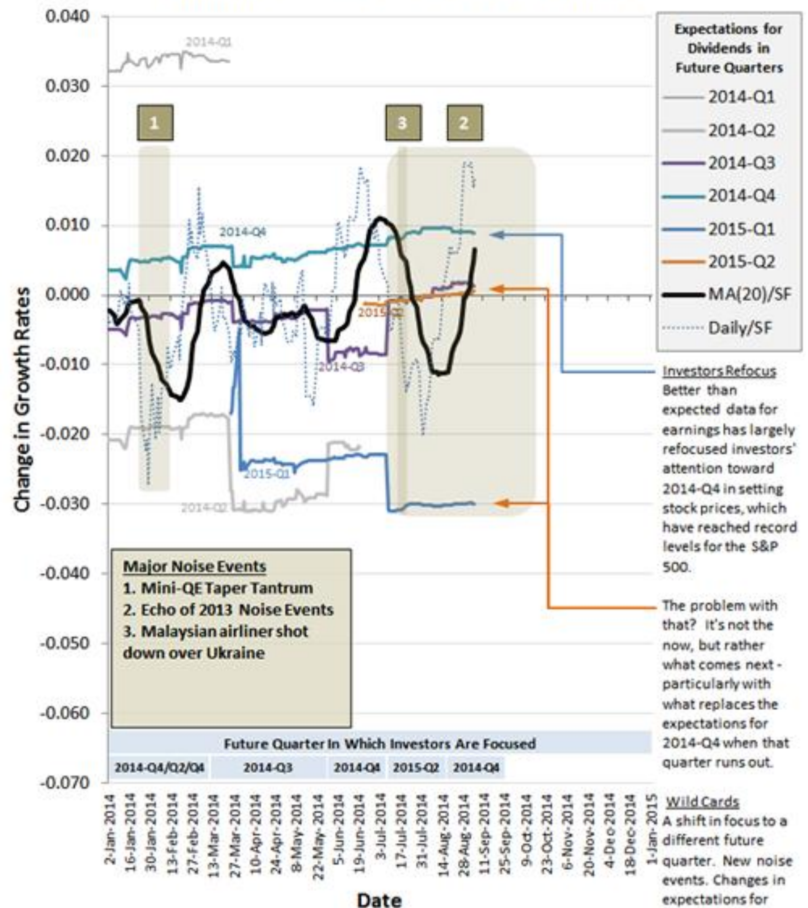
So we actually do have some idea of when stock prices will change. How much they will change will hinge upon three factors: the future point of time to which investors turn their attention next, the expectations that correspond to that future point in time, and how those expectations might themselves change.

Sorting it all out is complex, but not difficult. It's not like stock prices haven't always behaved this way."

RESEARCH CORRELATIONS - ***Swiss economic and financial consultancy Wellershoff & Partners*** *in their paper:* Cape Around the World: Update 2014 – The Relationship between Risk and Return (July 24, 2014). Available at SSRN:http://ssrn.com/abstract=2470935 or http://dx.doi.org/10.2139/ssrn.2470935

As reported by MarketWatch:

> At some point in the next five years, the U.S. stock market is likely to be more than 30% lower than where it stands today. That is the frightening conclusion in a recent study by Swiss economic and financial consultancy Wellershoff & Partners. The company, whose chief executive is former UBS chief economist Klaus Wellershof, found a strikingly strong inverse correlation between the stock market's valuation and its maximum drawdown over the subsequent five years.
>
> The reason this finding is such bad news for U.S. stocks: As judged by the cyclically adjusted P/E (CAPE) ratio that is championed by recent Nobel laureate Robert Shiller, the U.S. stock market's current valuation is at one of its highest levels in history. The latest CAPE reading is 25.69, which is 61% higher than its historical median of 15.95 (and 55% higher than the historical mean of 16.55).
>
> Wellershoff & Partners found that, since 1900, the average five-year decline following CAPE levels as high as current readings is

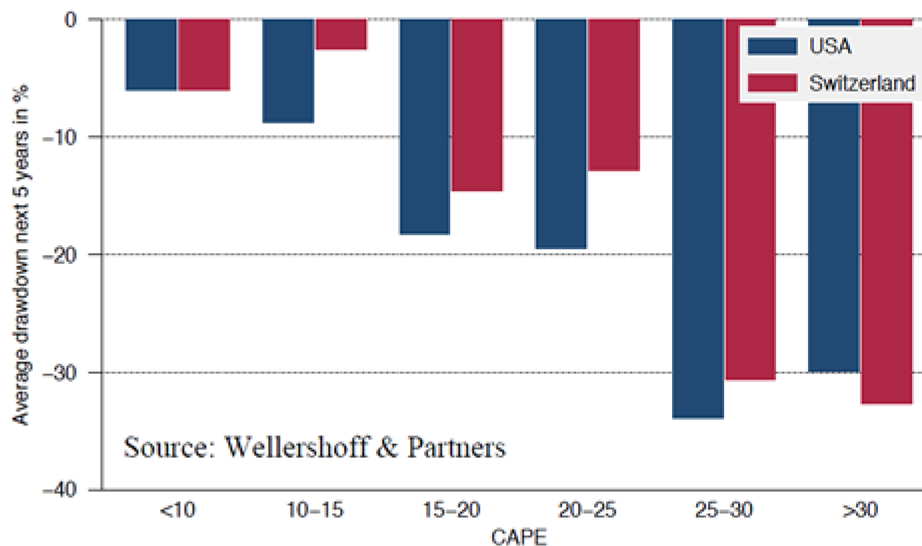


between 30% and 35%. In contrast, when the CAPE has been below 15, its average drop over five years was below 10%.

Furthermore, the study found that there is little basis in the historical record for thinking the market will somehow be able to sidestep a big decrease during the next five years: "Going back to 1900, there has been only one instance when the valuation levels we see today were not followed by drawdowns of 15% or more over the subsequent five to six years. Thus, at least for the U.S. market, it seems fair to say that the risk of losing capital is substantial."

In addition, as you can see from the chart, there is a remarkable similarity in outcomes between developed and emerging markets. This increases our confidence that the inverse correlation the study reports is statistically significant.

To be sure, this recent study is not the first to point out the bearish implications of the above-average CAPE level in the U.S. But what is unique is that it focuses not on overall returns but on drawdowns. That's important because long-term averages mask how volatile the market may be along the way, which, in turn, is related to how likely it is that we'll bail out of stocks at some point in the next few years. The bailout point is usually at the point of maximum loss.



Imagine, for example, that the stock market will provide an inflation-adjusted return of 1% to 2% annualized over the next decade. That's consistent with some analyses of what today's high CAPE reading means. While that return is mediocre, it may still be high enough to convince you that it's worth remaining invested in stocks, especially given the bleak outlook for long-term bonds.

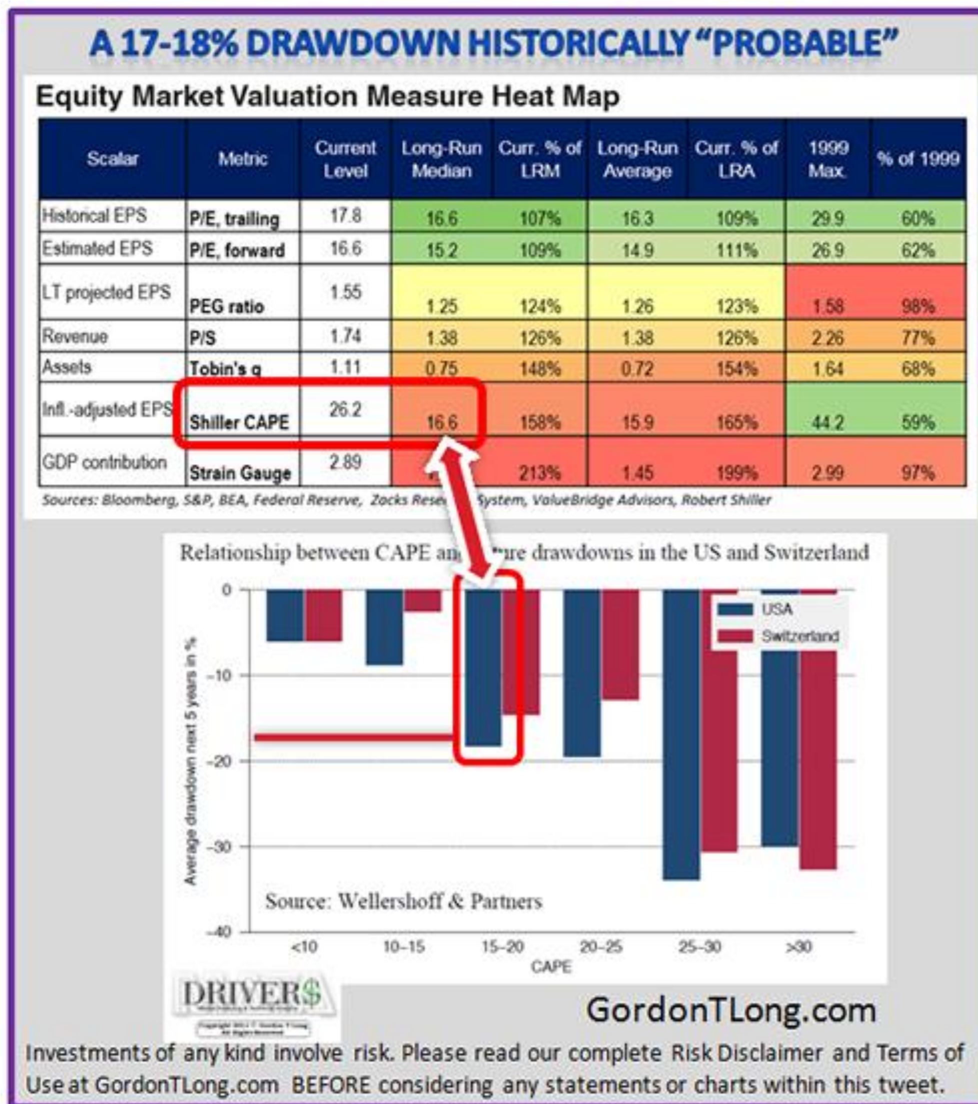
But what if, on the way to producing that modest longer-term return, the market at some point plunges 35%? Many investors would find that loss intolerable and, therefore, bail out of stocks — which means they would not participate in any subsequent recovery that produces the net longer-term return of 1% to 2% annualized.

Note carefully that this study, by focusing on a drawdown that may occur at some point over the next five years, sheds no light on when it might occur. But if the study's conclusions are right, the bulls are playing a very high-risk game.

Do you really want to play that game with your retirement assets?

CONCLUSION

If we put all the above together in graphic format, we arrive at the following:



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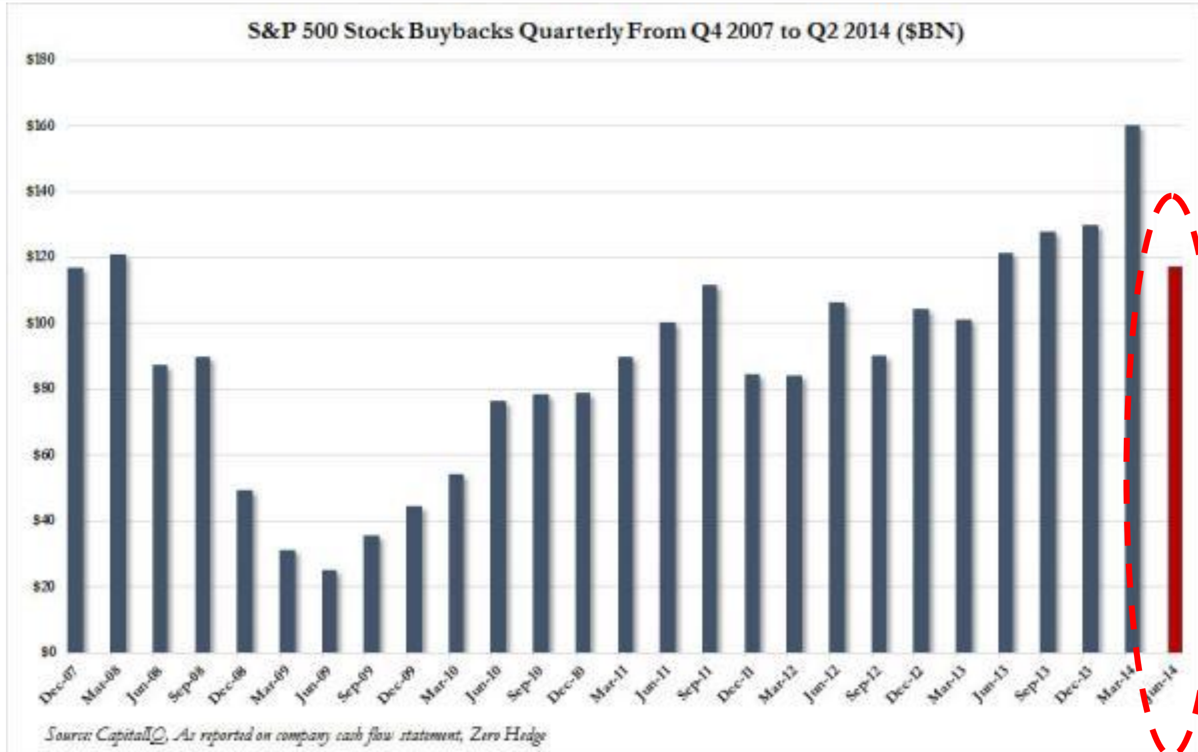
We can expect a 16-18% equity market drawdown in US Equities in the not too distant future.

ADDITIONAL CATALYST*: Stock Buybacks Are Slowing*

Though earnings per share (with fewer shares outstanding due to corporate buybacks) had been steadily increasing, this is changing AND is a major concern since it has been supporting the equity markets.



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