



**For the discerning,
risk-conscious investor.**

December Newsletter 2013

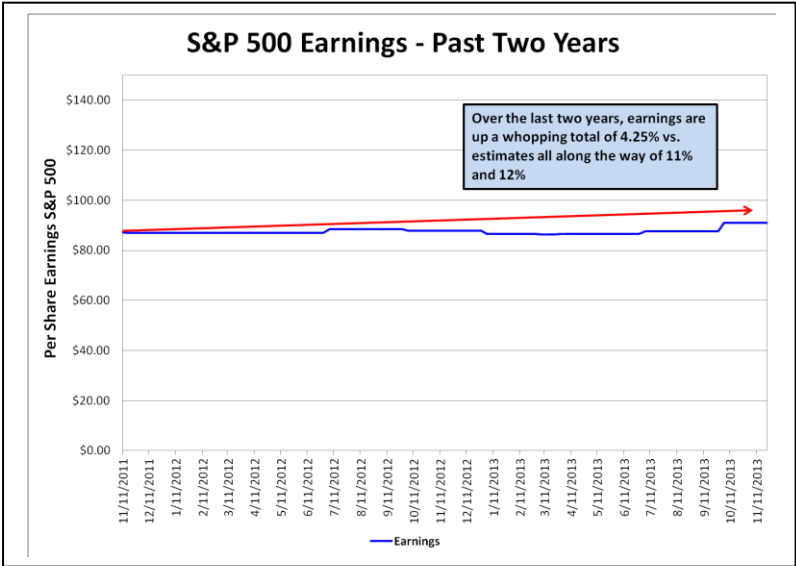
The US stock market has had quite a run in 2013 so far. Unfortunately, the market has moved not because of fundamentals, but because of the Fed's money-printing scheme called "quantitative easing." Those that utilize some other narrative to justify their bullishness are generally unfamiliar with the following chart:



The blue line in the chart to the left is the assets held by the Federal Reserve - Treasury securities and mortgage-backed securities. The red line is the S&P 500. Who really thinks this is merely coincidence? Clearly, the money being printed for the purchase of US Treasuries and mortgage-backed securities is being invested into stocks by the banks that receive the money - directly or indirectly. Still unconvinced?

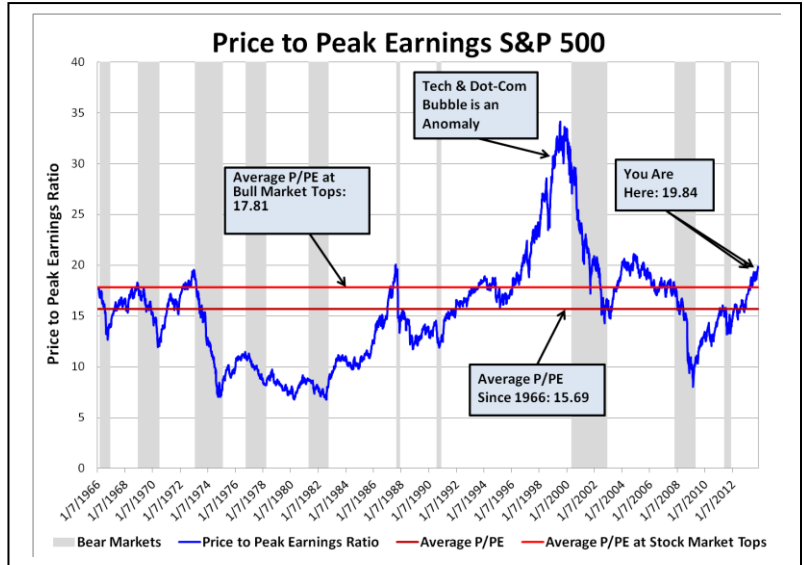
Let's look at the one fundamental statistic most directly tied to demand for stocks - the ability of companies to generate profit. The profit generated is typically referred to as "earnings." Here's the earnings environment over the last two years.

So, where is the profit growth? So far, it just hasn't happened. Stocks can go up for two reasons: (1) an increase in the amount investors are willing to pay for \$1 of earnings (confusingly called "multiple expansion"), or (2) the amount investors are willing to pay for \$1 of earnings remains unchanged, but earnings themselves increase. By far and away, the reason stocks have moved in 2013 is due to reason #1 - investors are willing to pay more for every \$1 of earnings. Why have investors adjusted their views on stock values? Because the Fed is printing money and asking them to kindly invest it in stocks.



Investors have never really changed their long-term willingness to pay up for the earnings embedded in stocks. It does fluctuate, however, but high levels of investor willingness to pay up for stocks are generally followed by periods of low willingness. This is exactly what the stock market's price-to-earnings ratio (colloquially referred to as the "PE" ratio) tells us - are investors willing to overpay for stock earnings? Or are they demanding value from stocks?

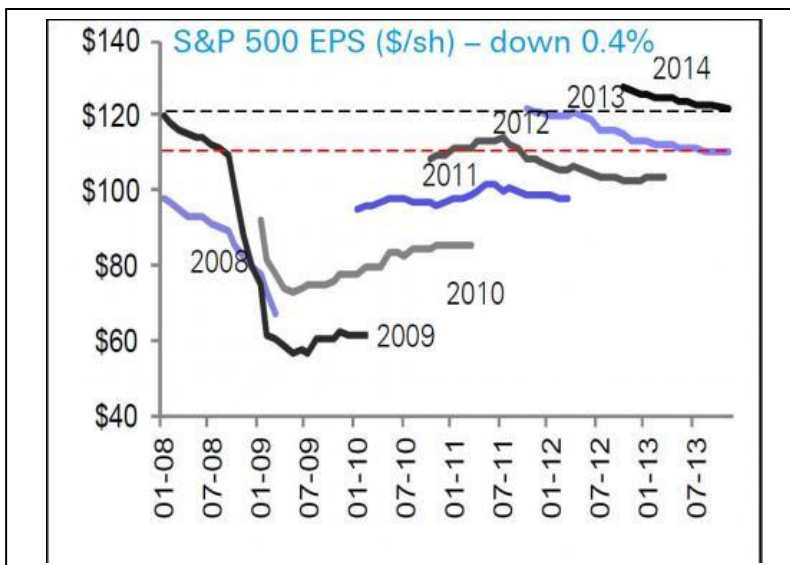
Because recessions perversely make stocks look like investors are overpaying for earnings, while the stock market is dropping dramatically, we use the price-to-peak-earnings (the PPE ratio) as a better measure than the simple PE ratio.



At a current PPE of about 20, we are 27% above the historical average PPE of 15.69. What does this mean? It means that investors are willing to pay a whole lot more for \$1 of earnings than they have, on average, since 1966.

And, as the chart above shows, current PPE levels are 12% higher than the average PPE reading at the end of bull markets (bull market peaks). In fact, since 1966, there have been 10 bear markets (indicated by the gray shaded areas on the above chart). The current PPE is higher than all but three of them - the market crash of 1987, 2007 and the Technology/Dot-com bubble. The current PPE is essentially the same as it was in 1987 and only slightly lower than the peak before the stock market top in 2007. Of course, it's unlikely any market will be allowed to bubble up quite like the Technology/Dot-com market. But that is the only stock market top with a significantly higher PPE than current levels.

We listen with interest at the daily barrage of analysts and pundits marched before the cameras at CNBC who, when asked if the stock market is over-valued, respond with comments like, "No because the price of the S&P vs. next-year's earnings is only 15." They're using what's known as a "forward PE." And taking that valuation measure as meaningful would be akin to making life-changing decisions based on a palm reading. The point is that if armies of Ph.D.'s trained in economics and statistics working for well-funded global organizations like the IMF and World Bank cannot come close to forecasting future economic growth (and they have an abysmal track record), how much better are brokerage firm analysts? Probably not much. Their record is, in fact, quite poor, particularly at cyclical turning points.



To the left is a chart of "consensus" earnings estimates for the companies that comprise the S&P 500, on a per-share basis, provided by brokerage firm analysts. The consensus in this case refers to an average of every analyst's estimate for future earnings that offers such analysis on the S&P 500. Generally, analysts start giving full year estimates 14 or so months prior to the start of the target year. In other words, 2013 earnings are estimated starting in about the fourth quarter of 2011. Every month, the analysts change their estimates based on ever-changing economic data. Note that analysts started their estimates for 2013 at about \$121. But this estimate was from late 2011. As time went on, analysts became less and less excited about earnings prospects for 2013.

The most recent estimates for earnings on the S&P 500 come from November 29 of this year. They're expecting \$107.10 earnings per share for 2013. So over the course of 26 months, estimates have fallen from \$121 to \$107.50 per share. That's a drop of over 11%. What's the point here? The point is that when someone uses "forward earnings" in their analysis, you should run. The future is unknown and hard to predict. Taking the price of the S&P 500 today and applying it to the future is ridiculous if you understand this simple fact.

Now we need to examine the actual probability that the E in PE and PPE ratios is even legitimate. It's our contention that the E is arbitrarily high and cannot get much better. In other words, even if the PPE ratio were in the "fairly valued" territory - and as shown above in the PPE chart, it's not - stock prices would be suspect given the probable reversion to the mean in future earnings.

Before explaining the "reversion to the mean" characteristics of corporate earnings, we need to understand the macroeconomic origin of earnings. Corporate profits are tracked by the Bureau of Economic Analysis (BEA) and include both public and private corporations.

For over 100 years, what we know about the economic character of corporate profits comes from a simple accounting identity. This is a mathematical definition - it is not a theory. In fact, the first few formulas below are simple, non-contestable definitions. Admittedly, this gets a little geeky. But if you really want to understand what's going on in the stock market, it will be worth hanging with us until the end.

Investment = Savings

In national income accounting, the two are identical sums. Further, Savings are defined as:

Savings = Household Savings + Government Savings + Corporate Savings + Foreign Savings.

Going back to the original "Investment = Savings" and utilizing the fact that Corporate Profits = Corporate Savings, we can use simple algebraic substitution to get:

Investment = Household Savings + Government Savings + Corporate Profits + Foreign Savings.

We can now use just a hair more simple algebra to get:

Corporate Profits = (Investment - Foreign Savings) - Household Savings - Government Savings + Dividends.

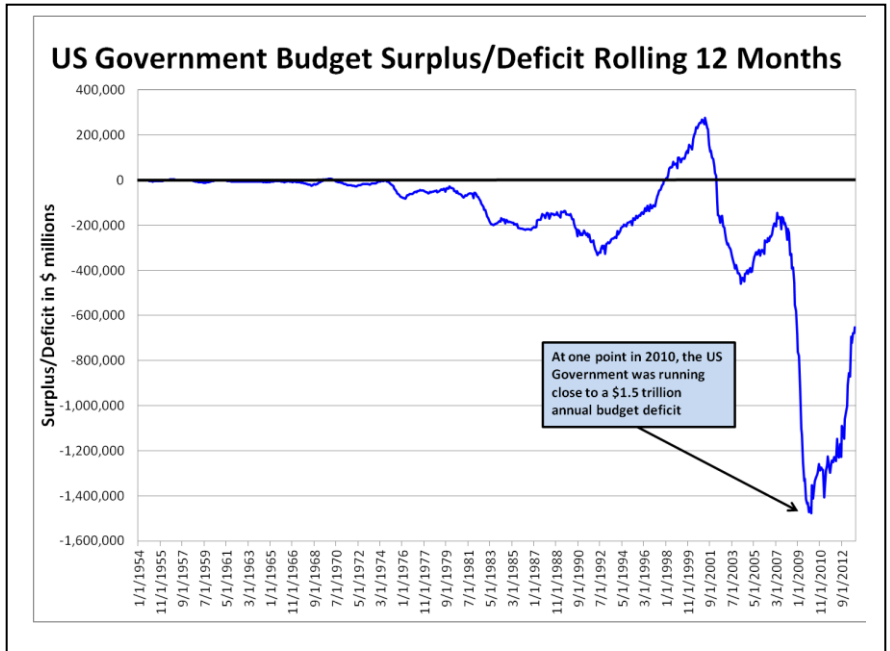
Now we add a few bits of theory for practical purposes. Investment and Foreign Savings are almost complete inverses of each other, so they have been placed in parentheses. The term (Investment - Foreign Savings) usually equals zero, or close to it. Dividends are very stable over an entire business cycle and are negligible compared to the value of these other variables, so it too is ignored. That would leave us with the following adjusted identity:

Corporate Profits = - (Household Savings + Government Savings). Or, in other words, Corporate Profits are inversely related to Household and Government budget surpluses. And in economics, savings are simply defined as income minus expenditures.

Here's the entire point: if governments and households are running huge deficits, we'd expect corporate profits to be high. Conversely, if governments and households are running huge surpluses, we'd expect corporate earnings to be quite low, or even \$0.

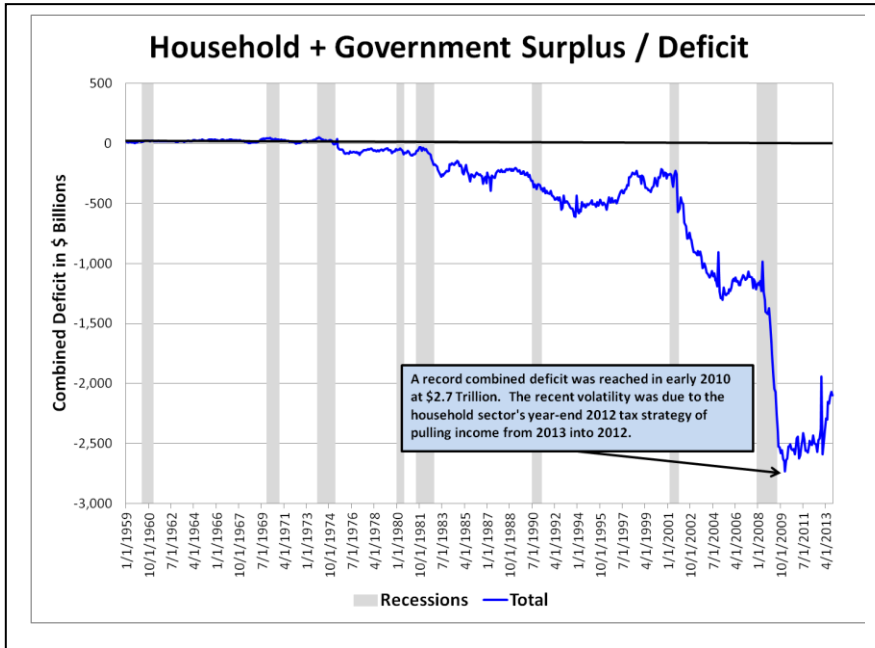
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Earnings depend on the government and households to spend more than they take in to have "great" earnings. Why? When the US government runs a budget deficit, more money is being injected into the private economy than is being drained from it. Consumers use that money to buy goods and services from the corporate sector. That drives corporate profits. Similarly, when households are running deficits, they are spending more money than they are earning. They are spending more money on goods and services provided by the corporate sector than they are taking from it in the form of wages, salaries and dividends. Please re-read this paragraph if you must. It's an important concept for understanding the sustainability of the current profit environment for stocks, and therefore, their value.



Record levels of corporate profits require either households or governments to run record-level deficits, or at least, the two combined to be at record levels.

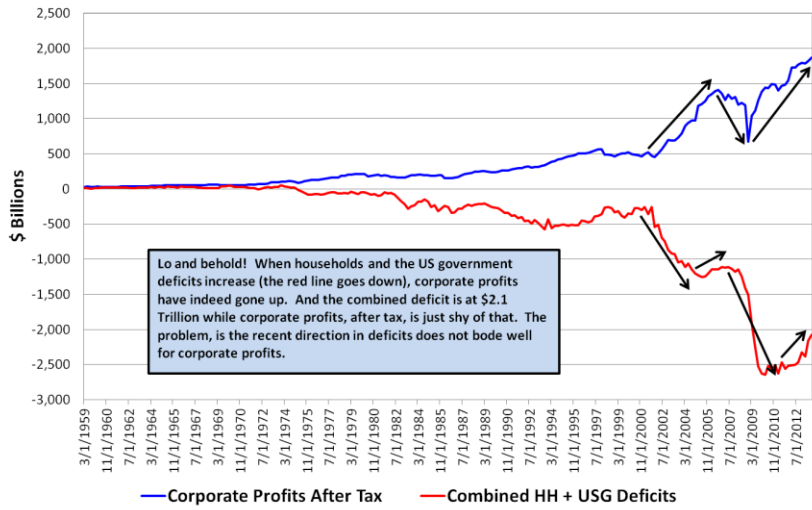
And guess what happened immediately following the Great Recession? The US government ran record level deficits.



If we add in the budget deficits of households, we get a similar picture. We set an all-time record about the same time which combines household and government deficits.

Most of you know that you can hear Butler, Lanz & Wagler's Chris Butler every Saturday morning at 8:00 on KCMO AM and 103.7 FM on *The Capitalist Pigs* radio show. But you can also hear Chris every Friday morning at 8:35 on Greg Knapp's KCMO Morning Show on the same stations.

Corporate Profits vs. Combined Household + US Government Deficits



Do the deficits of the household sector combined with the US government really drive corporate profits? Judge for yourself.

Of course, the problem for those who have continually forecast huge increases in corporate profits from 2012 on through 2014 is that they do not understand that to get that, you need huge increases in the deficits of the other two sectors, combined - households + US government. While that may be the case ultimately, we'd not only need to have another recession, but we'd need a similar fiscal response to that recession as we got in 2008. The recent trend in deficits, however, would contradict the "high corporate earnings forever" thesis. Deficits in households and the US government have begun to shrink - not grow.

However, since reaching the peak deficit in 2010, corporate profits have not really suffered. Their rate of growth may have slowed, but they have not come down as one might expect. There are several reasons for this. Record low interest rates for an abnormally long period of time have allowed corporations to cut interest expenses by refinancing older, more expensive debt. Just like the last five years have seen huge numbers of homeowners refinance their mortgages to reduce their monthly mortgage payment, we've also seen corporations do this to their big debts outstanding.

Second, we actually have seen in a reduction in the top line of the corporate profit equation. Remember that Profit = Revenue - Expenses. Low interest rates have allowed corporations to drive their expenses lower, but revenue has languished. Revenues have just not been coming down as fast as expenses.

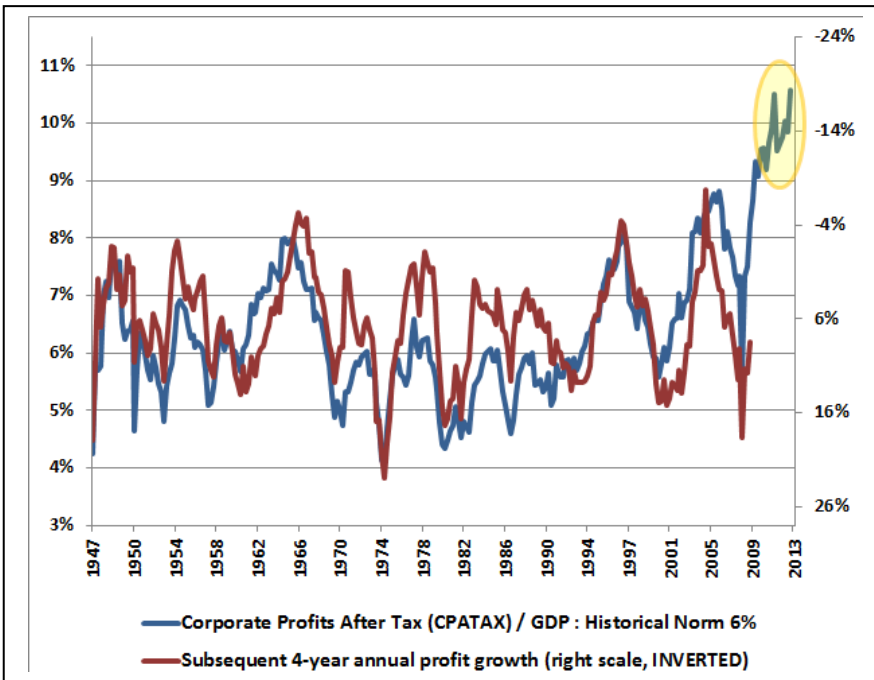
The important thing in all of this is that the growth rate in corporate profits is mean-reverting. What does that mean? It means that high positive growth rates in corporate profits are usually followed by low rates of growth and there is a very simple reason for this. Profits are cyclical because deficits are cyclical.

When households spend beyond their means, this can go on only so long before a rise in interest rates exposes and amplifies the pain of this situation.

Think of it like this. If consumer credit grows at a rate faster than incomes, eventually the interest payments on the debt must become increasingly unaffordable. At some point, the debt must be paid down, or erased by bankruptcy. Both outcomes would damage the consumer's ability to continue to spend and both outcomes would hurt corporate profitability directly and indirectly.

The US government has a completely different set of constraints place on it. After all, the Fed can print money to finance government debt issuance, an advantage households do not have. In this way, the Fed can help the US government print itself out of a debt jam by sparking inflation. And remember, US government deficits need to be financed by government debt. Because interest rates eventually rise, this is a natural constraint on the issuance of debt as it increases government expenses when rates rise. Or, at least, it should. Political pressure from various constituent groups tends to force some measure of budgetary prudence. Also, excessive government debt acts as a headwind on economic growth. Almost every economist, regardless political leanings, would acknowledge this.

Inflation makes the notional value of government debt less and less meaningful as prices escalate. However, unless the government is willing to slow the rate of growth in their deficit, and therefore the debt, they will be caught in a position of issuing debt in a rising interest rate environment, thereby increasing government expenses.



That is exactly what's going on now - the government has dramatically slowed its issuance of debt because it has slowed the growth of its budget deficit. Look again at the chart above showing the US government deficit. It has narrowed dramatically in the past three years. That means fewer dollars are being put into the hands of consumers to spend. And that means less revenue for corporations. And at some point, that means less profit, or earnings, for corporations, including those traded on the stock market.

So the question is, "How much reversion to the mean should we expect?" If corporate profits are at an all-time high, how much can they come down? Economist and mutual fund manager John Hussman recently posted this chart, which indicates a drop of about 19% in corporate profits over the next four years.

In conclusion, this is the rub for equity investors: if earnings on the S&P 500 drop by 19% over the next four years, it puts the earnings per share of the S&P 500 at \$73.67 per share annually. That's down 19% from today's peak earnings of \$90.95. But that kind of reduction in profits would almost certainly mean we have entered a bear market in stocks. The average bear market low P/E since 1966 is 10.74. That means investors, at the bottom of the last 10 bear markets in stocks, have only been willing to only pay 10.74 times the previous peak in earnings to own stocks, on average. 10.74 times the peak earnings (which would be ostensibly today's \$90.95) equals an S&P 500 value of 976.80. That would be a drop of about 46% in the price of the S&P 500 from today's level. Let's be clear, there are a whole lot of "ifs" in this thought experiment. And, the likelihood of a scenario playing out exactly this way is quite remote. But the point is this: corporate profits are mean reverting for logical, economic reasons. When stocks must drop some 46% to be considered a "value," you can be sure that there is a higher than average amount of downside risk in this market.

Particularly when this stock market is the most leveraged of all time. Yes, you read that right - *of all time*. And particularly when the number of stock market bears is at an all-time low (another mean-reverting situation that's bearish for stocks). What this means is that everybody is on one side of this stock market with leveraged bets on its continued ascent when corporate profits are extremely high, in an environment where households and the government are reducing their five-year gift to corporate America - their profligate spending. There is risk in this market. Caution is warranted. No, there is no telling when, or even if, the market dives. Hopefully, the fundamentals catch up to the market in a smooth and easy transition period. And, surely, over-valued markets can become even more so. The point is that, yes, this market is over-valued, and such valuation levels are dangerous.

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