Exclusive Subscriber Content

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Will the market boom or bust in 2015?

The answer to that question will be known in a few short months. We already have some pretty good indications that validate our optimism. But some equally solid arguments can be mounted that validate our caution.

On one hand we believe, for a variety of reasons, that the ultimate drivers of aggregate stock market performance – earnings and earnings multiples – are themselves being driven by factors that aren't sustainable and must ultimately reverse.

On the other hand, those same factors are currently supportive, and suggest further gains are not only feasible, but likely.

The Bear Arguments

Putting the bear case forward first, we observe the following; most people would agree there are few bargains to be had. Montgomery's Head of Research, Tim Kelley, recently re-mapped the valuations of a selection of companies of interest to us, relative to their past valuations.

Figure 1. Australian Market Aggregate Relative Stock Valuations

The red dashed line represents fair value, and the market is considered expensive when the blue 'value line' is below it. As you can see, the market is currently slightly expensive relative to the recent past, including the periods before, during and after the GFC.

Many bears also argue that the world economy has major problems. China's rate of growth is declining precipitously, Europe and Japan are stable only because of asset purchasing programs, also known as Quantitative Easing, and Australia's deteriorating conditions are sufficiently dire to warrant record low interest rates.

We are also concerned that low interest rates are doing little for the real economy, instead only driving asset prices. Double-digit real estate price growth, for example, when the economy is weak and job insecurity high, produces very little flow-on benefit, particularly to those who do not own a property.

An illustration of the magnitude of real estate price rises fuelled by rate cuts might be offered by the following example. My good friend in Melbourne owns a large commercial building leased for ten years to A-Grade tenant Westpac. If he tried to sell this property in the market he might secure $6,000 per square metre (sqm). By contrast Melbourne CBD residential apartments are selling for $12,500 sqm, and in Sydney's leafy Lindfield, a new development abutting the train line is earning its owners $15,000 sqm!

The domestic economy's yawning chasm, left by the end of the resources boom, is not being filled by the consumer or building construction sectors. Private capital expenditure has also fallen off a cliff in both mining and manufacturing and the extent of the decline could amount to a hit to GDP of nearly 1.5 per cent.

Private capital expenditure is of course the primary driver of employment in the economy. The recent and continuing slump in capex suggests unemployment is some way from peaking.

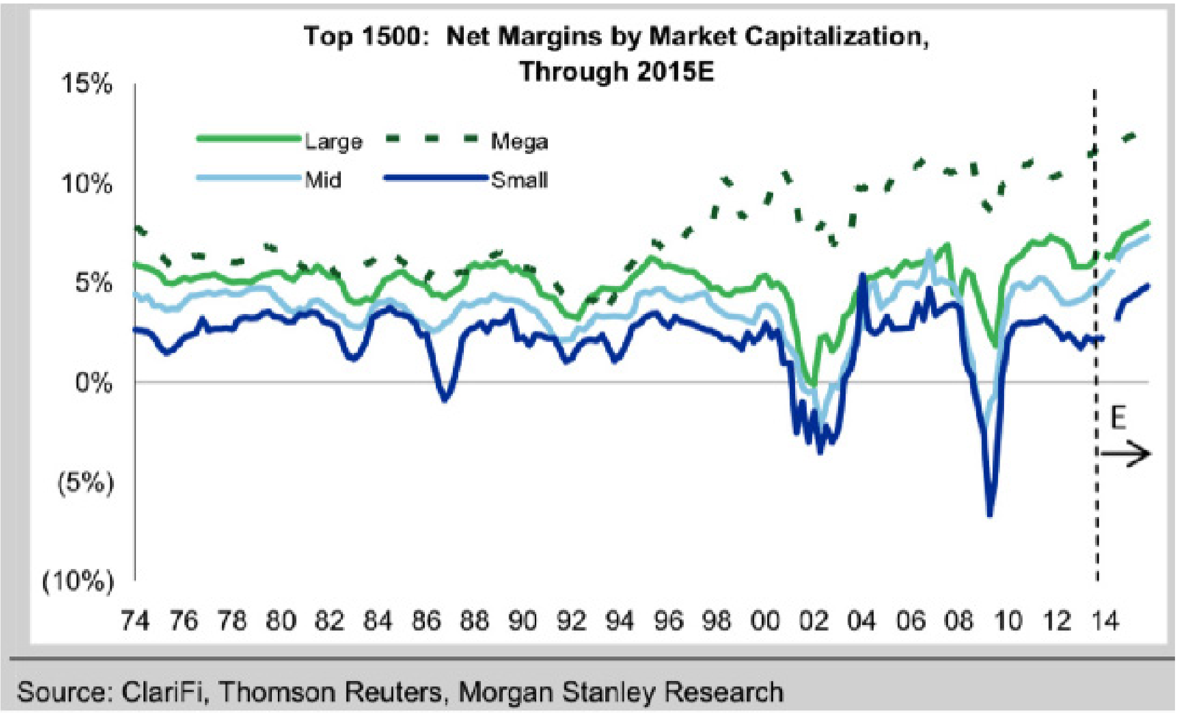
At some point this year, investors could turn their attention toward these concerns.

A Low Return Future

We are also cognizant of the drivers of aggregate stock market returns. These are of course earnings and earnings multiples. Earnings are driven by GDP growth and margins. GDP growth is driven by labour and productivity, and the labour force is being hollowed out by retiring baby boomers (not to mention the slump in both private Australian capex and Chinese growth). This is a negative influence on GDP growth, and in turn, a negative influence on medium-term stock market returns.

The other driver of earnings is margins and one of Montgomery's senior analysts, Andrew Macken, discovered these are now at historic highs and are mean-reverting. Figure 2. provides a solid argument, that while all currently looks rosy, in the medium term, pressure on margins will lower the rate of earnings growth.

Figure 2. Net margins by Market Cap.



Remembering that the forces on aggregate stock market returns can be reduced to earnings and earnings multiples, we can argue that pressure will come from earnings via slower GDP growth and mean-reverting margins.

Turning to the other influence on aggregate stock market returns – earnings multiples, or the price investors are willing to pay – we find the biggest influence is interest rates.

Despite the RBA's decision to leave rates on hold at their March 3 2015 meeting, interest rates in Australia remain low and they continue to fuel the baby boomers' desperate migration out of low-yielding cash and into stocks and property.

In the wild, when too many animals migrate at the same time, their sheer mass denudes the fields of the food they depend on, leaving them starving en-mass. The same thing can be seen in the current generational avalanche out of cash and into stocks. Yields are being compressed and investors forced into a narrower and narrower band of higher quality securities offering stable dividends. Eventually the yields offered by these stocks fall towards those offered by bonds and the current argument for migrating into equities tends to disappear.

Speculation in Pockets

Turning to areas of speculative froth, we note the near 25 per cent premium some listed A-REITs are trading at compared to their Net Tangible Assets (NTA). Back in September last year, A-REITs were trading at an aggregate 29 per cent premium to NTA, according to property analyst John Kim at CLSA. Just this week Deutsche Bank noted "*most A-REITs are trading well above our fundamental valuations*" adding this, despite "*the medium term outlook for rental growth [is] currently below long-run average levels across all three major commercial real estate asset classes*."

More worryingly, some of the A-REIT research we have seen appears to be justifying, or offering a rational reason for these premiums. ***The simple fact is that paying a massive premium over the market value of a building for a small piece of it is irrational***. If a building is trading at an elevated price in the property market of $1 million, its purchase via the stock market should not be considered at $1.2 million.

Nonsense Elsewhere

We also chuckled when one particularly loquacious institutional broker suggested to his clients that they consider the attractive 13-month yields on offer in the stock market. With only a few days due before some dividends for the December 2014 half-year are paid, it was suggested an investor could hold the shares for 13-months and receive three dividends making the share price very attractive indeed. Of course the 'analysis' failed to take into account the fact that the third dividend is 'borrowed' from the subsequent year, leaving that year with just one dividend, not to mention the possibility for capital loss at the end of the 'trade' if all of his clients followed the strategy.

The Bonds that Bind…

Looking to the bond market for guidance also provides some evidence of low growth expectations.

While our own research suggests they are lousy interest rate forecasting tools, interest rates yield curves are considered by some analysts as one of the better leading indicators of economic trajectory. Indeed, it is claimed by some analysts, that inverting yield curves (long bond rates heading below short term rates) have presaged every US recession since 1945 (except 1966).

With that in mind, it is worth noting that in the last twelve months, no major country's yield curve steepened. In fact all major yield curves, from those of Russia and China, to the US, Australia and Japan, flattened (towards inverting).

While a flattening is not an inverting – curves can steepen again – the current trend does signal slowing economies and lower capital investing intentions.

Nobel Laureate, Robert Shiller offered an interesting observation recently, stating "I think fears have been growing for years that represent the willingness of people to bid up bond prices…They are worried about their future. They are worried not just about next year; they are worried about the next twenty years, the next forty years. So they are desperately trying to provide for that, they'll even accept negative yields…There's this increasing fear of technology, information technology, artificial intelligence, robotics, 3-D printers, the internet and all these different forms…[Technology] seems to be changing life in such a fundamental way … Where will my children be? I want to leave something for them because they could be in terrible straits'…This is desperation for many people…The problem now is we are going through a technological revolution, unlike any in history..."

Technological change is helping US companies earn record margins but the lid on labour costs is also limiting wages growth, which in turn might explain why central banks are finding it difficult to achieve their inflation targets and why, despite a very long US recover, wage gains remain mediocre.

Low wage growth and technological change could be causing, not only the support of the bond market, but also lower spending and higher savings. If this thesis is correct then it is yet another reason to expect global growth to remain muted. ***It is worth keeping in mind that the significant drop in oil prices has not, on this occasion, seen a leap in consumption spending anywhere.***

Fundamentally Expensive Stocks

Finally, one needs to consider the very high price to earnings (P/E) ratios being paid for the shares of some companies. While an argument can be put forward to justify these high P/E's ***the reality is that P/E ratio themselves reflect rational valuations some of the time, and the level of popularity the rest of the time***.

With Ansell at 55 times earnings, Beacon Lighting at 45 times, Brambles 28 times, Fantastic Furniture 38 times, Computershare 53 times, Coca Cola 29 times, Spotless 38 times, Freedom Foods 39 times, Dominos 55 times and Corporate Travel Management at 68 times earnings, it becomes difficult to believe that baby boomers are willing to adopt even more risk in order to extend the share prices gains already experienced.

The Bull Case

'It is certainly hard to be a saver in this world of negative real returns on cash and term deposits.' That sentiment is the main driver of stock market direction today.

The largest population cohort – the baby boomers – are in, what we at Montgomery have coined, the Panic Accumulation Phase of their pre-retirement. Meanwhile, interest rates are so low that the return on a million dollars of cash in the bank, is less than the poverty line in Australia. And at the same time, thanks to the GFC, baby boomers have a disproportionately large amount of cash in their bank accounts.

That weight-of-money influence on the stock market, is not ending any time soon.

Another weight-of-money argument might also be responsible for further strength in the US market. When European Central Bank President Mario Draghi revealed his one trillion euro version of Quantitative Easing, he explained that the European Central Bank will buy 60 billion euros worth of European sovereign bonds per month, until September 2016. This action has already pushed nine European country's bonds to negative levels. While in the short term, the action will cover over the cracks in the European Union, it must also cause enough consternation to see funds flee Europe. The 24 per cent decline in the euro against the US dollar, over the last year, appears to be evidence of this trend. And keep in mind, the centralised buying of European bonds, should keep yields there low, and even negative, until at least the third quarter of 2016.

P/E's not that lofty

We recently pointed out some of the eye-popping multiples being paid for unlisted businesses in the technology space. Private equity funding rounds for the likes of Uber, Snapchat, AirBnB and others are pricing these businesses in the tens of billions of dollars. Some have revenue but many simply don't. While the multiples suggest caution might be warranted, it is not entirely obvious that one should conclude the technology sector in its entirety is in a bubble.

According to Bloomberg, the P/E ratio of the tech-heavy NASDAQ Composite Index was 152 times earnings before the year 2000 Tech Wreck from which the market has taken 17 years to recover. This week, the P/E ratio was 30.1 times. Apple, which accounts for ten percent of the index, has a P/E of 19.9 times.

Prior to the Tech Wreck the price to cash flow ratio was 33.1 times. Today it is less than half that level at 15.2 times.

When price to earnings, dividend yields and cash flows ratios become eye-watering, analysts often turn to new ratios to justify the prices being paid. One such ratio is the Price/Sales ratio. That ratio currently stands at 2.1 times. Prior to the Tech Wreck, the ratio stood at 4.8 times.

Academia Suggests Buy, Don't Sell

Some academics tell us that through recent history corrections tend to occur when the earnings yield (the reciprocal of the P/E ratio) on stocks is close to or lower than the rate of interest on ten-year bonds. The idea is that stocks and bonds compete for investment dollars. When interest rates are low, stocks are preferred and when interest rates are high, bonds become flavor of the month, and importantly at the expense of stocks. If after subtracting the earnings yield from the long-bond, the product is a very large, positive number, then history suggests there is a greater chance of a stock market crash.

Of course many academic studies do not make a perfect predictor. While many research reports have added to the appeal of this comparison as a predictor of stock market corrections, we refrain from adopting such models and predictors in our investing process. They may nevertheless serve to inform you about the rationality of your fears.

And while we note that the historical studies have been conducted prior to Quantitative Easing's influence, and after the high inflation years of the 1970s, the current earnings yield for the Australian market is 4.6 per cent and the ten year bond rate is 2.55 per cent, giving a Bond Stock Yield Model (BSYM) figure of -2.05 per cent.

Negative two per cent is not a large positive number, suggesting there is little reason to expect an imminent correction.

Australia, however, can be influenced by machinations in the US market, so it may be helpful running the BSYM ruler over the S&P500 to determine whether it is displaying any worrying signals using this methodology. With the historical P/E ratio at 18.9 times, the earnings yield is therefore 5.3 per cent. Meanwhile ten-year bonds are trading at 2.08 per cent, producing a BSYM figure of -3.22 per cent.

Once again, and with the caveat being that there is no perfectly predictive model, this model suggests there is little reason to expect an imminent correction in the US market. It is also worth keeping in mind that US companies currently enjoy record earnings, record sales and record margins. And technology and productivity improvements suggest margins many not mean-revert.

And if you thought that the risk of a correction might emanate from Europe, keep in mind that European companies, are at a 40 per cent discount to US companies [using a Shiller P/E ratio].

Ashley Owen, my good friend from Philo Capital Partners, has studied another relationship that includes, this time, nominal dividend yields and inflation rates. Owen observes that when the real dividend yield (nominal dividend yield less inflation) is 2.5 per cent or higher, rallies in the Australian stock market have subsequently transpired on every occasion since 1984*. The current Real Dividend Yield is 2.5 per cent, suggesting strength in the Australian market is more than a slim possibility. We also note that the Real Dividend Yield was also at 2.5 per cent in December 2014, and since that time the market has rallied 10 per cent.

So it seems, one signal is suggesting the market is due for a rally and another indicator is suggesting the market is not due for a correction.

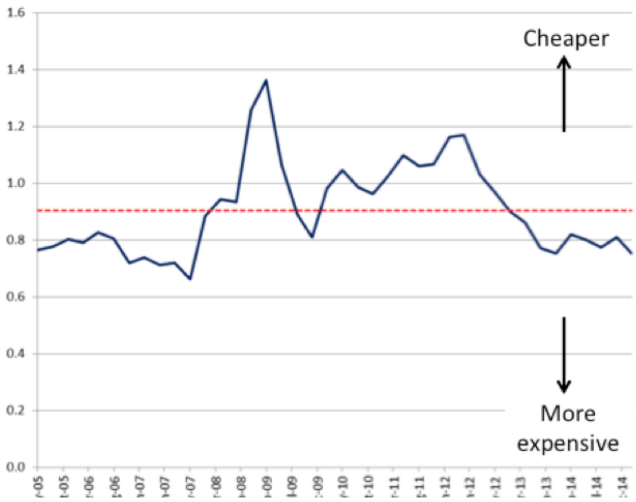
*Once again, the study does not include the high inflation 1970s.

Markets Can Remain Expensive

While Figure 1. (repeated below) revealed the market to be expensive, it was not so expensive that we at The Montgomery Fund are rushing for the exit. The market can remain expensive for some time and indeed Figure 1. reveals that prior to the 2008 crash, the market was far more expensive and had been expensive for three years.

Many investors have pointed out to us that our own investment process is producing a very large cash weighting. It is true that we currently have as much as 20 per cent of The Montgomery Fund's portfolio in the safety of cash. But it is also true that our model has The Montgomery Fund 80 percent invested in securities. The Montgomery [Private] Fund is similarly weighted.

Figure 1. Australian Market Aggregate Relative Stock Valuations (repeated)



Observations

There is a human tendency to look for the arguments you already have a leaning towards, and ignore or dismiss those that don't concur. Success in this endeavour then reinforces one's already-established view.

The arguments above suggest there is merit in each camp's case.

Ultimately however, the answer to successful investing over the long term, lies not in the ability to predict the market's next zig or zag, but in the successful selection of a portfolio of businesses who's earnings rise as a result of the compounding of retained profits at an attractive rate.

Obviously, the share markets' participants will change the price they are willing to pay, even for the most attractive opportunities, and therein lays the opportunity, rather than the risk.

Should the market rally strongly, The Montgomery Fund and The Montgomery [Private] Fund are both invested in portfolios of attractive businesses, with bright prospects, purchased at rational prices. Should the market decline, both funds also have sufficient cash, compared to most of their peers, to buy more and significantly reduce the time required for investors to recover any price-related drawdown that must ultimately prove to be temporary.