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Summary Points

- Interest rates and economic growth likely to remain low for years more due to secular debt cycle.
- Cyclical rebound in credit markets is underway, and U.S. economy expected to re-accelerate by second half of 2015.
- The Federal Reserve may start to raise short–term rates starting after its September meeting.
- After the big rally in the dollar's foreign exchange value, we think some consolidation is in order and a trading range of $1.05-to-$1.15 per Euro is a likely prognosis.
- The downward trend in inflation is supporting equity valuations and we are sticking with the year-end target for the S&P 500 of 2250 that we published last January.

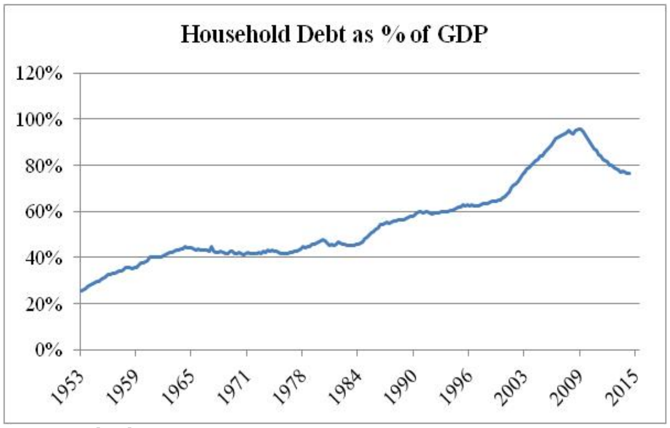
The View from High Above the Earth

The U.S. and most of the advanced economies are in the grip of a secular debt cycle that will not end for many years or decades to come. During the six decades leading up to the Great Recession of 2008-9, debt levels grew steadily in all sectors of U.S. society and throughout much of the world. Bank lending generated the money needed to buy houses, commercial buildings and new businesses. Additional financing was created in the securities markets when private lenders bought bonds and other instruments sold by governments, businesses and financial institutions. Such lending created purchasing power that propelled growth. The behavior of the major economies in recent years suggests that this secular expansion in debt has reached a natural limit. Debt will either decline enough through repayment or default, so that a new secular expansion can begin, or debt may just stay at these high levels. If debt remains near current levels, as we suspect will be the case, Central Banks will have to indefinitely provide liquidity to maintain aggregate purchasing power because of the absence of incremental lending and spending.

We think the recent rise in bond yields is temporary and that interest rates are likely to stay low as far as the eye can see. The common belief is that interest rates are low because the central banks have been aggressive in supplying loanable funds. But we would propose the idea that interest rates are now low because, with debt levels high, borrowers are unwilling or unable to take on more debt. Demand for debt has fallen, so new borrowing can be enticed only with very low prices (interest rates). In this view, easy monetary policy is *an effect* of low demand by private borrowers for additional debt. In an environment where there is little stomach for additional borrowing, borrowers walk away as a soon as rates rise.

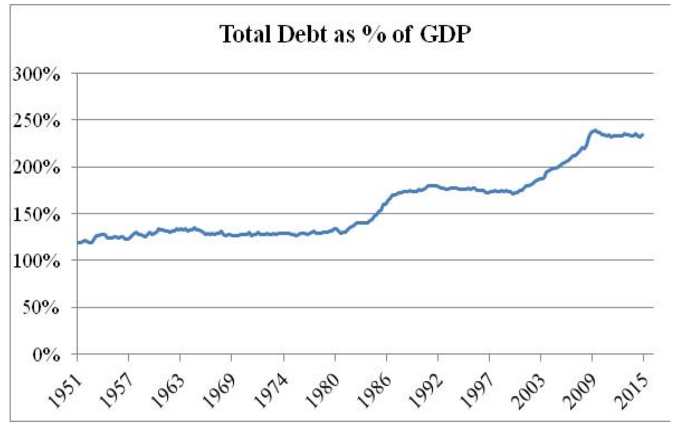
Within the long-term, secular view described above, there are still credit cycles. Since the first quarter of 2009, near the start of the financial crisis, total non-financial Credit Market Debt in the U.S. has stayed flat at about 230% of GDP (see Chart 2) because of a sharp increase in government borrowing. Federal government debt held by the public ballooned from 47.5% of GDP to the current level of 73.6%. However, some debt has been reduced: U.S. households have reduced their total debt from 95.5% of GDP in the first quarter of 2009 to about 76% of GDP today (see Chart 1). Businesses have also reduced debt from 73.9% of GDP to 67.6%.

Chart 1



Source: Federal Reserve, FVCM

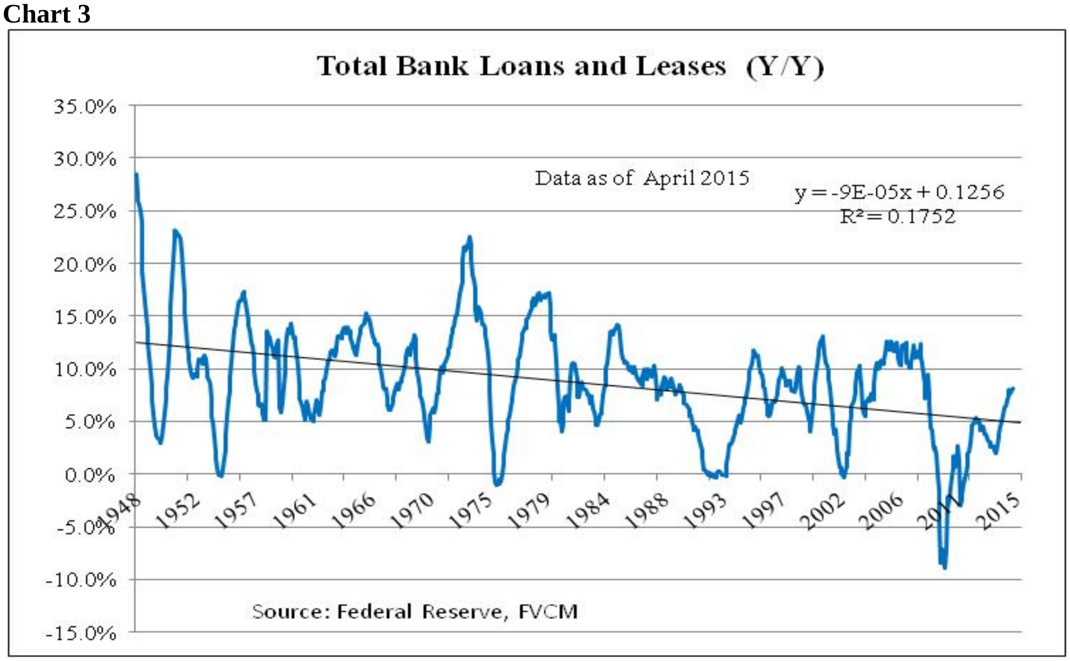
Chart 2



Source: Federal Reserve, FVCM

The decline in private debt, relative to income, is providing room for a cyclical upswing in lending. Bank loans and leases were up a strong 8.1%, year-to-year, as of April 2015. Not coincidentally, this strength in bank lending is being accompanied by a pickup in the housing market and auto sales. Furthermore, the Federal Reserve was able to end Quantitative Easing (QE) precisely because the increase in loans was providing the spending power needed to fuel growth and keep the rate of unemployment in a downward path.

Chart 3



After the recent period of weakness, real GDP is expected to accelerate in the second half of 2015. The softness in economy over the winter months appears to have been due to temporary factors. Harsh winter weather over large parts of the country affected construction in particular and general business activity in general. Also, there was a strike at the seaports on the West coast that impacted trade and production, and the sharp decline in energy prices has so far hurt capital spending more than it has boosted consumer spending. Furthermore, the stunning rise in the dollar against the Euro and other currencies put downward pressure on corporate activity. Real GDP declined slightly in the 2015 first quarter after growing at a 2.2% annual rate in the 2014 fourth quarter. However, most economic indicators remain good and JP Morgan, for example, is forecasting that real GDP will grow at a 2.0% rate in the second quarter and a 2.5% rate in the second half of 2015.

Chart 4

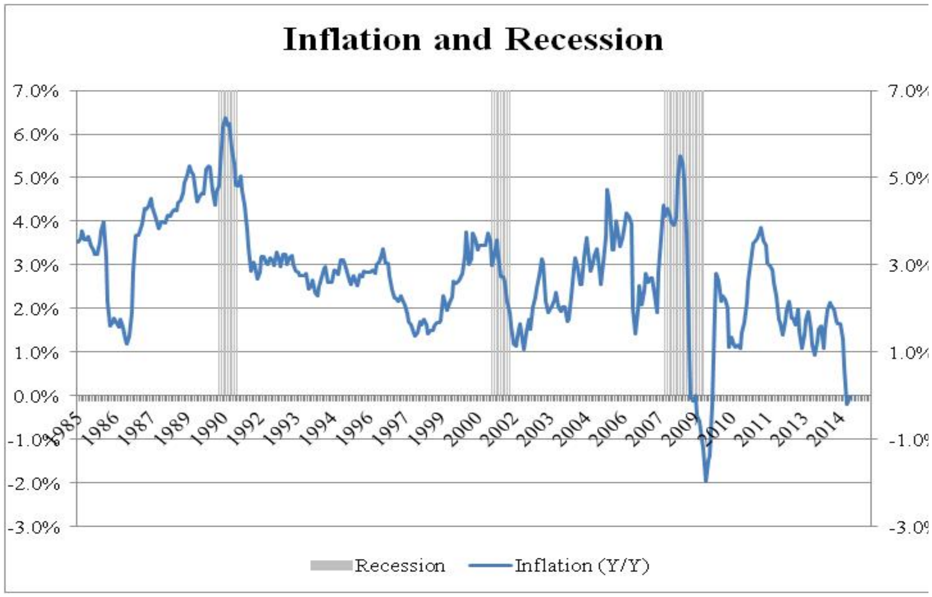
Source: The Federal Reserve, FVCM

The Federal Reserve is expected to start raising short-term interest rates in September if the economy picks up as expected. The Fed has had its eyes, firstly, on the unemployment rate. As seen on Chart 4 above, the rate of employment has been steadily declining and now stands at 5.5%. The Fed has repeatedly and specifically cited high rates of unemployment as a reason for keeping short-term interest rates so low. But as unemployment approaches 5%, the Fed has to begin worrying about the delayed impact on inflation. As labor markets tighten and factory utilization rises, economists commonly say that the economy doesn't have much "slack" and monetary policy must be used to prevent demand from growing beyond the economy's ability to produce. At the same time, there has been persistent nervousness that the economic expansion is fragile and the Fed does not want to risk another recession. In our judgment, there is a fragile nature to this economic expansion and it is the result of the secular debt cycle discussed at the beginning of this report. Putting it together, the signs point to the Fed starting to raise the Fed Funds rate in a very limited way, and observing the impact on housing, consumption, business investment and the capital markets each step of the way. The Fed wants to keep growth at a modest level without tipping the economy into a recession.

"I don't know when (the rate hike will come), but when that begins, that's good news, not bad news because it means the U.S. economy is strong enough"
Ben Bernanke, 27 May 2015

Rising interest rates by the Fed imply a growing economy. As the Bernanke quote above states, the Fed will only be raising rates if the economy is growing. We can say this now because inflation is very low and there are no signs of rising inflationary pressure. It is when inflation becomes a problem that things can get bad, because rising inflation could cause the Fed to have to tighten even if real growth stalls. Notice in Chart 5 below, that a rising trend in inflation preceded each of the past three recessions. Today, the year-over-year growth in inflation is zero. This means flexibility. Because inflation is low, the Fed can always reverse course and cut rates again, or even start a QE4 if growth hits a wall. For this reason, we consider inflation to be the primary destroyer of economic growth and Bull Markets, and it's not a problem now.

Chart 5



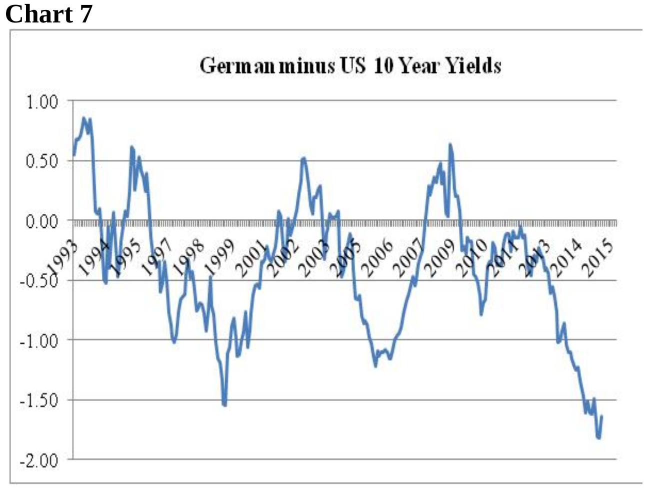
Source: The Federal Reserve, FVCM

We are neutral on the dollar's foreign exchange value. Based on OECD data, the fair value of the dollar versus the Euro on a purchasing power basis is probably something like $1.20 - $1.25 to the Euro. However, actual exchange rates typically deviate from such valuations for long periods—ten years is not uncommon. Over shorter periods, exchange rates are affected by international capital flows chasing returns, not the relative prices of tradable goods and services. The recent rise in the dollar reflects the expectation that the Fed will raise interest rates this year, compared with the ECB's determination to keep rates low and implement a QE program. Also, the spread between the yield on the German 10 year bund and the 10 year U.S. treasury bond is unusually negative at this point (see Chart 7). That negative spread gives European bond portfolio managers a strong incentive to send capital to the U.S. and buy U.S. bonds. So we think the tension between the dollar's purchasing power basis, and its attractiveness in terms of safety and yield, will possibly keep it in the range of something like $1.05 to $1.15 to the Euro.

Chart 6

Source: European Central Bank, Federal Reserve, FVCM

Chart 7



Source: European Central Bank, Federal Reserve, FVCM

S&P 500 Corporate Earnings

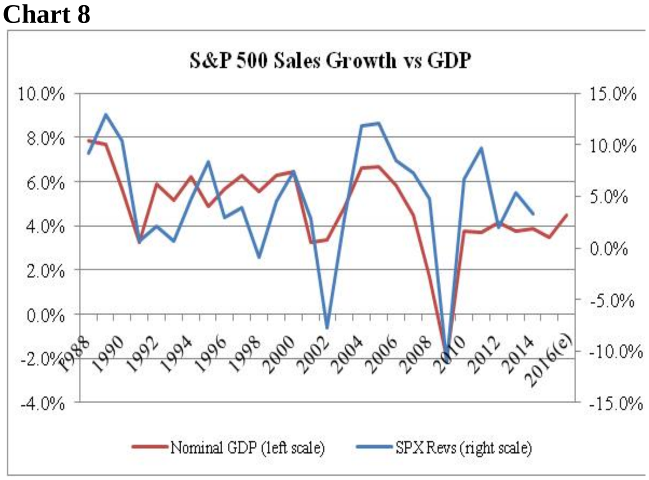
Operating earnings in the 2015 first quarter were down about 5%. The energy sector accounts for only 2% to 3% of total U.S. GDP, but in the third quarter of last year it had been accounted for more than 12% of the earnings for the S&P 500. According to Standard & Poor's, by the first quarter of 2015 the energy sector had a negative contribution of 0.55% (a loss), and helped drag down earnings for the entire index. There were other factors too, of course. The sharp increase in the dollar's foreign exchange value chopped off several percentage points of earnings growth and the bad weather and the strike at the West Coast shipping ports also had a negative impact. Nevertheless, earnings for the full year 2015 should still be up slightly (see Table 1 below).

S&P 500 (Table 1)

	Revenue	Operating Earnings	Special Items	GAAP Earnings	Oper Margin	Net Margin
1987	373.84	19.31	1.81	17.50	5.2%	4.7%
1988	408.19	27.65	3.90	23.75	6.8%	5.8%
1989	461.15	24.46	1.59	22.87	5.3%	5.0%
1990	509.08	23.22	1.88	21.34	4.6%	4.2%
1991	512.57	19.03	3.06	15.97	3.7%	3.1%
1992	523.64	22.75	3.66	19.09	4.3%	3.6%
1993	527.22	26.54	4.65	21.89	5.0%	4.2%
1994	552.06	31.28	0.68	30.60	5.7%	5.5%
1995	598.41	37.71	3.75	33.96	6.3%	5.7%
1996	616.43	41.18	2.45	38.73	6.7%	6.3%
1997	640.40	45.08	5.36	39.72	7.0%	6.2%
1998	634.51	44.49	6.78	37.71	7.0%	5.9%
1999	663.21	50.88	2.71	48.17	7.7%	7.3%
2000	712.28	56.34	6.34	50.00	7.9%	7.0%
2001	732.41	45.17	20.48	24.69	6.2%	3.4%
2002	675.93	48.13	20.54	27.59	7.1%	4.1%
2003	695.36	55.55	6.81	48.74	8.0%	7.0%
2004	777.70	66.99	8.44	58.55	8.6%	7.5%
2005	871.58	76.29	6.36	69.93	8.8%	8.0%
2006	945.17	88.17	6.66	81.51	9.3%	8.6%
2007	1,013.57	86.23	20.05	66.18	8.5%	6.5%
2008	1,061.28	68.63	53.75	14.88	6.5%	1.4%
2009	943.00	65.26	14.29	50.97	6.9%	5.4%
2010	1,005.98	86.73	9.38	77.35	8.6%	7.7%
2011	1,103.11	102.76	15.81	86.95	9.3%	7.9%
2012	1,124.63	104.57	18.06	86.51	9.3%	7.7%
2013	1,184.88	110.66	10.46	100.20	9.3%	8.5%
2014	1,224.52	118.64	16.33	102.31	9.7%	8.4%
2015(e)	1,255.13	121.00	14.48	106.52	9.6%	8.5%
2016(e)	1,305.34	130.00	15.57	114.43	10.0%	8.8%

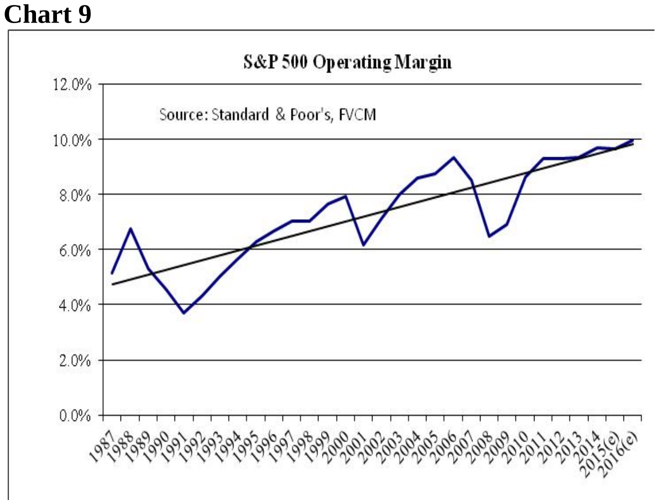
Source: Standard & Poor's, Thomson Baseline, FVCM

Chart 8



Source: Thomson Baseline, Federal Reserve, FVCM

Chart 9

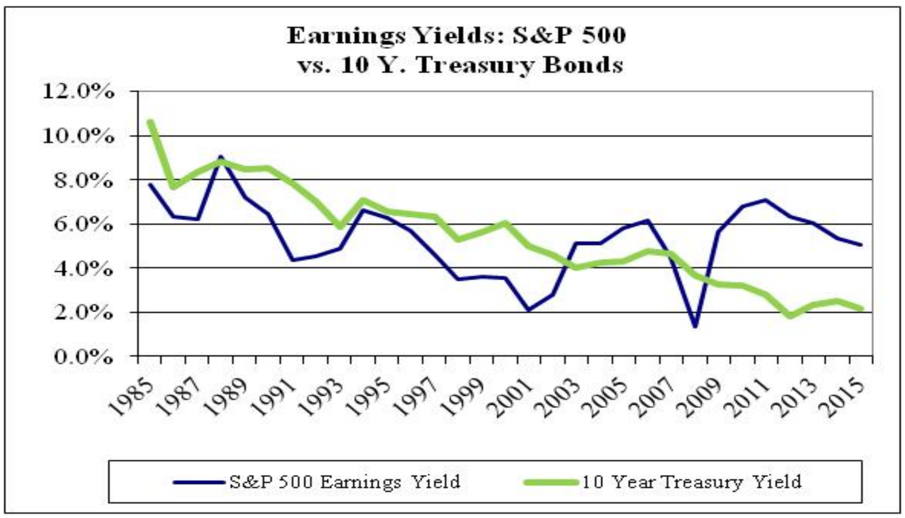


Earnings for the S&P 500 pretty much mirror the general economy—slow but extended growth. Particularly with the dollar's f/x effect, revenues for the S&P 500 now look like they will limp along in 2015 at a rate of perhaps only 2%-3%. We think that the dollar's value should generally begin to stabilize, thanks in part to gradual improvement in the major economies of Europe and Japan, and the revenue depressing impact should lessen going forward. Employment costs are showing signs of picking up in the U.S. and profit margins are not forecast to increase much, but could still inch ahead through 2016. And, while any unforeseen pickup in wage growth could put downward pressure on profit margins, higher wage growth could, at the same time, translate into better revenue growth as spending picks up. All-in-all, modest sales and margin improvement should help overall earnings increase about 2% this year and 7% in 2016.

S&P 500 Valuation

Values are always relative. And compared to bond yields, stocks still look attractive. It is true that most measures of value, like price-to-book value or price-to-earnings, look relatively high compared to some years past in an absolute sense. However, investors need to take into consideration the alternatives. Bank and other cash deposits essentially return nothing. Low demand for debt and the low level of aggregate spending has resulted in low inflation and bond yields. As we saw back in Chart 6, the yield on the 10 year U.S. treasury bond is now only about 2.2%, versus an earnings yield (earnings/price) of 5.1% for the S&P 500 (see Chart 10 below). And while stocks alone carry earnings risk if there is a recession, since the interest payments on bonds are fixed, both stocks and bonds face the greatest risk together—inflation. If spending and inflation were to accelerate, bond prices would suffer. And, somewhat perversely, equity earnings and prices would benefit in the early stages of a pickup in spending and inflation. Bonds would not. Between the two of them, stocks look more attractive.

Chart 10



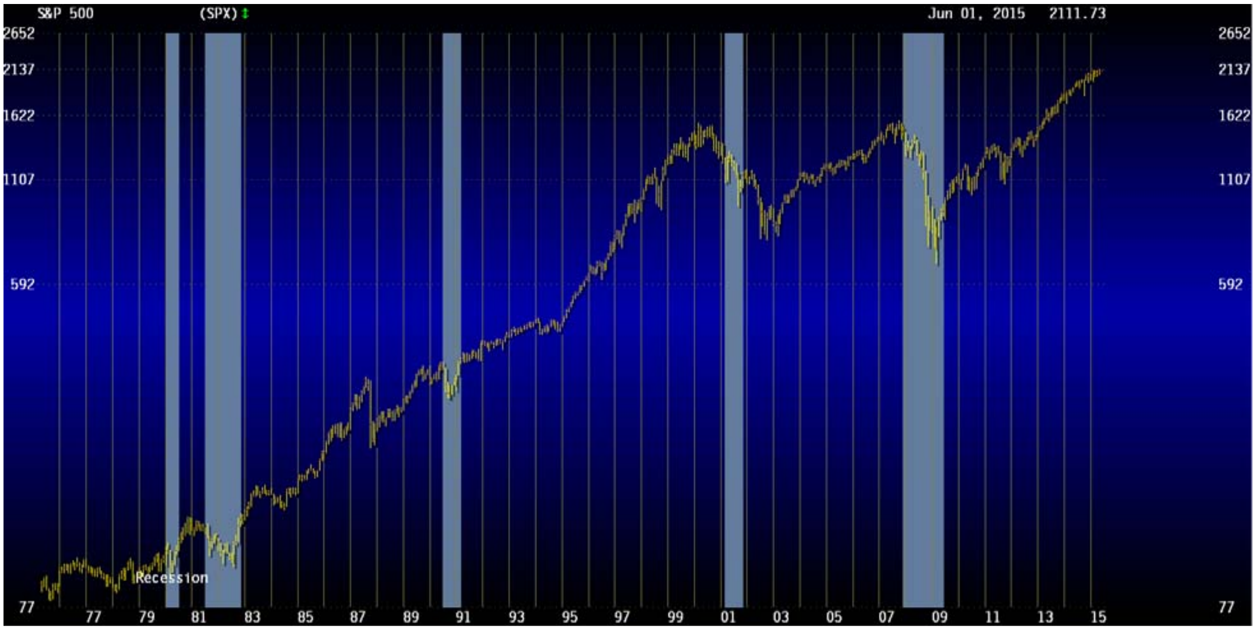
Source: Standard & Poor's, Thomson Baseline, FVCM

As we have tried to emphasize, inflation is the key variable to watch. For now and the next year or two at least, inflation does not look like a problem. Inflation is so important for two reasons:

1) Inflation is the primary determinant of bond yields and normalized stock earnings yields. We say "normalized" stock earnings yields because, once you've factored out the effect of the business cycle by using a trailing average of earnings, as is done in the famous "Shiller Model," inflation becomes the primary determinant of the S&P 500's P/E ratio. It makes sense because stock prices are the discounted value of future earnings (dividends). When inflation rises, interest payments on bonds are worth less in real terms and, similarly, future earnings and dividends are worth less as well.

2) As we mentioned previously, rising inflation removes central bank flexibility and requires tighter monetary policy. Imagine if inflation in Europe today was 10% or even 5%. The ECB would not have the latitude to engage in quantitative easing (QE). Because inflation is so pernicious and hard to stop once it gains momentum, the ECB would have to tighten monetary policy even if it causes a recession, which is usually the case. And, in recessions, corporate earnings decline, as do stock prices (see Chart 11 below – the grey shared areas represent recessions).

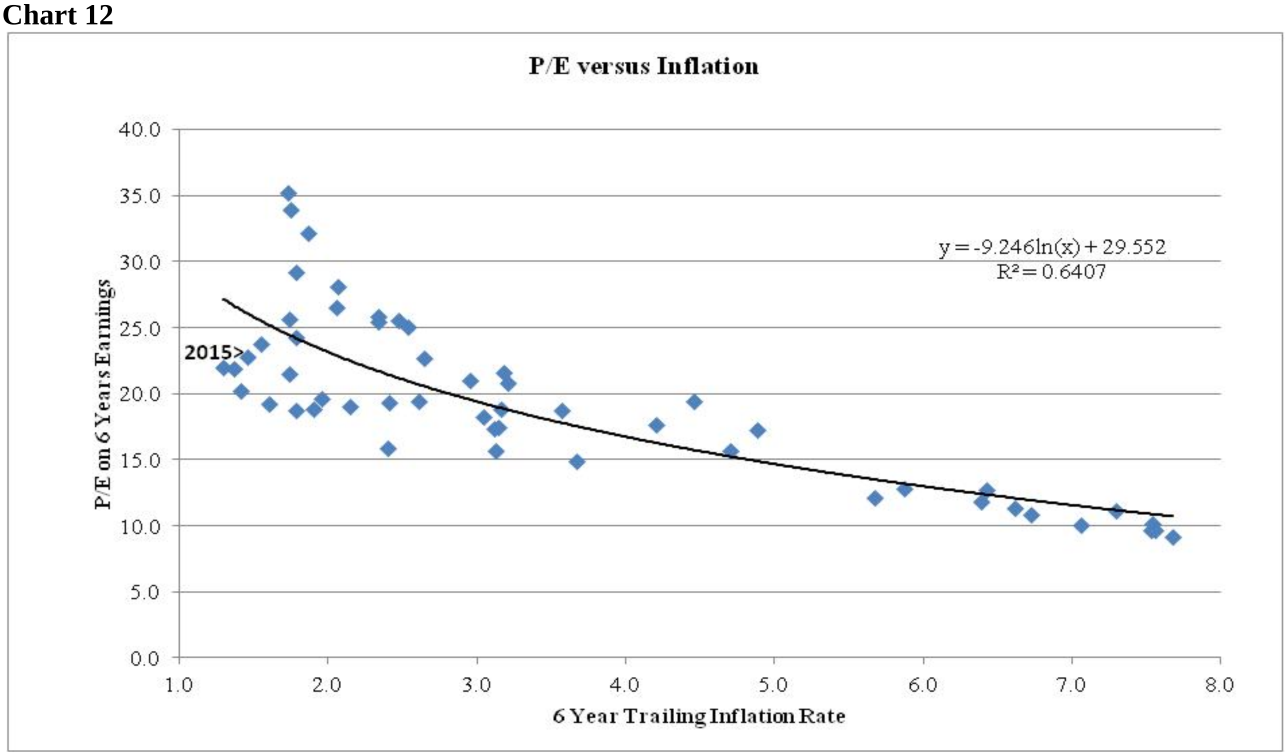
Chart 11: The S&P 500 Index



Source: Thomson Baseline

A "Fair Value" for the S&P 500 is in the eye of the beholder, but with inflation low, we still see plenty of upside in stock prices. The Shiller PE10 model is widely discussed in the media because it suggests that the current S&P 500 is above the average cyclically adjusted P/E using trailing 10 years earnings. While helpful, the Shiller model has one huge shortcoming: It simply compares today's P/E with the historical average. The problem is that P/E's should be higher in periods of low inflation, and it should be lower in high inflation environments. Second, theoretically, valuations should be a function of expectations not simply the past. We have done some statistical testing and have found that people's expectations about *the future* reflect the past six years, not the past ten years. Therefore, we look at the relationship between trailing six year inflation and P/E ratios using trailing six year GAAP earnings (see Chart 12 below).

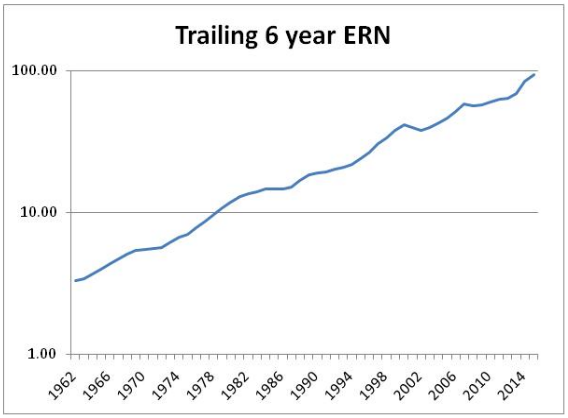
Chart 12



Source: Standard & Poor's, FVCM

The "best fit" line in Chart 12 is our measure of the "fair" P/E ratio, based on trailing six years earnings and inflation (see Chart 13). Just to review, trailing six years earnings are used in order to smooth the results and lessen the variability due to the business cycle (see Chart 13). We've moved one step forward by adding in our estimate for 2015 earnings to get an average for the period 2011 to 2015, as well as calculating a six year inflation number the same way. Notice in Chart 12 that we have indicated the dot representing the 2015 data and that it is below the best fit line. This suggests that the S&P is still a good value considering the low level of inflation. The numbers plugged into the model are shown in Table 2 below. Just to be clear, the "Fair P/E of 26.3 is based on trailing earnings. Because earnings are always in a rising trend long term, that P/E is higher than the P/E when calculated using either the conservative present year GAAP earnings, which our model is based on, and especially operating earnings. The bottom line is that the model suggests a fair S&P 500 of 2,454, which is about 17% above current levels.

Chart 13



Source: Standard & Poor's, FVCM

Table 2: S&P 500 Fair Value

Trailing 6 Year Earnings (2015)	93.31
Trailing 6 Year Inflation (%)	1.4
Fair P/E on Trailing Earnings	26.3
Fair S&P500	**2,454.4**
Earnings GAAP 2015(e)	106.5
Earnings Operating 2015(e)	121.0
P/E 2015 GAAP Earnings (target)	23.0
P/E 2015 Operating Earnings (target)	20.3

S&P 500 Outlook

We remain bullish and think the S&P 500 target of 2250 for year-end 2015 that we wrote about last January remains a reasonable expectation. Since we made that forecast, we've reduced our earnings expectations for the S&P at the same time that the rate of inflation has declined, which should provide upside to valuations. True, our valuation model calls for an even greater year-end target of at least 2,454 (see Table 2 again), but the models are only approximations of reality. Investors remain skeptical despite more than five years of growth, and we think prices will only gradually move higher. So a further gain of 7% this year seems about right. Add on another 1% for dividends paid in the second half of the year and equity returns should look quite good compared to the alternatives.

This Bull Market will not last forever. The current unemployment rate is both good and bad. Now at 5.5%, there are a lot fewer people who are looking for work than five years ago—an unqualified good. However, by 2016 the unemployment rate will fall below 5% and labor will become a limiting factor on growth. The "mainstream" thinking is that wage growth will almost certainly accelerate as employers try to lure the best employees from a dwindling supply. By 2017 or perhaps 2018, under this scenario, inflation will likely show signs of moving up and the Fed will have to ensure that inflation doesn't gather too much steam. Inflation is like a huge ship which takes time to both accelerate and decelerate once it gains momentum. For both bond and equity markets, rising inflation would likely end the current Bull Market.

There is also an alternative scenario that we think is a serious possibility. As we noted near the beginning of this report, consumers have reduced indebtedness over the past several years and there has lately been a cyclical pickup in loans and leases. It is possible that consumers will hit that natural debt wall again and spending dies out before inflation ever gains any momentum. At that point the disinflationary spiral could again take hold and QE4 could become a reality. This scenario may actually be a better for markets than if inflation picks up. It is quite possible that asset values would be supported by the central banks and stock markets would likely trade in a range while debts are again reduced. We don't think either scenario is likely to come to pass for at least a couple years and, in the meantime, we recommend investors stay with equities.

Stock Market Crosscurrents

Defensive stocks have erratically outperformed cyclical stocks for about the past year as investors have bid-up the prices of companies perceived as big, stable growers (see Chart 16). Stocks like Apple and Amazon have reached amazing heights thanks to the perception that they are immune to slow economic growth. Biotech and other healthcare stocks that we own have also done well, as have stocks in the consumer staple sector. However, there is a lot of noise and variability over shorter periods of time as different stocks catch investor's interest while others become unpopular. The fundamentals at the individual stock level are what really determine performance in the long run, and we still see some good values in many "cyclical" companies. Also, we regularly observe that cyclical stocks will rise during periods of weakness in defensive names and vice versa. Short-term volatility and risk can be reduced by maintaining exposure to different types of businesses, and long-term performance can be driven by picking the good companies that trade at good values, whether they are cyclical or not.

Chart 16

Source: Evercore ISI
