Volatility Returns

While the stock market was able to escape through the third quarter with respectable year-to-date gains, October has greeted investors with a dramatic rise in volatility and an ample dose of fear. Through September, the S&P 500 Composite, Dow Jones Industrial Average and NASDAQ Composite had gained 6.70%, 2.81% and 7.59% respectively for the year. Meanwhile, the Composite of all equities under management at Osher Van de Voorde Investment Management gained 6.29% for the first three quarters of 2014. As we went to press, with the first two full weeks of October under our belt, the gains of 2014 seem like a distant memory.

In our July newsletter, we highlighted various warning signs about the stock market's ascent that led us to reduce equity exposure for our clients. That call now looks fairly prescient and the market's recent weakness has given us increased opportunity to hunt for bargains. Especially during periods of excessive pessimism, it is important to take a deep breath, analyze the factors influencing the market's decline, focus on the fundamentals and act opportunistically and decisively to improve the overall quality of portfolios, increase current income and growth of income potential and improve prospects for predictable, long-term capital appreciation.

To be sure, the recent surge in volatility has coincided with the emergence of ISIS and Islamist terrorism in Iraq, Putin's power play in the Ukraine, the threat of double-dip recession in Europe, softening economic conditions in China, escalation of the Ebola virus disease outbreak, a sharp climb in the U.S dollar and a steep decline in the price of crude oil. Collectively, this steady onslaught of headline risk has weighed on sentiment, turning optimism to pessimism seemingly overnight. As newfound fear envelopes the market, investors tend to extrapolate only negative conclusions from the current woes of the day. As we parse through the immediate fear and focus on the fundamentals, we are convinced that the current correction is just that and has provided us with the most significant buying opportunity in many months.

While global economic conditions have clearly softened, the International Monetary Fund recently reduced its forecast for 2015 global GDP growth by a mere 0.2% from 4.0% to 3.8%. The IMF cited the growing probability of recession in Europe, disappointing output in Japan and a slower trajectory of growth in emerging economies such as Russia and Brazil as primary concerns. While China's economy is also slowing, the IMF still expects Chinese GDP growth of 6.5% in the coming year. On the bright side, these global weak spots are more than offset by the strengthening U.S. economy.

The super-tanker U.S. economy grew 4.6% in the second quarter and is expected to sustain growth north of 3% for the second half of 2014, marking the fastest pace of GDP growth during the current recovery. Despite this acceleration of growth and unemployment having recently fallen below 6% to 5.9%, U.S. interest rates have plummeted. The ten-year U.S. Treasury yield now hovers near 2.0% and the thirty-year U.S. Treasury yield has broken below 3% for the first time since May 2013. Concurrent with the plunge in Treasury yields, the U.S dollar has surged in a global flight-to-safety trade. As the dollar has strengthened, the combination of tumbling energy prices and cheaper imported goods, in addition to lower borrowing costs, will serve effectively as a tax cut for the U.S. consumer. Responsible for 70% of U.S. GDP and 20% of global GDP, consumer spending in the U.S. will continue to buoy U.S. and global GDP growth in the months ahead.

While the stronger U.S dollar will increase the cost of U.S. exports and may indeed increase the probability of revised earnings guidance from U.S. multinationals, currency related swings to the corporate bottom-line tend to be short-term phenomena. The secular trend of accelerating demand from a rising middle class in emerging economies will be a driver of earnings for multinational corporations for decades to come and should not be dismissed due to quarterly fluctuation in currencies.

Peeling back the onion of the current volatility in the stock market, ample evidence exists that we are witnessing yet another case of hedge funds run amok. The very crowded trade of long oil and short Treasuries has forced massive liquidation upon the overleveraged hedge fund community.

With declining import costs, lower energy prices and weakened economic growth overseas, the prospects for heightened inflation and inflation expectations have diminished and all but taken off the table any immediate necessity by the Federal Reserve to hike interest rates. Indeed, global conditions today are aligned much closer to the “new neutral” world championed by Bill Gross and described in our last newsletter. IMF Chief Christine Lagarde offered her own descriptive for the global economy recently, echoing Bill Gross with the newly coined “new mediocre”. The odds that Bill Gross may be right seem to have risen markedly over the last few months and would only serve to increase the value and attractiveness of high-quality growth companies as dividend yields climb in the wake of the current correction even as the yield on Treasury bonds plummet.

Consensus earnings expectations for the S&P 500 stand at $118.13 for 2014 and $132.64 for 2015. At today’s lower prices, the PE (price-earnings ratio) for the S&P 500 now stands at just under 16 for 2014 and just over 14 for 2015. Valuations are much more reasonable and downright attractive in light of the recent decline in Treasury yields. While it is probable that earnings expectations will decline given the weakness overseas, we simply cannot ignore the fact that dividend yields significantly trump the “safety” of Treasury yields.

While the media is presently focused on negative headlines and what might go wrong, there are any number of potentially positive outcomes. For instance, economic weakness is forcing leaders in Germany and France to reevaluate fiscal policies and ECB President Draghi is under considerable pressure to show his “all-in” hand. Also, the decline in energy prices has significantly eased tensions between Russia and the Ukraine. And, as already mentioned, the plunge in interest rates and energy prices will boost the consumer’s capacity to spend in the months ahead.

While the Ebola scare is a humanitarian disaster and not to be dismissed, the outbreak may ultimately prove to have had the same kind of short-term impact on markets as the SARS outbreak in 2003. Clearly, any signs that the outbreak has been contained will go a very long way to restoring investor confidence.

Today's panic selling might only be warranted should the U.S. be on the cusp of recession. Yet, all of the tell-tale signs of recession are presently absent. Federal Reserve policy remains highly accommodative. Real interest rates are historically low. The yield curve remains steep. Energy prices are falling. Banks have trillions of dollars of reserves and lending is picking up. Corporations possess trillions of dollars of cash on their balance sheet. Investors have trillions of dollars of cash on the sidelines in money market funds.

Finally, recent prognostications give the Republicans an increasingly large chance of maintaining the House and also winning control of the Senate. Should this occur, it is probable that we will see fiscal policy measures introduced to reform corporate taxes and entitlements during President Obama's final two years in office. While President Obama is unlikely to sign any meaningful reform, we may be set to witness a sea change in fiscal policy, marking the peak of Big Government in the U.S.

We will continue to follow the sage words of Warren Buffet and "be greedy when others are fearful".