The Search for Abundant Clarity

Bob Osher was fond of suggesting that decisive action on any particular dilemma be delayed unless the course of action was "abundantly clear". If we use abundant clarity as a litmus test for analyzing today's stock market, it might be very difficult for us to navigate a precise course. Yes, uncertainty, rather than abundant clarity, seems to be today's market mantra.

As we predicted in our January newsletter, the stock market exhibited heightened volatility as the major indices bounced back and forth from barely positive to barely negative for the first quarter. The S&P 500 and NASDAQ Composite eked out gains of 0.44% and 3.48% respectively, while the Dow Jones Industrial Average declined by -0.26%.

With revenues for the Osher Van de Voorde core equity portfolio derived from foreign operations, the strong U.S. dollar served as a major headwind. We identified this hurdle in January and do not intend to make any major shifts away from dominant global franchises to a more domestic focus in order to hide from the dollar's present strength. In three short months, the consensus forecast for 2015 earnings for the S&P 500 has been reduced from $126.49 to $120.46. This sharp haircut has been driven almost entirely by the expected impact of the strong dollar and especially by the impact of the plunge in the price of oil on the energy sector. As we went to press, the S&P 500 was trading at 2110 and now sports a PE of 17.5x the consensus 2015 forecast. This is the same valuation we finished at year-end for trailing 2014 earnings. Due to a lack of attractive alternatives, investors are willing to pay the same multiple despite the decline in earnings expectations. At least for now, investors are looking through the short-term impact of dollar strength and energy weakness on quarterly results.

A PE multiple of 17.5x may seem relatively high, especially when we consider the generational low valuations observed during the 2008-2009 economic crisis. However, it is important to consider that the peak PE ratio, both mean and median, for all bull markets over the past 50 years is 20x. Prior to the economic crisis, Goldilocks conditions that we presently enjoy – low inflation, moderate growth, low interest rates and accommodative monetary policy – would be rewarded in the stock market with premium valuations. Yet a vast many investors still have themselves anchored to the dismal experience of the 2008-2009 bear market and remain unwilling to climb the ladder of risk. We continue to think that the surprise in today's markets will be to the upside as yesterday's bears grow increasingly frustrated and succumb to the Siren-like seduction of this stubbornly resilient stock market. While we are finding it particularly difficult to find great bargains, we think this bull market phase has not yet run its full course.

Overall, economic underpinnings remain mostly favorable. Commercial and industrial loans at U.S. banks grew at 19% annualized pace during the first quarter. With over $2.5 trillion in excess reserves, the abundance of bank capital may finally synchronize with rising business confidence. With lending to small and medium business rising sharply as unemployment has stabilized at 5.5%, the potential for inflation to unexpectedly tick higher remains a stealth concern that may influence more hawkishness within the Fed. Real estate continues to fare well: mortgage applications are soaring, purchase of vacation homes soared 57% in 2014, and nationwide office vacancy stands at its lowest level in six years. Meanwhile, services activity in the U.S remains robust even as manufacturing has softened over the last few months.

The international Monetary Fund just recently reduced its forecast for 2015 U.S. GDP growth from 3.6% to 3.1%, citing the strong dollar's impact on exports as its major concern. Offsetting the drag caused by dollar strength, the IMF believes that favorable energy prices, modest inflation and an improving housing market will continue to serve as catalysts for growth. The IMF still sees global GDP rising by 3.5% in 2015.

With our economy downshifting in the first quarter, the debate on timing for the Federal Reserve's first rate hike for this cycle is growing louder. Recent economic weakness and the Fed's continued telegraphing of patience leaves the consensus expectation pegged at a rate hike towards the end of the year. Even if the Fed raises rates sooner, it is important to understand that *real* rates will remain accommodative even after the fed hikes rates by 50 to 75 basis points. This level of rate hike is not likely until sometime in 2016, so we are a long way off from monetary policy becoming restrictive

Globally, it is encouraging to observe the sharp gains in equity prices in Europe, Japan and China as the U.S. markets have seesawed. Despite a flattish U.S. stock market, global equity prices rose 9% in the first quarter and global equity market capitalization has now reached a new all-time high of approximately $70 trillion. It appears that quantitative easing measures are having their intended impact overseas which will ultimately prove to be very positive for U.S. companies and investors alike.

While the recent slowdown in the U.S. economy and questions on the outset of the first rate hike by the Fed have induced a renewed level of uncertainty and lack of abundant clarity, Bob might have agreed with the sage words of Warren Buffett, master value investor who influenced our firm's investment philosophy more than any other, that "it is better to be approximately right than precisely wrong". Despite the lack of abundant clarity, we continue to believe that the U.S stock market will deliver attractive gains for the year, especially relative to alternative considerations.