Capital Planning Advisors

Family, Business & Legacy Wealth Advisors
Sacramento ▪ Walnut Creek ▪ Roseville

Written by
Brian J. Pretti CFA, CFP®
Partner & Chief Investment Officer
Capital Planning Advisors

CAPITAL INSIGHTS

Economic Briefing • May 2014

Are We Moving Into A "Clara Peller" Market Environment?

Certainly Clara Peller is far from a household name, especially for anyone under the age of about 30. Clara Peller was a manicurist living in Chicago most of her life. At the age of 80, she was hired as a temporary manicurist for a television commercial set in a Chicago barbershop. Both outspoken and possessing a unique tobacco cured voice, she impressed the agency who hired her, ultimately prompting them to offer her a position as a spokesperson in a 1984 commercial for the Wendy's fast food restaurant chain. Remember her now? The tag line of that very well-known Wendy's commercial was "Where's the Beef?"

As far-fetched at this may sound, the Clara Peller story is perhaps an apropos analogy for what we have been seeing in the US stock market over the last few months. It's a story we've seen before in prior market cycles and worthy of consideration as we move ahead. At some point as every market cycle ages, market participants begin to ask the question, "where's the beef?" The supposed claim to fame of Wendy's back in the 1980's was that their hamburger had more beef and was meatier than those of their competitors. Less bun, more beef. In the stock market, the real beef is corporate revenues, earnings and cash flow, the directional mother's milk of stock price movements over time. What we have seen in prior market cycles of age is that equities characterized and driven primarily by a promising story (a lot of "bun"), yet not showing terribly much in terms of current earnings and cash flow (the "beef"), come into question and often begin to underperform companies that produce consistent revenues and cash flow, yet do not have wildly exciting stories of "tomorrow."

Think back to the dotcom boom of the late 1990's and early 2000's. Isn't this exactly the character point change that occurred as the year 2000 played out? Technology stars and starlets possessing plenty of promise, but little in the way of tangible near term cash returns, fell from the skies, some forever, in deference to unexciting, yet consistent blue chip revenue and earnings growth stalwarts of the period. You probably have not seen too many Pets.com commercials lately, have you? The same thing occurred with many a subprime mortgage

Where's the Beef?

lending underwriter and home builder in 2007. Stories come and go in every market cycle, but companies able to consistently compound and allocate financial capital persevere across the cycles.

Let's look at some bigger picture facts of the moment as we consider changes we've seen in the stock market recently. Largely thanks to the handiwork of the Federal Reserve in printing close to $4 trillion dollars since late 2008 (and they are not quite done yet), we are now over five years into the current equity bull market cycle that began in March of 2009. At the end of April, the current equity bull market is officially 267 weeks old. According to Standard and Poors data, the average length of US bull markets since 1930 is 165 weeks. The bull market of the moment is no youngster. Furthering the special character of this cycle, again according to S&P data, is that the current bull market is now the second longest equity bull in over 80 years. The only bull market to exceed the current in length was the bull market that began in late 1990. You'll remember that period marked a massive secular technological turning point for the real US economy. That bull was underpinned by significant real economy change and acceleration, especially as it concerned technology led productivity acceleration. Bull market age says nothing about price tops or timing, for that we need to watch character and, as always, focus on risk management in ongoing portfolio management.

Although the stock market has not made a lot of progress this year, price volatility has increased. There has not been wildly meaningful downside, but it "feels" a lot different than what was close to a straight up market last year. As always, it's important to look behind the headlines at the character point fingerprints of the equity market. After all, it's a market of stocks and stock sectors, not a monolithic equity market block the averages tend to reflect.

In 2013, some of the most highly valued (stock price relative to earnings, price relative to sales and cash flow, etc.) portions of the market did very well and beat broad

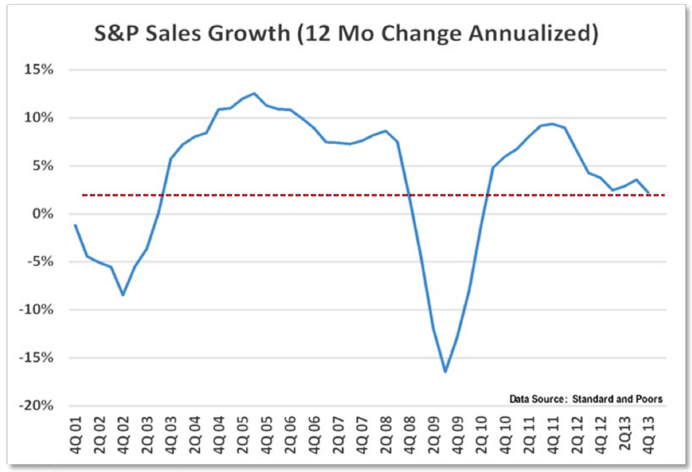
Are We Moving Into A "Clara Peller" Market Environment?

Continued from page 1

market averages by a mile. This year, it is some of these same riskier by valuation areas that are suffering the most in terms of price, often sporting double digit declines, as the overall averages have not strayed too far from beginning of year price anchorages. In many cases, these companies can be analogously described as having "more bun and less current beef." This may change in the years ahead as companies grow into the lofty expectations that have been placed on them and fulfill the bright futures being projected for them. It is perhaps more a character point of equity bull market age where stories (more bun) have already been celebrated to a point approaching price exhaustion. After all, it may sometime for many of these companies until the "beef" of meaningful revenue and earnings growth actually arrives.

There may be yet another very important factor at work in the current market environment in addition to an aging equity bull taking on a different temperament, causing character change in the markets. In 60 of the last 65 months, the Federal Reserve has been engaged in Quantitative Easing, the printing of money used to buy bonds from the financial community. QE, as it affectionately has been called, has provided incredible amounts of liquidity to the broad financial system. The Fed's specific intent in QE was to raise asset prices – equities, bonds, real estate, etc. The Fed believed in what is called the wealth effect, the thinking being that if asset prices inflate, consumers will feel better and both spending and borrowing will increase. Given that we are largely a consumption based economy, that increased spending and borrowing would theoretically engender a self-reinforcing economic upswing. Yet recently, Street economists have lowered 1Q 2014 GDP estimates to levels close to 1%, which is far from an upswing. The important point being, much of that Fed-sponsored liquidity indeed found its way into financial asset prices over the last half decade, just not so much into the real economy.

Beginning in December of last year, the Fed began the journey of unwinding the magnitude of their financial stimulus. From $85 billion in financial largesse monthly,



the Fed is now down to buying $45 billion of bonds. We expect that by year end they will discontinue QE entirely, barring a major market setback. This is a dramatic change to the environment of expanding liquidity character market participants have come to know since 2009. A market environment of excess liquidity coupled with relative youth can allow for more bun and less beef equity stories to not only play out, but thrive. Importantly, excess Fed-driven liquidity also marked the pre-Y2K late 1990's dotcom boom era. In 2007, the excess liquidity was found in the US mortgage markets. It was when the excess liquidity waned in the prior two market cycles that investors began the late cycle familiar chant of "where's the beef?" Have we reached that point in the current market cycle?

The change in market character over the last few months demands we ask this question and monitor forward market tone and rhythm closely. Although the strength of corporate earnings and cash flows drive stock prices over time, it is sales (revenues) that are the starting point for each. As mentioned, despite the historic QE, end demand in the economy has not shown us significant strength, even after an unprecedented five years of Fed stimulus. The following chart makes the point quite clearly.

Capital Planning Advisors

Written by
Brian J. Pretti CFA, CFP®
Partner & Chief
Investment Officer
Capital Planning Advisors

Lawrence A. Hansen Partner & CEO
Brian J. Pretti CFA, CFP®, Partner & Chief Investment Officer
Jim Wilson Partner & President
Michael Sollazzo, Esq., CPA, (INACTIVE) Partner & Advanced Planning Counsel
Matt Page CFP®, CRPS®, Vice President Wealth Management

Sacramento
(916) 286-7650
Walnut Creek
(925) 524-2800
Roseville
(916) 290-9180

Are We Moving Into A "Clara Peller" Market Environment?

Continued from page 2

As of the fourth quarter of 2013, the annualized 12 month rate of change in S&P sales growth was the lowest of the current cycle, registering 2.4%. Again, the historic Fed sponsored QE has failed to spark broad based demand growth as is reflected in total S&P company sales strength.

More importantly, we have been running in low sales growth territory for over a year. This type of historically subdued growth was completely absent in the prior economic and financial market cycle. "Where's the beef?" So what allowed equity prices to ascend in excess of 30% last year when annualized S&P sales growth could not even attain 1/10th of the prior cycle's level? The artificially low interest rate environment of the last five years has no precedent in US history, yet it has allowed corporations to borrow very inexpensively in order to buy back stock. That continues today. Shrinking share bases helped earnings "per share" expand while corporate top lines (sales) grew anemically at best. As we described in our last correspondence to you, foreign capital coming to the US has been more than plentiful, escaping potential confiscation (China), currency debasement (Japan), and anemic real economy investment opportunities (China and Europe). That foreign capital certainly found its way into domestic equity markets and that also continues. But are these relatively artificial factors now coming into clearer focus for investors? Is diminishing liquidity (the Fed) acting to change the character of the market environment as it did in 2000 and 2007? Is the bull now of an age where investors are focusing less on "the bun" and more on "the beef?"

We believe there are two absolutely key risks faced by investors. One is the actual loss of capital and the second is lost investment opportunity. Our charge is to prudently balance between these over total market cycles. Neither can be eliminated simultaneously. The markets for now are shifting focus from highly valued equities where revenue, earnings and cash flow strength lay years ahead, to more of an of the moment focus on immediate top line corporate sales and ultimately earnings growth – "the beef", if you will. We need to remember that five years into a bull market equity prices relative to sales are not cheap by historic standards, quite the opposite. The current average S&P price to revenue multiple has only been exceeded by what was seen in the year 2000. The median price to revenue multiple rests at a record high. The markets have priced in a lot of tomorrow's "opportunity." For now, it is a time to more heavily weight in our thinking and actions the first of the two key investment risks. Everything in balance. Although Clara Peller is no longer with us, her tobacco cured refrain is applicable to the markets of the moment – "where's the beef?" This is the implicit question investors appear to be asking in recent months.

Capital Planning Advisors

Written by
Brian J. Pretti CFA, CFP®
Partner & Chief
Investment Officer
Capital Planning Advisors

Lawrence A. Hansen Partner & CEO
Brian J. Pretti CFA, CFP®, Partner & Chief Investment Officer
Jim Wilson Partner & President
Michael Sollazzo, Esq., CPA, (INACTIVE) Partner & Advanced Planning Counsel
Matt Page CFP®, CRPS®, Vice President Wealth Management

Sacramento
(916) 286-7650
Walnut Creek
(925) 524-2800
Roseville
(916) 290-9180