SIGHTLINE INVESTMENT PERSPECTIVES NOVEMBER/DECEMBER 2011

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The Blonde

"We see things as we are, not as they are.[1]"

Now that I have your attention, you may remember the 2007 remake of the 1970's film, Sybil, which was based on a true story that popularized multiple personality disorders. In the story, Sybil had developed 16 personalities as a result of trauma early in life. The 16th personality was *The Blonde*, a nameless perpetual optimist that was the last to emerge before Sybil's integration into a single self. Of course the other 15 personalities had different ways of seeing and interacting with the world – fearful, confident, listless, enthusiastic etc. – that were *triggered by environmental cues.* Sybil's personality condition sounds a lot like markets, particularly the current post-Great Recession market, except that this market has a lot more than 16 personalities.

When the stock market has a big drop, the bear opinion-makers are trotted out on cue to make us feel more bearish, and vice versa. Either way, their arguments appear sound. They offer selected and convincing data to make their case. Let's take a look at some of their arguments.

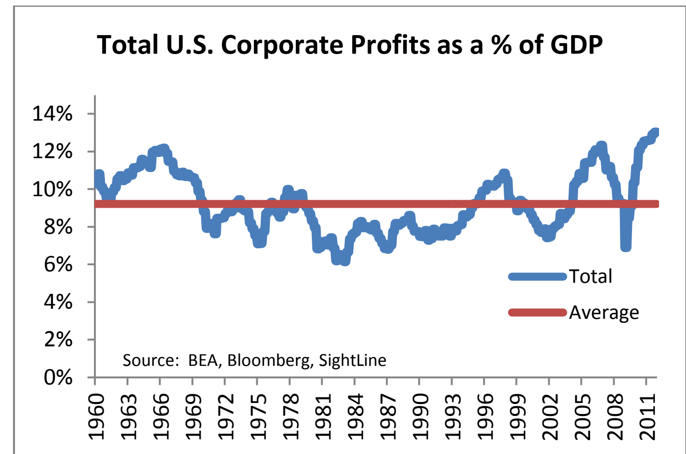
Are Stocks Rich or Cheap?

The Bulls: Stocks are cheap. Stock prices are low compared recent earnings and stock yields are high relative to bond yields. Corporate profits are high with no reason to believe they can't stay high or go higher. Economic conditions will keep labor costs low and Fed policy remains supportive. Yes, there are concerns with regard to a European debt contagion, but this is already reflected in market prices.

The Bears: Stocks are rich. Corporate profits are unsustainably high, relative to GDP and relative to long-term trend rates of earnings growth. Europe is headed into recession, China is weak, and domestic spending is constrained. Stocks will suffer in the face of lower growth prospects in 2012 and collapsing margins. Profits will disappoint as they return to more normal and sustainable levels.

Our View: Both the bulls and the bears use the same corporate profits data to support their differing views – clearly a case of "we see things as we are, not as they are."

The chart that follows shows total U.S. corporate profits as a percent of GDP.



As a percentage of GDP, corporate profits are higher than any time in more than 50 years. The bulls look at this and think how strong U.S. companies are right now. The bears look at it and think it can't persist, that profits are at a cyclical high and will eventually revert back toward the average.

The way we see valuation:

1. The price-earnings ratio is about 20% below fair value based on trailing 12-month earnings for the S&P 500.
2. Earnings are about 25% above fair value based on trend rates of growth for the S&P.
3. If we adjust the low historical P/E for the cyclically high corporate profits, stocks are about 5% above fair value as of the end of November – nothing to get excited about.

However, relative to bonds, stocks remain very cheap because bond yields are so low. The Fed is keeping interest rates low to reduce debt burdens and support the recovery. Some commentators fault the Fed for inflicting "financial repression" on bond investors – keeping interest rates artificially low, and below inflation, to reduce the debt burdens of borrowers, particularly, government borrowers. Given the choice of a debt-induced deflation or a debt-induced inflation, the Fed will pick inflation every time.

Will the Recovery Continue or Stall?

The Bulls: The Fed will continue with its unprecedented monetary stimulus and it is having the intended effect. Recent economic data show that both employment and consumer spending are improving. While we may still be at risk from the euro zone crisis, the path laid down by the Fed is unequivocal; just follow the yellow brick road.

[1] Variations of this quote have been attributed to the humorist Leo Rosten, the writer Anais Nin, and the Talmud

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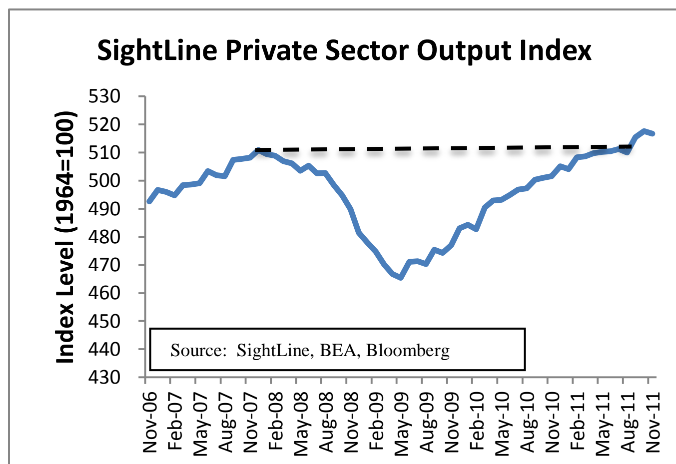
The Bears: Fed policy is simply sowing the seeds of future inflation and enabling profligate debtors, both public and private, to hang around and continue to be a drag on long-term growth. The Germans will have none of it. They will insist on better fiscal discipline in the euro zone before agreeing to bail out the European periphery. The austerity imposed by the German discipline will drive Europe into recession, and European banks to curb lending. This will have a negative impact on developing market economies as well as the U.S. The Fed has spent all their bullets – short-term rates are already at zero and the Fed balance sheet is already too large. The U.S. government has also overspent and is about to embark on an austerity program of its own. Yes, consumer spending has improved, but this is really just "frugality exhaustion" for the holidays. People are tired of penny pinching and are dipping into savings. Current consumer spending levels are unsustainable without significant and sustained job growth. The recent better-than-expected employment numbers won't move the needle. Job growth needs to be at least 50% higher on a sustained basis to support healthy consumer spending growth.

Our View: Again, both the bulls and the bears use the same information – Fed policy, consumer spending, and employment – to draw opposite conclusions. More support for the case that "we see things as we are, not as they are."

Let's start with the U.S. *private* economy:



We estimate private sector output as the product of:

- Number of private sector (nonfarm) workers, times
- Hours worked, times
- Output per hour

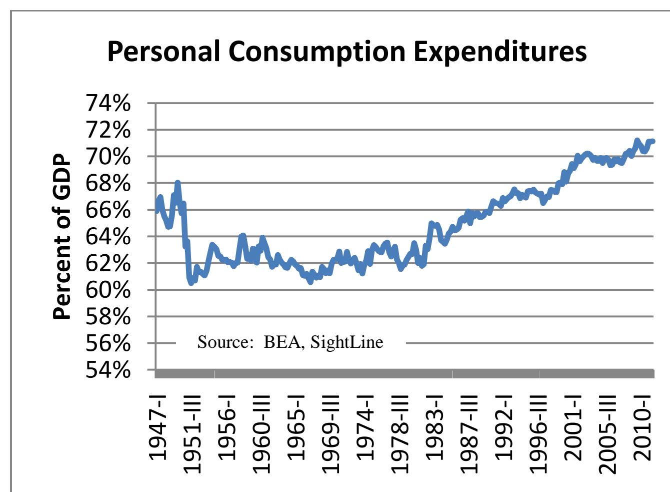
This estimate is more timely than the quarterly GDP data as the employment data is published monthly and the hours worked comes out on a weekly basis.

As shown in the chart, the nonfarm private sector has recovered from the recession and has expanded beyond the pre-recession output levels of 2007. This is a result of productivity gains, not job gains. The problem is that demand has not come from business investment spending. Since the end of 2007 through the third quarter of this year:

• GDP has grown by just	0.1%
• Personal Consumption Spending is up	1.4%
• Domestic Personal Consumption Spending[2] is up	1.9%
• Government Spending is up	2.1%
• Foreign Spending (Exports) is up	10.0%
• Investment Spending is down	-16.4%
• Employment is down	-5.3%

Policy makers need to reconsider their approach to stimulating job-creating investment. Without export demand, we would be in a world of hurt right now. If not exports and investment spending, from where will growth and jobs come?

Don't look to the U.S. consumer to drive growth. The recent uptick in holiday spending came with a decline in the savings rate. The consumer still has a large debt burden to work down, and consumption expenditures are already a very large proportion of the economy as shown below. Consumption needs to grow, but its growth needs to be slower than income growth to put us on a sustainable path.



Don't look to government spending to drive growth. The federal government is now in deficit reduction mode. State and local government spending has been shrinking for a while

[2] For domestic personal consumption spending, we use a simple proxy: total personal consumption spending less imports. Imports fell by 0.1% from the end of 2007 through the 3rd quarter of 2011. They represent about 17% of the GDP.

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now. It is down by more than 5% since the end of 2007 and down by about 2.5% over the past year.

The Blonde Perspective

Like Sybil's 16th personality, *The Blonde*, a perpetual optimist that was the last to emerge before she was cured, an optimistic perspective is needed to look past the obstacles to see a path to stronger, more sustainable growth. Here is the optimistic path forward:

1. The Fed will continue to lean against the debt and deficit headwinds with stimulative monetary policy, which will support continued slow growth for 2012.
2. The low rate environment will ultimately drag money off the sidelines and business investment spending will rise. Sustained job growth will follow business investment spending.
3. The biggest risks are political, with the European debt crisis now front and center and the U.S deficit debate to heat up again later next year. Miscues on either front can easily tip the balance to recession. However, mutual self-interest will prevail and miscues will be avoided.
4. The primary support for stocks will be low interest rates, not earnings growth. Expected real (above inflation) returns over the next 10 years for the S&P500 are around 4.5%, not great but much better than the negative real returns expected for government bonds.

Should you buy or sell?

You should do neither based on a single view. Smart people can make compelling cases for why stocks and bonds will go up or down. All of them will be right some of the time. None of them will be right all of the time. If you get in the habit of view-based investing, your risk becoming a "Sybil" investor - held hostage to the latest view, alternating between over confidence, fear and confusion. These states of mind affect decision-making, either paralyzing it or causing self-destructive investment decisions along the way, even if they feel good at the time.

The key is to get the big decisions right. First, set your long-term risk allocation based on your goals, your risk tolerance, and *plausible* expectations for long-term returns based on current valuations, not simple historical averages. This helps set your expectations and puts you in control of your investment experience. Second, manage your risk allocation as value opportunities and risk conditions evolve. Use a disciplined framework, not the latest consensus or contrarian view.

Your Questions Addressed

In September we published a piece demonstrating disciplined approaches to managing your equity risk exposure based on various valuation metrics:

- Shiller's Cyclically Adjusted Price-Earnings Ratio (CAPE)
- Historical Price-Earnings Ratio using the most recent 12-months earnings (Trailing P/E)
- A Cyclically Adjusted P/E based on trend rates of growth in real earnings (CAPE-B)
- A Cyclically Adjusted Relative Value measure (earnings yield relative to bond yield) that is also volatility adjusted. (CARV-VA)

Some of you were interested in how the Shiller measure would have performed in a relative value context (earnings yields relative bond yields). We have updated our original test results for cyclically adjusted relative value measures accordingly. They are shown below in bold:

Description	Return	Chance of Loss	Chance of Loss >10%	Worst Loss
Benchmark: 50% Stocks/50% Cash	7.7%	15.4%	3.6%	(28.5%)
Strategy 1: Dynamic - Shiller CAPE	8.2%	11.9%	3.5%	(34.6%)
Strategy 2: Dynamic - Trailing P/E	8.4%	12.5%	4.0%	(36.0%)
Strategy 3: Dynamic - CAPE-B	8.8%	11.6%	2.8%	(33.0%)
Strategy 1RV: Dynamic - Shiller CARV	*8.9%*	*10.2%*	*1.7%*	*(31.8%)*
Strategy 3RV: Dynamic - CARV-B	*10.0%*	*9.1%*	*1.7%*	*(31.2%)*
Strategy 4: Dynamic - CARV-VA	9.8%	9.4%	0.2%	(18.6%)

Data: 12/61 through 08/11, monthly. Annualized returns. Source: Bloomberg, Shiller, SightLine
Loss Frequencies based on rolling 12 month returns. Worst Loss is the largest peak to trough.

Over the almost 50 year test period, the relative measures test better than the P/E measures in terms of both returns and downside risk. The trend based cyclical adjustment (CARV-B) performed better than the Shiller-based adjustment, as well.

Strategy 4 - the relative value and volatility adjusted strategy (CARV-VA) - reduced downside losses with just a modest give-up in average return as compared to CARV-B. Our Dynamic Strategic Allocation (DSA) service uses a methodology that, like Strategy 4, captures relative value and adjusts for changing volatility.

If you would like a copy of the original article for reference, let us know. We appreciate your feedback and questions.

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