Outlook for February, 2014: "An Ongoing Correction…"

With equity markets posting negative returns for January, the ***naysayers*** appear to be coming out of the woodwork. The ***Cassandras*** of the world point to such things as high corporate margins ("expect mean reversion", they say with a solemn tones), the Federal Reserve's largesse, last year's outsized gain in the equity market and troubles in emerging markets – all as evidence of what is wrong with equity markets.

Economic data released in the US has, on balance, ***been mixed:*** Last Friday, or should we say Jobs Friday, the Bureau of Labor Statistics released its assessment of labor market conditions in January. On the surface, the report was disappointing. The US added a ***meager 113k*** jobs in January, failing to meet expectations around 181k. Contrast that with November's revised 274k increase and December's 75k increase and one can see that the labor market seems to have hit a speed bump. Whether the paltry increase is an aberration (weather related?) or speaks to continued softening remains to be seen.

The ***unemployment rate*** from the household survey ***dropped 0.1% to 6.6%*** in January. The labor force participation rate rose to 63.0% (from 62.8%), the number of long-term unemployed declined by roughly 232k, and the U-6, a more robust measure of unemployment in our view, dropped to 12.7% from 13.1%. That is the lowest level since November 2008 and a solid improvement from a peak of 17.2% seen in April 2010.

The ***ISM's manufacturing index***, which surveys the overall health of that sector through a diffusion index, came in at 51.3 in January, a far cry from the prior month's robust 56.5. A closer look at the components that comprise the headline rate shows a ***sharp drop in new orders***, falling from 64.4 to 51.2 and posting one of the largest monthly declines in history. On the services side of the economy, the ISM non-manufacturing index pointed to continued growth and expansion with a reading of 54.0, up from 53.0 in the prior month.

Gross Domestic Product (GDP) registered an increase of 3.2% (q/q, SAAR) in the fourth quarter of 2013 based on an "advance" estimate provided by the Bureau of Economic Analysis of the Department of Commerce. This represented a modest decline from third quarter's 4.1% growth rate. On the positive side, real final demand in the private sector continued to grow and the trade deficit shrunk notably while government spending and private inventory investment showed declines.

The troubles with ***emerging markets*** started when investors realized that some of these countries (***"the fragile five"*** including Brazil, India, Turkey, South Africa and Indonesia) were vulnerable due to a variety of factors: Higher and chronic inflation, weakening currencies, political instability as well as draining global liquidity. While the trouble with these countries has a specific (and distinct) reason in each case, it goes without saying that all of them run larger than normal current account deficits.

Weaker currencies appear to be the ***transmission mechanism*** for these vulnerabilities in many cases and incumbent Central Bankers in these countries have raised interest rates by varying degrees to defend their currencies. While raising rates does appear to stem the tide to some extent, it also raises the ***ugly specter of recession*** in many of these economies.

Central Bankers in many of these countries appear to blame the Federal Reserve for draining global liquidity, suggesting that their economies were ill-prepared for ***"tapering"*** by the Federal Reserve. It is quite clear that the Federal Reserve is more concerned with ***weaning the patient*** away from the emergency measures (i.e., quantitative easing) rather than assuaging the fears of emerging markets alone.

The ***contrarian*** in us is salivating at the prospect of ***buying emerging markets*** in client portfolios at steep discounts to "fair value". As many of our regular readers will recall, we have been wary of exposure to this sector for many quarters now (from a ***valuation*** as well as ***risk*** standpoint) and still feel that there might be further downside in the near term. We are sifting through emerging markets with a fine tooth comb with a view to gaining exposure to this sector. We are getting close, but not there yet.

The Federal Reserve at its FOMC meeting in late January decided to continue its ***"tapering"***, reducing further the monthly purchases of US Treasuries and Mortgages by another $10.0 Billion to a still significant $65.0 Billion per month. The reduction in purchases appears to be at a "measured" pace, thus implying that the Fed will eventually stop purchasing Treasuries and Mortgages some time towards the end of the year.

Janet Yellen has taken over as the new head of the Federal Reserve. Word has leaked out that Ms. Yellen would prefer to be called the Fed Chair rather than Chairperson or Chairwoman. Last time we checked, a chair is an ***inanimate object*** and not a person! Be that as it may, Janet Yellen appears to have acquitted herself quite well during her first testimony in front of the Congress earlier this week.

She did take pains to deliver the message that while much has been done to ***support economic growth*** in the good old US of A since the global financial crises, more remains to be done. Tapering is an ongoing exercise and while it was going to occur in an ***"orderly and measured"*** fashion, nothing is given or certain. She also appeared to intimate that the FOMC's decisions were ***data dependent***, thus giving herself much needed room to maneuver.

Having been Fed watchers for over two decades, we pine for the days of Greenspan's ***obfuscation***, complicated sentences that were full of double negatives and modifiers like "relatively moderate", rather than the more direct language that seems to be in vogue currently. Nonetheless, more transparency is a good thing – although, we might place this under the category of "be careful what you wish for!"

A word on ***corporate earnings***: 367 (or 73.4%) of the S&P500 companies have reported earnings so far for 4Q2013. Of these, 287 (=78.2%) have posted positive earnings growth, 69 (=18.8%) have reported lower earnings and 11 (=3.0%) have reported earnings at the same level as the previous quarter. The ***share-weighted percent gain*** in earnings for the quarter is at 10.3% (which compares to 9.7% for the same period last year and a paltry 4.8% for 3Q2013).

It is in relation to Street ***expectations*** that earnings reports really shine: 248 of the 367 that have reported so far (=67.6%) have exceeded expectations, 43 (=11.7%) have met expectations, while 76 (=20.7%) have missed. In other words, 79.3% of companies that have reported earnings so far have either met or exceeded expectations (the comparable number for 4Q2012 is a still respectable 78.3%).

This implies that corporate earnings are quite healthy and if anything, corporations might finally begin to feel confident again in their ability to generate revenues going forward. A return of ***confidence*** would also unleash mergers and acquisitions activity as well as spur a new round of investment spending and capital goods orders – both of which augur well for economic growth going forward.

Being neither a Cassandra nor a Pollyanna, we feel that the ongoing correction in equity markets is a healthy one, and such a pause is likely to refresh markets from a longer term perspective. As always, our abiding faith in a ***fully diversified portfolio*** - that has a balanced approach to both risk and return - as the main way to attain ***favorable investment outcomes*** over the long haul, remains steadfast.

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