Long, Lazy days of Summer

It would be cruel to suggest that it was time to look in the garage for the snow shovel, or to stock up on rock salt, make sure that the furnace had oil, and all the other dreary to-dos that make up a pre-winter checklist. Summers are notoriously short in most of Canada, and here in the middle of the sunny weather only the most prepared or deeply obsessed would turn their gaze past the autumn and into the cold and dark that winter surely will bring.

Many maxims surrounding the stock market are calendar based, like sell in 'May and go away'. The Farmer's Almanac notes the correlation between the performance of the market in January and the remainder of the year. Many investment themes crop up around the summer driving season, or the need for heating oil in the fall, or the shopping season between U.S. Thanksgiving and the end of the year. Mark Twain noted *"October. This is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August, and February."* While a prolific writer and satirist, little is written about his investment acumen.

While the months of July and August tend to be the warmest, the day with the longest span between sunrise and sunset is in June. Every day between now and late December will bring just a little less sunshine; sad but true. Correlating the markets to a calendar year, it is impossible to know exactly where in summer we are today. The U.S. market, as measured by the S&P 500 index, has nearly tripled, from the low of 666 on March 6th 2009 all the way to June 30th 2014's close 1960 index points. The Canadian market, represented by the SPTSX index, has nearly doubled in the same period. This has been a long and fruitful summer, we are unlikely to see a further doubling or tripling; it is not clear if this is August or October though, and it is hard to know exactly how prepared we need to be today for the winter that will eventually arrive. Unlike winter, which arrives roughly on schedule, the timing of any portending correction is unclear. Like any long-term weather forecast, the severity and duration of winter in late-summer is at best guesswork.

And the business of selling out of a substantial portion of a portfolio to sidestep a downturn in the market is a radically different proposition than selling an individual stock. Individual names are bought because at that time the belief is that on the whole, there is no better place to have capital invested. A single stock is an ownership stake in a business, a share in the cash-flows, profits, dividends, and management decisions both good and bad. The sale of an individual name is often done to rebalance risk in a portfolio, or because management execution is poor, or because business conditions have changed in the sector and geography that stock exposes investors to. Selling wholesale reduces market risk, but requires precise timing and execution, and at this point will likely involve taxes on capital gains. Worse still, it demands that an investor be correct on the direction of the market, which has never had as many moving parts as it does today. The case for correction, made by many skeptics, deserves at least some consideration.

S&P 500 Return by Month, in %						
Month	2009	2010	2011	2012	2013	2014
Jan	(8.54)	(3.82)	2.27	4.25	5.04	(3.56)
Feb	(10.69)	2.85	2.95	4.06	1.11	4.31
Mar	9.36	5.80	(0.21)	3.12	3.60	0.69
Apr	9.98	1.32	2.57	(0.75)	1.81	(0.08)
May	5.32	(8.34)	(1.47)	(6.26)	2.08	2.12
June	(0.43)	(5.20)	(1.83)	3.99	(1.56)	1.91
July	7.24	6.84	(2.15)	1.25	4.72	
Aug	3.07	(5.25)	(5.70)	1.98	(3.34)	
Sep	3.68	8.71	(7.19)	2.43	2.79	
Oct	(1.77)	3.48	10.79	(1.99)	4.41	
Nov	5.74	(0.44)	(0.32)	0.28	2.68	
Dec	1.48	5.99	0.86	0.70	2.31	

China continues to see slowing growth and has massively overbuilt capacity, with entire cities pre-built and unoccupied. And this has been the case for about a decade. Sovereign debt remains a concern in Europe and the United States, and perhaps Argentina too. This is also not new. Modest economic expansion has been seen in developed markets, and largely because of what may be an excess of freshly printed money. Forms of quantitative easing have been in place since the credit crisis of 2007, though liberally low rates and governments overspending budgets have been the norm for practically all of this century. Central Banks have shown a willingness to keep rates very low for a very long time, which may lead to some inflation creeping into the system, and rates will eventually have to move higher. But none of this is particularly new, and certainly all of it is priced in to the market, even as we close at new highs. What then brings on the winter to this summer, the bear to this bull market? It may be prudent to worry less about the what, than the when. The likeliest what, to upend this five-year rally is that the market, to oversimplify things, becomes tired.

From March 2009 to present, there have been several different underpinnings to each leg of the rally. At the bottom, with few sellers left and buyers aplenty, value investors turned the tide and drove the market. In the middle, Quantitative Easing provided the confidence that the banking system, the U.S. housing market, and troubled European nations were all going to be supported. And here, in the probable tail, the combination of negative real returns in parts of the Treasury curve and a thirst for yield replacement through dividends, have led to an expansion in price-to-earnings multiples; investors have been paying higher prices for their claim on future cash flows, earnings, and dividends. Value investing and quantitative easing have seen their summers end, and multiple expansion can only go on so long before investors grow tired of paying higher and higher prices for the same fundamentals. Increasing earnings is never guaranteed, the same for increasing dividends; though both create enthusiasm for stocks and the market, hope is an insufficient underpinning for a long-term investment thesis.

What has been remarkable about this long summery bull market is that the conditions that brought on 2007 and 2008's wintery bear appear to have largely thawed and melted. Balance sheets of banks around the globe were in tatters five years ago, and the lesson appears to have been learned; balance sheets resemble fortresses today. Credit conditions in 2007 and 2008 were dismal, and today we see a rebound in both the American housing market and in corporate credit; both investment grade and high-yield credits are offered at cyclical lows in terms of yield, reflecting confidence in these assets even in the face of both the ongoing tapering by Federal Reserve and potential inflation. As far as causes for worry go, these seem to be reasonably light fare, and could actually be framed as positives in terms of Global economic health.

The causes for concern in the equity markets seem to revolve largely around possible overvaluation, though even at the multiples commanded today we are not at valuations that seem out of line with historical prices. In the event of a correction, companies that have solidified their balance sheets and shorn up businesses seem less likely to fall farther or faster than in 2008's sell-off. No doubt the by-product of any kind of correction will be massive buybacks of shares; companies today are loaded with cash and on top of that possess great ability to leverage at low rates, retiring shares through buybacks represents return to shareholders in a differing form. With a lower share count, each share still held represents a greater and growing claim on earnings and dividends going forward – a little winter here and there makes one appreciate summer even more. The cries of bubble or correction or reversal always draw attention, representing perhaps a flashier message than the call to buy a shovel and stock up on rock salt, which at some point will be needed.

While snow is sure to eventually fall, the timing and scale of a correction is never guaranteed, it is a certainty that soon enough there will be consecutive months of negative returns. Many will claim an ability to sidestep a downturn, and some – though far fewer - genuinely possess that skill. And selling would be the easier half of the trade, precisely timing the re-entry only adds to the degree of difficulty. Net of taxes, lost dividend income, commissions, the difficulties of timing the market, the risk that individual securities that may continue to appreciate, investors may well be better served staying the course, rather than heeding the calls of a market sell-off.

Living in a cold weather nation, we know that summers end and winter is always out on the horizon, an unsure duration of unknown unpleasantness. We also know that winters last a short time, and that soon enough it will be summer again.

Guardian Capital Advisors Investment Committee