May 17, 2013

Dear clients and colleagues,

Earlier this month, both the S&P 500 and the Dow hit new all-time highs. From the bottom of the financial crisis in March 2009, the S&P 500 is up 162%.

But many other indices around the world are also setting new all-time highs, like Germany. But also many emerging and frontier markets like Mexico, Turkey and even Pakistan. Yes, Pakistan!

How do we explain the rise? The economy is not so strong. The US recovery is ongoing but still hesitant and the US consumer is still highly leveraged. Europe is still in recession and unemployment is hitting new highs. Commodity-dependent countries are faced with lower commodity prices and strong currencies. China is still trying to fine tune its economy.

The answer could be lower rates and a record amount of liquidity. Earlier this week, South Korea's surprise rate cut was the 511th reduction worldwide since June 2007, and central bankers are still ready to ease further. This is an economic experiment that is unprecedented, and no one knows what the outcome will be.

Although CPI inflation has been benign, other assets are being inflated: Prime real estate in cities like Hong Kong, London and New York, farmland and of course the stock market.

This massive liquidity has thus far had no impact on bond yields; Japanese 10-year bonds are still at 0.69% and the US 10-year is 1.84%. Even Greek 10-year notes are now below 10%, down from over 28% one year ago.

As we mentioned earlier, this massive stimulus has had little impact on the real economy so far, and a Citigroup of global economic indicators started coming down in mid-March and is now at its weakest since last August.

In the face of this slowing, austerity is now being questioned. But ultimately there is no way around it. Households and governments need to pay off debts.

So what do we think about equity markets today?

The Q1 earnings season is almost complete. According to data compiled by Bloomberg as of this morning, 452 of the S&P 500 companies have reported. Of those, 47% beat sales estimates and 72% beat earnings estimates. However, earnings growth was only 3.2% and sales growth was actually -0.1%. In terms of valuation, the S&P 500 is selling at 14.0x forward 12 months earnings.

The market is not without the risk of a correction. With no revenue growth and little earnings growth, multiple expansion is the only way for the stock market to go up. Political instability in Europe will be a theme in the coming months. With an election in Germany in the fall, posturing by PIGS countries and France against austerity can only aggravate German electors.

Despite that, we remain optimistic for equities in the mid to long term, and even more so for smaller capitalization companies.

Valuations are still below the long-term average, especially compared to interest rates.

Companies' balance sheets are extremely strong.

The equity pool available has shrunk with companies buying back shares aggressively. As an example, in the last 20 years IBM has reduced the number of its shares outstanding from over 2.4 billion shares to 1.1 billion shares. So although IBM's earnings have grown less than 5% per year, its earnings per share has grown more than 10% over that same period. The same is true for many companies.

For smaller companies, we are even more optimistic. For our benchmark, the MSCI World Small Cap Index, sales growth is expected at 6.8% and profit growth is expected at more than 15% for 2013. Smaller companies do not have pension issues. Banks only represent 4% of the index. Therefore, the increased regulations of the financial sector will not have a big impact on our benchmark.

In the absence of strong revenue growth, we expect larger companies to acquire growth. A positive for smaller capitalization companies

Our strategy is not to make asset mix calls; we have a fully invested global small cap fund. We believe our portfolio will deliver growth long term and is well positioned for corrections or volatility. Our portfolio companies have superior growth profiles, better profitability and lower debt.

Have a good week.

The Global Alpha Team