September 13, 2013

Dear clients and colleagues:

The S&P 500 is up 150% from the low of March 9, 2009. This year's rally continues to be greeted with skepticism. Most investors are asking themselves if this is another bubble waiting to burst and, if so, are we there yet?

The current risk and momentum plays appear to be the only trades working. In fact, a study done by Bank of America found that quality factors performed the worst in the last 12-month period. Factors such as Return on Capital Invested and Return on Equity were lagging while beta and price volatility continued to soar.

How do we explain the rally this year?
The action in the equity markets reflects an economy that's growing at a modest pace. Indicators such as unemployment claims, manufacturing PMI in Aug, and existing house prices continue to improve. The US recovery is ongoing. Europe is still in recession but the recovery appears to be taking hold. The latest numbers out of China are also encouraging. Another reason for the rally could be that a lot of investors are still cautious. Corrections occur when everyone is bullish, which has not been the case.

Are we there yet?
We are of the opinion that a small correction is expected and would prove to be healthy. Geopolitical concerns have influenced the price of oil's dramatic rise. An indication of Fed tapering on May 22 gave global equity markets a chill. One could also argue that corporate profits have peaked and the next leg of growth has to come from the top line and not mere cost cutting. According to a recent article in the Wall Street Journal, US corporate after-tax profit margins are at 9.3% which is above the historical average of 5.9% (dating to 1952).

US:
The economy is not accelerating. New house sales dropped 13% in July compared to June. Companies such as Wal-Mart, Macy's, Target, Sears, Staples, and UPS have reported disappointing numbers.

In addition, most of the new jobs created are part-time and low-paying. The economy needs jobs that can lead to a healthy and robust middle class. The labor force participation rate remains low at 63.4%.

Tapering comments by the Fed have increased mortgage rates by about 100bps to 4.5%. What does this mean? Monthly payments on new home loans will increase which might reduce the offer price on new and existing homes on the market. The housing affordability index peaked in Q1 2012 from its low in Q2 2006 when mortgage rates were low. However, it is currently down 15% from its peak and we have yet to see the impact of the spikes in mortgage rates. Looking beyond the rates, the Fed's tapering comment led to massive capital outflows from emerging markets and had a dramatic impact on their currencies.

Japan:
The Bank of Japan (BOJ) balance sheet continues to expand. BOJ appears committed to expand the balance sheet if they see downside risks to the economy and/or the Nikkei. The fiscal and monetary stimulus implemented by the BOJ and Shinzo Abe are beginning to prove the skeptics wrong and may help alleviate the deflationary environment in Japan. The run-up to the 2020 summer Olympics in Japan will also help the economy further.

Emerging Markets:
Emerging markets are facing their own concerns. The Indian Rupee continues to depreciate and upcoming elections next year do not help the situation. Other emerging market currencies are also in free fall. The Brazilian real is trading at its weakest level since 2009. This complicates policymakers' efforts to rein in inflation. China's growth is slow; however, the latest indicators are showing signs of a rebound.

Europe:
Europe has yet to resolve its debt issues, but is showing signs of stabilizing and some of the economic readings are encouraging.

The good news:
If there are no policy errors, global growth should accelerate and lagging sectors will catch up. Mergers and acquisitions could pick up, highlighting the undervaluation of quality stocks, especially in small caps. Rising interest rates could lead to the "great rotation" from fixed income and cash into equities.

We continue to believe quality will ultimately outperform in the long run. The Global Alpha team takes a long-term approach and our portfolio has high-quality companies. Our turnover rate – excluding companies acquired or reaching our upper market cap limit – is around 20%. Combined with our search for growth across many industries, we believe our approach leads to a source of sustainable added value.

Have a good weekend.

The Global Alpha Team