THE OMNIVEST MARKET VIEW

Investments

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Now the Problem is Corporate Profits!

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Doubters of the equity market rally (in place for 3 consecutive years) have now latched on to the idea that Q1 earnings will not be able to match expectations and therefore will finally halt the current rally. While this new argument is convenient, given that we are fast approaching the beginning of Q1 earnings season, it does not take into account certain fundamentals that are currently at work.

First, the S&P 500 Index has more than doubled since hitting its low in March of 2009, but the P/E multiple has remained basically unchanged (using quarterly data) despite the fact that corporate earnings as a percent of GDP have moved to record levels. The conclusion is that the equity market is cheap relative to earnings. Hence, the market is priced to absorb a potential softening in earnings rather than being priced to perfection.

Second, the interest rate environment is very favorable when comparing the current level of the S&P with the last time it traded near current levels. In early June of 2008 which is the last time the S&P traded slightly above 1400, the yield of the 2-year Treasury note was at 2.5% and the 10-year Treasury note sported a yield of 4.04%. Today, the 2-year yields are at 0.38% with the 10-year yields at only 2.37%. The dramatic change in yields is due to the Federal Reserve's decision to cut the Federal Funds rate from 2% to 0%. One of the reasons that the Fed has slashed rates to 0% and profess to maintain them at these levels until 2014 has been the reduction of inflation from 5.6% to 2.9%. Corporate borrowing costs, as measured by high-yield spreads, have also narrowed over this period from 663 basis points (bps) to 632bps.

Another powerful factor that may fuel additional gains for equities will be a further rise in Treasury yields. Since the end of January, 10-year Treasury yields have risen from a low of 1.79% to a current level of 2.38%. It is our contention that a sustained rise in long-term Treasury yields would herald a fundamental change in the need for investors to own risk-free assets. The recent rise in German Bund yields is corroborating the move of US Treasury yields, suggesting that economic and geo-political tensions in Europe may finally begin to wane.

Investors have loathed to act upon the positive move in risk assets, as memories of the October 2007 - March 2009 market collapse remain deeply entrenched. However, the upward move in Treasury yields maybe the first real signal that institutional investors are beginning to allocate towards risk. If so, then P/E multiple expansion may not be far off which could lead to much further gains for equities versus debt. Another positive sign has been the impressive rally in bank shares. Financials have historically led market rallies and this may be occurring again. Let's hope so.

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