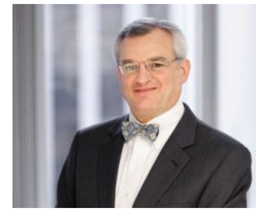
# *Investment Commentary Quarterly*
## Equity Pricing and Earnings



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The S&P 500 index surged 10.6% in the first quarter, pulling the total annual return for the large-cap-stock index to 14%. Most of the benchmark's 12-month return was achieved in the last 12 weeks. Whether rational or accidental, the market leaders were a curious sector combination. Healthcare led the 10 sectors of the S&P 500 with a 15.2% gain, while consumer staples was the runner-up.

Leadership consisted of big-pharma stocks like Amgen and Bristol-Myers Squibb and consumer staple darlings such as Clorox and General Mills. It is interesting that these old battleships are also commanding rich price-to-earnings ratios of between 20 and 30 times this year's projected earnings. This valuation seems rather troubling to me considering that these companies' earnings are most likely to grow at only single-digit rates. I question whether fund managers are buying growth companies or downside protection.

My concerns about earnings are not currently shared by the market. During the marvelous first-quarter run-up, earnings growth estimates were being quietly reduced. While every equity sector was moving higher in price, earnings growth estimates for nine of the sectors were moving lower. Only the financial sector earnings estimates were not cut.

According to FactSet, first-quarter S&P 500 earnings are now projected to *decline* 0.7% on a blended basis, versus the 2.1% growth rate projected on December 31.[1] Should the final quarterly earnings rate end up negative, it would mark the second year-over-year decline in the past three quarters.

While FactSet expects a decline in earnings in first quarter 2013, its consolidated market estimates still predict that earnings growth will ricochet back to the double digits in the second half of 2013. For third quarter 2013, the estimated earnings growth rate is 10.1%. For fourth quarter 2013, the estimated earnings growth rate is 15.6%.[2]

I am on board for earnings growth in the single digits for all of 2013. However, the likelihood that the index will achieve 10% and 15% earnings growth rates in the second half of 2013 is rather dubious. While Wall Street's first-quarter earnings estimates have been quietly lowered, it is more noteworthy that many corporations have been issuing their own reductions in guidance.

According to Thomson Reuters, 94 S&P 500 companies issued negative guidance for the first quarter, whereas just 23 companies issued positive guidance. The negative-to-positive ratio of 4.1 is the highest since third quarter 2001 and well above the long-term aggregate of 2.4.[3]

Ignoring corporate downgrades, especially when the negative-to-positive ratio has spiked, has historically led to suboptimal returns. In the bull market that crashed in 2007, the negative

[1] FactSet Earnings Insight, John Butters, March 22, 2013
[2] FactSet Earnings Insight, John Butters, March 22, 2013
[3] Time-weighted average of the current year's and next year's consensus earnings estimates. April 3, 2013, Thomson Reuters I/B/E/S.

corporate guidance ratio hit a peak in third quarter 2007, precisely when that bull market run was ending. Alternatively, one of the lowest ratios of negative guidance was registered during second quarter 2009, at a time when most analysts and investors were quite negative on the market and, again, precisely when the equity markets marked a 13-year low.

Corporate guidance is always important; with a negative-to-positive ratio at a 12-year high, however, I believe it is more important than ever to heed this indicator. The first-quarter earnings season should prove particularly instructive since it will help illuminate whether the markets ran up too high too quickly with its economic recovery and corporate earnings expectations.

I currently believe it is much more likely that earnings growth estimates will be reduced to meet the lower revenue projections than revenue forecasts will be raised to meet the lofty earnings growth estimates.

The stock market performance in the first quarter was stellar even while earnings estimates were being reduced. The market's strength can be attributed in part to a stronger real-estate market, consumer spending, increasing employment, and especially to its almost religious faith in the low-interest-rate-easy-money policies sanctified by the Federal Reserve. That still appears to be the holy sceptre that eradicates all market demons, at least for first quarter 2013.

**New Headwinds for the Economy**

The largest survey of manufacturers signaled that U.S. activity slowed unexpectedly in March. The Institute for Supply Management (ISM), a group of industry purchasing managers, reported that its manufacturing index surprisingly declined 2.9 percentage points from 54.2% (a two-year high) in February to 51.3% in March.[4] This was nearly 3 percentage points below the consensus forecast.

Based on the index's history, any reading above 50 indicates GDP expansion and below 50 indicates contraction in the economy. The overall index, which accounts for about 12% of the economy, had indicated expansion for four straight months. The March index, however, illustrates a slowing of business activity. Further, headwinds are building based on key forward indicators that make up the index; the forward-looking new orders component fell 6.4%, to 51.4; production dropped 5.4%; and backlog of orders fell 4%.

In addition, the ISM's gauge of inventory levels for customers reveals sustained contraction during March, which should leave them at historically low levels. The low inventory levels and lack of business restocking suggest that this key economic component may not add to real GDP growth during the first quarter.

Softness in manufacturing has spread to the U.S. service sector. March service industry growth, which represents the largest part of the economy, advanced at the slowest pace in seven months as new orders and employment slackened.

The ISM's nonmanufacturing index declined to 54.4%, from a one-year high of 56% in February. The all-important employment gauge fell from 57.2% in February to 53.3% in March, the largest decrease in four years.[5]

The majority of executives surveyed "continue to be positive about business conditions," but there is an "underlying concern regarding the uncertainty of the future economy," said Anthony Nieves, chair of the ISM Survey Committee. The fall in new orders displays a "slowing in the pipeline," which has caused the pace of employment to ease, Nieves said.

[4] March 2013 Manufacturing ISM Report on Business, *Press Release April 1, 2013*
[5] March 2013 Non-Manufacturing ISM Report on Business, *Press Release April 3, 2013*

Additional softness in the economy is appearing in private-payroll growth, which slowed in March. Automatic Data Processing (ADP), the largest public payroll processor, reported that the economy gained only 158,000 new private-sector jobs in March.[6] This compares poorly with the 237,000 new positions created in February.

According to the details of the ADP private-employment report, the March gain was the lowest increase since before the election; small businesses added 74,000 full-time-workers, midsize businesses added 37,000, and large businesses added 47,000. Service providers added 151,000 jobs.

Employment data released by the Labor Department confirms the slowing employment picture. U.S. nonfarm payrolls increased only 88,000 in March.[7]

My analysis is that small businesses (those employing fewer than 50 employees) and restaurants have been holding off on hiring additional employees in anticipation of the unknown burden that the new healthcare regulations will have on their businesses.

Another economic report shows that first-quarter consumer confidence also slumped. The Conference Board Consumer Confidence Index®, which had improved in February, declined sharply in March. The index now stands at 59.7 (1985=100), down from 68.0 in February. The Present Situation Index decreased to 57.9 from 61.4. The Expectations Index declined to 60.9, from 72.4 last month.[8]

The confidence reading came in significantly below the consensus estimate. February's reading also was revised downward. A significant percentage of the decline came from deterioration in the Expectations Index, which slumped to 60.9 from 72.4.

Lynn Franco, director of economic indicators at The Conference Board, stated in a press release, "Consumer Confidence fell sharply in March, following February's uptick. This month's retreat was driven primarily by a sharp decline in expectations, although consumers were also more pessimistic in their assessment of current conditions."

The more pessimistic confidence report, coming on the heels of lower ADP employment, combined with the disappointing data on service industry and manufacturing suggests to me that 2013 may be suffering a loss of momentum. Unfortunately, this may be the third consecutive spring slowdown.

The salient point to remember is that the main index components of both ISM indices remain above the 50.0 threshold. These data points have historically indicated continued expansion in the economy, despite some stronger headwinds, both foreign and domestic.

## Raiders of the Last Cypriots

In 1570, the Turks led a full-scale invasion into Cyprus. From July 2 to September 9 of that year, 60,000 Ottoman warriors laid siege to Nicosia Cyprus, putting 20,000 Nicosians to death in the last day alone. The assault ended with the looting and destruction of every church, public building, and palace in Nicosia.[9]

During one weekend of March 2013, current Cypriot President Nicos Anastasiades surrendered his country without a single arrow being launched. The Cypriot president capitulated to the Troika known as the European Central Bank, the European Commission, and the International Monetary Fund by agreeing that personal bank accounts in Cyprus will be looted and the funds transferred to the state.

[6] ADP National Employment Report, March 3, 2013
[7] http://www.bls.gov/news.release/pdf/empsit.pdf
[8] The Conference Board Consumer Confidence Index Declines in March, *Press Release, March 26, 2013*
[9] Cyprus- Ottoman Rule, *U.S. Library of Congress*

This unconditional surrender raids the personal bank accounts of customers who have deposited more than €100,000 in Cypriot banks. EU officials have stated that about 40% of these deposits will be confiscated at the two largest Cypriot banks: Bank of Cyprus and Cyprus Popular Bank, which is 84%-owned by the Cypriot government that is looting it.[10]

In this astonishing development, the leaders of the Troika heralded the seizing of assets from individuals' bank accounts as a rescue program that supposedly represents a "new template" for resolving eurozone financial problems.

Jeroen Dijsselbloem, the Dutch chairman of the eurozone, declared that the hefty losses exacted from depositors in Cyprus banks would be the template for resolving future banking crises across Europe. The new program reverses the long-standing policy of protecting large depositors, over €100,000, of eurozone banks. Mr. Dijsselbloem asserted that the raiding of Cypriot assets showed that private investors could now be sacked to pay for bad banking debts.[11]

I believe the confiscation program is highly momentous in that it signals the start of three major shifts. First, for EU policy, it seems to remove or reduce in importance the European Stability Mechanism (ESM), which was positioned to be the EU's "big gun" €700 billion bailout fund. The ESM was the mechanism that Spain, Ireland, and, recently, Italy were planning to use to recapitalize their troubled banks.

Second, when confiscation of private property becomes the "new template" for stabilizing bloated and poorly run governments, it creates a dangerous precedent. I believe it may begin to chip away at a sacred principle of banking: the security of individual deposits.

Based on Mr. Dijsselbloem's "new template," savings accounts in other European countries could be raided to protect the euro by propping up failing governments and banks. The Cyprus confiscation of individual deposits will make it increasingly difficult for European banks, especially in weaker countries, to raise new deposits. After Cyprus, I assert that it will be politically impossible for countries like Italy, Ireland, Greece, Portugal, and Spain to ask for Troika assistance, knowing full well that debt restructuring will cause their citizens to face a loss on their bank deposits.

In a research note published on Monday, March 25, 2013, following the Cyprus raid, the investment firm Barclays warned, "The imposition of a levy on depositors in Cyprus is a material development that furthers the erosion of bondholder protection at European banks." "We believe the haircuts of depositors in Cyprus . . . form an ominous trend."[12]

Third, I believe that the Cyprus confiscations begin to undermine the credibility of the ECB and EU and the measures they have established that have underpinned the recent relative stability in the EU. I am concerned that this loss of credibility may cause a capital flight from banks in countries like Portugal, Ireland, Italy, Spain, and possibly France into generally more stable countries like the United States and England.

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[10] Cyprus Salvaged After EU Deal Shuts Bank to Get $13B, Rebecca Christie, James G. Neuger, and Patrick Donahue, *Bloomberg* 03/26/13
[11] Cyprus bail-out: savers will be raided to save euro in future crises, Bruno Waterfield, *The Telegraph,* 03/26/13
[12] Cypriot Bank Levy Is 'Ominous' for Bondholders, Gregory Viscusi, *Bloomberg* 03/25/13