Market Commentary - April 2016

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This week investors will watch as the start of the new earnings season unfolds. Corporate profits are expected to fall a whopping 8% year over year, and this time it is not only energy stocks dragging down the composite number. Earnings are expected to drop 4.7% even after excluding energy stocks. Only three sectors are expected to show gains: healthcare, telecom, and consumer discretionary. Even though expectations are low, it will likely take much better than expected earnings for the recent rally to continue.

Let's also take a quick look back at earnings growth since 2009 and the myth that corporate stock buybacks are largely responsible for earnings gains since then. Deutsche Bank authored a compelling research piece showing that stock market appreciation since 2009 has been driven by earnings and not by buybacks. First, the market capitalization increase for the S&P 500 since the bull market began is about $10 trillion. Total buybacks over the same period total about $2 trillion. This shows the vast majority of the increase in share prices has nothing to do with buybacks. Second, buybacks as a percentage of total market cap have averaged about 2% per quarter for the past five years, again suggesting buybacks have not played a significant role in the bull market. Finally, buybacks were at cyclical highs in 2015, yet the broad market moved sideways through that timeframe.

While the market recovery of the past six weeks has been a welcome respite, there may be more volatility to follow, especially in international markets. The difficulties among most emerging market (EM) countries, especially those reliant upon commodities exports, have not been resolved. A majority continue to struggle with the aftermath of their debt driven commodities bubbles–much of it encouraged by China's spectacular demand growth. These EM countries are increasingly vulnerable to market volatility, short term competitive currency devaluations, capital outflows and a lack of growth or pricing power in their respective commodity markets. All of this raises the specter of economic insolvency and growing political risk within these EM countries.

We believe the plight of EM economies, essentially over-building of commodities infrastructure in anticipation of an endless commodities super-cycle, will take years to resolve itself and is just now beginning. It is likely that this deleveraging will be messy, in due course threatening unwary EM investors with losses. And bear in mind that the necessary debt-unwind could, at some point, have a negative impact on developed markets like ours.

Time for Value Stocks?

Stocks can be classified as either value stocks or growth stocks. Value stocks are underpriced relative to corporate fundamentals. They typically grow earnings more slowly (<10%) which is reflected in attractive (less expensive) valuation metrics (price/earnings ratio, price/cash flow, price/sales, price/book…). Growth stocks tend to grow earnings faster (>10%) than value stocks with more expensive metrics to reflect this. Growth stocks have higher expectations so disappointments can result in quickly marked down share prices. Over time, growth and value perform about equally well with value having a very modest edge. But over a year’s time, or even an entire cycle, one style can substantially outperform the other. For example, **growth stocks have outperformed value for nine straight years!** Recently, however, value stocks have recaptured the lead this year as growth (including momentum) now trades at the biggest premium to value since 1980 (tech bubble time frame excluded).

Investors that buy and own only one style are likely to have more portfolio price volatility and are at risk of significant underperformance for a number of years within these cycles. This is exactly what has happened recently, as growth has outperformed value.

Value and growth cycles are not predictable–much like timing the market. It makes sense, in our view, to own a thoughtful mix of value and growth stocks and to focus new purchases on the style that has better valuation characteristics. This will smooth volatility and should generate a portfolio return somewhere between the two styles. Over time, Clearview will have hold? about an equal number of both growth and value stocks, with a slight bias towards value. Therefore, the recent move of value stocks regaining market outperformance compared to growth may provide a boost to our stock portfolios.

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