SELL AMERICAN. I AM.

BEN MICHAUD

MARCH 26, 2013

OCTOBER 2008: FINANCIAL ARMAGEDDON

- **Bear Case for Stocks:**
  - Depression 2.0
  - Lehman Brothers chapter 11 filing
  - Bear Stearns take-over
  - Housing market implosion

- **S&P 500 Valuation (10/15/08):**

Price Level	908
Fair Value	957
SPX 10-Year Projected Return	9.93% per annum
10-Year US Treasury Yield	4.04%
Market Risk Premium	**5.89%**

SOURCES: Schiller . FRED. Analyst Estimates.

BUY AMERICAN. I AM.

- In his now famous October 2008 op-ed titled "Buy American. I Am.", Warren Buffett said:
  - "The financial world **is a mess**, both in the United States and abroad. Its **problems**, moreover, have been leaking into the general economy, and the leaks are now turning into a gusher. In the near-term, unemployment will **rise**, business activity will **falter** and headlines will continue to be **scary**.
  - "So…I've been **buying** American stocks….Why? A simple rule dictates my buying: Be fearful when others are greedy, and be greedy when others are fearful. And most certainly, **fear** is now widespread, gripping even seasoned investors."

SOURCES: New York Times.

MARCH 2013: FINANCIAL NIRVANA

- **Bull Case for Stocks:**
  - Stocks cheap relative to bonds: 7.5% SPX earnings yield versus a 1.95% 10-year treasury bond
  - Central banks have taken tail risk off the table: Draghi's "Whatever it takes" comment + Bernanke's QE Infinity
  - Housing market recovery
  - Energy independence

- **S&P 500 Valuation (3/22/13):**

Price Level	1,557
Fair Value	1,042
SPX 10-Year Projected Return	3.87% per annum
10-Year US Treasury Yield	1.93%
Market Risk Premium	**1.94%**

SOURCES: Schiller. FRED. Analyst Estimates. Capital IQ.

SELL AMERICAN. I AM.

- I believe the precise opposite of Buffett's 2008 quote applies to the current market environment:
  - "The financial world **has healed**, both in the United States and abroad. Its **strength**, moreover, have been leaking into the general economy, and the leaks are now turning into a gusher. In the near-term, unemployment will **fall**, business activity will **improve** and headlines will continue to be **encouraging**.
  - "So…I've been **selling** American stocks….Why? A simple rule dictates my buying: Be fearful when others are greedy, and be greedy when others are fearful. And most certainly, **greed** is now widespread, gripping even seasoned investors."

SOURCES: New York Times.

THE CASE FOR SHORTING THE S&P 500

1. **S&P 500 49% overvalued** – projected return 3.87% per annum over next ten years

2. **U.S. secular bear market still in progress** – March 2009 low likely did not mark the end of this secular bear

3. **Extreme Optimism** – Fund managers aggregate long exposure at multi-year highs

S&P 500 OVERVALUED

- **S&P 500 49% Overvalued**
  - Dividend Per Share: $31.25
  - FV Dividend Yield: 3% (9% Re, 6% growth)
  - **SPX Fair Value: 1,042**
  - Projected 10-Year Return: 3.87% per annum
  - 10-Year Treasury Yield: 1.93%
  - Market Risk Premium: 1.94%

- At February 2013 month-end, GMO estimated U.S. large-caps will return approximately **1.6% per annum over the next 7 years**

- Even Warren Buffett cannot admit stocks are cheap in absolute terms:
  - "Equities are still cheap relative to any other asset class." – February 27, 2013 CNBC

SOURCES: Schiller. GMO. CNBC. FRED. Analyst Estimates.

SECULAR BEAR STILL IN PROGRESS…

- **1906 to 1921 secular bear**
  - Fair value dividend yield: 6%
  - Beginning % of fair value: 204%
  - Ending % of fair value: 53%
  - Duration: 15.6 years
- **1929 to 1942 secular bear**
  - Fair value dividend yield: 5%
  - Beginning % of fair value: 261%
  - Ending % of fair value: 60%
  - Duration: 12.7 years
- **1966 to 1982 secular bear**
  - Fair value dividend yield: 4%
  - Beginning % of fair value: 172%
  - Ending % of fair value: 59%
  - Duration: 16.5 years

SOURCES: Ned Davis Research. Schiller. Analyst Estimates.

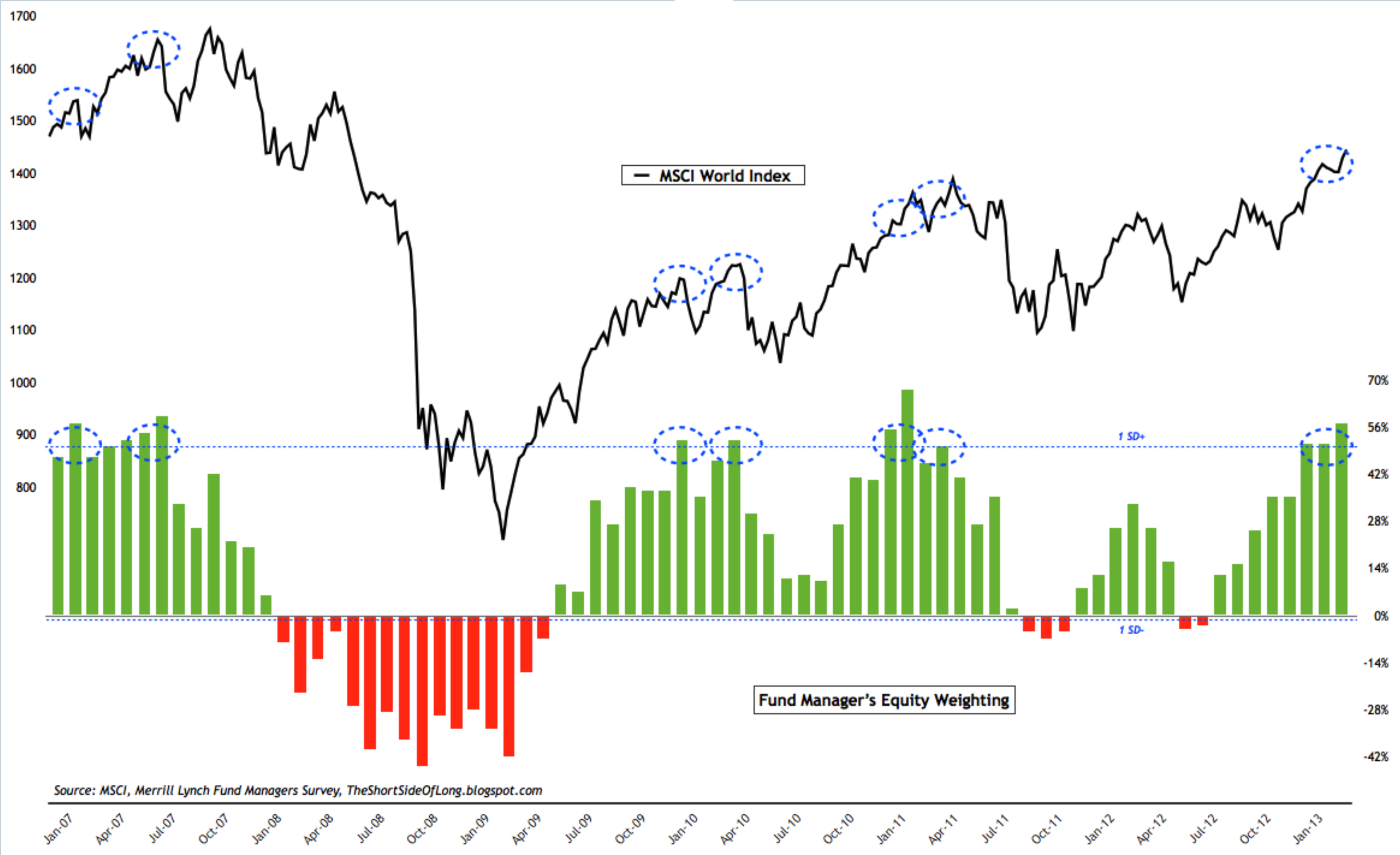
…SECULAR BEAR STILL IN PROGRESS

- Average secular bear duration: **14.9 years**
- Secular bear average ending % of FV: **60%**
- **2000 to 2009 secular bear??**
  - Fair value dividend yield: 3%
  - Beginning % of fair value: 286%
  - Ending % of fair value: 74%
  - Duration: 9.2 years

2009 fails both the duration and valuation test for whether it marked the end of this secular bear market

SOURCES: Ned Davis Research. Schiller. Analyst Estimates.

EXTREME OPTIMISM…



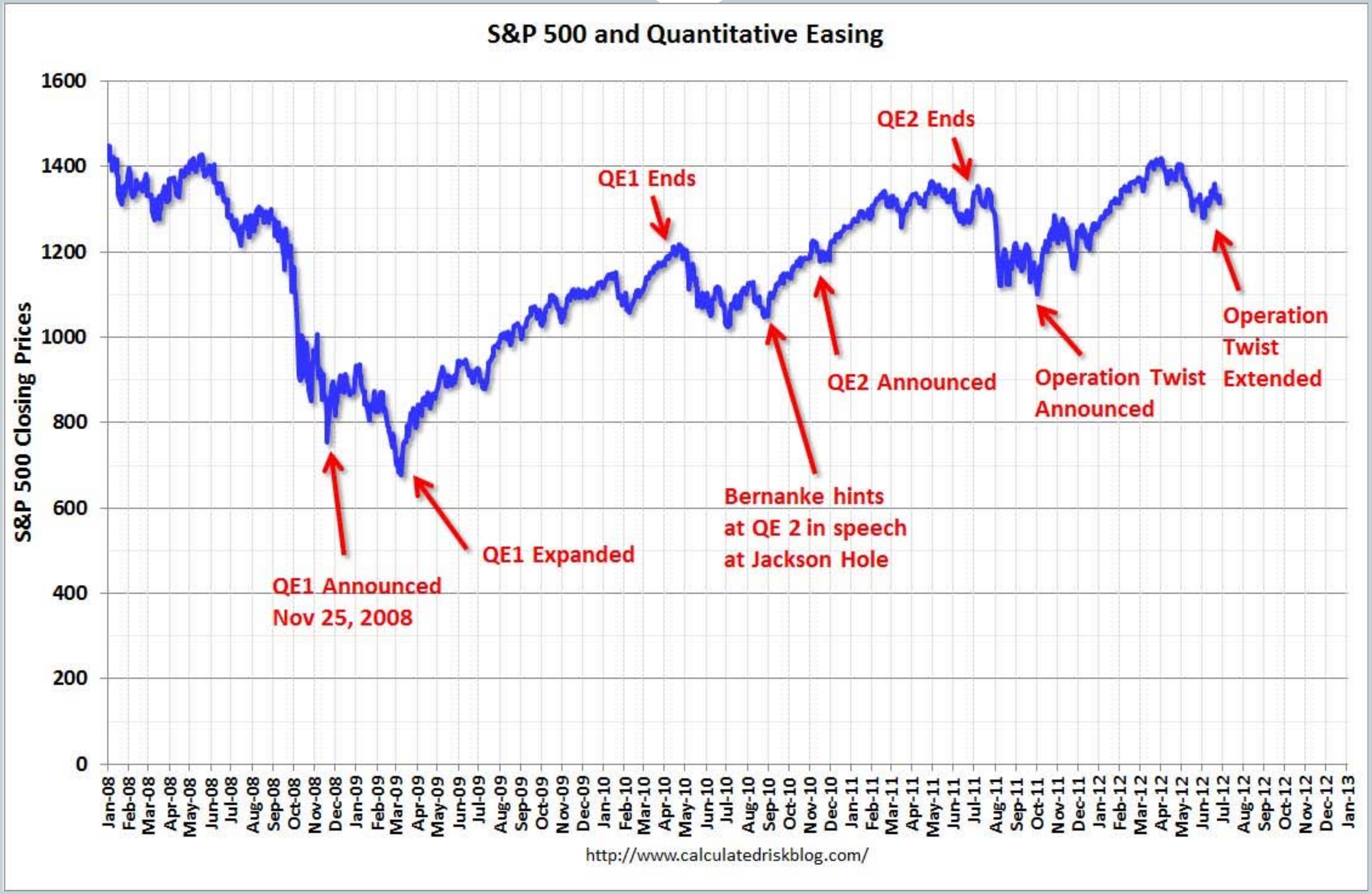
SOURCES: Short Side of Long Blog.

…EXTREME OPTIMISM

- **Bull Case:**
  - Stocks are cheap relative to bonds: 7.5% 2014 forward operating earnings yield for the SPX versus 1.93% 10-year Treasury yield
    - **Reality:** Corporate profit margins at record highs, thus rendering current earnings entirely unsustainable over the long term
  - Mario Draghi's "Whatever it takes" comment took European tail risk off the table
    - **Reality:** YES, Draghi effectively back-stopped the Euro's existence….however, poisonous austerity medicine remains in place, which is far more relevant to the health of corporate profitability
  - Quantitative easing here in the U.S. limits equity market downside
    - **Reality:** QE is a psychological façade that deserves its own discussion….

SOURCES: Capital IQ.

QUANTITATIVE EASING TIMELINE



SOURCES: Calculated Risk Blog.

QE: THE POISONED APPLE…

Bulls and bears alike point to the preceding timeline to demonstrate QE's effect on equity prices

- If QE truly puts a "floor" under the stock market, why did the SPX fall -21% from the close on November 25, 2008 to the close on March 9, 2009?
- If QE could not create a bottom in the market in November 2008, why is it that the balance-sheet-neutral Operation Twist program is cited as a reason for the equity markets bottoming in October 2011?

Is it possible that QE has virtually nothing to do with equity market performance, but rather investor sentiment and profit expectations are what truly drive equity markets?

Was it perhaps the massive stimulus package passed in early 2009 that put a "floor" under markets?

SOURCES: Calculated Risk Blog.

...QE: THE POISONED APPLE

- Mario Draghi's "Whatever it takes" proclamation in July 2012 put a floor under European equity markets without expanding the ECB balance sheet by a single dime.....**because it actually removed the legitimate risk of a Eurozone break-up**.

Is it possible that markets do not care about money printing, but rather the containment of legitimate risks in the system? Does QE remove a legitimate risk in the system?

QE CONCLUSION

If QE's record since 2008 and Draghi's OMT program in 2012 prove markets respond to the actual removal of risk rather than to money printing…

…and we know that QE does not actually remove a legitimate risk from the system…

…can we reasonably conclude that the QE program currently in place is not a reason to believe stock prices will not materially decline from current levels?

SO WHY NOW?

V<u>aluation</u>, <u>sentiment</u> and the <u>secular environment</u> all combine to create a powerful ceiling over the market.

The time is right **NOT** because I believe the market will decline within the next year or even two years, but rather because I believe the market will not **<u>sustainably</u>** rise above current levels before completing its secular bear market cycle.

In other words, the risk-reward equation the SPX is asymmetrically skewed to the downside.

A NOTE ON MARKET TIMING

- The criticism du jour of those who believe worrying about market risk is investment suicide is to say one is "timing the market".

- Definition of timing:
  - "The ability to select the precise moment for doing something for optimum effect." – Merriam-Webster

- Question for the critics: was Buffett attempting to "time" the market in his October 2008 op-ed? Did the subsequent -15 to -20% decline render his declaration wrong?

Bottom line is that <u>I DO NOT CARE</u> when the market actually declines. All I know is that the risk-reward equation is heavily skewed in my favor.

Isn't this what value investing is all about? Nobody knows when a 50-cent dollar bill will re-value to 100 cents, but rather that the risk-reward is heavily skewed in one's favor.

SOME PROJECTIONS…

- The past three secular bear markets have contained an average of **<u>5 cyclical bull markets</u>** and **<u>6 cyclical bear markets</u>**.

- To-date, this secular bear has had 4 cyclical bears and is currently in its 4th cyclical bull.

- Within secular bears, the median gain and duration for cyclical bulls and bears are as follows:
  - Cyclical bulls: +60% / 371 days
  - Cyclical bears: – -32% / 517 days

SOURCES: Ned Davis Research.

...SOME PROJECTIONS...

- If this secular bear follows historical precedent, it has 2 cyclical bears and 1 cyclical bull remaining.
- The current cyclical bull is over 530 days old, just over the mean duration of 523 days but well over the median duration of 371 days.
- The current cyclical bull has returned 36% to-date versus the median gain of 60%. Not surprising given the April 2011-October 2011 cyclical bear was a shallow -19% decline versus the -32% historical median.

We can reasonably conclude that from a duration perspective, the cyclical bull that began in October 2011 is past its sell-by date...

...meaning we should be looking for the next cyclical bear market to commence.

SOURCES: Ned Davis Research. Analyst Estimates.

…SOME PROJECTIONS

- Two more cyclical bears at 517 days each plus one more cyclical bull at 371 days, equals approximately **3.85 years remaining in this secular bear**.

- Assuming a 6% growth rate, the SPX dividend per share will be 39.11 in 3.85 years, and the SPX fair value will be 1,304.

- The average end-of-secular-bear valuation is 57% of fair value.

Following historical precedent, the SPX would trade at 743 in 3.85 years.

SOURCES: Ned Davis Research. Schiller. Analyst Estimates.

THE TRADE

- Short the SPX at 1,557
  - 3.85 years of cumulative dividends: 139
    - Assumes 6% growth from current DVPS of 31.25
  - Adj. short sale basis in 3.85 years: 1,418

- Buyback the SPX at 743 in 3.85 years for net proceeds of 675

3.85-year IRR: 15.5% per annum

Given the asymmetric risk-reward equation, the enterprising investor may consider levering up this short position, by perhaps 50% for a 20%+ IRR.

DOWNSIDE

- Assuming the SPX returns a straight-line 3.87% per annum (the current projected 10-year total return per annum), a short position would lose -3.87% per annum over the next 3.85 years, for a **cumulative loss of -14%**.

SUMMARY

- Bull case for stocks is:
  - Equities cheap relative to bonds with a 2014 operating earnings yield of 7.5% versus a 1.93% 10-Year US Treasury Yield
  - Central banks have taken tail-risk off the table
  - U.S. QE program limits equity market downside
- SPX currently 49% overvalued and projected to return 3.87% per annum over next ten years – BULL CASE ALREADY PRICED INTO THE MARKET
- Secular bear market that began in 2000 did not end in March 2009 based on lower-than-average duration and higher-than-average valuation
- Based on historical precedent, SPX likely to fall to around 743 in less than 4 years

Proposed trade: short SPX at 1,557 for a 3.85-year IRR of 15.5% per annum