# Bull Market Celebrates Sixth Birthday: Will It Turn Seven?

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March 9th marked the sixth anniversary of the start of the current bull market. The ride has been nothing short of spectacular; the S&P 500 has more than tripled in value since the bear market low on March 9, 2009.

Few bulls have enjoyed such length and rise. Since World War II, only three have gone on longer, and none have had bigger run ups at this point from their start.

While the current bull is riding a wave of positive developments, like low interest rates, cheap energy prices, and an improving economy, there are certainly a number of headwinds. So, what should investors plan for now? Will the bull see its seventh birthday?

## Upshot

A one year forecast, like any short term forecast, is most difficult; essentially, short term market movements are a product more of psychology than of underlying fundamentals.

Nevertheless, despite a wide array of very positive trends, like an improving jobs picture, positive sentiment, low interest rates, and marked down energy prices; market valuations are now a sticking point. Always be prepared to weather a correction or worse, and make sure you have a long enough time horizon to see it through to the other side.

In the meantime, tilt your portfolio toward recent laggards, and lighten up in areas that have become quite speculative.

## Corporate Earnings Drives the Bull

Markets are driven by two factors. The first is corporate earnings, the second is the amount investors are willing to pay for them.

Corporate profitability has had a remarkable rebound from the worst recession since the 1930s, doubling since 2009. Earnings per share have grown even faster.

Companies, facing a dearth of reinvestment opportunities, skittish on the economic outlook, and fearful of shareholder activism should their share prices lag, are pumping billions into repurchasing their own stock. In February, US companies announced buybacks of $104 billion, trumping the prior record of $99.8 billion from July of 2006.

The current daily buyback rate of $3.4 billion could lead to a full year tally exceeding 2007’s record. This increases earnings per share even without any increase in profits, as it reduces the number of claims on those earnings.

## P/E Multiple Expansion Spurs Shareholder Value

The other factor is the multiple, a/k/a price to earnings ratio, investors are willing to pay for those earnings. That continues to increase, driven by improving confidence and declining interest rates.

It now sits at over 17 times this year's earnings, the highest since 2004, and over the 14.1x ten year average. The bullish take is that our economy is getting traction, that the only earnings that matter are the next few years', not this year's or last year's; stocks look forward, not backward.

Further, earnings multiples bear a relationship to interest rates. One can analogize bond prices as a multiple of their income payout. With the 10 year Treasury now yielding about 2%, that security is trading at a 50 multiple. Higher fixed income multiples encourage and warrant higher stock price multiples.

## A Coming Halt to Earnings and Multiple Expansion?

Near term trends are calling into question the bull's future. Corporate earnings for 2014's fourth quarter were barely positive, up just 3.3% year over year.

2015's first quarter is projected to show an earnings decline, down 5.1%, the first down quarter since 2009. If you subtract just one stock, **Apple (AAPL)**, the projected decline could be more severe, over 7%. Declining earnings will drag down the market averages absent growth in the P/E multiple.

Although P/E multiples are a function of sentiment and interest rates, the interest rate outlook is, well, mixed. Janet Yellen and the Federal Reserve are determined to try to create some normalcy in interest rates now that they've ended "quantitative easing," the buying of bonds by our central bank.

The pundits forecast a hike in short term rates as early as June. If short term rates rise, money will come out of longer dated bonds like the ten year Treasury, kicking up its yields.

A rise from 2% to 3% on the ten year Treasury will reduce the bond "multiple" from 50 to 33. That has to have a depressing effect on the stock market's multiple.

## Additional Headwinds

Sentiment has been positive, creating tremendous momentum for the market. That's now reflected in the above average valuations. Positive sentiment sows the seeds for a negative turn in the market; when everyone's bullish, everyone is fully invested, so additional buying can start to wane.

A rise in interest rates not only affects the multiple that investors are willing to pay, it can also affect the earnings part of the equation. Higher rates will increase costs to borrow to buy a home, a car, and plant and equipment.

As the US has emerged more quickly from recession than overseas economies, money has poured into the States, driving up the value of the US Dollar, 22% over the last year. Indeed, the US Dollar has appreciated 13% against the Euro just this year!

As a result, S&P companies will see earnings pressure, as 40% of their business is overseas; Dollar strength makes exports less competitive and depresses the value of overseas revenues.

## How to Play It

Don't be pessimistic longer term. Interest rates won't rise forever. Plus, corporations will always find new ways to increase earnings. Make sure you have an adequate time horizon and prepare to stay the course. You won't be able to time exits and reentries.

Tilt your portfolio to areas of the market where multiples are less demanding, sentiment less bullish. That includes overseas stocks, financials, and energy plays. Lighten up on areas that reflect excess optimism, like biotech and social media.

## Overseas Stocks

Overseas markets have greater potential than ours. Valuations are lower, fixed income yields lower, and monetary authorities are hell bent on further loosening the money supply, not tightening it as in this country. The European Central Bank plans to buy over $66 billion of bonds monthly into 2016.

Europe is the poster child. With many bonds at negative interest rates, yet stocks cheaper than Stateside, there's huge incentive to gravitate from fixed income to equities.

Earnings multiples are nearly 20% cheaper, at 15.1 times earnings. Profits margins are still 20 to 30% below their pre-crisis levels.

Europe also benefits mightily from low energy costs. Some analysts believe European stocks have upside of 70% or more.

## Financials

Your opportunity here is that valuations are lower and earnings may well rise as rates rise. Banks will be able to earn more as mortgage rates tick up, while insurers will be able to generate more from their float, meaning the proceeds of premiums held until claims payout.

Many financials will be able to earn more just on the money market funds they offer; right now fund providers are subsidizing returns as the portfolios generate less than the cost of

their operations. **T. Rowe Price (TROW)** and **Schwab (SCH)** are two examples of brokers/money managers which will benefit from an uptick in rates.

## Energy Stocks

With crashing crude oil prices, down some 50% since last June, many energy stocks have no earnings. Here, the bet is that supply dwindles as incentives diminish, while demand increases as the economy improves. As oil and gas prices rebound, so do earnings and stock prices.

Here again, overseas energy outfits generally have lower valuations, particularly per barrel of reserves. **Royal Dutch (RDSA)**, **BP (BP)**, and **Total (TOT)** have operations rivaling **Exxon (XOM)**, but with substantially lower valuations.

## Health Care Sector, Specifically Biotechs, Seems Overpriced

Biotech and health care stocks generally have done rings around the general market. It's not just mom and pop investors bidding these up; merger and acquisition activity reflects an overheated sector.

A good example is **Abbvie's (ABBV)** recent bid for **Pharmacyclics (PCYC)**. Pharmacyclics' revenues were just $700 million last year, but Abbvie agreed to pay $21 billion to acquire the company, a whopping 30 times trailing earnings. Pharmacyclics' key drug had been acquired for just $6 million in 2008. Pharmacyclics' stock traded for just $1 per share back then; the current buyout reflects a per share price of over $231.

Consider also that PCYC's key drug costs patients $9,000 monthly. With consumer health care spending now at a record 21% of all spending, up from 15% as recently as 1990, the country's ability and willingness to pay up for these very specialized drugs may well come into question.

Given some of the speculative activity in certain healthcare names, any push back on drug pricing could create some severe reversals in these stocks.

In sum, higher rates and more challenging valuations make it uncertain if the current bull will turn seven. However, longer term investors have plenty of opportunities to ride out any volatility.