KWB 2014 4th Quarter Update

NOW IS THE SUMMER OF OUR DISCONTENT

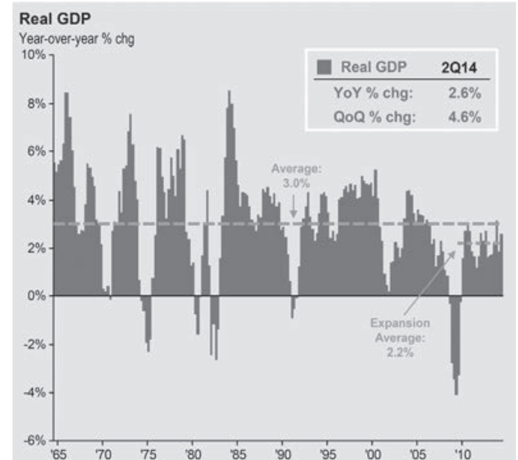
WINTER = RECESSION
SPRING = RECOVERY
SUMMER = EXPANSION
FALL = MATURITY

The economic cycle is much like the four seasons of the calendar. Recession would be Winter, Spring recovery, Summer expansion, and Fall maturity. We are currently in the Summer (Expansion) of the current cycle, but I'm not sure most people feel this way. The title of this newsletter is a misquote from the William Shakespeare play "Richard III." The actual line is "Now is the winter of our discontent." It seems as though many believe we are still in Winter.

I did a quick Google search for two terms: "2014 Economic Expansion" and "2014 Economic Recession." Economic expansion had quite a few hits, 4.72 million. Economic recession, 28.4 million or 6 times more hits. Staggering!

Perhaps the single biggest reason that people don't realize we're in Summer is that the last Winter (Recession) was more brutal than any of us have ever experienced. The Winter was so harsh, in fact, that Spring (Recovery) was much longer than usual. Since World War II, there have been 12 recessions and the average time between recessions has been 5.5 years. In this cycle, the economic Spring may have taken that long all by itself.

This doesn't mean that we are "due" for another recession. We believe that it means this economic Summer could last a little longer than normal as well. According to LPL Research, there are certain characteristics that each "season" exhibits.



Graph 1: Sources — BEA, FactSet, J.P. Morgan Asset Management

The Spring has these five characteristics:

- Economic output recovers, check!
- Lost jobs recouped, check!
- Markets rebound, check!
- Credit expands, check!
- The Fed stimulates the economy, check and it's still stimulating with bond purchases and low rates!

Here are the characteristics of Summer:

- Moderate Gross Domestic Product (GDP) growth. GDP has been lackluster in recent years, but is showing signs of speeding up.
- Slow return of inflation. The Consumer Price Index (CPI) is back to a normal rate of about 2%, but doesn't seem to be overheating.
- The Fed normalizes policy. The Fed is tapering its bond purchases and should be done with QE by the end of this year.
- Interest rates rising. Rates have actually fallen this year.
- Double digit gains for stocks. Last year was a very strong year for stocks, and so far this year stocks are on pace to rise double digits, check!

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According to these characteristics, we are firmly into Summer and not close to drifting into Fall. So, what indicators should you look for that may predict when the next Winter may be on its way? LPL Research has come up with five that have proven to be good predictors of recessions.

Inverted Yield Curve

Every recession over the past 50 years has been preceded by the Fed hiking rates and causing the yield curve to invert. An inverted yield curve means that short-term rates (2-Year Treasury) are higher than long term rates (10-Year Treasury). The 2-Year currently sits at 0.44% while the 10-Year is at 2.30%. Nowhere close to inversion.

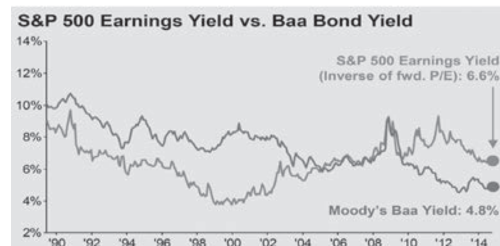
Index of Leading Economic Indicators (LEI)

The Index of Leading Economic Indicators is comprised of 10 fundamental indicators designed to predict the path of the economy. When the year-over-year (YOY) rate of change in the LEI turns negative and begins to fall, a recession has historically followed by anywhere from 0-14 months. In August, the YOY change in the LEI was a positive 6.3%.

Trailing Price-to-Earnings (PE) Ratio

Every bull market since WWII has ended at a trailing PE between 17-18, except the bull market that peaked in 2000 which had a PE of 28.2. The current PE is right about 18, so this indicator may be a little overheated. However, we think that PE multiples could expand for one simple reason: stocks are cheaper than bonds.

Graph 2 shows that the yield on investment grade bonds is lower than the implied return of forward earnings of S&P 500 companies. In an environment like this, stock market PEs can continue to rise because historically "safe" bonds are actually more expensive to buy.



Graph 2: Sources – Standard & Poor's, FactSet, Robert Shiller Data, FRB, J.P. Morgan Asset Management.

Market Breadth

Market Breadth is a technical indicator and measures how many stocks are participating in a market rally. When the market is rising on the strength of fewer and fewer stocks, it's more vulnerable to a decline. When this indicator has been confirmed, a recession has often taken place in the following 1-16 months. Currently, market breadth has been rising; a good sign for a continued rally.

Institute for Supply Management Survey (ISM)

The ISM surveys purchasing and supply management professionals each month and publishes the results. Purchasing managers offer a strong look into the future of manufacturing activity as they order supplies to produce new products. The most recent ISM came in at 59, which is the highest level since before the recession. The ISM has been an excellent predictor of profits and a peak in the ISM suggests that profits may peak around six months later. As you

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can see in Graph 3, profit margins are at all time highs.

With the majority of headlines talking about recession over expansion, it's hard to believe that things are actually very good. We continue to employ our Advance & Defend approach to investing your portfolios. As long as this economic Summer continues we will likely stay in Advance mode. If the indicators mentioned in this piece begin to concern us, we will attempt to Defend your portfolio gains prudently. We think the sun will continue to shine on portfolios for the time being, but are ready to shift should Fall or Winter winds begin to blow.

Graph 3: Sources – BEA, Standard & Poor's, Compustat, J.P. Morgan Asset Management.

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he Standard & Poor's 500 Index is a capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

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Investing involves risk including loss of principal.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.

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