The View From Princeton

Market Commentary ♦ March 2015

A "TINA" STOCK MARKET
Part I

On May 22, 1980, Conservative British Prime Minister Margaret Thatcher, in the Daily Telegraph, opined that free markets, unfettered trade, and capitalist globalization were necessary to stem the advances of socialism and return the United Kingdom to prosperity. Her strong declaration, "There Is No Alternative," morphed into the acronym TINA which became the rallying cry of neoliberalism …. and her nickname.

Today, in a period of global geopolitical disruptions and erratic economic recoveries, investors, here and abroad, are attracted to the stability of the US stock and bond markets, also sensing "there is no alternative."

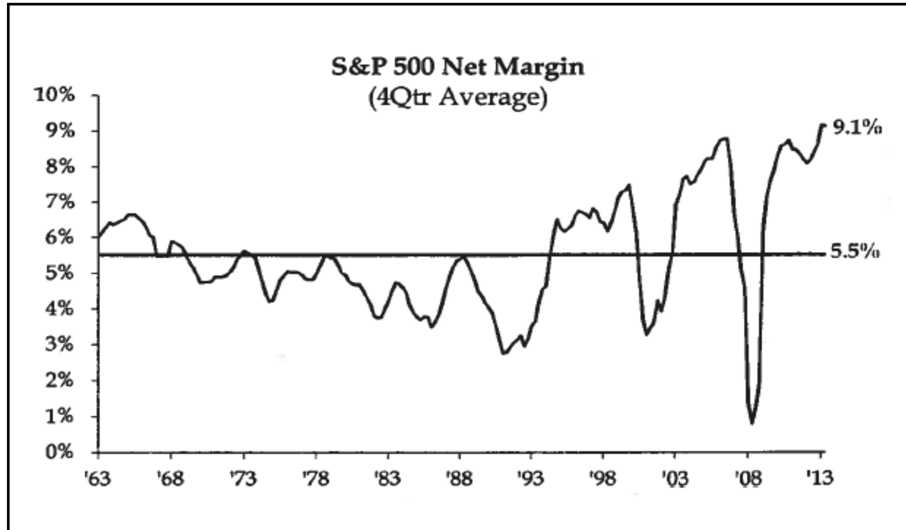
The resultant investment inflows from abroad and a preference for equities by US investors have caused our financial markets to steadily advance in the face of subpar domestic economic growth and the ending of the Federal Reserve's extended period of unconventional easing. There are few signs of this trend reversing or of a quelling in the rallying cry of the bulls, "TINA."

However, there is a growing fraternity of skeptics questioning the sustainability of the market's strong recovery. After advancing for over five years, there is a supposition among some forecasters that the bull market has reached maturity and they have begun to warn of its imminent demise. While the premise of TINA is still bullishly reflected in their equity weightings, guardedly they search for reasons to reverse course and seek the safety of reduced exposure.

In our second quarter 2014 commentary, we addressed analysts' forecasts that rising interest rates would abort the economic recovery and bring an end to the bull market. Our conclusion was that, while interest rates would rise over time, the ascent would be moderate and economic risks minimal. Easy foreign central bank policies, global fund flows and the diverse nature of US bondholders' investment objectives would combine to moderate the magnitude of the upward move.

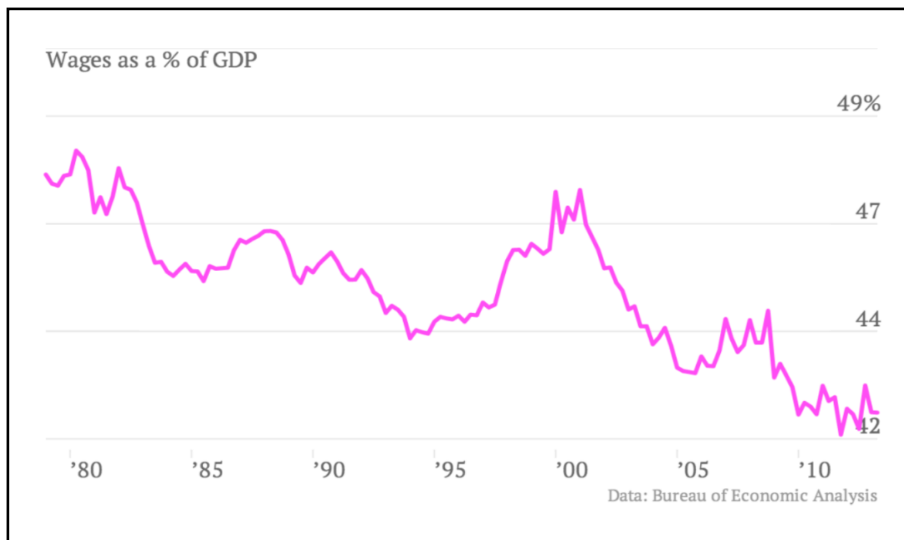
There are three other concerns that are dampening investor enthusiasm. First, with the economic recovery now entering its seventh year, it is "long in the tooth" and its durability is called into question. Second, with the bull market bringing the market averages back to their historic peaks, overvaluation is a present danger. These issues will be addressed positively in future letters.

And third, wary investors are becoming increasingly fearful of an impending and potentially sharp decline in corporate profitability. With operating margins at a cyclical high of nearly 9.1% and persistently tepid top line revenue growth, the concerned feel a reversion to something closer to the historic mean margin of 5.5% is on the horizon; a scenario not friendly to the economy or the equity market.

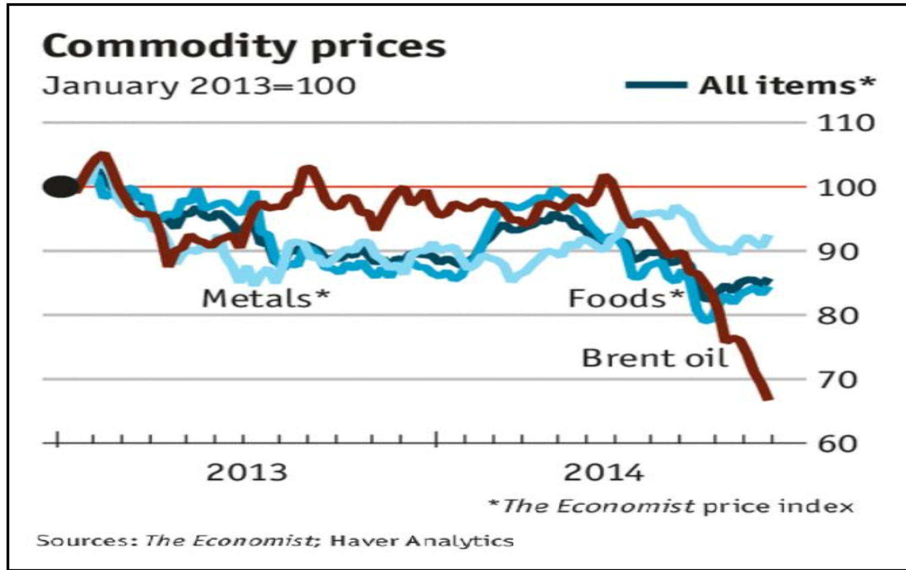


However, an analysis of the major cost components determining corporate earnings does not affirm their fears of an imminent, deleterious decline in profitability.

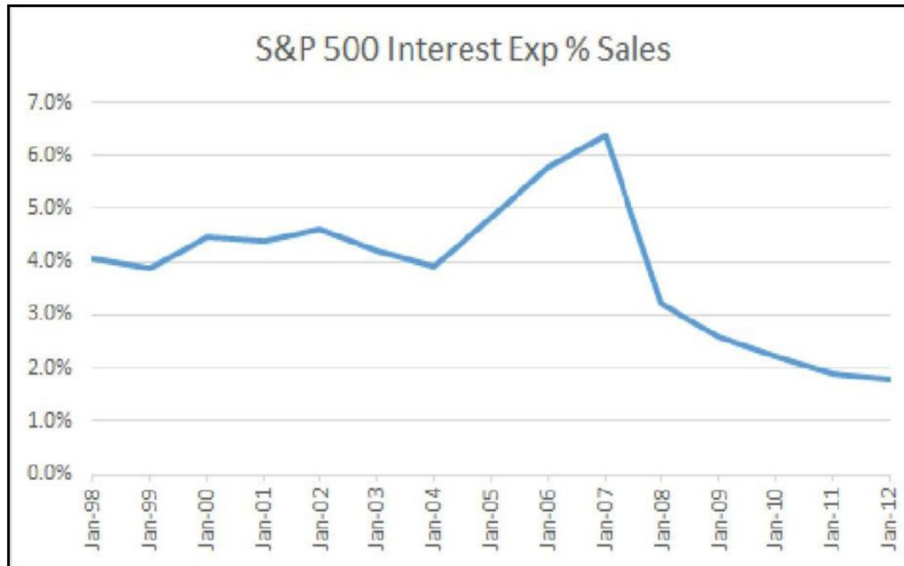
1. Labor: In spite of the recent drop in the unemployment rate, wage inflation pressures do not appear to be threatening. Presently, the interaction between the forces of the weakness of labor unions, economic globalization, domestic underemployment and innovation/productivity improvements provides a headwind to rapid wage rate acceleration.



2. Raw Materials: The combination of sub-par global growth, new supplies (especially US energy) and conservation should keep commodity prices well contained.



3. Interest Cost: The outlook for moderately rising interest rates combined with a lengthening of the duration of debt on corporate balance sheets should mitigate any sharp cost escalation.



4. Taxes: While there is growing pressure from the government on corporate tax abuses, there is a general understanding that the relatively high US corporate tax rate is non-competitive on a global basis. So, dramatic tax code changes are not currently anticipated. Eventual reform would increase corporate payments and most likely, would be accretive to the Treasury; but not meaningfully so.

Over the next few years, prospects for the trends in the "costs of doing business" do not appear to be worrisome. With stable profit margins and moderately growing revenues, the outlook is for a continuation of a historically high level of absolute profit generation. This will have a very positive impact on the economy and American corporations:

1. The building excess cash flows can be deployed in share buy backs, increased dividends and merger and acquisition activities.

2. Already strong balance sheets can be fortified.

3. An acceleration of business expansion can occur through increased capital spending and new hiring.

4. The anticipated ongoing decline in energy prices, as the result of the dramatic growth in US energy production/conservation, can continue to exert an increasingly positive influence on our inflation, growth and employment, balance of trade, and global manufacturing competitiveness.

The simulative effects of the anticipated continuation of US corporations' healthy financial and operating condition bode well for the overall economy and stock market. Thus, we maintain our positive stance on the US equities.

Alfred R. Berkeley	James Fitzpatrick	Hugh Fitzpatrick	Ken Berents	Steve Reynolds

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