MARKET PERSPECTIVE

BY RICHARD SKEPPSTROM

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> "A Catch-22: The powerful earnings advance will peter out without better economic growth but the Fed will raise rates if the economy accelerates."

Neutralish

U.S. markets appear boxed-in. A pause was inevitable but this may be something different and it hinges on the catalyst for higher prices. It's something of a Catch-22. The powerful earnings advance will peter out without better economic growth but the U.S. Federal Reserve will raise rates if the economy accelerates. It's likely to be one or the other and the markets aren't thrilled with either; hence, the pause. We've ignored weak gross domestic product (GDP) quarters in the past few years because margin expansion won the day and the Fed was on hold. But the Fed targeted 2015 for rate increases and while the thrust of margin expansion may not be exhausted, it's certainly narrowing.

In any case, we must face facts: We are slowly but surely sun-setting a period of remarkable earnings strength and Fed accommodation. How long the market will remain in stasis is unknowable. I wouldn't be shocked to find us in this range a couple years from now. But that's a pragmatic view and the markets aren't failingly pragmatic. Ignoring the fine print for a moment, history will show a furious capital-markets advance on the heels of the 2008 crisis followed by, in my view, a stubbornly long period of low returns. But I'm more melancholy than alarmed at the moment. The economy will grow some this year; valuations aren't mad; and earnings won't seriously disappoint. If this doesn't exactly sound bullish, what exactly does it sound like? Neutralish? That's a half-clever term for a half-satisfying strategy: somewhere between neutral and bullish on stocks. You can see why I'm not widely or even narrowly quoted in the financial press. Anyway, I have modestly reduced my exposure to U.S. stocks and raised my cash. I still find bond yields forbidding.

A critical question is: Should there be more exposure to markets outside the United States? Waiting for a pull-back in European bourses has so far been a mistake. The Euro Stoxx 600, a broad European index, is up 18 percent with Germany, its largest market, up 21 percent. Those figures surely won't annualize but it demonstrates the swiftness with which investment regimes can change. As to the evidence of real economic improvement, there's more smoke than fire. Clearly European quantitative easing (QE) and collapsing bond yields (German 10-years at 0.15 percent) are driving money into stocks. That all seems rather extreme and leaves very little in the way of slack should growth turn decisively in either direction. But it's important to keep in mind that a defining characteristic of this global economic recovery has been its plodding nature: tailor-made for central-bank experiments and relentless asset inflation. Like a tough water balloon, you can squeeze it hard (like in the United States) but it instantly bulges someplace else. Europe and China come to mind. Should economic growth stay modestly positive in Europe—not too hot to bring an end to QE (and a fixed-income disaster) and not too cold to throttle earnings—the rally could easily continue without any obvious entry point. I'm wrestling with this.

What's going on in China

And speaking of China, the Shanghai composite is up 38 percent on year-to-date basis and 121 percent year-over-year! Never mind that the economic data consistently tell a deceleration story. Stan Druckenmiller, the famed billionaire investor, says he's never seen an equity advance this powerful not transition into a stronger economy. It probably won't surprise you that I have a somewhat different view. I continue to believe that the staggering degree of mal-investment in China dooms it to many more years of decelerating growth and this market move is the first in a series of big dead-cat bounces not dissimilar to Japan's decades-long experience. That's pretty grim but it's not even my best reason not to invest there. The No. 1 reason is China's inscrutability; we have no idea what's really going on in the country. There is no reliable source of information. I can't say I'm thrilled to stand in the corner and watch while the party gets wild but a massive rally isn't a prudent substitute for discipline and common sense. I'm sure the stock gods will have a new hero when the history of all this is written. But there will also be a herd of goats.

Thank you for taking the time to read this month's Market Perspective. I hope you found it helpful.

Strategic Return Portfolio	
Equities	67%
Bonds	13%
Gold	2%
Cash & similar	18%
Total	**100%**

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Richard, an investment professional with more than two decades of experience, manages Eagle's Strategic Return Portfolio. His views are his own and may not reflect those of other Eagle portfolio managers.

880 Carillon Parkway, St. Petersburg, FL 33716
800.237.3101 | 727.573.2453 | eagleasset.com
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