

# CAZ Investments

## Quarterly Letter

### “Borrowed Time or a Pause to Refresh?”

Markets around the world were choppy in the first quarter and made little progress one way or the other. However, under the surface there are some significant trends that deserve attention and commentary.

The jobs picture is beginning to cloud as the energy sector lays off people in response to the 50%+ decline in energy prices. Other industries are expanding head count, but it is unclear if they will be able to offset the jobs lost in energy. The statistics received the last few months have been decent, but it is premature to form an opinion on the resiliency of the job market.

Energy prices have begun to stabilize and the decline in domestic production has been sharp as a result of aggressive cutbacks in the energy patch. Demand has been encouraging, which has allowed prices to at least stop going down. The 2<sup>nd</sup> quarter will be very interesting to watch as we will face a situation that is nearly unprecedented. There will be oil coming to market that must be delivered at a time when there is virtually no place to store it. Industry estimates show that existing capacity is more than 99% utilized. It takes time to increase capacity, and so the question is what will people pay for oil that they cannot easily, or inexpensively, store? No one knows, but the fireworks around the April – June delivery dates will create some interesting market moves.

### **Valuations Matter... Really**

Last quarter we discussed our concern with market valuations, and provided several charts to illustrate the point. Those concerns have not dissipated. They have heightened as stock prices stayed roughly flat for the quarter, but the outlook for profits has begun to deteriorate sharply.

To provide an update on general market valuations, here are some key points to consider:

- The total market cap as a % of the GDP of the United States is now above 150%, which is one of the highest levels in history, and above the level seen in 2007.
- The CAPE ratio, created by Robert Shiller, is now higher than every point in history other than 2000 and 1929.
- Replacement values relative to company valuations, measured by Tobin’s Q, is now the 2<sup>nd</sup> highest level ever recorded.



These facts make it clear that valuations are expensive compared to historical levels, and those extreme levels persist in spite of deteriorating profit expectations. Contrast those lofty valuations to the following bullet points related to profits:

- Since 12/31 Earnings expectations have been lowered in every sector for 1Q 2015.
- The 1Q 2015 year over year earnings change is expected to now be the worst since the depths of the Great Recession.
- Since 12/31 expectations for full year 2015 Earnings have been lowered in every sector, except healthcare.
- Since 12/31 expectations for full year 2015 Revenue changes have been reduced in every sector, except healthcare.
- For 1Q 2015 for every one company that has preannounced a positive earnings surprise, four companies have issued a negative earnings warning.
- Since 12/31 the expectations for the 1<sup>st</sup> Quarter S&P 500 year over year earnings change has declined from an expected gain of 4.3% to an expected decline of -4.6%.
- Since 12/31 the expectations for the 1<sup>st</sup> Quarter S&P 500 year over year revenue change has declined from an expected gain of 1.6% to an expected decline of -2.7%.

This trend is unsustainable. Time will tell whether this was a market “on borrowed time” or that took a “pause to refresh.” What we can say without equivocation is that earnings will drive stock prices over time. If you have an expensive market and earnings grow at a healthy clip, stocks can move higher. If that expensive market experiences a persistent decline in earnings, that market will inevitably pull back very sharply. We are watching this very closely, and it is the most likely catalyst that would cause us to change our rating on the CAZ Scale. Stay tuned...

### **Paying for the Privilege of Lending Money?**

The massive decline in nearly every major world currency relative to the U.S. Dollar has been well documented. The impact from this cannot be underestimated. It creates ripple effects across virtually all investment areas and causes unique challenges for all U.S. companies doing business internationally. The impact on earnings is substantial and is a cause for concern when forecasting earnings estimates for 2015 and beyond. What has not been talked about as much is how irrational behavior has now reached epic proportions in Europe. There are currently more than \$2 Trillion invested in bonds issued by some of the European governments that are yielding less than zero. Yes, you read that correctly. There is more than \$2 Trillion that is currently **paying** European governments for the **privilege** of lending them money. How long are investors going to be willing to hold bonds that have negative yields?

When we see logic leave the marketplace it gets our attention, and we certainly want to focus on anomalies such as this to frame our outlook for the assets that we choose to invest in. It is for this reason that we continue to prefer cash flow creating assets and strategies, preferably with little correlation to broad stock market indices. There are pockets available to make good returns, they just may



1<sup>st</sup> Quarter 2015

not be as easy to find. It is for this reason that we continue to maintain our rating at a “2” on the CAZ Scale.

We are cautious, and growing more concerned, which means that every investor absolutely must evaluate how much risk exists in their portfolio. Allocations have shifted as a result of solid stock returns, therefore it is easy to look up and realize that you have more stock market risk than you might think. Please don't be complacent. Make a conscious decision how much exposure you would like to have to the general market, and then trim exposure if necessary to get to that level. This period feels eerily similar to the 3<sup>rd</sup> quarter of 2007, and we do not want to have any unintentional risks. There is nothing wrong with taking risks, just know what they are, and why they are being taken. We are happy to discuss your situation and assist in any way we can.

Our firm continues to grow, and we are excited to introduce you to the new team members who joined us in the 1<sup>st</sup> Quarter. Please visit [www.cazinvestments.com](http://www.cazinvestments.com) to read more about each person.

- Jennifer Chohan – Vice President – Investment Strategies
- Elizabeth Connor – Associate – Investment Strategies
- Emerald Lewis – Vice President – Financial Operations
- Emily Van Keppel – Vice President – Investment Strategies

Thank you for your continued confidence in us. We value our relationship and are available to answer any questions you may have. Enjoy the spring weather, and we look forward to seeing you very soon.

The CAZ Investments Team

