Interesting research for intense ‘students’! We are not forecasters of gold or oil, but are very confident, and positive, about the dividend analysis. Enjoy! No quiz!

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Bears Roar but DJII Rebounds After Declines

Every pull-back offers yet another great opportunity to buy low.

Summary

QE has ended in the United States, it continues in Japan but has only just started in Europe. This should keep downward pressure on long-dated U.S. Treasury bonds for some considerable time.

The high relative price of the U.S. dollar should help to temper any premature action by the Fed, which could further strengthen the dollar by attracting additional foreign capital to the long end of the U.S. bond market pushing the dollar even higher.

The yield of the DJII stands at 90% of the 30 year T bond yield and well in excess of that of the 10 year T bond. This points to continuation of the upward pressure on the DJII where the dividend-discount value stands at 38,046 versus a price of only 17,776.

The price of oil could fall by summer to under $20 per barrel as the industry runs out of storage space. While good for consumers the drop may result in margin pressure impacting counter-parties.

While the anticipated rebound of the gold price is underway, it is happening at a slower pace than expected. The direction is still up towards U.S. $1,400 per ounce. Couple this with the positive impact on costs of falling oil price and a lower Canadian dollar the junior and intermediate Canadian gold producers should perform well as the year progresses.

The Undisputed Facts.

On October 9, 2007 the DJII peaked for the last time before Lehman when the price was 14,165 and the dividend-discount value stood slightly above at 14,196. Since then there have been several changes:

October 9, 2007		March 31, 2015
U.S. GDP at $14.8 Trillion		$17.7 trillion up 19% or 2.5% pa
DJII Peak Price 14,165		17,776 up 25% or 3.3% pa
Div Disc. Value 14,196		38,046 up 168% or 7.3% pa
Earnings at $833.70		$1,137.07 up 36% or 4.52% pa
P/E Ratio 17.0		15.6 down 1.4
Payout Ratio 35%		36% Virtually unchanged
Dividend $290.37		$405.88 up 40% or 4.7% pa
Yield 2.05%		2.28% ip 11%

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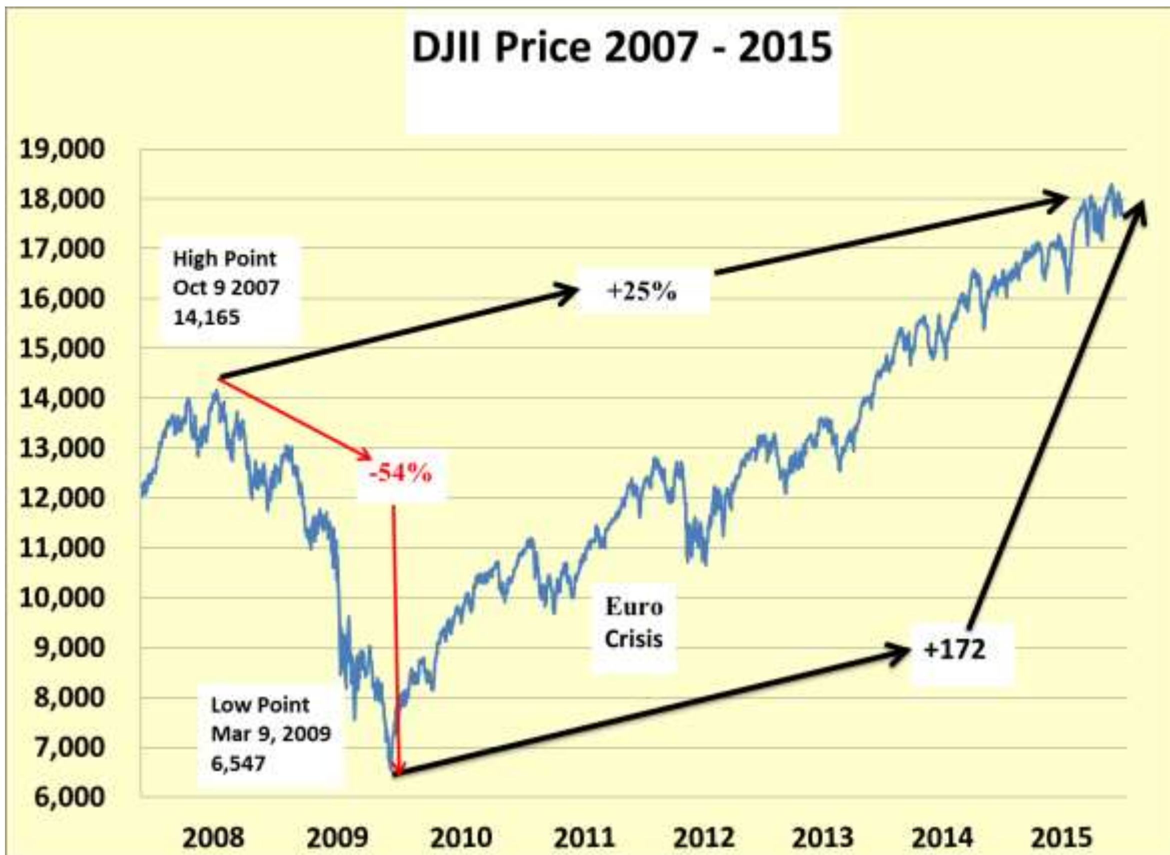

On March 31, 2015 the P/E multiple of the DJII was 1.4 points lower and the yield is 11% higher than in October 2007. The price of the DJII was up 25%. Some-what less than might have been expected the 36% increase in earnings and a 40% increase in the dividend.

Date	DJII	DJII	DJII	Payout	DJII	DJII	GDP
	Index	EPS	P/E Ratio	Ratio	Dividend	Yield	$billions
Oct 9 2007	14,165	$ 833.70	17.0	35%	$ 290.37	2.05%	14,843
Mar 31 2015	17,776	$ 1,137.07	15.6	36%	$ 405.88	2.28%	17,701
Change	25%	36%	-8%	2.5%	40%	11%	19%
Rate Per Year	**3.2%**	**4.2%**			**4.7%**		**2.5%**

All other things being equal.

The 36% increase in earnings alone should have pushed the DJII up to 19,319. Using the 40% rise in the dividend the DJII should be at 19,800.

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However, not all other things are equal.

There has been a major change in **the interest rate environment** as a result of a near five-fold increase in the U.S. monetary base. **Since October 2007 the yield of the U.S. 30 year T bond has fallen from 4.87% to 2.54%**

Date	30 Year T Bond	Reported Monetary Base $Bills	Working Monetary Base $Bills	Excess Reserves $Bills
Oct 9 2007	4.87%	$ 826.00	824	$ 2
Mar 31 2015	2.54%	$ 4,091.00	1,442	$ 2,649
Change	**-48%**	**395%**	**75%**	**1,324**

Over the same period from October 2007, the bond market has effectively doubled. Thus adjusting for the substantial drop in the discount rate, **the dividend-discount value of the DJII is 38,046**, more than double the current price and roughly double the 19,000 plus values arrived at by just using the 36% increase in earnings and the 40% rise in the dividend.

These are the facts and they point to:

There still being great upward pressure on the price of the DJII. Further upward pressure could also come from a higher dividend as the result of both rising earnings and a rising payout ratio.

Why then is the price of the DJII not at 38,000?

In a word fear, one of the market participants' four horsemen of the apocalypse, the others being greed, hope and ignorance:

- **Fear** of a repeat of the financial meltdown brought about by a collapse in Europe and the emerging markets.
- **Fear** of the Fed raising interest rates despite only having control over the very short end of the market.
- **Fear** of either the U.S. dollar either rising to the moon or falling through the floor.
- **Fear** of weak economic conditions abroad where the ECB and Japan are flooding their respective bond markets with liquidity, to the point where most countries are now able to borrow at much lower rates, even negative rates, than the United Sates,
- **Fear** of a depression emerging from low oil prices and those of other commodities.
- **Fear** of all-out wars in the Middle East and Ukraine.
- **Fear** on the part of US Banks driving them to hoard excess reserves at the Fed
- **Fear** on the part of US Corporations to invest and instead they just hoard cash

Furthermore, the persistence of irrational pessimism that has been with us since Lehman, is keeping market participants on the sidelines "hoping" for a correction. This has been the case for six years since March 2009 from which point the DJII has almost tripled as it continues to climb the "wall of worry". It seems that the 90% rule is once again holding:

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90% of market participants miss 90% of the move, both up and down, 90% of the time!

The facts support a much higher DJII price

Yet again there is a tremendous opportunity to buy the DJII at a price of **47 cents for the dollar of value**. This is value investing in its rawest form, all one needs do is to buy and be patient awaiting the waking of the rest of the world to the realization that unlike bond coupons, **dividends tend to grow over time.**

The counter argument

Interest rates are going to return to "normal" now the Fed has finished easing. This begs the questions of when and what is normal? Assuming the price of the DJII is correct then it could be argued that the price of the DJI is discounting a doubling of the 30 year T Bond rate.

If correct why are investors still buying the bonds?

Should long rates start to rise, the last place one should invest is in the bond market. Furthermore, rising rates must surely be an indication that economic activity is strengthening and better earnings and dividends are in prospect.

Changing interest rates impact the price of money both at home and abroad

Monetary easing lowers the price of money domestically, in the form of lower interest rates, and internationally in the form of a lower priced currency. Since Lehman, QE has kept both the U.S. dollar and interest rates low. Since the ending of U.S. QE last year and the introduction of QE in Japan and the Eurozone more Euros and Yen have been created than US dollars and that has resulted in lower Japanese and Euro interest rates and the respective currency exchange rates.

Whether intended or not, devaluation is the result and exporting corporations tend to benefit. The opposite holds true as a currency strengthens, as shown in the latest quarterly the results of many U.S. multinational corporations. However, should interest rates spreads widen too much, capital should flow from lower to higher priced currencies. This is probably the main reason for the continuation of the 34 year bull market in U.S. bonds.

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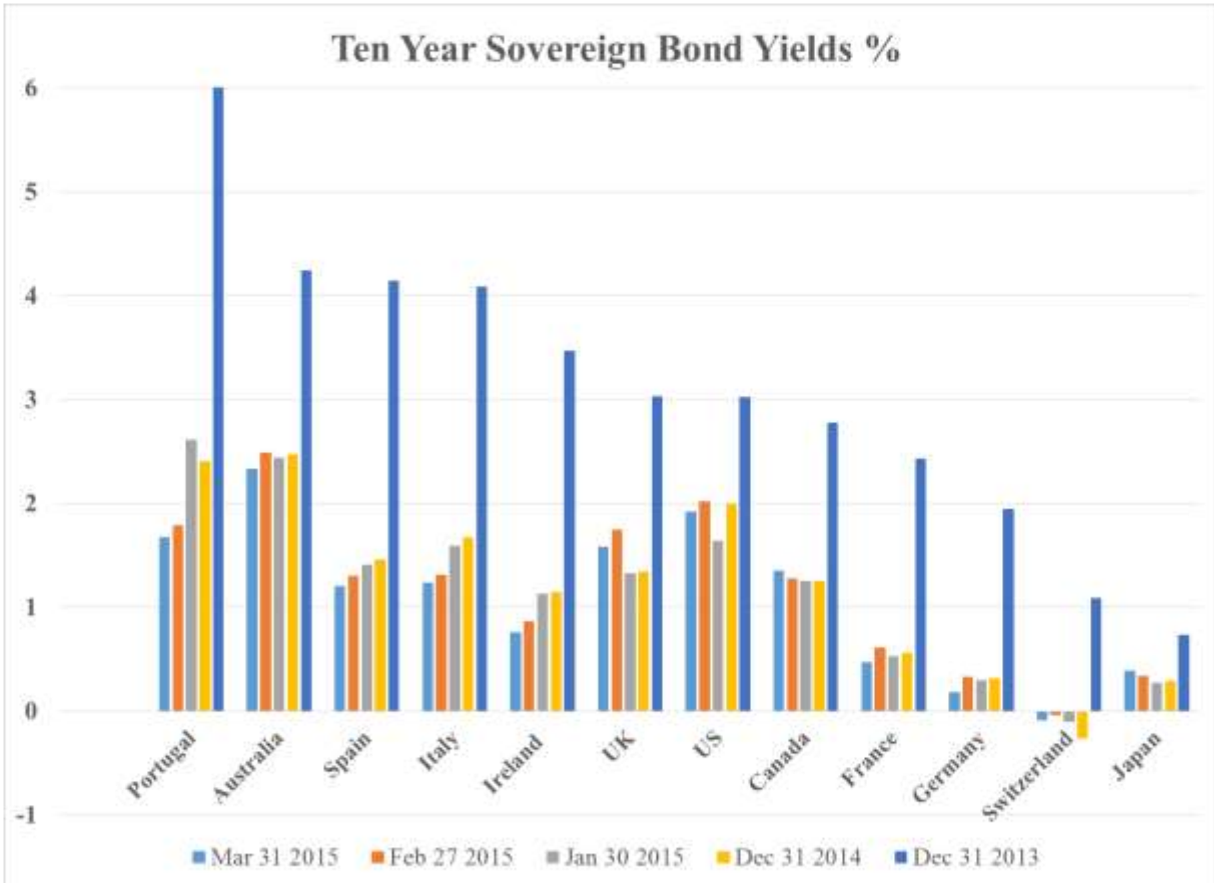
How Sovereign Bond Rates have changed in 15 months



Over the past 15 months yields of 10-year Irish, Portuguese, Italian and Spanish government bond have plunged to below those of comparable U.S. securities. Only a short time ago these countries were considered financially pariahs. Their borrowing costs are now below those of "riskless" U.S. government bonds.

Yields on comparable French government bonds are less than a quarter of those in the U.S., while yields on benchmark German bonds have fallen to half that of Japan and one tenth of the U.S. Swiss bond yields remain negative. Even European corporations can borrow at rates below that of the United States with investment-grade corporate bonds in Europe trading at a record-low of under 1%.

With QE slated to continue into 2016 in Europe and Japan interest rates seem destined to stay low worldwide including the United States with the possible exception of the Fed funds rate. For despite the economic circumstances in the Eurozone being worse than in the United States, U.S. yields should continue to remain low and could even fall. The relative strength of the U.S dollar along with its higher sovereign

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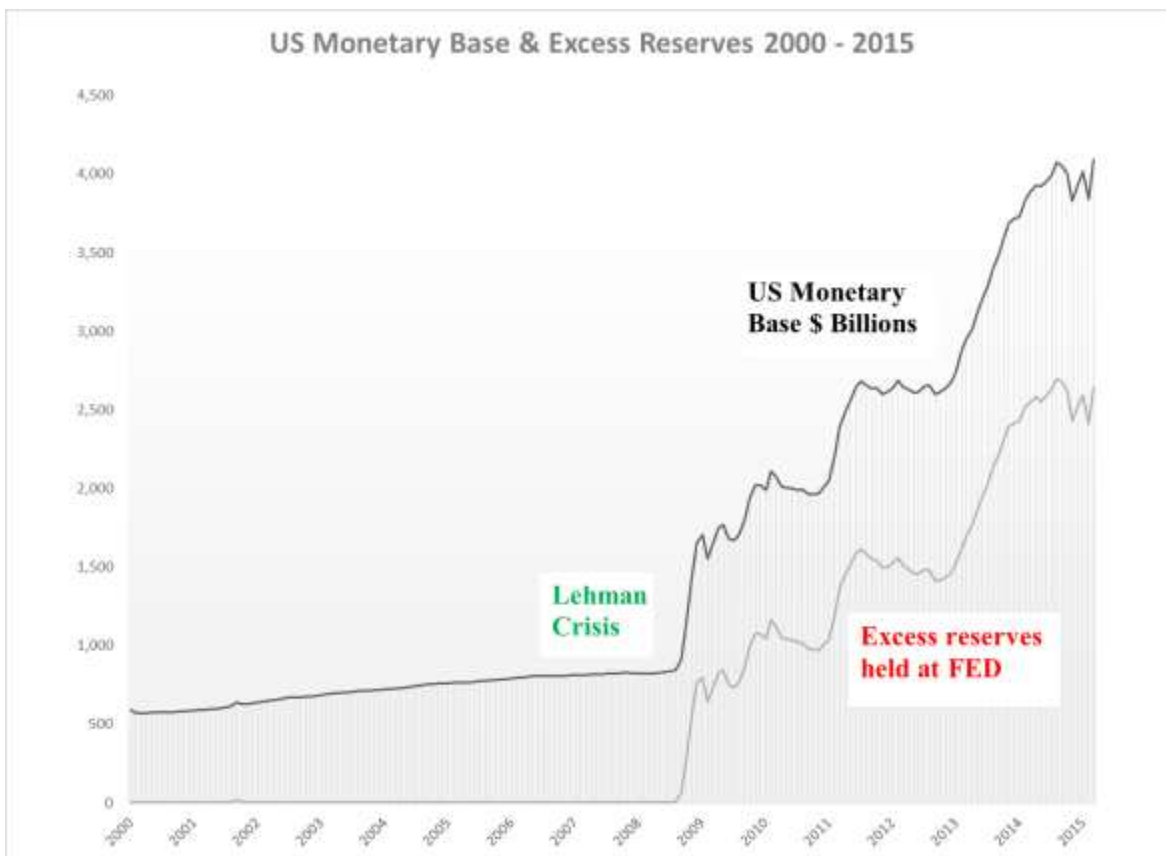
rates should accelerate the flow of foreign funds into U.S. Treasuries, thereby putting additional downward pressure on U.S. yields.

It makes no sense for any of the Euro nations being able to borrow at rates below that of the United States. Bond momentum investors that can buy outside their own nations must be tempted to buy U.S. bonds which have been very profitable of late, benefitting from both falling rates and a "strengthening" U.S. dollar.

Fed has done its job of easing but Commercial banks have yet to do their job.

As of mid-March the U.S. commercial banks were sitting on $2.74 trillion of excess reserves that are earning only 0.25% per annum. This money too will eventually flow out into the real economy whether as a result of the dissipation of **fear** at the bank level or action by the Fed to discourage the holding of excess reserves by either eliminating the deposit rate or introducing negative deposit rates



Subtracting the $2.74 trillion excess reserves from the total U.S. monetary base of $4.09 trillion leaves $1.44 trillion as the actual amount of the monetary base that is working.

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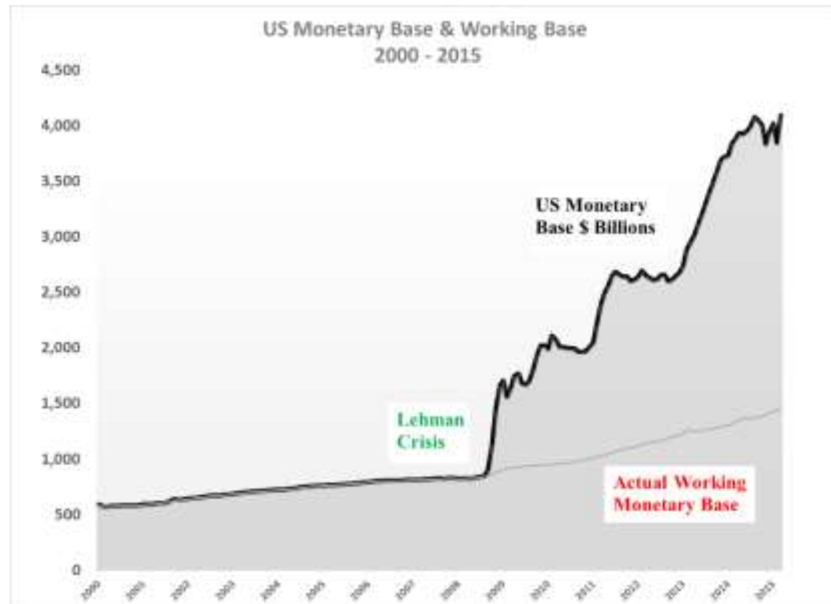
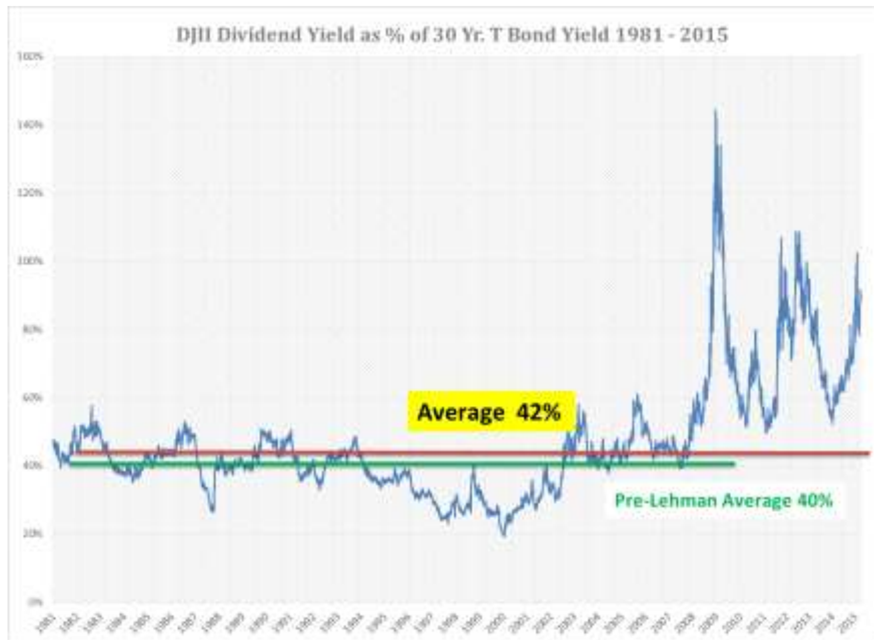


There is too much money sloshing around the world with no desire to invest in anything more risky than sovereign debt, which is increasingly in short supply as the ECB is competing to buy the same securities.

Dividend Discount Value of DJII Continues to Put Upward Pressure on Price

At the close of markets on March 31, the pre-tax dividend yield of the DJII stood at 2.28%, which was 90% of the 2.54% yield of the 30 year U.S. T bond.



On an after-tax basis the DJII yield is considerably higher than the yield of the 30 year T Bond. Furthermore, **dividends** tend to **grow** over time whereas bond coupons remain static. In the search for higher yields investors need look no further than the **DJII where the dividend discount value stands at 38.046.**

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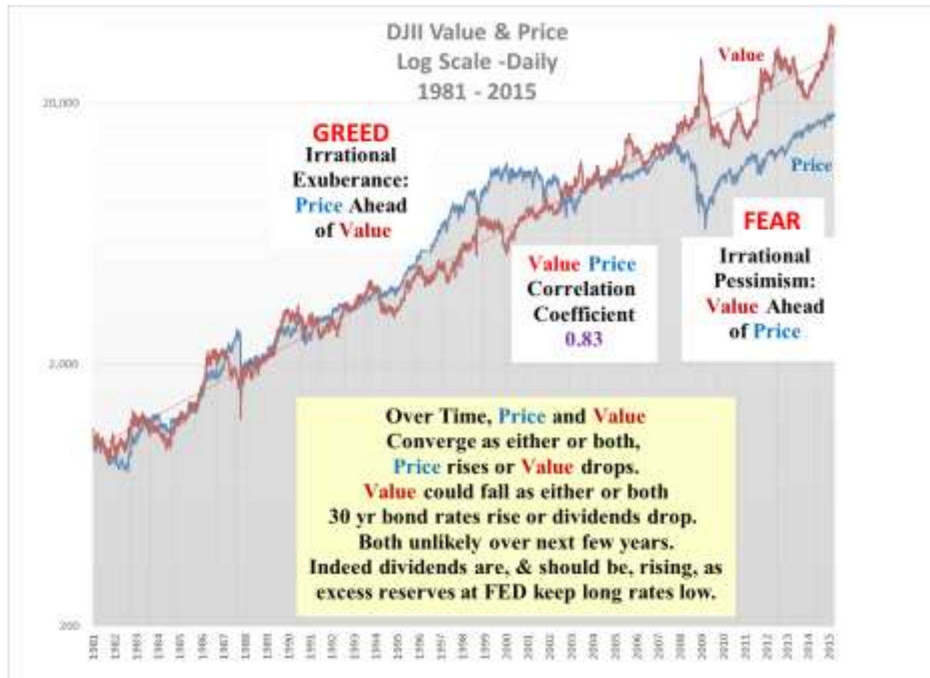
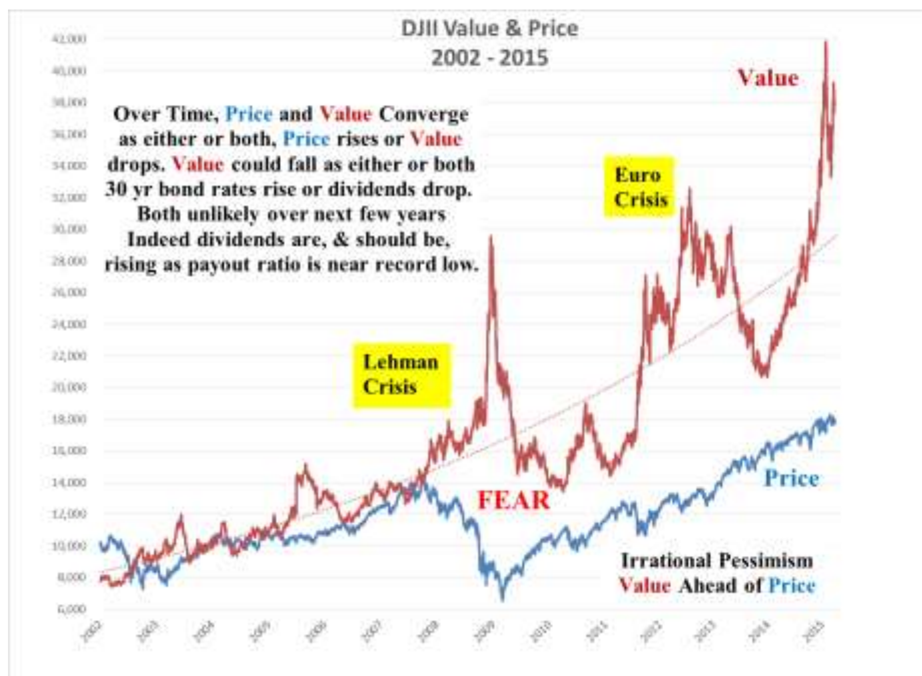


Using an arithmetic scale and a shorter time frame changes the preceding chart to a much more dramatic chart that screams BUY as it has done since the days of Lehman. It makes no sense to buy low yielding Treasury bonds when the value of the DJII is so much above its price.



There is an argument that equities in general and the DJII is too high on the basis of the P/E multiple being too high. However, the following chart shows it is difficult to see where the average P/E multiple has been let alone where it should be and yet numerous commentators are bearish on the basis of the P/E multiple being too high.

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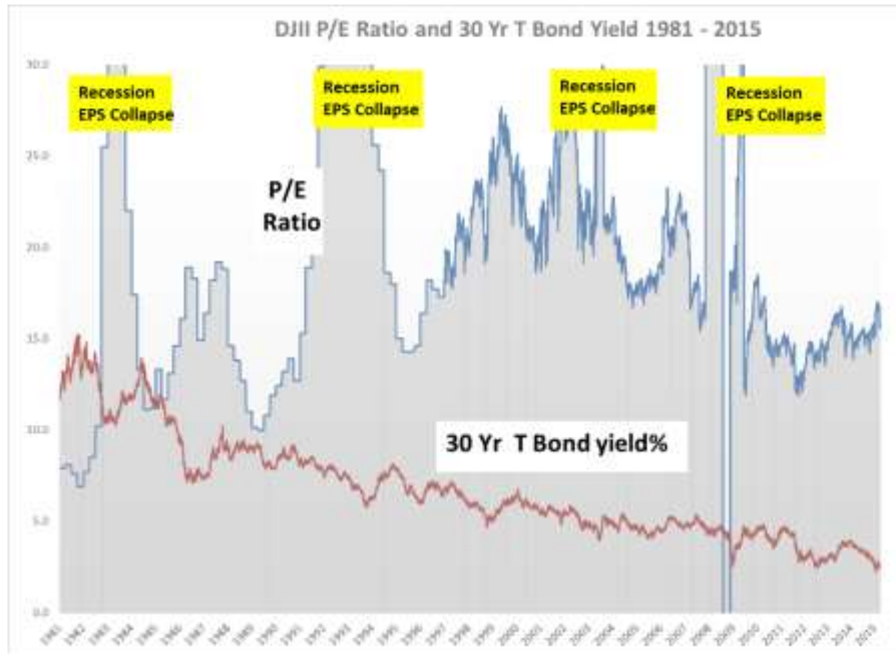
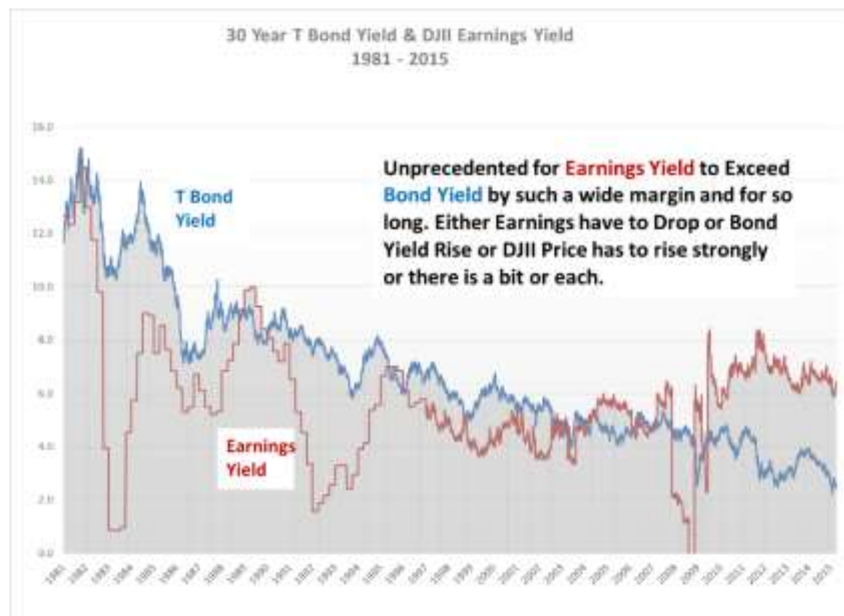


Many such bearish commentators fail to put the P/E in to the context of the prevailing interest rates. The following chart does. It shows the earnings yield, the reciprocal of the P/E multiple, and the prevailing interest rates since 1981.



The question this raises is, "Will earnings fall?" While unlikely to fall much, it is possible. However, long Treasury rates should also fall and counter the impact as a broad recession would underway. The most probable source of earnings weakness in the short term is the energy sector but countering that would be just about every other sector that should benefit from lower energy prices and consumers enjoying what is effectively a most welcome tax cut.

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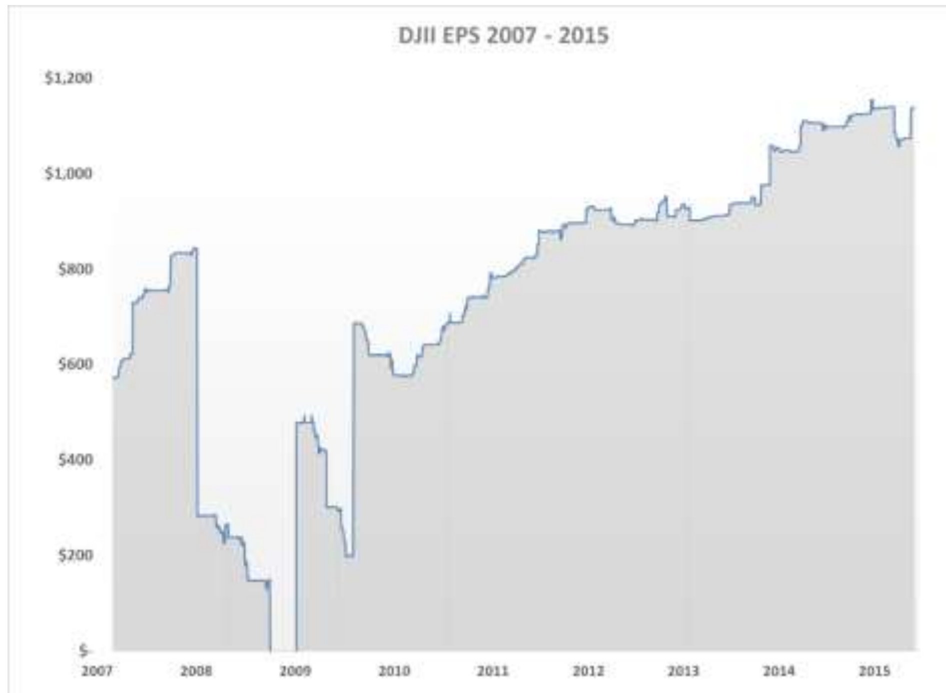
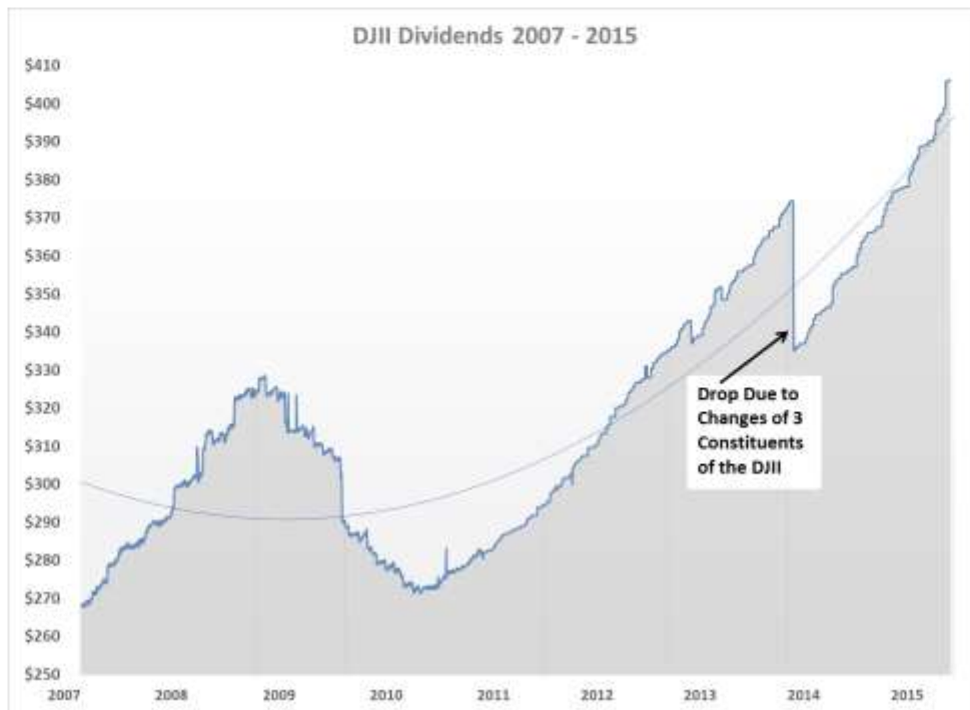
Some earnings cuts have been encountered during the final quarter of 2014 that have shown up so far in the aggregate earnings of the DJII possibly from the impact of the "stronger" U.S. dollar on the results of the multinationals.



However, it is extremely doubtful that the now *record* DJII dividend will be affected as:



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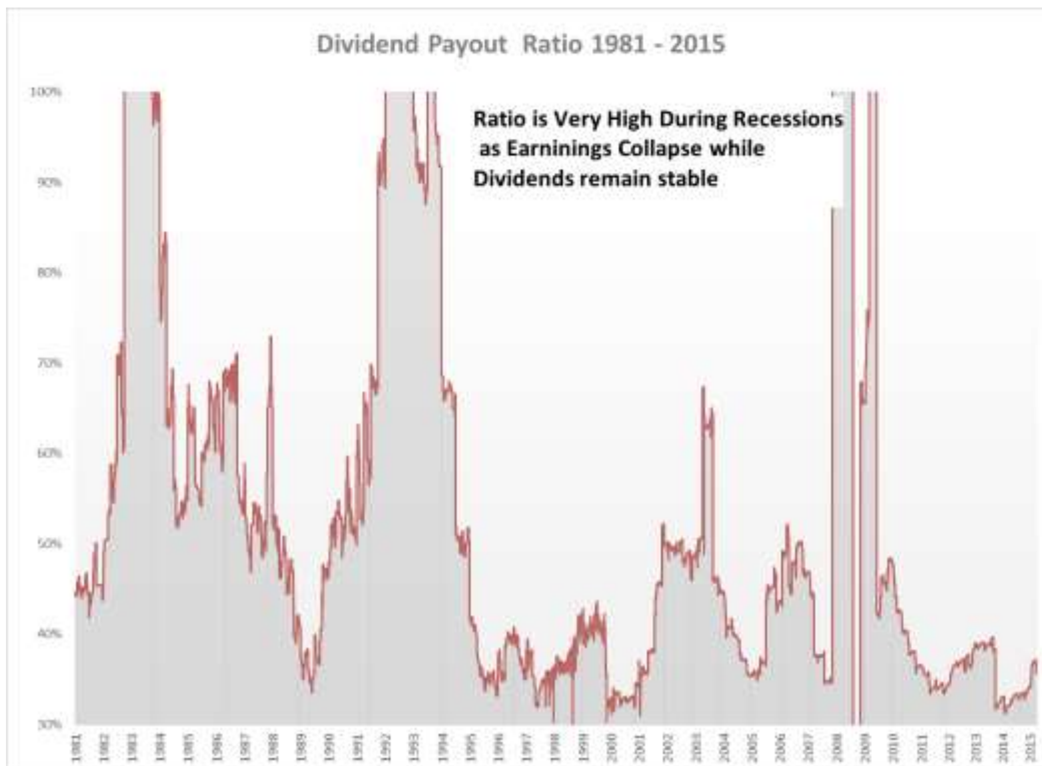
DJII payout ratio is still low.



Oil price headed lower to under $20 per barrel

It is doubtful that there will be any improvement in the price of oil this year as production continues to rise and storage facilities are almost at capacity. Once full, the price of oil could well tumble to a market clearing price below $20 per barrel. Not good for the oil producers but great for consumers.

However, a nagging concern about the prospect of the drop in the oil price to-date and its probable further decline is the prospect of massive counter-party failure creating a "Black Swan" event but if the counterparties are the banks their excess reserves should be sufficient to stem a disaster

Lower oil price means lower production costs all round even for oil producers.

A lower oil price will have a positive impact on the costs of manufacturing, transportation, mining, logging etc. which will see a further positive impact from the lower Canadian dollar. Lower costs increase profit margins, profits and dividends that should all feed through to increased share prices. A similar scenario should be seen in the Eurozone where domestic shares, in particular German shares, are already rising to new high levels at least as measured in Euros.

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Modest gold price recovery has been underway since November 5, 2104

Again while no fireworks are expected, the price of gold should move above $1,400 per ounce which would be more in keeping with the actual working monetary base. The recovery has already breathed some life into gold equities and this should continue.

Data Sources: US Federal Reserve, Dow Jones, Bloomberg and the London Bullion Market

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