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A month ago, we argued that the mid-summer drop in U.S. share prices, which some saw as the start of a more precipitous fall, made little sense given strong economic data and solid company earnings growth in the second quarter. We called it buying opportunity – and so it was. In August, the S&P 500 rapidly rebounded to reach new record highs, topping the 2,000 benchmark for the first time. The entire episode proved an object lesson in the importance of keeping a calm focus on fundamentals in the face of unfounded market jitters.

So what now? Some market bulls are already charting a "clear path" for the S&P 500 to hit 3,000. Someday, perhaps. But we prefer to set our sights on less loftier goals: steady gains, perhaps 12% by the end of the year (compared to 8.4% year-to-date), based primarily on improved earnings, supported by modest multiple expansion as the economy gains momentum, as well as continued share buybacks by companies flush with cash. With S&P 500 operating earnings per share (EPS) up 11.7% in Q2 from the year before, and 7.8% from the previous quarter, and with the 12-month trailing P/E ratio well below bubble territory at 17.9x, such gains are realistic, and put the market on a solid footing for further gains next year. This market doesn't need to shoot the lights out to make us happy, just keep on delivering.

The U.S. economy appears to have maintained its momentum into the third quarter. Durable goods orders in July surged a record 22.6%, compared to a year before, driven primarily by aircraft sales; but even excluding aircraft, orders were up a solid 6.6% year-on-year. The ISM manufacturing index leapt to 59.0 in August, from 57.1 in July and 55.3 in June, while the new order sub-index reached an exceptional 66.7, up from an already very strong 63.4 in July, suggesting better data ahead. Car and light truck sales jumped 6.4% year-on-year in August to an annual rate of 17.5 million vehicles, the strongest pace since July 2005. Consumer confidence hit a new post-recession high of 92.4 in August. Existing home sales have steadily recovered from a substantial dip earlier in the year, while new housing starts surged 15.7% in July compared to June, up 21.7% compared to a year ago. The U.S. trade deficit, after expanding earlier this year, has started shrinking again. And while the August employment report fell far short of expectations, with only 142,000 jobs created, it would be premature to read too much into a single month's data, considering that the 4-week moving average for weekly jobless claims has been steadily falling. In light of the other strong data, a moderation in new hiring – rather than indicating a downturn – may suggest that productivity is improving and inflation remains in check.

It's a solid if not necessarily spectacular story, and it leaves some investors craving more. Lately, they think they've found it in emerging markets, where lower P/E ratios have some convinced that stocks are cheap. And indeed, while the S&P 500 is up 8.4% year-to-date, the MSCI Emerging Markets index is not far behind at 7.8%. The MSCI China index, after falling 12%

earlier this year on (much justified) fears of a slowdown, has rebounded 18% in recent months, putting it up 4% year-to-date. India has surged 25.4% year-to-date, and nearly 50% over the past year. Brazil is up 20.2% year-to-date, South Africa 9.5%. The BRICS, so they say, are back. Only Russia, down -16.4%, mars the overall picture; and at a P/E of 4x, some would argue even Russia looks like a buy.

We disagree. S&P 500 and MSCI Emerging Market returns may be comparable so far this year, but the risks are not. As for China's latest surge in share prices, we have no hesitation calling it a false dawn, dead cat bounce, or whatever colorful term conveys the idea that investors who rush in are making a big mistake. China's investment-led growth model has reached its sell-by date, and there can be no sustainable rebound in growth without a dramatic, and painful, shift to a new model – something that China, with its renewed attempt at credit stimulus, is farther away from than at any point in the past year. Far from turning around, China's slowdown will deepen, leaving a lot of shattered hopes in its path. We are not nearly as negative on India's prospects, but it reminds us of the Japanese market a year ago: a steep *anticipatory* run-up in stock prices based on a new leader's promises of far-reaching reform, followed by a let-down when those reforms prove much harder to implement in real life (Japan's Nikkei index has fallen -5.3% so far this year). In Brazil, the promising new leader isn't even in place yet; the run-up in share prices is driven by hopes that Dilma Rousseff will be turned out of office. If she isn't, or if her successor proves less than inspiring, expect a downward correction. Russia's economy was plagued inadequate rule of law, poor corporate governance, and a narrow reliance on commodities well before the crisis in Ukraine made Putin a pariah – issues that will persist even if the military stand-off is solved. Each of these BRIC countries has serious problems that we hope can be fixed, but won't be fixed overnight.

Make no mistake, there are a select number of emerging markets – the Philippines, Indonesia, Poland, Colombia, Mexico – where the fundamentals are strong and the investment outlook is far more appealing. Several of them have generated sizable returns this year. A number of frontier markets (up 13% this year) hold real promise. But we do not buy wholesale into the pop thesis that low P/E ratios make the larger BRICS, in particular, an attractive place to put your money. Steady stock market returns, based on a steady U.S. recovery, may not make much of a fairy tale. But we don't propose trading this cow for a handful of magic beans.

September 5, 2014 Patrick Chovanec

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