Quarterly Commentary 2016 | Q1

Risk control is the best route to loss avoidance. Risk avoidance, on the other hand, is likely to lead to return avoidance as well.
-Howard Marks-

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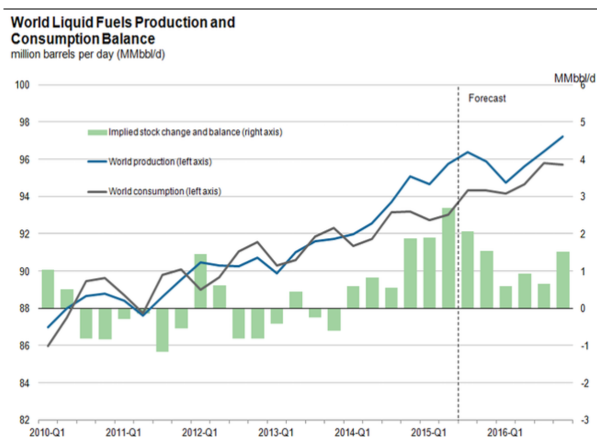
For investors, 2016 did not begin with a bang. It began with a thud.

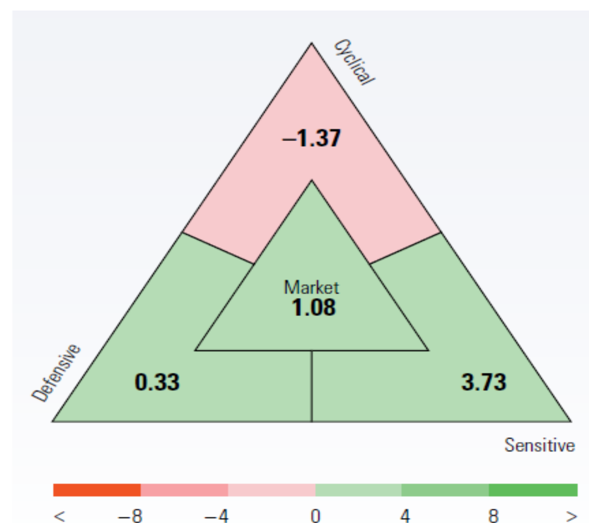
The downward trend in equities, which had begun in the latter half of 2015, intensified. Equity markets mirrored the drop in oil, which was seen as falling due to a lack of global demand.

Financials, in particular, took a hit, as fears of stymied credit began to over-hang the markets. Due to the long lead time in oil production, many large banks had extended credit to oil producers. As the price of oil continued to fall, investors worried that these loans would not be repaid.



Concerns of slowing demand emanated not so much from the United States, but from countries around the world. The European Union continued to wrestle with the threat of impending deflation. Russia and Brazil remained mired in recession. China, who is trying to transition to a more market-based, consumption-driven economy, continues to struggle with large corporate debt and massive credit leveraging among other systemic issues.

Markets also grappled with a Federal Reserve that seemed poised to raise interest rates. The market reaction was initially muted when news of the first rate hike in almost a decade broke across global media outlets. What was perhaps most concerning to investors was the expectation of an additional 3 to 4 rates hikes this year, leading one equity manager to declare, “Investors have to know that Central Banks have their backs.” For the first time since the Great Recession, investors began to question how much support they could rely on from the world’s central bankers.



Q1 2016 Morningstar Sector Delta and Return %

But as the quarter progressed, headlines became more encouraging. The Institute for Supply Management reported in February that the Purchasing Manager’s Index, widely used as measure of the economic health of the manufacturing sector, had reached a 13-month high of 49.7 in China. In March, the index registered 50 in the United States for the first time in seven months. A reading over 50 represents expansion in the manufacturing sector. This news, indicating improvement in the world’s first and second largest economies, was welcomed by investors. It was seen as something of a confirmation that a slowdown or contraction was not imminent.

Stateside, the positives began to out-weigh the negatives. Wage growth, consumption and real

disposal income increased, however, the advance in disposal income was attributed to deflation in some sectors.

Additionally, employment which had surged towards the end of 2015, continue to produce notable gains. Investors see job creation as an important sign of a healthy economy. Employers will only hire if demand is sufficient for expansion. No rational employer would hire if a slowdown appeared imminent.

Relative stability in real estate markets also boosted investor psyche. Investors were encouraged by new homes sales, even though the pace declined slightly during the quarter. The sale of new homes can provide a slightly greater boon to the economy, as more economic sectors typically benefit.

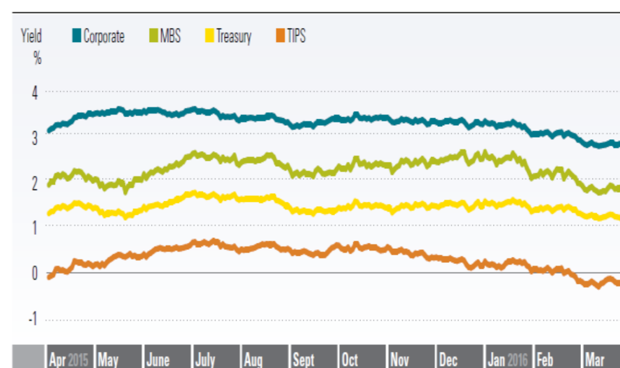
In the midst of improving metrics, oil reversed its downward trend and began a notable ascent, which further encouraged investors. Equities, which had slid with plunging oil prices, rode the wave higher, this time with a slight upside bias. Even on days when oil prices marginally fell back, equities often decoupled, closing slightly higher.

As expected, the trend was undergirded once again by a highly accommodative Federal Reserve, which elected to forgo any further increases during the quarter. Instead of the widely anticipate three to four increases in 2016, market sentiment now suggests there will be no more than two.

Although the returns were far from stellar, many indices ended the quarter well in the black. Interestingly, many 'sensitive' stocks fared the best, as the expected rate hikes failed to occur and the Fed seemed to assure markets that it was prepared to move at a slower pace than originally thought.

Fixed income also performed well, during a quarter marked by volatility. Gains were driven by a sovereign bond rally beginning in January. The relatively high-quality debt was seen as a refuge from deteriorating oil prices and global economic conditions. As the European Central Bank and others around the world continued to ease, in an effort to stimulate economies and boost inflation, sovereigns retained their gains.

US Bond Indexes: Average Yields



When Markets Over-React….

Volatility has been a constant since investors began trading stocks, bonds and other investment vehicles. Its periodic interjection into financial markets is not a new phenomenon, although many analysts and investors seem inclined to characterize it as such. Because the price paid for an investment reflects the purchaser's opinion of value, it is consequently subjective and constantly changing--at least in the near term.

Benjamin Graham, widely regarded as the father of value investing offered the following observation to explain price fluctuation: "In the short run, the market is a voting machine but in the long run, it is a weighing machine." In the end, the market will coalesce around an accurate valuation, but the precedent will likely be a period of instability.

Much of the concern surrounding volatility seems to emanate from a perception of the market as an

all-seeing, all-knowing, almost omnipresent entity, whose crystal ball can foretell the future of the global economy. Nothing could be further from the truth.

In reality, the market is nothing more than a collection of individuals, who have assembled an infrastructure to buy and sell investments. Some may argue this point, citing computers programmed to quickly trade at even the slightest price change. While it is true that markets today often employ algorithmic investing, it is still human beings who put this technology in place and program it to function.

Sector	Quarter	1-Year	3-Year
Cyclical	**–1.37**	**–1.44**	**10.82**
Basic Materials	4.91	–5.28	5.12
Consumer Cyclical	0.93	2.04	14.15
Financial Services	–6.09	–4.27	9.78
Real Estate	5.11	2.09	8.85
Sensitive	**3.73**	**0.34**	**9.85**
Communication Svs	7.50	11.85	11.73
Energy	3.59	–18.29	–5.88
Industrials	4.70	1.00	12.12
Technology	1.67	4.19	15.46
Defensive	**0.33**	**1.35**	**14.23**
Consumer Defensive	5.66	10.16	13.28
Health Care	–5.95	–6.48	16.03
Utilities	15.09	15.07	12.05

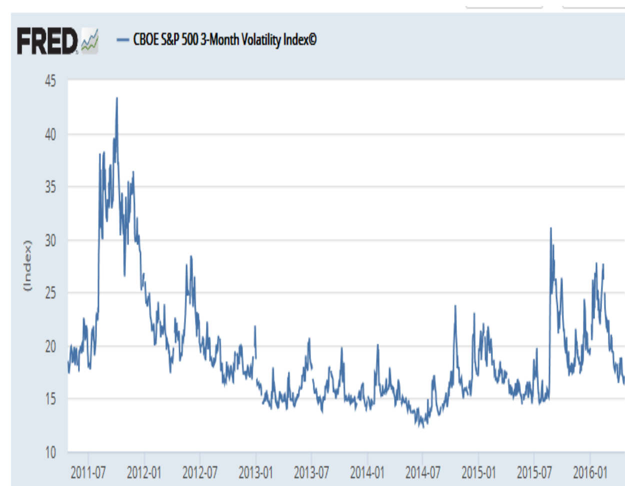
Q1 2016 Morningstar Sector Returns

Humans are by nature governed by emotion. For the most part, we are not perennially irrational beings, but we are often biased by our passing perceptions and at times act in irrational ways. We are also frequently and easily influenced by others. This characteristic is widely known as herd mentality, which can be quite pervasive. Philosopher Bertrand Russell pointed out that "Collective fear stimulates herd instinct, and tends to produce ferocity towards those who are not regarded as members of the herd."

Group think allows anxiety to quickly permeate markets, inducing traders and investors to over react and make poor decisions. One renowned investment manager remarked in January that he was happy that his firm was strategically located far away from Wall Street and not directly influenced by the irrational fear or exuberance that often drive financial markets.

In addition to being ran by a collection of human beings who are often subjective more than objective in their thinking, it is also important to note that the market is in many ways more reflective than it is predictive. For some who have typically seen markets as harbingers of the future, this reality requires a paradigm shift. In a world that is increasingly governed by a 24 hour news cycle, markets today frequently react to economic deterioration or improvement which has already occurred.

With that said, it is important to note that investors and analysts do look for insight into how the economy may perform in the future and how certain companies may fare in that environment. Investment decisions may then be initiated by these perceptions, as well.



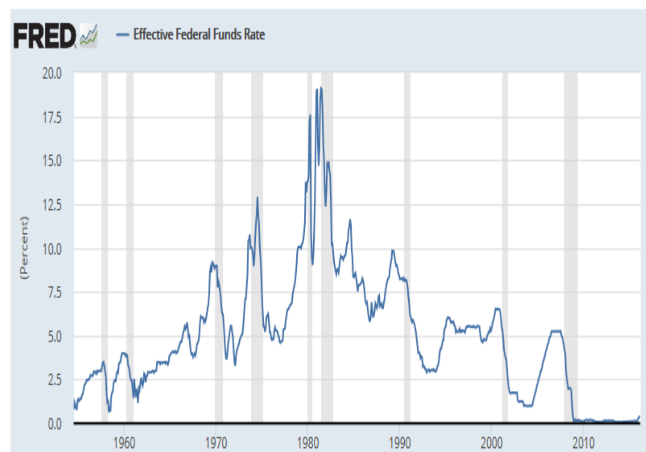
Despite the angst many investors feel when volatility becomes widespread, the ensuing results can be favorable for some. Market inefficiencies support the validity of active value management. Such managers are often ready to go shopping

when markets lose sight of the fundamentals, choosing instead to behave illogically.

In sum, free markets are governed by emotional human beings, who are subject to herd behavior, and are often merely reactive. While there is no superior alternative to the free markets, investors would be well advised not to be overly affected by short-term gyrations. Conversely, in the long run, free markets can be very accurate and their message should be heeded.

Looking Forward….

This past March marked the seventh year of what has proven to be a strong and enduring bull market. Much of the rise in equities is certainly attributable to the highly accommodative monetary policies instituted by the Fed and other central banks around the world.



Not only have ultra-low interest rates enhanced valuations by reducing the discount rate, they have stimulated a demand for equities, prompting a rotation from bonds into stocks. Equally important, the low interest rate environment has reduced borrowing costs creating affordable opportunities for expansion, research and development and share buy-backs. The low rates have also reduced fixed costs for many corporations, increasing profitability. But the well-meaning intentions of the world's central bankers, while mitigating the effects of recession, have not sparked significant growth or inflation, much to their disappointment. By all accounts, economic activity in the United States is stronger than in other parts of the world, however, it is repeatedly described as only "chugging along".

Inflation, which is often seen as a sign of demand, remains tepid. The Consumer Price Index, which seeks to measure the cost of living, actually declined during the first quarter. Core Inflation, which seeks to evaluate the cost of living by subtracting certain products, such as food and gasoline due to rampant price fluctuations, remained steady.

Although many economists, investors, and analysts now see the glass as half full and poised to potentially ebb higher, particularly in the United States, we must not gloss over the systemic problems which still exist. While investors applaud the easy-money policies employed by central bankers, we must remember that the global economy is still facing many hurdles which give justification to these polices.

Given the overall state of the economy, it is somewhat surprising that equities are trading above their historical mean value, based on the Price to Earnings ratio. This occurrence may be attributed to the demand for equities created by the Feds easy money policy. However, as investors pay an increasingly higher price for each dollar of earnings, expectations are also likely to rise. When those expectations are not met, a sell-off is likely to ensue.

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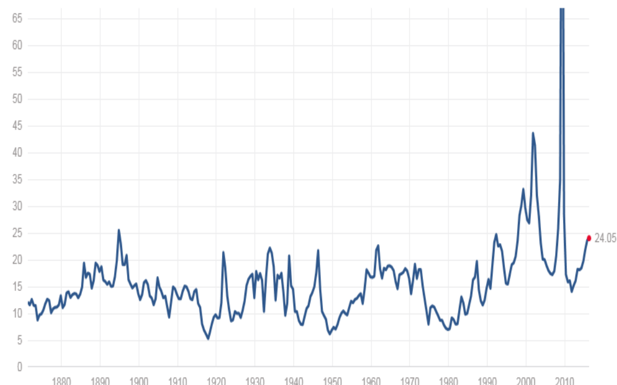

S&P 500 PE Ratio

While many companies are reporting earnings and revenues largely in line with expectations, it is important to examine the standard which has been set. Given the current economic headwinds, the bar for many of these companies has been set relatively low, allowing them to simply step over the threshold. Even so, some giants like Caterpillar, Microsoft and Google have failed to clear even a low-set bar.

Year over year earnings growth has been muted, producing what is often descried as a profit recession. The only validation then for the higher P/E multiples is a significant expectation of future earnings. It is reasonable to assume that over time those expectations will be met, but in the near term the economic landscape may be challenging.

World leaders are facing what will likely prove to be a delicate balancing act. For many, the need to stimulate the global economy, in an effort to ignite growth and inflation, will be paramount. For others, the need to take more concrete steps towards normalization will be equally important. All are attempting to find their way through largely uncharted territory.

As markets attempt to grapple with systemic issues for which there is little precedent, we would not be surprised to see additional spates of volatility this year. But once again, we will likely not be a seller, but a buyer. Despite the short term challenges--often dictated by emotions and devoid of fundamentals--we feel that markets are poised to reward long-term investors, who remain patient.

If you have questions or comments, we would like to hear from you.

Sincerely,
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