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Capital Markets Commentary, Winter 2016

Market Overview: A Look Ahead and a Look Back

WELCOME TO THE SERIOUS INVESTOR, WINTER 2016

Our take on the year's tough start

- World markets have been rattled by concerns about growth related to Fed tightening and the slowdown in China.
- Although risks abound, we think worries may be overblown and could present opportunities.
- We don't expect a bear market, but we think generating returns in U.S. stocks will require strong stock picking.
- We continue to hold overweight stock positions in Japanese and European equities, which are earlier in their profit cycle and offer more-attractive valuations than the U.S equities do.
- Resource-based emerging markets look like a classic value trap.

This year hasn't begun happily for financial markets. Investors have been spooked by a flurry of worries, including further weakness in oil prices, steep losses in China's stock market, strife between Saudi Arabia and Iran, and North Korea's claim to have tested a hydrogen bomb. Amid all this market noise, the S&P 500 fell 6% in its first trading week of the year—its largest one-week loss since 2011.

We'd like to dismiss a few popular explanations for the market's drop. Plunges in China's stock market are not driving world financial markets. China's market is relatively tiny and insulated, and it's dominated by retail investors. We're also skeptical of the theory that tensions between the Saudis and the Iranians are shaking global investor confidence. It's hard to see how the price of oil could be falling if people really thought two of the world's largest producers were about to go to war. And North Korea's actions are more troubling than ever, but that has not been the market's focus.

It seems clear to us that stock markets have fallen because the world is fretting about growth. China's currency—not its stock market—is key. The renminbi recently fell to its lowest level against the dollar since 2010 amid signs that the country's economy is slowing more than expected. Those trends suggest further disinflation in the world's second-largest economy. They also make global markets nervous about the risk that China's policymakers will lose control as they try to transition their economy's main drivers from exports and investment to domestic consumption. Currency declines may exacerbate the risk of a so-called hard landing; if it happens, that event would hamstring global demand, particularly for raw materials.

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Meanwhile, the markets are digesting the Fed's December rate hike and its stated intention to keep raising interest rates gradually through 2017. If the global economy is an engine, the Fed and other central banks effectively flipped the choke over the past seven years—trying to jump-start activity in frigid conditions by flooding the engine with fuel. Now the Fed is easing off the choke, and investors are watching closely to see if the engine sputters.

Cutting through the market noise

We are mindful of and vigilant about the risks to the global economy and markets today. That said, we think fears of a global slowdown may be overblown, and we're conscious that market fears often present value opportunities for disciplined investors. At the very least, the recent global market sell-off has created more-attractive points to enter the market.

For example, a hard landing in China clearly would exert a powerful negative influence on global markets. Yet we think that outcome is unlikely. The country appears to have the tools and resources it needs to prevent that turn of events, including huge (though declining) foreign reserves. What's more, China's economy is slowly but surely making the transition its policymakers are trying to orchestrate. For example, the country's service sector is now larger than its manufacturing sector.

Further, we believe the U.S. economy is healthy enough to keep growing at a slow and steady pace with slightly higher interest rates; in fact, we think the Fed could (and should) have raised rates earlier. And the Fed action hardly strangles global liquidity. Of the world's largest economies, only the U.S. is in the process of tightening. Europe, Japan and China are all adding to liquidity in major ways.

Although the drop in oil prices is terrible news for certain companies, industries and countries, most of the major players in the world economy—including the U.S., Europe, Japan and China—are net beneficiaries of cheap oil. That's one reason growth conditions in Europe are broadly improving. For example, German factory orders staged a surprising 1.7% surge in November, following a strong October report—one encouraging indication among many that Europe's economic recovery is gaining some traction. Japan also shows a number of positive signs, with a growing money supply, increased lending, less deflation and improved corporate fundamentals, including record profit margins.

In the U.S., consumers—who account for 70% of economic activity—have reasonably strong budgets and balance sheets. Last year was generally good for American households: The economy added 2.65 million jobs (including nearly 300,000 in December), wages finally started to rise, the price of oil and gas plummeted and home values rose 5%. Consumers' improving financial condition and confidence have shown up in strong restaurant and holiday retail sales, and even (unfortunately) in a spike in cigarette sales.

Wages finally on the rise

Connecting the macro to the market

When we put the picture together, we see a world in which the U.S. and many global economies look likely to grow. Growth does not guarantee stock market gains, and in fact a more significant correction would not be surprising (and seems to be taking hold as of this writing). But the growth and liquidity picture make a bear market look unlikely. With that in mind, we are staying alert to the possibility that fears of a global slowdown may present value opportunities for disciplined investors.

In a recent note to advisors, Schwab chief investment strategist Liz Ann Sonders quoted legendary investor Sir John Templeton: “Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria.” She noted that U.S. equity markets seem closer to skepticism than euphoria, and we agree.

That said, we are not making the case for strong returns in the broad U.S. stock market. The Fed’s low interest rate policies effectively have led the market to borrow returns from the future. Rising interest rates now put pressure on stock valuations. With little chance of rising P/E ratios, the market will focus on companies that can grow revenues, free cash flow and profits.

That increased focus on fundamentals will occur in the context of an extraordinarily narrow market. The S&P 500 managed a goose egg in 2015 thanks only to surges in a handful of the largest stocks—particularly the FANGs (Facebook, Amazon, Netflix and Google). In fact, the Value Line equal-weighted index of the 1,700 largest companies in the U.S. dropped 12% on the year. David Snowball of Mutual Fund Observer notes that fund investors lost money in:

- 8 of 9 domestic equity categories
- 17 of 17 asset allocation categories
- 8 of 15 international stock categories
- 14 of 15 taxable bond categories and
- 6 of 6 alternative or hedge fund categories

Historically, narrow markets have led to one of two outcomes. Either:

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1. Breadth ultimately increases, with money coming out of big winners and cycling into stocks with attractive valuations, or

2. The market narrows further, resulting in a bear market as a weakening economy tips into recession (usually pushed by aggressive Fed tightening).

The first outcome looks more likely to us than the second, with a solid U.S. economy, a cautious Fed and low energy prices. The recent budget deal in Washington provides corporate decision-makers with greater fiscal certainty and signals that the earlier zeal for austerity has largely evaporated.

HOW WE DID IN 2015, AND WHERE WE STAND TODAY

The beginning of a new year inevitably spurs reflection on the one that came before. With that in mind, we would like to review the major allocation decisions we made during the course of 2015. Our Valuation, Growth and Liquidity investment discipline steered us to make decisions that, while not perfect, were very positive for clients given conditions in the markets.

The following is a breakdown of our positioning changes last year: what we did, why we did it, how the decision turned out and where our thinking on the asset stands currently.

Emerging Markets: A contrarian underweight

What we did: We further cut the allocation in early 2015, bringing it to the lowest end of our range.

Our thesis: Emerging markets equities looked like a classic value trap. They were extremely popular among institutional investors and consultants entering 2015, largely because EM valuations appeared to have fallen to very low levels by historical standards. Our Value/Growth/Liquidity discipline led us to take a contrarian stance, to the point that we reduced our portfolios' emerging markets equity positions and replaced with an Emerging Asia focused manager.

As value investors, we firmly expect that over time extreme valuations will revert to the historical mean. Yet we weren't convinced going into 2015 that emerging markets stocks' low P/E ratios truly indicated value. The Growth pillar of our discipline steers us to investigate the earnings that make up the "E" in P/E, providing essential context for valuation judgments: If earnings are declining, a low-looking P/E may not be low at all. We were skeptical that emerging markets' "E" would hold up over the course of the year, given ongoing economic weakness in China and a moribund outlook for commodity prices.

We also worried about the liquidity outlook. Liquidity is essential to any asset class, but especially this one. Developing countries are subject to occasional bouts of capital flight that can spur crises and depress valuations in their financial markets. We saw that liquidity was leaving emerging markets as their economies softened and the Fed contemplated a rate hike—another reason to question whether the "low" valuations entering the year would spur a rebound.

That said, it's impossible to paint all emerging markets with the same brush. Many of them—notably Brazil and Russia—depend on commodity exports, largely to China, to service large, dollar-denominated debts. These markets are clearly in trouble, as their revenues decline and the cost of paying their debt rises. Yet others, such as India and Taiwan, are commodity importers with economies that are driven either by their own consumers or the U.S. These types of markets have better growth and liquidity outlooks than those of the resource-intensive countries, creating the potential for discerning managers to find opportunities.

The result: Cutting and capping our emerging markets equity exposure proved to be one of our best decisions of the year, as the dollar-denominated MSCI Emerging Markets Index fell 17% in 2015.

Our outlook: We continue to believe that emerging markets' growth and liquidity challenges make exposure to broad EM indices unattractive. Going forward, the performance of resource-focused markets is likely to diverge considerably from that of service- and consumption-focused markets (particularly those in Asia). Global policy trends are likely to diverge as well, as central banks in economies hurt by the fallout in commodities try to offset its impact by engineering reflation. These economic, policy and market trends will have ramifications for where to invest and where not to.

We are excited about our investment in City National Rochdale Emerging Markets. We believe this is a better structure to capitalize on a divergent and inefficient space, with an expert who is domiciled in the region and has the resources to capitalize on countries, industries and companies that stand to benefit from improving demographics and fundamentals.

Real Assets: Midstream energy companies (MLPs)--were we early or wrong?

What we did: In early 2015, we reallocated within our Real Assets allocation, transitioning out of commodities and producers and into midstream energy companies.

Our thesis: Since 2009, the United States has become the swing producer of oil and natural gas. Over this period U.S. oil production grew from less than 5 million barrels per day to more than 9 million. This growth resulted in a worldwide glut of oil. Increased supply and waning demand caused oil prices to drop from a 2014 high of $107 per barrel to less than $50 per barrel early in 2015 (and to just over $30 per barrel as of this writing).

A rebound didn't look imminent. Supply did not appear likely to come offline quickly, for a variety of reasons: OPEC was reluctant to give up market share by cutting production; and producers—whether emerging markets or drilling companies— needed to make debt payments, so they were willing to lose money in order to maintain cash flow. Meanwhile, demand seemed likely to remain tepid, due to a slowing economy in China and weak recoveries in Europe and Japan. Similar dynamics were at play with the prices of other commodities.

We responded to this outlook by eliminating our positions in commodities and companies that produce them. We also looked to see if oil price declines led to any opportunities. Midstream energy companies generate a majority of their revenue through long-term fee-based contracts, rather than direct commodity exposure. Therefore, they have not historically been highly correlated to the price of oil and natural gas. Yet their share prices had suffered declines similar to those of direct producers. With distribution yields in excess of 6%, midstream energy companies looked attractive.

We initiated our portfolios' midstream energy positions in early 2015, building an allocation half the size of what we consider full exposure.

The result: We entered MLPs early. We failed to anticipate not only how far energy prices would fall, but how the declines would affect MLP prices. The highest-quality MLPs continued to distribute attractive cash flows, but were forced to reduce their forward growth expectations and their future distribution growth—a key driver for many investors. It is interesting to note that the companies have reduced growth expectations not because of the expected decline in U.S. production, but primarily because they now are unable to tap capital markets to fund the completion of future projects. All told, any allocation to MLPs in 2015 was a significant detractor.

Our outlook: Some of the same factors weighing down many emerging markets—namely low commodity prices and the strong dollar—are likely to drag on commodity producers as well. That said, we have continually reevaluated our thesis on midstream energy MLPs as their prices have fallen, and it remains intact.

A number of developments give us reason to believe that the sector could turn up. The recent sell-off actually is encouraging, in our opinion, because it may represent investor capitulation—often the last stage before an asset recovers. Moreover, Congress recently eliminated the ban on oil exports. This change isn't good for global oil prices, but could benefit the midstream MLPs that move U.S. oil. As of this writing, we are evaluating whether to make a modest addition to our MLPs allocation.

Developed Non-U.S. Equities: Adding to Japan

What we did: In 2015, we moved our portfolios to an overweight position in Japanese equities.

Our thesis: Our Valuation/Growth/Liquidity discipline alerted us early in the year to an attractive opportunity in Japanese stocks. As we reported in the summer issue of The Serious Investor, valuations in the country's equity market at mid-year stood approximately 15% below their 15-year average and at double-digit discounts to other developed markets. Earnings were projected to grow by 15% in fiscal year 2015, aided by low oil prices. As for liquidity, the Bank of Japan pumped it in with a fire hose, enacting by far the largest quantitative easing (as a percentage of GDP) in the world.

Moreover, corporate Japan embarked on a variety of encouraging corporate reforms that looked likely to boost shareholder returns. The combination of all these elements made us more enthusiastic about Japanese equities than about any other asset class during the past year. We added to exposure in a passive, currency-hedged investment that focuses on large, dividend-paying companies.

The result: Japan proved to be one of the world's best-performing markets in 2015, rising 7.5% in U.S. dollars.

Our outlook: Japanese stocks continue to look more attractive than other parts of the developed world, with an economy earlier in its profit cycle and more compelling valuations. Domestic economic trends are not strong, but deflation is diminishing, corporate profits are significantly improving, valuations remain attractive and liquidity is ample. The country's challenges, including some of the least favorable demographics in the world, disqualify Japanese stocks from being a long-term overweight, but we expect further upside over the coming months.

Today's conditions lead us to the following conclusions:

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	Short to Intermediate Term	Longer Term
U.S. Equities	Neutral. Large-cap equities fairly valued, small-cap equities expensive Earnings growth decelerating, but not an "earnings recession"; with top-line growth hard to come by, companies that deliver will be rewarded; discrimination and differentiation likely to be higher Continue to emphasize and overweight long/short, hedged equity strategies that are true stock pickers	Current valuations likely to result in below-average long-term returns Differentiation among equities should prove more important, as earnings will be key to driving equity prices higher Dividends and dividend growth likely to be a much more meaningful part of equity returns
Developed International Equities	Overweight. QE tailwind in Europe and Japan Attractive valuations in Japan, maintain overweight Neutral currency exposure after significant dollar move	Europe and Japan are earlier in the profit cycle than the United States, and QE is in the early innings Current valuations likely to result in below-average long-term returns
Emerging Market Equities	Significant Underweight. Commodity deflation and slower growth are headwinds Continued Fed tightening could result in further EM outflows	Valuations are not stretched Selectivity among countries and regions will be critical
Real Assets	Underweight. Inflation expectations are muted Express exposure through real assets that produce durable income (such as midstream energy) and do not depend on higher commodity prices. As valuations fall the entry point becomes more attractive for a potential addition.	Varies depending on type of exposure
Multi-Strategy	Overweight. Emphasize strategies that have low correlations to each other and exhibit little interest-rate sensitivity and credit risk Underweight long-only credit due to rich valuations and potential liquidity risk Focus on skill-based strategies, with reduced dependence on traditional markets to generate returns	Seek opportunities to capitalize on active, skill-based management
High-Quality Fixed Income	Significant underweight. Current yields and potential for rising rates make this asset class unattractive Lack of return potential hinders investors' ability to meet long-term objectives	Remain at a below-average strategic weight in portfolios until interest rates return to more normal levels

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We welcome your comments on our Winter 2016 letter. Please feel free to contact Ron Rubin, Steve Schuler, Nina Mitchell, Wayne Zussman, Karen Baer, Chris Johnson, or Shellie Peters at 301-656-1200 if you would like to further discuss our outlook, positioning and new opportunities with you in further detail.

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