



## *2016 FALL INVESTMENT OUTLOOK*

The summer months were calm and relatively uneventful from a capital market perspective. While the U.S. stock market's initial reaction to the United Kingdom's June 23<sup>rd</sup> vote to leave the European Union was meaningfully negative, the pessimism quickly diminished. Market participants soon concluded that there were no near term threats to the outlook from this vote and, furthermore, that monetary policymakers would respond if conditions worsened. Indeed most of the world's major central banks quickly announced that they would act if necessary, further heightening the unhealthy codependence that has developed in recent years between monetary policy and stock market sentiment. After falling over 5% within two days of the vote, the S&P 500 rebounded to surpass its pre-Brexit closing value just two weeks later.

Perhaps not surprisingly, interest rates responded by heading lower with the benchmark ten year U.S. Treasury bond yield falling from 1.74% on the date of the U.K. vote to a range of 1.37%-1.67% in the months that followed. This move echoed similar trends around the world as central bank activism encouraged lower yields. Banks in the U.K., Japan and China offered various forms of stimulus which helped nudge rates lower including pushing more bonds into negatively yielding territory. At present, an estimated \$13 trillion of global sovereign bonds now offer negative interest rates.

In contrast, several Federal Reserve officials signaled in recent speeches that economic conditions may soon warrant higher short term interest rates in this country. Indeed, in late August Fed Chair Janet Yellen suggested the case for raising rates had strengthened given the solid pace of job market gains and expectations of modestly higher inflation. Data since that time has been mixed so it remains to be seen if the Fed will act prior to year end.

Progress for corporate America was uninspiring in the second quarter, continuing the recent trend. Revenue growth remains challenged in an environment of low economic activity and modest inflation. Cost cutting and share buybacks continue to boost earnings per share growth though the benefits from these tactics could be difficult to sustain longer term. While corporate profit margins remain high historically, they are on the decline as flattish revenue growth and rising costs hinder bottom line results. Though its rate of growth has moderated in recent months, the ongoing job market expansion continues. This has benefited consumers' wallets as have slightly higher wages which have outpaced inflation. Not all news on the job front has been positive, however, as labor force participation rates remain near record lows.

The political season is in full swing with less than two months to go until the November elections. The presidential race has been as polarizing as any in recent memory, exposing a deep divide within the country between the two major parties as well as within them. The two main candidates have record high unfavorability ratings nationally and each has failed to gain the passionate,

unquestioned support even of their own parties. This could be one reason that as the calendar turned to September, volatility returned to the capital markets as voters returned from their summer vacations, shook off their complacency and contemplated the many challenges noted above. In fact, historically September has been a difficult month for the stock market as it is the only one, going back to 1928, when the median return of the S&P 500 has been negative. Despite the recent pullback, the major stock market indices still show year-to-date gains as shown below.

Year-to-Date Market Returns (excluding income)

	<u>9/19/16 Price</u>	<u>Change From Year-End</u>
Dow 30 Industrials	18,120	+4.0%
S&P 500	2,139	+4.7
NASDAQ Composite	5,235	+4.6
MSCI ACWI-exUS*	248	+2.2

\*MSCI All Country World Index  
excluding U.S.

*Near and Intermediate Term Outlook*

**N**otwithstanding the many challenges noted above, the bull market advance continues. Now just over seven and one half years old, the current expansion phase for the broad based stock market is the second longest bull market of the past ninety years, trailing only the twelve and one quarter year long expansion that lasted from December 1987 to March 2000. As has been the case in the past, this bull is showing some classic signs of aging including a growing disconnect between the underlying fundamentals and the valuations investors are willing to pay for stocks. Forward looking market price to earnings ratios are currently 16.7x versus a historic average of 15.3x over the past thirty years. This is occurring at the same time that earnings growth has been disappointing in part due to the strong dollar and falling energy sector earnings. Broad based earnings declined in Q2 for the sixth consecutive quarter. Growth was modestly positive after excluding the volatile energy and materials sectors, though still not at a level that should support above average market multiples. The gap between reported and pro-forma earnings has also been widening recently. Pro-forma earnings (sometimes referred to as “earnings excluding the bad stuff”) are what certain company management teams try to get investors to focus on; for instance, if a company were to take a legitimate one time charge related to a discontinued line of business. However, all too often when business conditions worsen, companies classify regular recurring expenses as extraordinary and therefore exclude them from pro-forma results. In 2015, reported earnings were approximately 25% below pro-forma figures, the largest gap since 2008, and similar trends have continued in the first two quarters of this year. This is a development worth watching as investors could be paying above average multiples on artificially inflated earnings.

Cash on corporate balance sheets remains near record high levels at over \$1.8 trillion. According to a recent Associated Press story, however, this figure is somewhat misleading. The article notes that this cash is heavily concentrated with over half of it belonging to only twenty-five companies. Excluding these firms, cash levels have been falling over the past two years while debt levels have gone up, posing greater risks than many investors realize. Evidence of this mounting financial stress exists as more companies defaulted during the first eight months of 2016 than in all of 2015. Investors continue to discount the risks in the corporate bond market, however, as they committed nearly \$23 billion to corporate bond mutual funds through July of this year with much of that dedicated to high yield (i.e. junk bond) funds.

Increasingly, corporate cash is being spent on stock buybacks and increased dividend payments to shareholders and is not being invested in capital expenditures that will drive future profitability. U.S. fixed investment spending has now declined for three quarters in a row. This is happening at the same time that stock buybacks are approaching record levels. S&P Dow Jones Indices reported that in the twelve months ending in March, S&P 500 companies spent \$589.4 billion buying back their own stock, eclipsing the twelve month record \$589.1 billion spent in 2007. FactSet reported that first quarter stock repurchases for S&P 500 companies totaled \$166.3 billion, second only to the record \$178.5 billion in the third quarter of 2007. Perhaps not coincidentally, corporate borrowing was \$724 billion in the quarter which was the second highest level ever after Q3 2007's record \$807 billion. Dividend growth, which has averaged a very robust annualized rate of 13% over the past five years, can be expected to moderate in the years to come.

Despite extraordinarily loose monetary policy both domestically and abroad, economic activity in this country has failed to break out of its slow growth mode. Since the current economic expansion began in the second quarter of 2009, GDP growth has averaged only 2.1%, a very low rate making the expansion more vulnerable to exogenous shocks. This compares to the prior three post-recession recoveries of 4.3% from 1983-1990, 3.8% from 1991-2000 and 2.8% from 2002-2007. Growth is being constrained by falling inflation expectations, overly indebted consumers, governments unwilling to spend and companies reluctant to invest. Job gains have averaged 181,500 per month so far in 2016, a good number though down from over 228,000 per month for all of 2015. One positive development was reported last week as the Census Bureau noted that inflation adjusted median household income rose 5.2% to \$56,516 in 2015, which was the largest annual percentage increase since this metric was first tracked in 1967. While this is still below the pre-crisis level of \$57,423 achieved in 2007, it is nonetheless an improvement and evidence suggests these gains have continued in 2016. Importantly, income inequality eased as incomes grew faster for lower and middle income households. This is a welcome development as a recent McKinsey Global Institute study found that 81% of U.S. households saw flat or declining real incomes over the ten year period from 2005-2014. Gains for these folks could provide immediate support for the economy as these households are more likely to spend that income relative to higher earning households which are prone to increase their savings rates.

Monetary policymakers continue to use the tools at their disposal as they have since the last recession ended seven and one half years ago. Despite the fact that their efforts have displayed limited success in reigniting growth, one could argue that they have prevented even worse outcomes for the economy. Certainly, years of easy money have helped inflate asset prices, primarily stocks, bonds and homes, which has raised investors' confidence. Skeptics could argue, however, that this has also contributed to investors' complacency and led to unnatural distortions in the capital markets which must ultimately be unwound. For example, central bank action has allowed global debt levels to meaningfully increase since 2007, as if more debt was the solution to the prior debt crisis. As a point of caution, one could point to central bank's response to the technology bubble collapsing during 2000-2002. Among the prime contributors to the credit market bubble, which began to burst in 2007, was the extraordinarily low interest rate environment engineered by the Fed to restore calm to the markets during that aforementioned downturn. While it remains to be seen what the unintended consequences will be of the current period of low/zero/negative interest rates, we have concerns given our belief that the underlying imbalances in the global economy are even larger now than in the previous cycle.

At a time when political leadership and bipartisanship are desperately needed, those hallmarks of a successful democracy are sorely lacking in this country today. The two political parties have been moving increasingly apart for the past dozen years or so and the current election cycle offers little reason for optimism on that front. We will be keenly interested to see if the tone of conversations in Washington changes after the fall elections as this country would benefit from a thoughtful, bipartisan combination of regulatory reform, tax reform, skilled job training and infrastructure investment.

Another reason improved relations between the two main political parties would be welcome is that the geopolitical landscape remains as demanding as it has been in many years. Therefore, presenting a united political front would be beneficial to our national interests. Both China and Russia continue to exert new force in their respective spheres of influence. Europe continues to struggle with unsustainable debt levels and an immigration crisis that will challenge the continent for some time. Sadly, ongoing terrorism threats are now a reality we must face both here and abroad which merits our nation's undivided attention. Overall, many nations in the world are becoming more unilateral which is inherently destabilizing. The rise of both populism and nationalism are impacting the political process in many countries which will have important implications on foreign relations. As one small example, in this country the two candidates for president have increased the use of protectionist speech while denouncing trade as they pander to a populace that is receptive to such language. In our view this is short sighted as trade, despite some of its drawbacks, has unquestionably benefited America and our standard of living over the centuries.

### *Investment Conclusions*

**W**hile uncertainty is inherent in any near to intermediate term outlook, prospects in the coming quarters will be impacted by more unknowns than usual. Slow economic growth will continue to make it challenging for corporate America to make meaningful improvements to revenue and profit growth. Seven plus years of easy money has artificially inflated asset prices but has done little to spur a powerful economic rebound, showing the limits of central bank policy. Meanwhile, the political climate is particularly contentious making it unlikely that a near term compromise can be reached to provide much needed fiscal stimulus, regulatory relief or tax reform.

Combining these headwinds with the fact that overall stock valuations remain above long term averages leads us to temper our near term expectations. We will remain patient when putting new money to work and will continue to exercise a strict price discipline when committing capital to new long term investments. Despite their low yields, cash reserves and high quality short term bonds continue to serve an important role in client portfolios. When the next market downturn arrives, these reserves will provide some overall stability and will be an important source of funds that can be used to take advantage of the many investment opportunities that will be available at that time. Our firm's history strongly suggests that clients are best served when we have the ability to opportunistically purchase well managed, solidly financed, market leading companies with a track record of investment and innovation to drive future profitable growth.

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