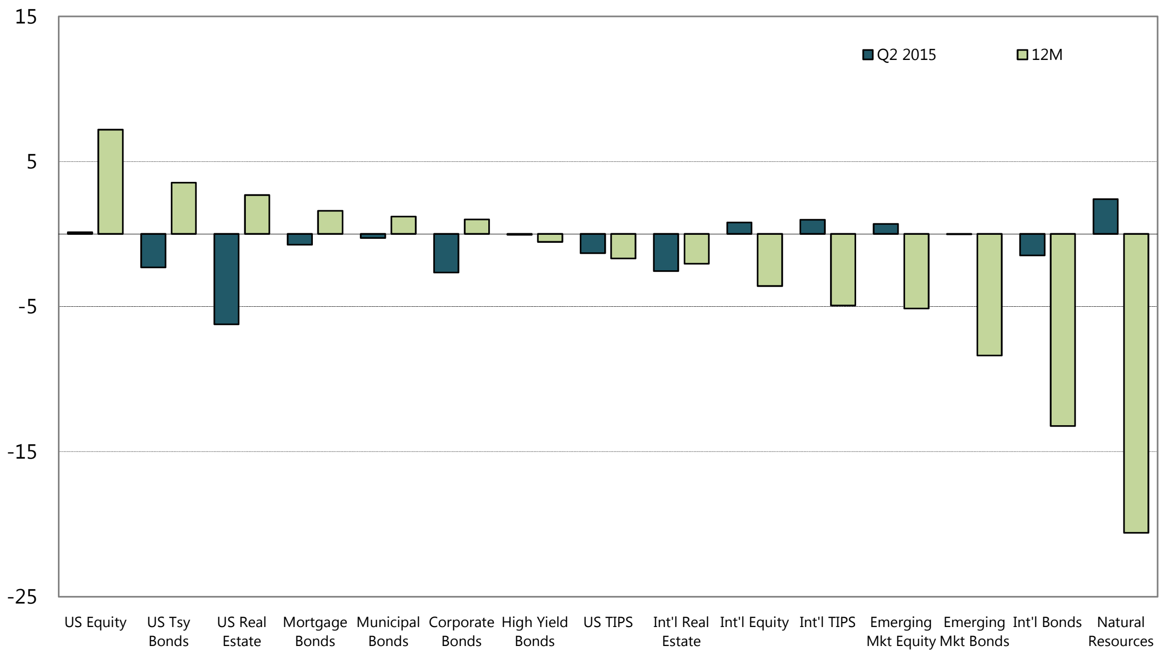
Quarterly Market Outlook & Strategy Letter

Second Quarter of 2015

July 2015

The second quarter of 2015 was a difficult period in markets, with most asset classes delivering low or negative returns. US real estate and bonds, as well as dividend-paying stocks, were among the worst-performing sectors, as investors anticipated the effects of higher US interest rates. Foreign currency-denominated assets performed relatively well, as overseas equity markets posted continued gains, while the dollar retraced some of its earlier strength.

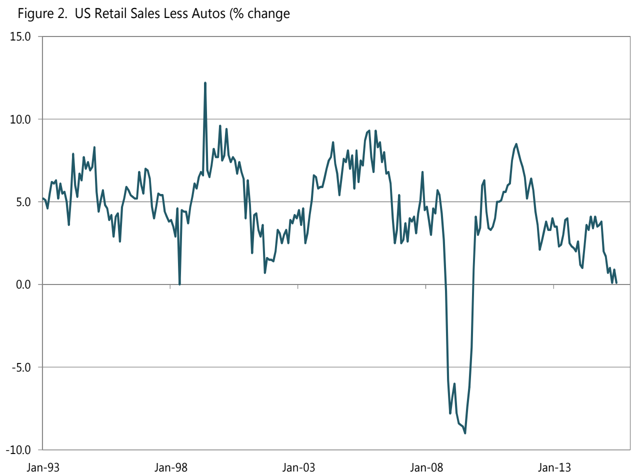
Figure 1. Benchmark Asset Class Returns

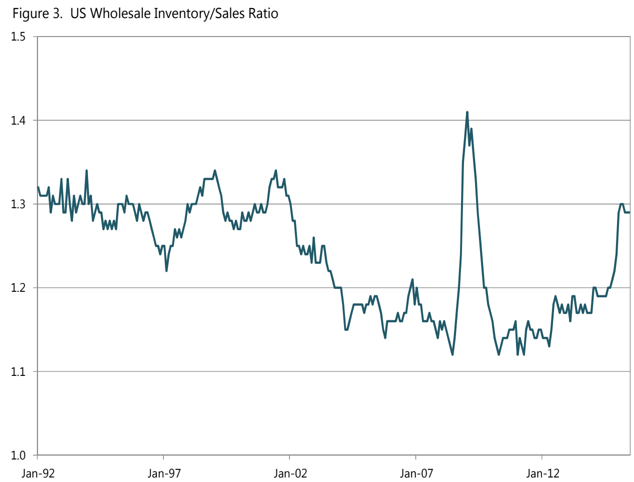


Source: Bloomberg

As we wrote earlier this year, the global economy is in the midst of a major rebalancing of demand, facilitated by large changes in interest rates, exchange rates and commodity prices. We have been hoping for a "healthy" adjustment, in which accelerating economic activity overseas balances the moderation in US growth. To some extent, this has been occurring. European and Japanese growth have picked up, helped by easy monetary conditions, more competitive exchange rates and lower oil prices.

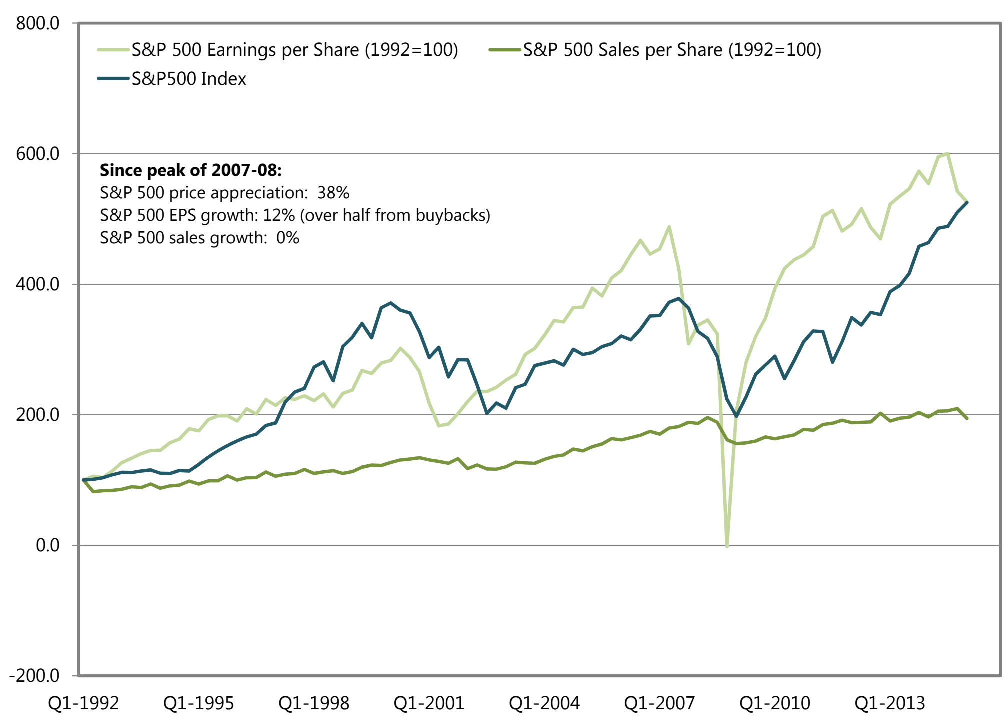
However, the boost to these economies has so far been modest, while the dampening effects on the US economy of a stronger dollar and lower oil prices have been larger than many expected. The oil and gas industry has experienced a significant contraction, with more to come as the price hedges put in place last year expire. Meanwhile, US consumer spending has remained sluggish, as households find they are allocating an increasing portion of their budgets to health care and housing costs, with less to spend on discretionary items. As sales growth is falling, inventories are rising (Figures 2-3). More of this diminished spending pool is heading overseas as US imports rise, helped by a stronger dollar.





The effects of the strong dollar are also taking a toll on the foreign earnings of US companies. As a result of these headwinds, corporate revenues have been stagnant, while profit margins have edged down (Figure 4). Despite a record amount of stock buybacks, analysts expect growth in S&P 500 revenue and earnings per share to be negative in Q2. **A sharp deceleration in US productivity growth, combined with rising wages, points to further compression in corporate profits over the coming year.**

Figure 4. S&P 500 Outpaces Earnings Growth, Which Outpaces Revenue



Slackening profitability, along with elevated valuations and rising borrowing costs, has taken a lot of the steam out of the US stock market over the past year. For the first time in several years, foreign equities have outperformed US stocks in 2015—a trend that looks set to continue. **The rebalancing of global economic activity is being accompanied by shifting relative market performance.**

Unfortunately, all is not well overseas. Economies that depend on the US consumer (i.e., much of East Asia) and/or revenue from commodities (much of Latin America) are struggling. The global manufacturing sector appears to have hit a major pothole, which is evident in rapidly rising inventories, weaker industrial production, and slowing export growth. The emerging markets, which appeared poised to accelerate at the beginning of the year, are slowing. The Chinese economy, in particular, is decelerating rapidly, with spillovers to its trading partners, especially in Asia.

It is apparent that the global economy has entered a slower trajectory of long-term growth, one which cannot be remedied by monetary policy alone. Central bankers around the world have been attempting to restore growth to pre-crisis levels by keeping interest rates at record-low levels, with little success. The reason is simple: one cannot solve a debt overhang by encouraging more debt. To use a memorable metaphor supplied by Jeremy Grantham, global bankers have been whipping the donkey, hoping to turn it into a racehorse**. The modest economic expansion of recent years has been "bought" with a rapid accumulation of debt; each one percentage point of global growth over the past six years has yielded a two percentage point increase in the ratio of global debt to GDP.**

The increase in debt is widespread across countries. It is also widespread across the public, corporate and household sectors. Following the crisis of 2008-09, governments have been borrowing heavily to cover losses in their banking systems, boost public investment, and beef up their social safety nets. Pension managers, (both government and corporate) have been borrowing to "fund" their future liabilities, essentially leveraging their investments in stock and bond markets. Institutional and individual investors have been borrowing on margin to boost otherwise anemic returns. Corporations have been borrowing to buy back their own equity, rather than using existing cash to invest in equipment and employees.

The rapid accumulation of debt is a headwind to long-term growth, as interest and amortization payments take a bite out of future spending. There are other adverse side effects of the liquidity binge. Most worryingly, the inflation central banks have been seeking has appeared mainly in the prices of financial assets, which are held largely by wealthy households. Quantitative easing has been much less effective at stimulating investment, and where investment has risen, it has often been unproductive. Marginal ventures that might not have been funded given a realistic cost of capital have blossomed, while unprofitable enterprises have been kept alive on the morphine drip of easy money. Investors have been encouraged—indeed, forced—by central banks to take on market risks they might otherwise be uncomfortable assuming, just to earn a decent rate of return.

These "moral hazards" associated with easy money policies have painted central banks into a corner. **There is growing awareness that the current strategy cannot continue, but great apprehension about normalizing policy given heightened risk of economic and financial instability.**

In June, the Bank of International Settlements, the "central bank of central banks" issued a stern warning to its constituents, the world's monetary leaders: policymakers have been relying excessively on liquidity injections to support growth. Weak activity reflects structural problems whose resolution has been delayed. Debt is excessive and weighing on growth. Aging populations make fiscal policy choices even more difficult. Central banks have been blowing asset bubbles. Liquidity is illusory because investors are all positioned the same way. Low market volatility belies heightened financial fragility—etc.

The financial strains associated with an untenable macroeconomic strategy—and the associated social backlash—are becoming evident all around the world. Faced with increasingly difficult choices, policymaker behavior has become erratic, and is beginning to undermine investor confidence. In the US, the Fed has been agonizing long and loudly over the false precision of a 25bps interest rate decision. This suggests excessive self-importance, and/or far greater fragility in the US economy than the Fed is willing to acknowledge. The Bank of Japan governor has compared himself to Peter Pan, emphasizing the importance of faith in oneself, while engaging in unprecedented market intervention. Stocks, bonds, currencies, you name it—the BOJ is buying it. The ECB, which pledged to do "whatever it takes" to save the euro, created a crisis in the European bond market, pushing yields into negative territory, only to see them soar once the program was launched. Contentious negotiations over aid to Greece brought out the worst among European policymakers, leading many to doubt the viability of the euro currency regime.

Not least, the Chinese authorities' efforts to halt the slide in country's stock market have become increasingly desperate—indeed bizarre. Massive liquidity injections were followed by easier margin requirements, followed by bans on short sales, insider selling and IPOs, followed by ad-hoc suspension of trading activity (which badly hurt those companies who allowed their shares to remain liquid), followed by massive buying programs by state agencies and affiliates, followed by a ban on institutional selling, followed by threats and action to arrest "malicious (short) sellers". All around the world, monetary policy has taken us beyond the so-called "new normal" into the new *paranormal*.

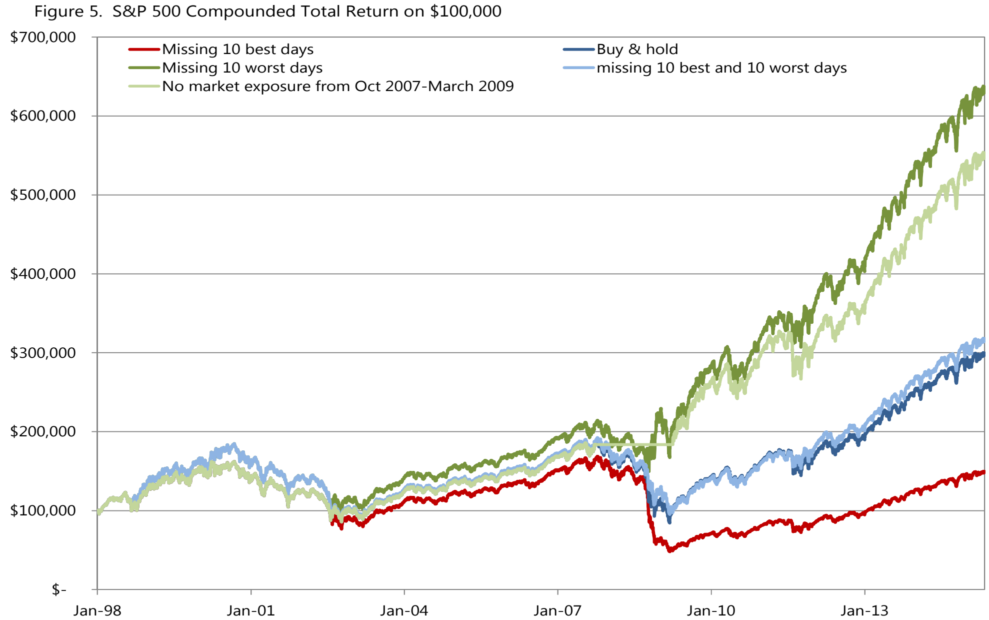
While investors remain confident in policymakers' *commitment* to easy money policies, there is growing doubt about the *credibility* of those policies. Eventually, the commitment will mean little without the credibility, since asset prices cannot diverge indefinitely from economic performance.

Since last year, we have been increasingly concerned about the growing mismatch between rising asset prices and deteriorating fundamentals. Our concerns have grown alongside data showing heightened leverage in global financial markets, record-low levels of cash in individual investment portfolios, complacent investor sentiment, and breakdowns in a variety of important technical indicators in global stock, bond, commodity and currency markets. We believe that global financial markets are in a fragile state, liable to be undermined by any unexpected shock, be it economic, financial or geopolitical. As such, we have tempered risk in our clients' portfolios. This spring we trimmed exposure to US and international equity, as well as corporate and high-yield debt, and mortgage bonds. We rotated equity exposure away from Europe and China, and into Japan. We closed investments in US real estate, emerging market debt, and natural resources.

As a result, we are holding a sizable cash (and relatively safe cash equivalents) cushion and a small position in gold, which we plan to increase. We have been adding selectively to our clients' municipal bond portfolios, while focusing on issuers with better credit fundamentals.

It is sometimes argued that one must remain fully invested in order to realize long-term portfolio gains. It's true that missing the ten best days in the market over the past two decades would have resulted in a lower return than a buy-and-hold strategy. However, missing the ten worst days would have resulted in a far better return *even though the sum of the ten best and worst days is virtually identical* (Figure 5). **The simple math of compounding means that it takes a much larger percentage gain recover from a loss than the decline that created it.** A simple example illustrates: suppose you have an investment of $100 that declines in value by 50%. Your investment is now worth $50. To recover its original value, your investment would have to double in price—an increase of 100%. Suppose you had liquidated the investment prior to the decline and held cash instead. Reinvesting the cash after the price dropped would have brought the value of your investment to $200.

Figure 5. S&P 500 Compounded Total Return on $100,000



This is not an argument for market timing. No one can predict which days will turn out to be especially good or especially bad in the market. Moreover, frequent trading is very costly from the standpoint of transaction fees and taxes, and should be avoided. The point is that there is more to be gained than lost by being cautious when markets are clearly overextended. Our precautionary risk reduction has substantially shielded our clients' portfolios from the increasing market turbulence we have witnessed since the spring—volatility that we expect to continue over the course of the summer. We are husbanding resources as a buffer against volatility, and in anticipation of better valuations down the line. We want our clients to enjoy peace of mind with regard to their investments, so that they can focus on more important things—like their summer vacations!