Quarterly Market Outlook & Strategy Letter

Third Quarter of 2015

October 2015

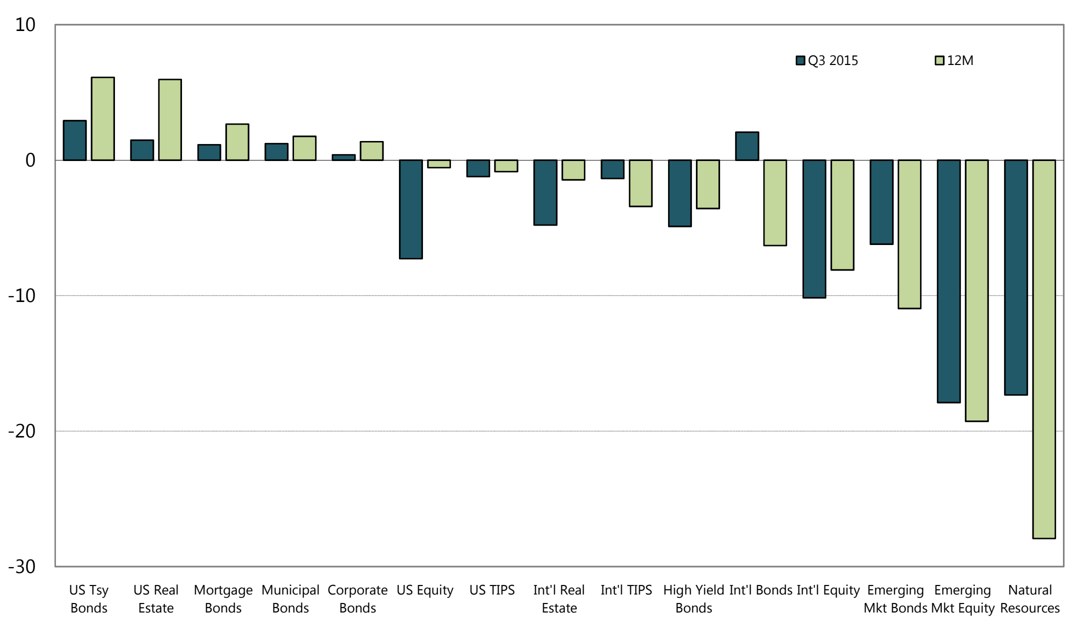
Introduction

Market turbulence escalated last quarter, as global growth slowed and investors began to doubt the effectiveness of monetary policy in supporting economic activity. Rising risk aversion has been apparent in falling asset prices and heightened volatility, accompanied by frequent trading halts and wild price swings. A wide variety of risk indicators, including fixed income term and credit spreads, reveal investors' growing anxiety.

As is typically the case, market weakness started in the higher-risk, cyclically-sensitive asset classes (emerging market equity, commodities, small-capitalization stocks, and high-yield bonds) and has spread toward the "heart of the market" represented by US large-cap stocks and investment-grade bonds. Market declines have been notable for their speed, fueled by an unwinding of leverage and rapid-response algorithmic trading programs. Twelve-month returns are now negative for all but a few asset classes (Figure 1). Even so, the valuation of many assets, including US equity, remains unattractive amid deteriorating fundamentals.

We retain a cautious investment posture, with ample cash and short-term debt holdings for our clients. We continue to favor foreign equity relative to the US, and prefer Japanese stocks to those in Europe. Earlier this summer, we trimmed exposure to the small-cap segment of the emerging equity markets, which had been a strong relative performer. We also reduced investments in the emerging market value stocks, which are more sensitive to commodity prices. However, we anticipate attractive investment opportunities to emerge from the current turbulence, especially in the East Asian region, in the coming months.

Figure 1. Benchmark Asset Class Returns



Source: Bloomberg

Reality Bites

The global economy is headed into a severe slowdown, with predictably negative effects on financial asset prices. The mature economies have been stuck at stall speed for several years now, despite massive infusions of liquidity by global central banks. The new bad news is that China, which contributed (directly and indirectly) over half of global growth in recent years, is now decelerating rapidly. The consequences of slower growth in the world's second-largest economy will be felt profoundly around the globe, through multiple trade and financial channels. A sizable inventory overhang has developed in the US and abroad, which is curbing manufacturing activity worldwide. However, the full effects of the coming inventory liquidation have yet to be felt.

The first circle of pain includes those who export to China (primarily commodity producers, but also suppliers of capital goods, such as Germany and Japan), and those who compete with China in global markets (primarily Asian manufacturers). These industries have been feeling the slowdown since late last year, but its effects are intensifying. The second circle of pain encompasses all those who trade with or extend finance to the first-round sufferers, which includes a wide swath of firms and industries in the mature economies. The third circle of pain, which includes all those who do business with the second-round countries, will touch virtually everyone. Already, there has been a severe contraction in global trade—of the kind that normally occurs only in a major global downturn.

Whether the US can withstand the effects of the global slowdown is the key question confronting economists and investors now. Recession risks are rising, and are now better than even, in our view. With 40% of S&P 500 revenues generated abroad, it is unrealistic to think US companies will be immune to the effects of the global slowdown. Already, US corporate earnings have been weighed down by falling productivity growth and the dollar's sharp appreciation over the past year. Analysts' earnings expectations for 2015 have been marked down every quarter since mid-2014, and are now 18% lower than they were in June of last year. The earnings revisions are now extending into 2016, and encompass a broader array of industries than oil and gas.

Forward estimates anticipate a 33% rebound in earnings between now and the end of 2016, which is wildly optimistic given the global backdrop. These forecasts center on operating earnings, which exclude "special items" that invariably flatter company performance. This is especially true at turning points in the economy, when stock analysts, like most economists, fail to see the downturn coming. A more reliable performance measure is as-reported earnings, which adhere to Generally-Accepted Accounting Principles (also known as GAAP earnings). At the end of 2014, analysts estimated that by Q3 of this year, reported earnings would exceed $131/share. The current estimate is $94—28% lower. Earnings have advanced much faster than revenue in recent years, helped by cost cutting and debt-financed share buybacks. However, long-term earnings growth cannot be sustained without revenue gains.

Figure 2. Slowing Productivity Growth Will Raise Unit Labor Costs

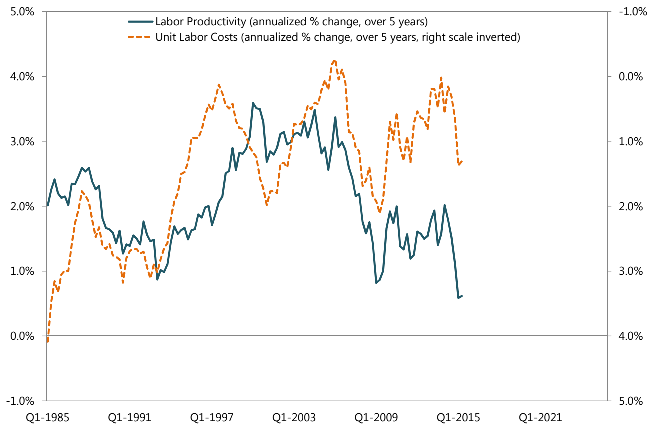
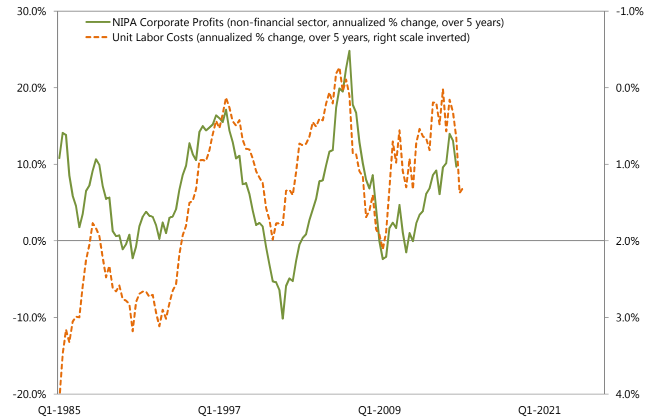


Figure 3. Rising Unit Labor Costs Will Curb Earnings Growth



The fall in productivity growth over the past decade poses a serious headwind to future corporate profitability (Figures 2-3). There is heated debate regarding the extent and possible causes of this trend—but less doubt about its impact on the labor market. Slow productivity gains mean higher unit labor costs, which are a key driver of corporate earnings. Without accelerating revenue growth, there is no way to reconcile higher wages and employment with improving corporate profits. Already, stock prices have risen beyond what could be justified by earnings (which are now on the decline), and far ahead of revenue growth. Thus there is substantial scope for further downward revisions to earnings, and investor disappointment, over the coming year.

Deteriorating investor sentiment is both a consequence and a cause of economic weakness. Indeed, it can create the very recession that everyone fears. One sometimes reads that a bear market in stocks (i.e., a decline of 20% or more) cannot occur unless the economy is in recession. That claim is simply untrue. Typically, the stock market leads the economy by six months or more; by the time recession is officially declared by the National Bureau for Economic Research (NBER), investors have already rendered their verdict, and many have lost a great deal of money. From when the stock market peaked in March 2000 to when the NBER confirmed the economy was in recession a year later, the S&P 500 declined by 21%. Similarly, the market fell 46% between October 2007 and December 2008, when the NBER finally called it.

Investors have been conditioned to expect that market recoveries will always come quickly. According to Nobel Laureate Robert Shiller, a large majority of respondents to a periodic survey he conducts expressed a view that the stock market usually recovers within a couple of years.[1] It's hardly surprising they would think so, since the US Federal Reserve has established a pattern of intervening in financial markets to curb or reverse declines, "easing and appeasing" investors.

[1] Robert Shiller. *Irrational Exuberance, 3rd edition*. 2015. See Chapter 5. As Shiller wryly notes, "It is curious that people do not seem to believe the converse of the premise stated in our question: they do not believe that the market will surely go back down in a couple of years if it goes up dramatically."

However, as Shiller notes, there is no basis in history to expect a rapid recovery. "There are many examples of markets that have done poorly over long intervals of time. To pick just one from recent memory, the Nikkei index in Japan is still selling at less than half its peak value in 1989. Other examples are the periods after the 1929 and 1966 US stock market peaks." Over the past decade, Shiller's data show that investors have been losing confidence in market valuations and, by extension, the economic fundamentals that support them. They are discovering that globalization, however beneficial it is for long-run growth, poses new challenges. Investors are also realizing that monetary policy is no panacea for growth.

Paradigms Lost

Investors' growing unease reflects a deeper questioning of two paradigms that have guided investment planning over the past three decades. The first concerns the productivity gains that emerged from the "golden age of globalization" and associated technological change. The second relates to central banks' ability to support the economy through expansionary monetary policies.

The Golden Age of Globalization is Over

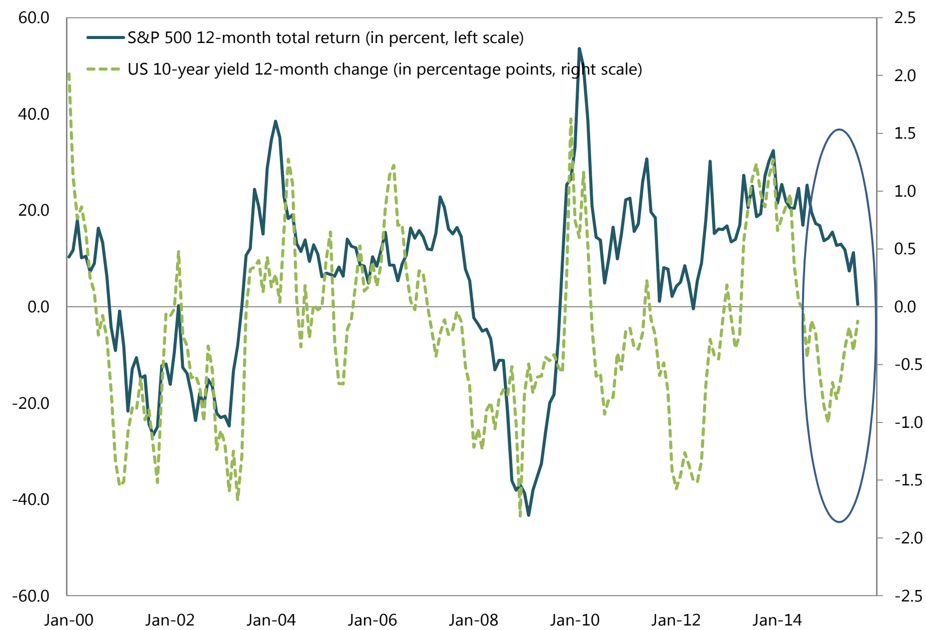
The past thirty years have been among the best periods for investors in modern history. Whether stocks, bonds, real estate, or commodities—US assets or foreign markets—virtually all sectors delivered exceptional returns from 1982 to 2014. These stellar results reflected a uniquely favorable macroeconomic backdrop of strong growth and low inflation. The entry of China and other emerging markets into the global economy, and new technology that enabled the creation of a worldwide supply chain, created additional sources of demand while restraining wages and production costs. Rapid growth with low inflation is the ideal scenario for asset prices.

Rising productivity and improved corporate profitability were one important result of these trends, but not the only one. Asset prices also received significant indirect support from the low interest rate environment created by the "recycling" of emerging market trade surpluses into developed economy asset markets. These reserves were invested primarily in the government bonds of their developed-market trading partners. Falling government bond yields, in turn, supported rising prices of many other assets.

Unfortunately, it appears that the era of easy macro tradeoffs and win-win outcomes from global business integration is over. Slower growth in the mature markets and rising labor costs in the emerging markets have begun to restrain corporate profitability. The transition of the emerging markets from export-led to consumer-led growth has encountered a major setback due to overly-rapid credit expansion. Nations are competing for shares of a global economic pie that is hardly growing.

As the price of raw materials and industrial goods fell, so too did exports and foreign exchange reserve accumulation by many commodity and manufacturing countries. An estimated $600b in forex reserves has left China over the past several months, while the Saudi Arabian Monetary Agency (SAMA) has withdrawn some $70b from global asset managers. Norway's enormous oil-financed sovereign wealth fund will begin liquidating assets next. Some have blamed asset sales by reserve managers for the failure of the bond market to rally in 2015 in the face of equity market weakness (Figure 4). That may be a factor, although we view the effects as largely transitory. More likely, investors are beginning to re-price the risk of sovereign default in light of the inexorable rise in government debt. In any case, bonds are no longer viewed as a reliable safe haven in the event of equity market weakness.

Figure 4. US Treasury Bonds No Longer Buffering Equity Declines



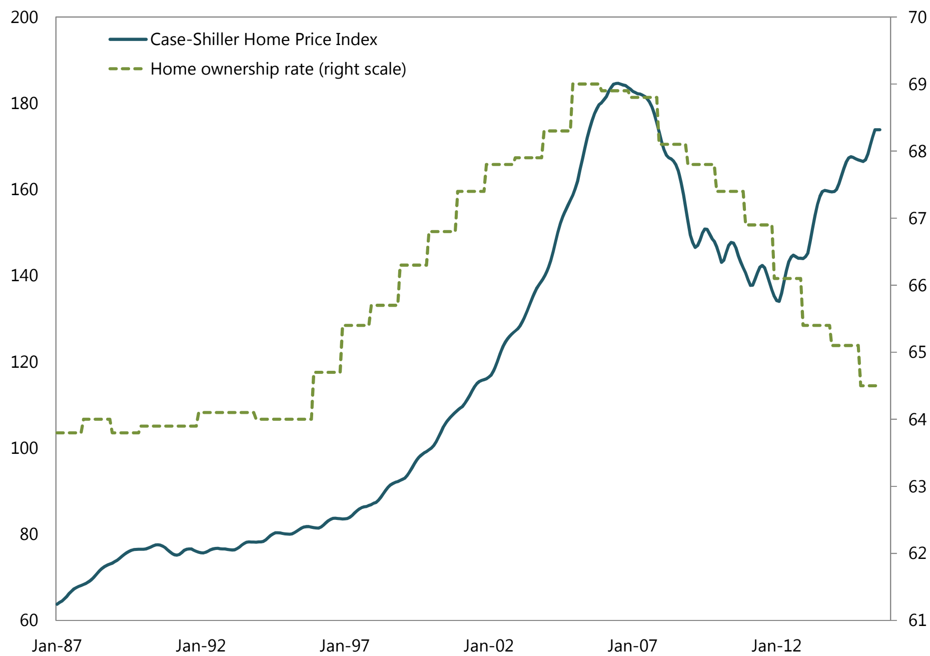
It is unlikely that we will see a reversal of globalization, as occurred in the 1930s; the forces of modern technology and finance seem too powerful to allow that. However, we believe that global growth will be slower, and occur against a less favorable backdrop for interest rates and inflation, than has been the case over the past few decades.

Central Bankers are Not Omnipotent

Against this challenging global backdrop, central banks' options for supporting growth are far less appealing than in years past. Global central banks have been easing monetary policy aggressively, in an attempt to stimulate faster growth in the face of negative demographic trends. The strategy worked initially—when interest rates were high and debt levels low. However, the more recent results of central banks' efforts have principally been asset price inflation, rising indebtedness, and financial engineering to satisfy investors' "reach for yield."

The US housing market offers a tangible illustration of the ineffectiveness of current policy. Low interest rates have driven house prices within striking distance of their 2006 peak, despite a collapse in home ownership rates. That's because investors, not families, have purchased properties, converting them into rental units that absorb as much as 30-50% of income. Real median household income has risen just 23% since 1965, whereas house prices have risen 95%. Given deteriorating affordability, it's not surprising that home ownership has fallen to 64% of households—back to where it was 15 years ago.

Figure 5. Home Ownership Declines Along with Affordability



Business investment & employment decisions provide another illustration. Despite ultra-low borrowing costs, private fixed capital formation has been anemic in this recovery. Apparently, CEOs would rather borrow money to buy back their own stock (and boost the share price) than invest in their companies. Weak investment spending has contributed to the slowdown in US productivity growth—which has, in turn, contributed to lackluster wage growth.

Indeed, both wage gains and private-sector job creation have been very slow since 2009. Many of the jobs that have been created are low-wage, part-time positions. It is only in 2015 that the number of full-time workers returned to its pre-recession level. As a result, large numbers of prime-age workers (those aged 25-54) have been dropping out of the labor force, bringing the participation rate to levels last seen in 1977. Job growth has been faster in the public sphere and related sectors such as education and healthcare, where employment trends are influenced more by budgetary decisions and regulatory demands than monetary conditions.

Central banks have sought to create the illusion of wealth in order to boost consumer and capital spending, along with employment. But businesses and households are no longer buying the illusion. "Fool me once, shame on you; fool me twice (or thrice) shame on me" is the view.

The fact that monetary policy has been ineffective in meeting its stated goals should not be surprising. Although the fortunate trends of recent decades fostered a widespread belief in the Fed's omniscience, the central bank's forecasts—like those of most economists—have rarely been accurate. Moreover, as John Hussman demonstrated, there has been only a weak link, at best, between monetary policy and subsequent growth and inflation outcomes.[2] To be sure, central banks earned praise by rectifying their disastrous policy mistakes of the 1970s, putting in place policy rules and targets to reestablish their anti-inflation credibility. But their supposed success in fostering non-inflationary growth during the golden era of globalization was mostly an illusion—rather like the rooster taking credit for the dawn.

The ineffectiveness of monetary policy reflects two realities that central banks have been reluctant to accept. First, that liquidity moves rapidly across borders, toward the most appealing target. Easy money in the US arguably did more to stoke the boom in China and other emerging economies, than it did to help US workers. Second, in a globalized economy, inflation trends are largely outside of policymakers' control. Despite widely divergent monetary policies over time and across countries, inflation has tended to rise and fall on a secular, global basis.

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[2] John Hussman, "The Beauty of Truth and the Beast of Dogma," September 14, 2015. *http://www.hussmanfunds.com/wmc/wmc150914.htm*

Beguiled by the illusions of a closed-economy model, the Fed has been fighting a phantom deflation since the early 2000s. Stable (or mildly declining) prices, in a context of manageable debt and easy access to credit, is not deflation.[3] On the contrary, the *disinflation* associated with the golden era of globalization was a great blessing for corporations and households around the world, who enjoyed a significant boost to their productivity, incomes and purchasing power. Central banks' efforts to solve a non-problem, one that lay outside their control, has encouraged excessive borrowing, rampant financial speculation, and misallocation of capital around the world. Indeed, policymakers have created the very liquidity trap they sought to avoid.

Investors are starting to question the Fed's wide discretion in setting interest rates, as the central bank has moved away from accepted criteria guiding monetary policy. Many (including this author) believe that interest rates were left too low, for too long, following the 2000-02 recession, producing an epic housing bubble. The Fed has repeated the same error since 2010—forever moving the goalposts to justify easy monetary conditions—with similar results.

KPF Global Strategy

Against this challenging backdrop, one asset class has done quite well: cash. This spring, we made a proactive decision to make a tactical investment in cash when no one else wanted to hold it. Since then, cash has risen in value against virtually all other asset classes (Figure 6). More than a psychological buffer against volatility, cash enables its owner to maintain the purchasing power of his or her portfolio in turbulent markets, enabling the acquisition of other assets at more attractive prices.

Figure 6. Cash Appreciation Since May 2015 vs:

US large-cap stocks	9%
US dividend stocks	7%
US small-cap stocks	9%
International (developed) equity	13%
Emerging market equity	20%
Inflation-protected bonds	5%
Emerging market bonds	10%
High-yield bonds	4%
Global real estate	7%
Commodities	20%

Returns through September 30, 2015

[3] Webster's defines deflation as: "a contraction in the volume of available money or credit that results in a general decline in prices."

When market yields are low and expected returns subdued, the price at which one acquires an asset becomes very important. In buoyant markets, it's easy to imagine that price gains will continue into the indefinite future. In reality—and quite reliably—the higher the price of an asset at purchase, the lower is its future return. The "mean reversion" that brings asset prices back in line with fundamentals can be very swift. Bear markets typically unfold quickly, erasing years' worth of market gains in the course of a few short weeks or months. Given the combination of high asset prices, deteriorating earnings, and a trend toward weakening risk appetite & liquidity conditions, we felt that discretion would be the better part of valor.

Assuming no further decline in earnings (which is probably unrealistic) fair value on the S&P 500 is around 1600. We expect that our clients' equity allocations will be back to neutral (i.e., in line with their strategic allocation targets) when the stock market is closer to that level. The specific target will depend on how earnings evolve. Investors' desired P/E multiples tend to fall as earnings contract, but the contraction in earnings creates a countervailing upward pressure on multiples. That is the principal reason why markets tend to overshoot on the downside. Should that happen, we will assume an overweight position in stocks, consistent with our value-oriented investment discipline.

We continue to favor foreign equities over those in the United States, acknowledging that these tend to be more volatile during periods of market turbulence. Nevertheless, foreign investments generally offer better valuations and are enjoying more of a cyclical lift from weak currencies and low commodity prices. Although heavily exposed to the slowdown in China, Japanese corporates are in a stronger financial position than companies elsewhere in the developed world. Earnings are on a firm upward trajectory, corporate cash balances are enormous, and the deleveraging process has run its course. Capital expenditure plans show corporate optimism, and small business confidence is robust. It has been little recognized that, in per-capita terms, the Japanese economy has performed on par with that of the United States in recent years. Yet, unlike the US, labor force participation has been rising steadily. The yen is very cheap on a relative basis, and typically strengthens during periods of risk aversion. Thus the currency offers a partial hedge against equity market risk. For all of these reasons, our international equity investments have a Japanese flavor.

Although market turbulence is never pleasant, the good news is that the re-pricing of financial assets will produce better investment opportunities than would be available if markets linger in their current overvalued state. We anticipate some terrific buying opportunities to emerge from this period, especially in East Asia, where long-term fundamentals are sound, and where countries will benefit most from low commodity prices. South Korea and the Philippines stand out in this regard. The Brazilian stock, bond and currency markets have become incredibly cheap and will respond positively to *any* improvement in the economy or commodity markets. We are also on the lookout for attractive investments available in the distressed credit and real estate markets—which will be attractive again, at lower prices.