



Quarterly Market Outlook & Strategy Letter

First Quarter of 2016

April 2016

Executive Summary

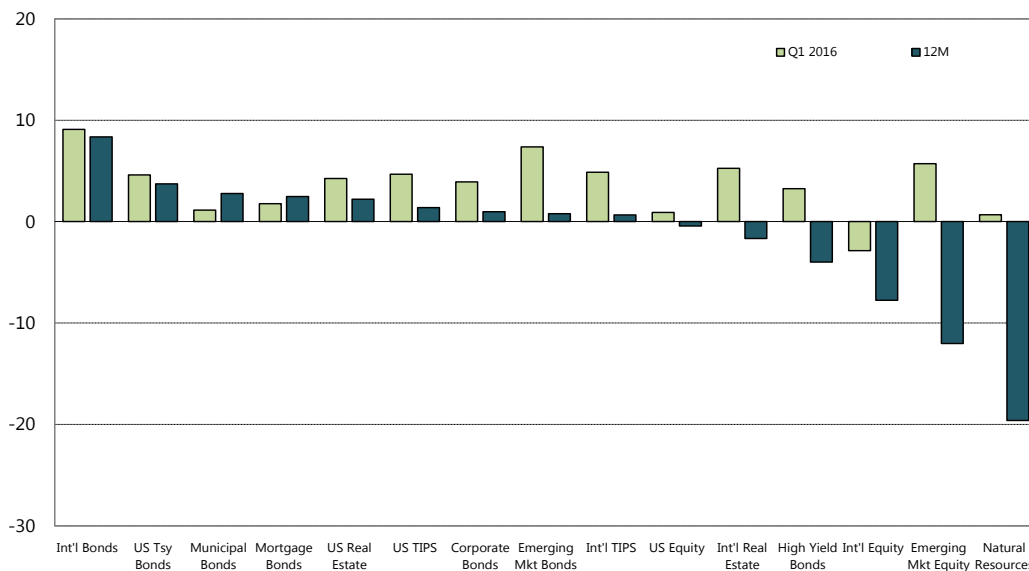
- The first quarter of 2016 was a tale of two halves, both marked by extremes. One might imagine that the turnaround in market sentiment reflects a sea-change in thinking about the global economy, consumer demand and/or corporate earnings. Such thinking would be very old-fashioned! This latest market rally resulted from nothing other than central banks' backing away from even the *slightest suggestion* of the *merest hint* of normalizing interest rates. Liquidity remains abundant, buoying financial asset prices.
- Our economic challenges are more structural than cyclical, and cannot easily be remedied by cheap money. On the contrary, ultra-low interest rates have made things considerably worse in the long run. Our biggest problem is not sluggish growth. It is politicians' unwillingness to face facts, and deal openly and productively with the reality of our economic circumstances: excess indebtedness and rising inequality.
- Many households no longer have the capacity or willingness to borrow, given straitened financial circumstances. The median household income, adjusted for inflation, was the same in 2013 as it was in 1989—and 12% lower than it was in 2007. Median household net worth was just \$81,000 in 2013. That's 40% lower than in 2007, and is equivalent to just two years of average retirement spending.
- The "twin deficits" of retirement (insufficient private savings and unfunded Social Security commitments) amount to at least \$20 trillion, and are likely closer to \$26 trillion. How will the gap be closed? The top 1% of earners hold \$33 trillion in accumulated wealth, which will be the target of redistribution policies.
- As retirement realities sink in, Americans have begun saving more, which is contributing to weaker consumer demand and, with it, stagnant corporate revenue. Profit margins are coming under significant pressure, notwithstanding companies' attempt to disguise the weakness through debt buybacks and "adjustments" to operating earnings. Escalating dividend cuts speak to the deterioration in corporate cash flow, as do rising rates of credit default.
- The largest equity market declines have, historically, occurred in a context of high valuations and rising recession risk—exactly the circumstances we find ourselves in now. We remain underweight US equity and fully invested in relatively safe fixed income sectors. We have taken profit on tactical positions in commodities and gold.

Introduction

The first quarter of 2016 was a tale of two halves, both marked by extremes. In the first half of the quarter, bonds experienced their best performance in years—in a mirror image of the worst equity market performance since 2009 (and the worst opening week for the stock market ever). Then, in the second half of the quarter, cyclical stocks, commodities, emerging market equity and debt—that is, the riskiest asset classes—had *their* best quarter in years.

One might imagine that the turnaround in market sentiment reflects a sea-change in thinking about the global economy, consumer demand and/or corporate earnings. No, such thinking would be very old-fashioned! Economic and corporate performance has continued to deteriorate over the past quarter and year. This latest market rally resulted from nothing other than central banks’ backing away from even the *slightest suggestion* of the *merest hint* of normalizing interest rates. Liquidity remains abundant, buoying financial asset prices.

Figure 1. Benchmark Asset Class Returns



Source: Bloomberg

Demographics, Debt and Denial

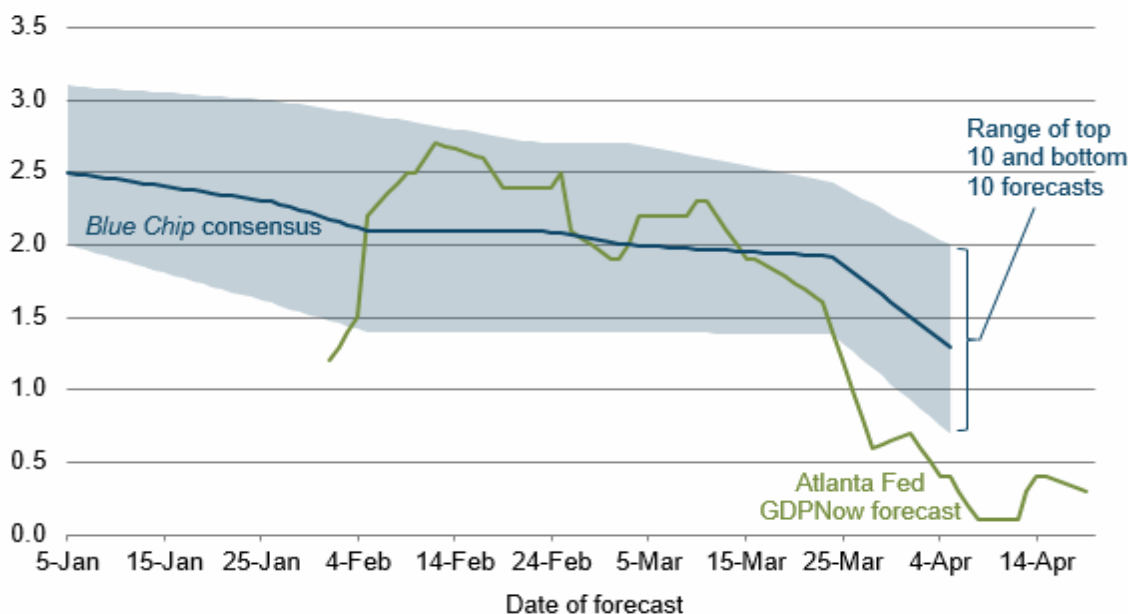
Fundamental challenges abound—challenges we have highlighted often in these letters. Yet *the world is not suffering from crisis conditions that warrant the extraordinary policy experimentation (i.e., negative interest rates, the elimination of cash, and “helicopter drops” of money directly to households to inflate away our debts) that global central banks are now pursuing.*

Economic growth, though sluggish, is positive and consistent with what one might expect from a mature economy with an aging population, burdened by excessive debt and inadequate savings. Inflation, while low, is not collapsing—once you net out the effects of the recent fall in energy prices.

Our economic challenges are more structural than cyclical, and cannot easily be remedied by cheap money. On the contrary, ultra-low interest rates have made things quite a bit worse for the long run. They have encouraged excess borrowing by over-indebted households, who are already in a precarious financial position. They have incentivized corporations to leverage their balance sheets with unproductive stock buybacks. They have kept global excess capacity and zombie companies alive. Not least, “free” money has enabled governments to delay the inevitable day of reckoning for unsustainable social insurance programs. The “long-term challenges” that experts have been warning about for decades are coming home to roost, amid widespread denial about the reality of our circumstances. By fighting the natural deceleration in growth associated with the above forces, rather than achieving a constructive restructuring of debts, policymakers are sowing bigger problems down the line.

Figure 2. Evolution of Atlanta Fed GDPNow real GDP forecast for 2016: Q1
Quarterly percent change (SAAR)

GDPNow™



Sources: Blue Chip Economic Indicators and Blue Chip Financial Forecasts

Central bankers are talking out of both sides of their mouths, claiming there’s an economic recovery while acting as if the sky is falling. It’s certainly true that growth is sluggish: the Atlanta Fed’s US GDP forecast for Q1 (see Figure 2 above) indicates that growth has ground to a virtual halt. Over the past few years, the expansion has consistently undershot forecasts—whether those forecasts came from Wall Street or independent analysts. *The sluggish pace of growth (and associated weakness in corporate earnings) is not consistent with equity valuations that are near the peak of historical norms.* Yet the US has experienced slow growth before, and come through it just fine. The problem now is not the pace of growth, but the fact that it is so unevenly shared. However, monetary policy can do nothing to improve the distribution of income. On the contrary, activist policy has boosted the prices of assets held primarily by wealthy households, while encouraging borrowing by those who cannot afford it.

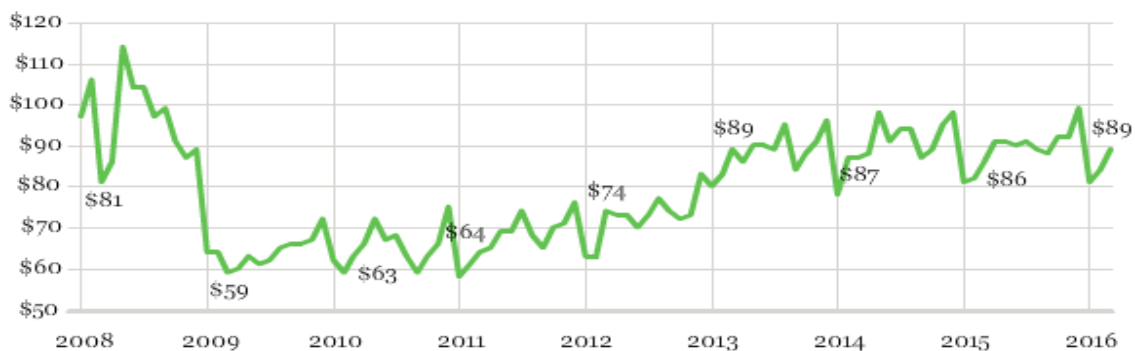
Indeed, many households no longer have the capacity or willingness to borrow, given straitened financial circumstances. The Federal Reserve publishes detailed data on household finances every three years, in its [Survey of Consumer Finances](#). The most recent survey, conducted in 2013, showed that the *median* household income, adjusted for inflation, was the same in 2013 as it was in 1989—and 12% lower than it was in 2007! Even the *average* household, buoyed by high-wage workers, experienced an 8% decline in income between 2007 and 2013.

It should not be surprising, given stagnant incomes, that household spending has been flat in recent years. Gallup regularly surveys household expenditure patterns (Figure 3) which show that the daily value of spending has not increased since 2008. Aggregate spending may have risen over these years, but that merely reflects population growth, not an improvement in household purchasing power.

Figure 3.

Monthly Averages of Reported Amount Americans Spent "Yesterday"

2008 to 2016



Figures shown are for March of each year
Gallup Daily tracking

GALLUP®

The bottom line is that American households' median net worth was just \$81,000 in 2013. That's 40% lower than in 2007, and is equivalent to just two years of average retirement spending. Even high-income households have experienced a drop in their net worth; the top income decile reported an 11% fall since 2007. Only half of US households have been saving anything over the past 25 years, and 60% are now living from paycheck to paycheck, without so much as an emergency fund. Of those that have saved, their net worth is less than half of what will they need to maintain their living standard in retirement.

The [Center For Retirement Research](#) updates annually its estimates of the US retirement income deficit—that is, the gap between the pensions and retirement savings that American households have accumulated today, and what they should have today to maintain their standard of living in retirement. The gap currently stands at \$7 trillion, which many agree is a conservative figure; some estimates run as high as \$14 trillion¹.

Additionally, according to its [Trustees](#), Social Security (and the affiliated Disability Trust Fund) has unfunded future liabilities of \$12 trillion, and will, absent a change in promised benefits, be insolvent by 2034 at the latest. The public and private “twin deficits” of retirement are at least \$20 trillion, and likely closer to \$25 trillion². How will the savings gaps to be closed? Taxing the wealthy is a popular idea, but consider that the *entire* net worth of the top 1% of US households (those who earn \$380k or more annually) was about \$33 trillion in 2013. Beyond tax policy, policymakers are focused on raising inflation, with the goal of boosting wages while eroding the real value of public and private sector liabilities. Of course, one person's debt is another person's asset; such policies often produce in a major transfer of wealth.

Now that retirement realities are sinking in, Americans have begun saving more (Figure 4). The US saving rate has risen from a low of 2% in the mid-2000s to about 5%. But households have a long way to go; simple math indicates that a 10% saving rate is the minimum necessary to provide for a secure retirement—if one starts early. We used to know how to do that, back in the Frugal Fifties, when consumption represented 60% of US GDP, not 70%.

¹ It assumes, for example, that individuals will continue to work and accrue retirement benefits until the age of 65, that households find ways to annuitize all of their wealth (ensuring a consistent income stream over their remaining lifespans, that all currently-promised Social Security benefits are received, that all pension assets will be spent, and that they earn an inflation adjusted 3% rate of return on their savings. See also the [National Institute on Retirement Security](#).

² These deficits are in addition to the unfunded liabilities of Medicare (estimated at \$48 trillion) and the accumulated debts of our Federal (\$18 trillion) and state (\$1 trillion) governments, as well as sizable private and public sector pension deficits.

Figure 4. United States: Personal Savings Rate



Americans are also taking steps to whittle down their debts. After rising steadily from 1989 to 2010, median household debt has begun to decline, but only slightly, leaving an average balance of \$290,000 in 2013—the same as in 2007. According to Gallup, a majority of Americans (62%) now say they prefer saving to spending, up from 52% in 2007. In this environment, it’s easy to see why monetary policy has been ineffective in stimulating demand. Even so-called “helicopter money” drops may not be spent, and instead used to replenish needed savings.

As consumer spending has waned, business revenue has slowed in tandem. In March, real (i.e., inflation-adjusted) retail sales posted a year-over-year gain of less than 1%, the slowest of this recovery. Total business sales in February 2016 registered the same dollar value they did in 2012, while business inventories continue to rise. That unhealthy dynamic has pushed the inventory-sales ratio well into recessionary territory (Figure 5, below).

Not surprisingly, corporate earnings have come under significant pressure, as we telegraphed would happen from early last year. As Figure 6 on the next page illustrates, weakening corporate profitability is both a cause and consequence of recession. We expect pressure on earnings to intensify, given weak demand and the negative impact on margins of deteriorating productivity and rising wages. Total business sales per employee already have dropped 7% since mid-2014, twice the rate of decline in 2000-2002. Invariably, employment follows (Figure 7).

Figure 5. United States: Total Business Sales & Inventories (in millions)

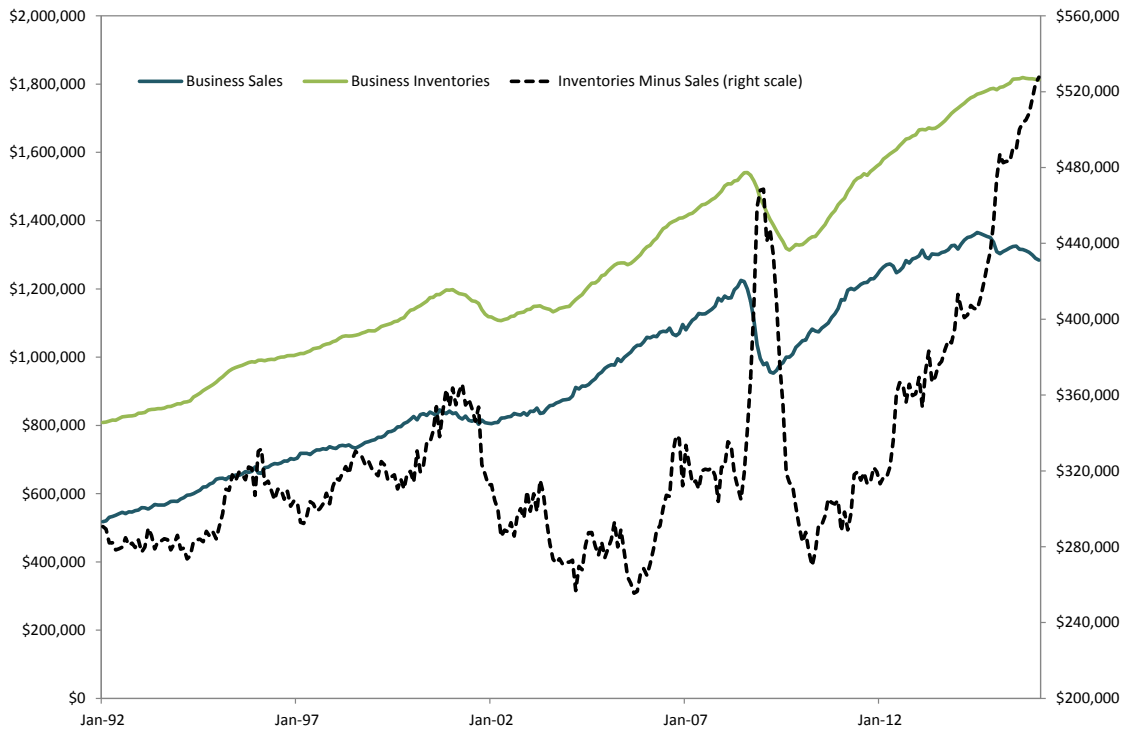


Figure 6. United States: Annual % Change in Nonfinancial Corporate Profits as a Share of GDP (with IVA and CCA, Seasonally Adjusted)

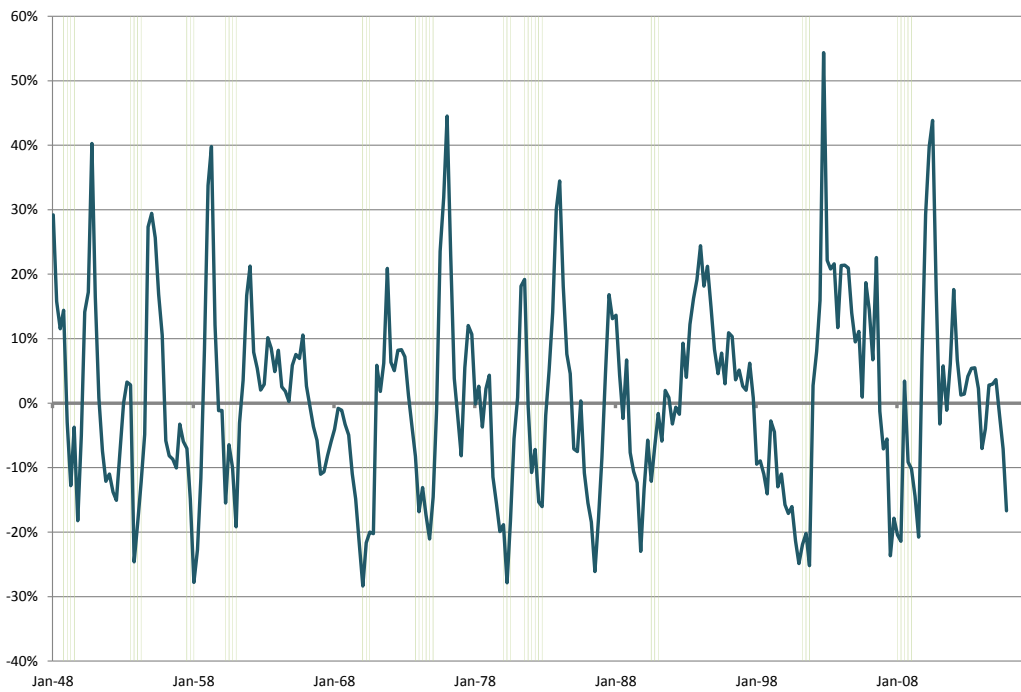
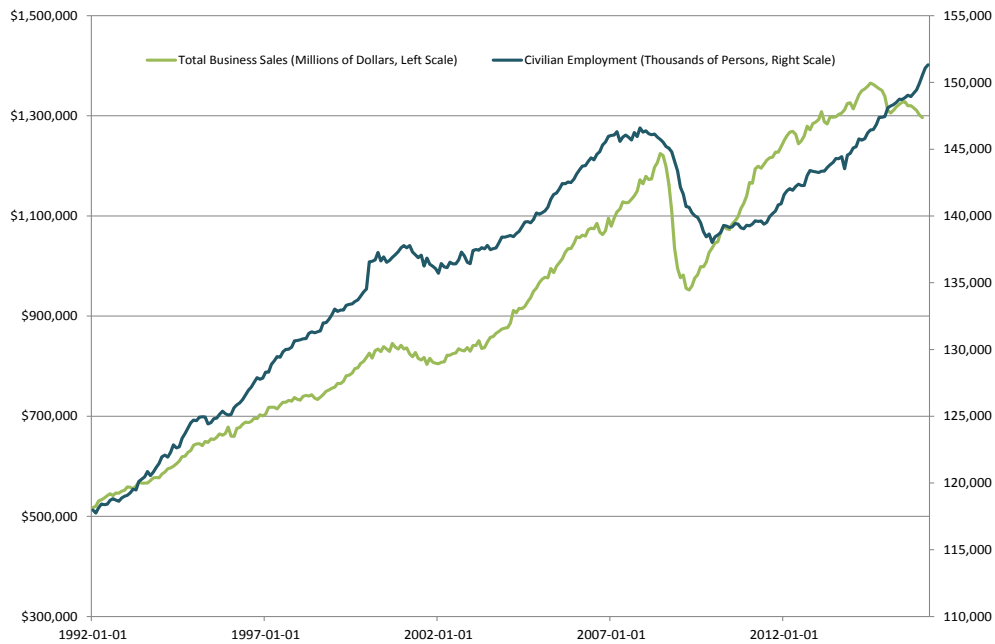


Figure 7. US Employment Follows Corporate Revenue



Companies have been trying to hide the deterioration in earnings through stock buybacks, which reduce the number of shares outstanding, thereby boosting earnings per share. Additionally, many firms have been reporting "one-off" adjustments to earnings that invariably flatter performance. The gap between GAAP earnings and adjusted (or operating) earnings has widened since late 2014, just as it did prior to the last recession, and those of 2000-02 and 1990-91 (Figure 8).

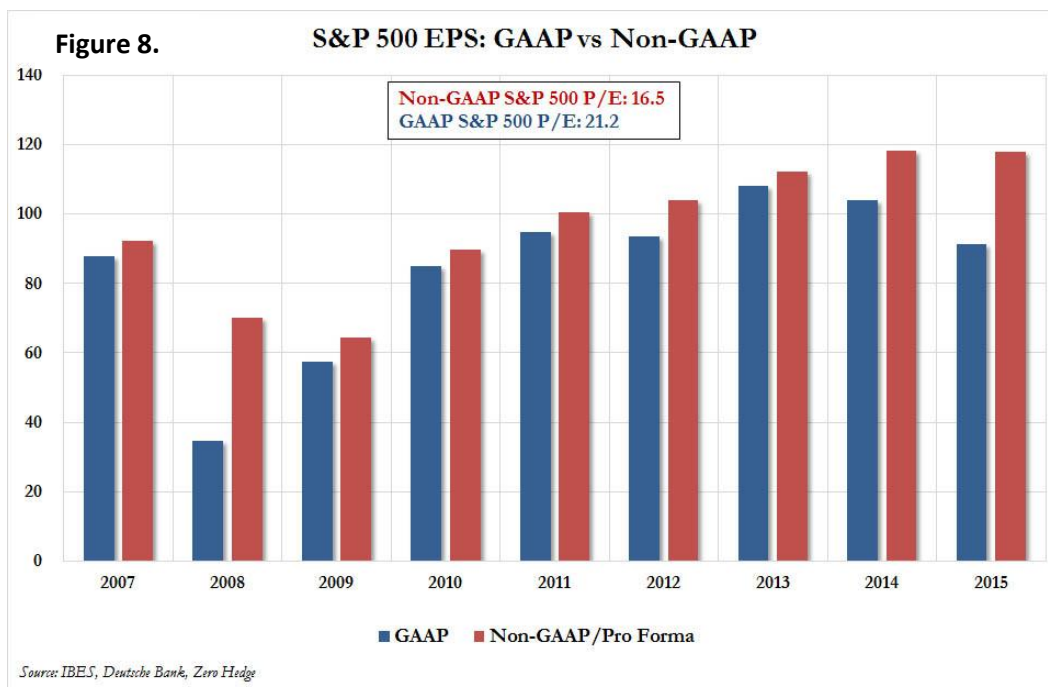
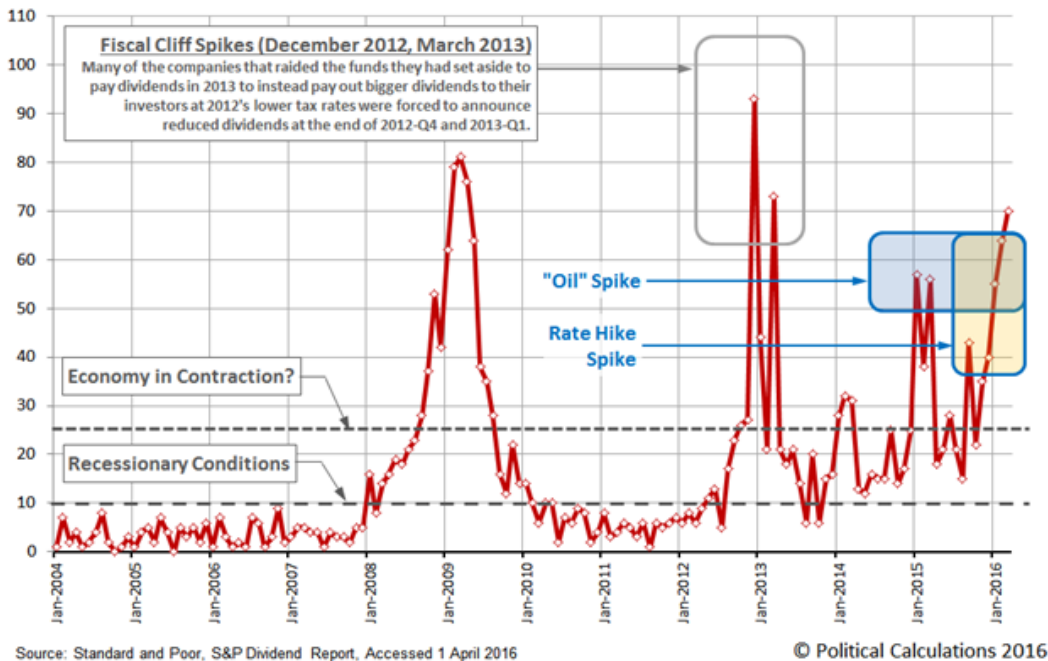


Figure 9. Monthly Number of Public U.S. Companies Announcing Dividend Cuts, January 2004 through Present



In any case, companies' actions speak louder than their 10-K reports. Generally speaking, firms are loath to cut their dividends, even when times are tough, since this hurts their reputation for consistency and prudent management. *When dividend cuts accelerate, as they have in 2016, it is a sign that firms' ability to conceal their profit problems is waning* (Figure 9 above). It's not all about energy; about half of the dividend cuts are coming from the oil industry, with finance, real estate, IT, mining and manufacturing making up the rest.

There are other signs that the economic outlook and investor risk appetite have deteriorated—signs that typically are precursors to recession:

- Three consecutive quarters of negative year-on-year earnings growth
- Widening credit spreads, both in speculative names and among high-grade issuers
- Warnings by ratings agencies of a surge in credit defaults
- Stalling of the IPO and M&A booms
- Sharp flattening of the yield curve, a leading (negative) indicator of economic activity
- Weakness in stocks of major banks, which lie at the heart of the economy and market
- Sharp appreciation of the Japanese yen, a sign of investor risk aversion
- The "January Effect" in stocks, which signals a weak year ahead

When earnings deteriorate, companies cut capital spending first (done) then jobs (starting). Economists and investors are pinning their hopes on the strength of the labor market, which continues to register robust growth. However, recent employment data are at odds with the weakness in corporate earnings. It is important to recognize that payroll surveys rely heavily on statistical models that lag changes in the real economy. Other indicators, such as payroll tax receipts, suggest that labor earnings have been decelerating since late last year. That may be a reflection of the fact that many of the jobs being created are low-wage, part time positions. Also, layoff announcements reported by the outplacement firm Challenger, Gray & Christmas were 25% higher in the first quarter than over the same period last year. Layoffs have extended beyond the energy sector into retail, finance, and real estate. Bottom line: job growth usually lags other activity indicators, and cannot be relied upon a signal of economic health.

All this is happening against a backdrop of very high stock market valuations. The broad US market indices are within spitting distance of their May 2015 highs, even though earnings are 18% lower than at this time last year. In fact, at \$85/share, S&P earnings are back to 2007 levels (even lower, in real terms), although the market is 35% higher than it was then. That means the price-earnings ratio has risen to 24, vs. 20 at last year’s highs, and 18.5 at the 2007 peak. The most reliable guide to future returns is current valuations—which point to large losses if and when a recession should occur (Figure 10 is from Doug Short’s [Advisor Perspectives](#)).

Figure 10. Equity Valuations, Recessions and Market Declines				
Recessions	Number of Months	Average Valuation, Month Prior to the Recession, Deviation from Mean	Market Price, Peak to Trough*	Change in GDP
Mar 2001 to Nov 2001	8	106%	-49.1%	-0.3%
=> We are here		76%		
Aug 1929 to Mar 1933	43	74%	-86.1%	-26.7%
Dec 2007 to June 2009	18	64%	-56.8%	-4.3%
May 1937 to June 1938	13	32%	-54.5%	-18.2%
Dec 1969 to Nov 1970	11	22%	-36.1%	-0.6%
Apr 1960 to Feb 1961	10	9%	-13.6%	-1.6%
Nov 1973 to Mar 1975	16	7%	-48.2%	-3.2%
Aug 1957 to April 1958	8	2%	-20.7%	-3.7%
July 1990 to Mar 1991	8	1%	-19.9%	-1.4%
Feb 1945 to Oct 1945	8	-32%	Gain	-12.7%
July 1953 to May 1954	10	-37%	-14.8%	-2.6%
July 1981 to Nov 1982	16	-40%	-27.1%	-2.7%
Jan 1980 to July 1980	6	-43%	-17.1%	-2.2%
Nov 1948 to Oct 1949	11	-43%	-20.6%	-1.7%

* The S&P Composite pre-recession market peak to the post-recession market trough

KPF Global Strategy

We are operating in a financial market that has become dependent upon liquidity, rather than fundamentals (which are deteriorating). This context has created an uneasy sense of calm among investors, punctuated by periods of extreme anxiety. The global economy is laboring under the effects of excess capacity, large inventories, heavy debt burdens and weak final demand—all of which is taking a toll on corporate earnings. Consumers are beginning to save more, since most households are far behind in preparing for retirement. In this context, slow growth and low inflation are likely to continue for the foreseeable future—even though headline inflation will receive a boost from the stabilization of oil prices.

Central banks are doing everything they can to boost inflation—not because it is too low *per se*, but because they believe it is the only way to alleviate our unsustainable debt burden (the same burden they helped to create). While a little inflation is probably good for asset prices, it would not be enough to solve the debt problem. Moreover, when it comes to the temptations of debt monetization (aka helicopter money) there is a non-trivial risk that things get out of control.

There is no telling when fundamental concerns may trump central bank's ability to levitate asset prices. However, one thing is quite clear: the balance of risk vs. reward does not support investing in the majority of global equity markets whose prices are high and earnings trajectories are poor. We remain underweight US stocks relative to foreign, and within the latter are tilted toward the higher-quality emerging markets. We favor value stocks over growth stocks, and dividend-payers overall. We are fully invested in international real estate, municipal bonds, mortgage-backed securities and cash equivalents, but have taken profit on tactical investments in gold and oil. We are pleased to see the repricing of credit instruments, and anticipate better buying opportunities in high-yield debt and US commercial real estate over the course of 2016.