Quarterly Market Outlook & Strategy Letter

Fourth Quarter of 2016

January 2017

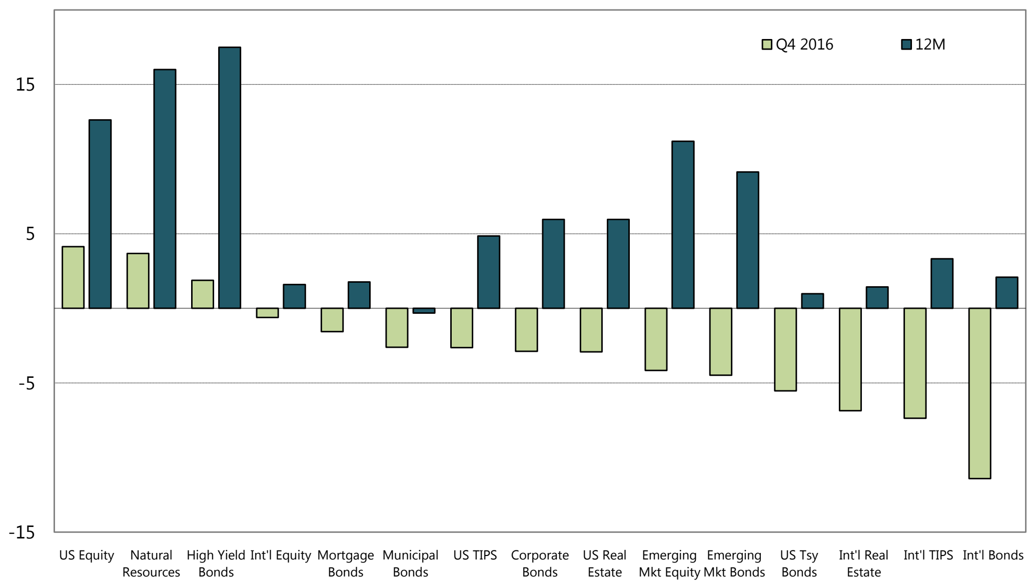
Executive Summary

- The fourth quarter of 2016 produced a startling reversal of fortunes. After a strong year for global markets, most asset classes produced *negative* returns at the end of last year. Bonds experienced their biggest upset since 2013, pushing the US$ higher.
- Since other countries represent the bulk of the global economy, the "translation effects" of a strong dollar make the rest of the world look weak—and US relatively strong—for a time. However, when it comes to currencies, everything that goes around eventually comes around. The dollar is now in the 8th or 9th inning of its strengthening trend, which is becoming too much of a good thing for the United States.
- On the flip side, weak foreign currencies are contributing to a synchronized global upswing—the first since 2013. Stronger global growth is supportive of cyclically-sensitive assets such as emerging market equity and debt, commodities, real estate, small-capitalization stocks, and high-yielding bonds.
- Expectations of stronger growth have led US equity analysts to raise their earnings forecasts for 2017. Forward estimates anticipate a 20% earnings gain, which represents a triumph of hope over experience. Every year since 2012, S&P 500 earnings forecasts have started out rosy and collapsed by year-end. Given shrinking profit margins, there is no reason to believe that 2017 will be different.
- More than earnings, future equity returns depend heavily on valuations; if you pay above-average prices for stocks, you will get below-average returns, and vice versa. Pricey US stocks are set to deliver low returns over the coming decade.
- By contrast, the MSCI emerging market P/E declined to 9.6 in January of 2016, and these markets are dirt-cheap in US$ terms. Given their relatively low valuations, emerging equity markets stand to benefit the most from the ongoing global recovery. Despite their strong performance last year, the emerging markets have tremendous upside potential.
- Emerging markets are an unloved asset class. The range of current worries can be summed up as a "heads they lose, tails the US wins" perspective. Weak growth is the principal risk to these markets; emerging market equity and debt historically have proven themselves resilient to higher interest rates and inflation.
- We maintain a "barbell" portfolio strategy for our clients. At the safer end of the risk spectrum, we are overweight cash, short-duration fixed income and TIPS. At the other end, we are overweight international equity (with strong tilts toward Japan, non-Japan Asia, and other emerging markets), as well as international real estate. We are substantially underweight US equity, real estate, international bonds, corporate credit and duration.

Introduction

They say a picture is worth a thousand words, and that certainly is true when one reviews the performance of various asset markets over the past year. The fourth quarter of 2016 produced a startling reversal of fortunes (Figure 1). After a strong year for global markets, most asset classes produced *negative* returns at the end of last year, as bonds experienced their biggest upset since the Fed-induced "taper tantrum" of 2013. Many investors have been focused on the new highs registered by the US stock market, and have not been paying attention to what happens to financial markets when US interest rates rise. In a word (or three): it's not good!

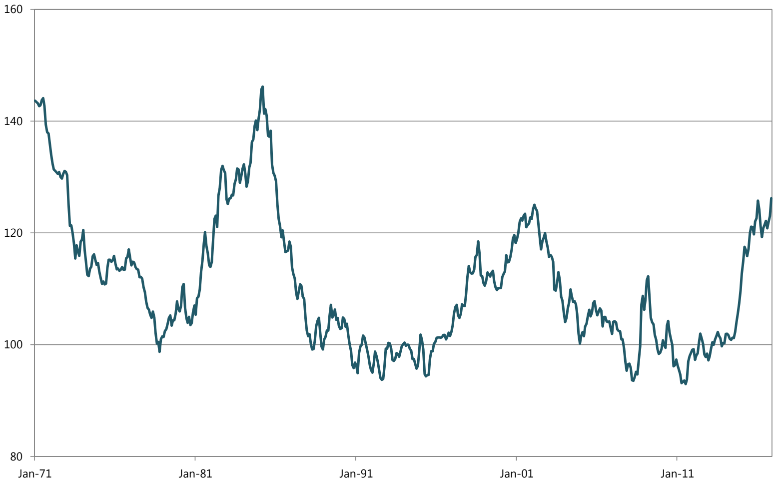
Figure 1. Benchmark Asset Class Returns



Source: Bloomberg

For better or worse, the United States is the 600-pound gorilla of international finance. The greenback remains the standard of monetary value in global markets, as well as the currency of denomination for a large portion of international trade, borrowing and capital flows. When rising interest rates propel the US dollar higher, it: (a) makes commodities that are invoiced in dollars more expensive to overseas consumers, which reduces demand and thus drives down the prices of those goods; (b) increases the cost of debt service for foreign governments and companies that borrow in dollars; and (c) diminishes the value of economic activity and assets denominated in foreign currencies. Since other countries represent the bulk of the global economy, these "translation effects" make the rest of the world look weak—and United States relatively strong—*for a time*. Indeed, the dollar's sharp appreciation since late 2014 (Figure 2) was a major contributor to the downturn in global growth in 2015 and early 2016.

Figure 2. United States: Real Trade-Weighted US$ Index

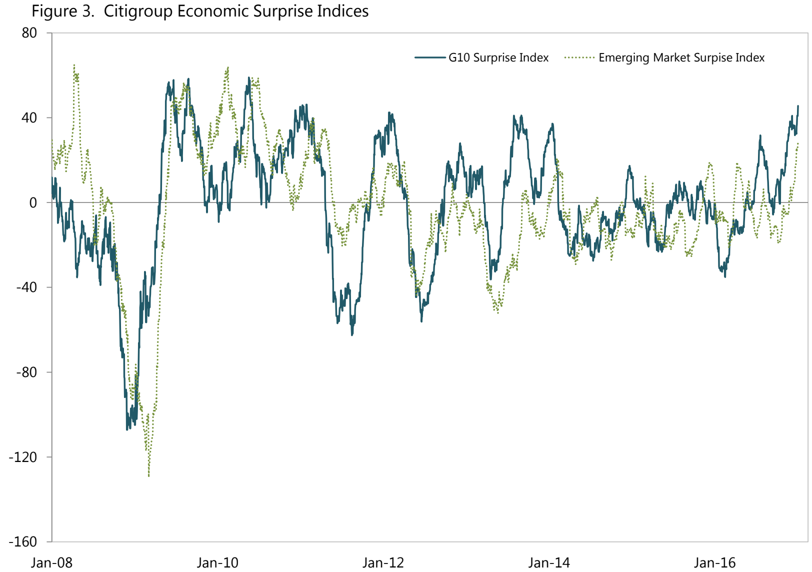


Source: Federal Reserve Bank of St. Louis (FRED) database.

However, when it comes to currencies, everything that goes around eventually comes around. Rising interest rates will create a headwind to US growth (as we are already seeing in the housing market). Additionally, a stronger dollar reduces the competitiveness of American firms in overseas markets, even as it encourages consumers to substitute imports for domestically-produced goods. The dollar's appreciation was a principal cause of the 2015 slowdown in US growth and associated sharp contraction in S&P 500 earnings.

By contrast, relatively low interest rates, combined with weaker currencies, contribute to better performance overseas—which leads eventually to higher interest rates, curbing the decline in foreign exchange rates. These adjustments take time, to be sure. However, they are quite reliable, and help to explain why currency cycles tend to be self-correcting. The dollar is in the 8th or 9th inning of its strengthening trend, while overseas economic activity is accelerating.

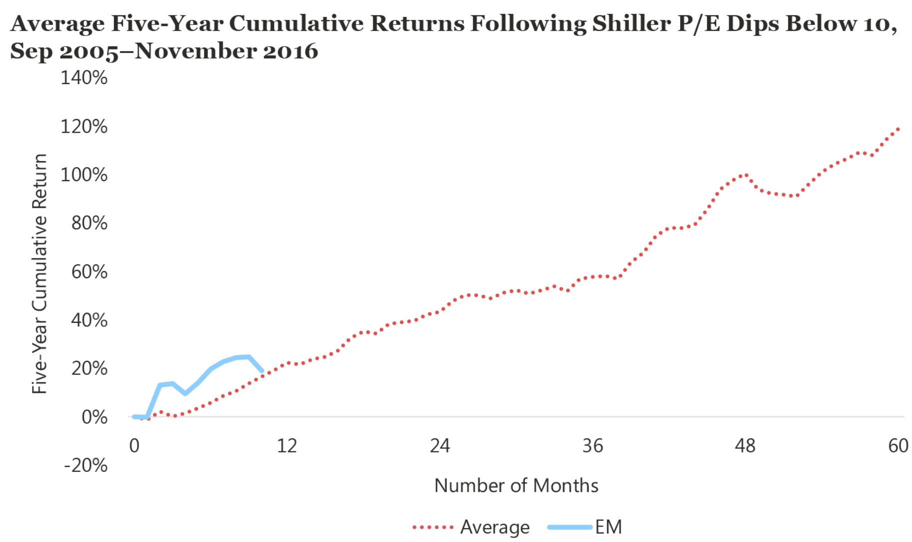
Figure 3. Citigroup Economic Surprise Indices



We are in the midst of the first synchronized global upswing since 2013 (Figure 3), which is supportive of cyclically-sensitive assets such as emerging market equity and debt, commodities, real estate, small-capitalization stocks, and high-yielding bonds. Given their relatively low valuations, emerging equity markets stand to benefit the most from the ongoing recovery. Indeed, the combination of cheap stocks and currencies, along with improving growth and earnings, has created the best conditions for emerging market assets since 2002. We see similarly positive trends unfolding for the Japanese equity market, which appears to have broken out of its 30-year downtrend. KPF Global client portfolios have been heavily tilted toward these sectors since 2015.

As you will recall from our prior letters, future equity returns depend heavily on current valuations; if you pay above-average prices for stocks, you will get below-average returns, and vice versa. Research Affiliates, who manage portfolios according to value-oriented principles similar to ours, has tracked the subsequent five-year returns of stock markets whose Shiller (cyclically-adjusted) price-earnings ratio (CAPE) fell below 10.0 (Figure 4). The MSCI Emerging Market p/e declined to 9.6 in January of 2016, a rare event. Despite their strong performance last year, the emerging equity markets have a long recovery ahead of them—*if* the global economy maintains its composure.

Figure 4. The January–November 2016 rebound in EM equities is tracking the average subsequent five-year return rebound following an equity market's Shiller P/E dipping below 10.0x.

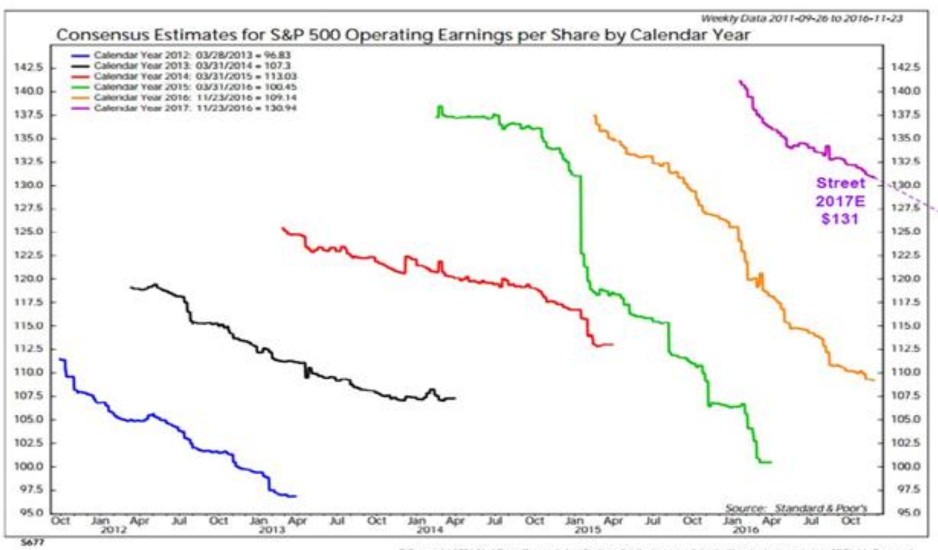


Source: Research Affiliates, LLC, based on data from MSCI, Inc., Bloomberg, and Barclays.
Note: The figure shows the average subsequent five-year returns of the 24 non-overlapping instances in which a country's Shiller P/E drops below 10. The five-year (60-month) span begins in the month immediately after the Shiller P/E ratio drops below 10, and the next 60-month span does not begin until the Shiller P/E drops again below 10 *after* the completion of the first 60-month span. The 60-month spans of each individual country do not overlap, and no scenarios exist in the data sample of a country's equity market perpetually trading below 10.

Emerging market equities are highly cyclical, and depend on a favorable economic backdrop to fulfill their potential. It remains an open question whether the nascent global recovery can withstand the effects of higher interest rates and a massive debt overhang in the mature economies. A lot of hope is riding on the US following the election of Donald Trump. Consumer and small business confidence have soared, spurred by expectations of lower tax rates and lighter regulatory burdens. Infrastructure programs are expected to boost capital investment, as the new administration jawbones US companies to keep jobs at home.

Rising wages will certainly be supportive of consumer spending. However, many households are keeping their wallets closed; the savings rate has remained higher in this recovery than during any other in the postwar period. That's not surprising, given the precarious financial position of many families, who don't have an emergency fund, much less a retirement nest egg. Credit card debt has been rising, which will, in combination with higher interest rates, take a bite out of future spending. So will rising gas prices, increased rents and escalating health care costs.

Figure 5.



Expectations of stronger growth have led equity analysts to raise their earnings forecasts for 2017. Forward earnings now anticipate a 20% gain, breaking the US stock market's 5-year streak of disappointments. This optimism represents a triumph of hope over experience. Every year since 2012, S&P 500 earnings expectations have started out rosy, and collapsed before the year was through (Figure 5, above). There is no reason to believe that 2017 will be different. Earnings have stabilized along with oil prices, but corporate profitability faces numerous headwinds, such as rising labor costs, higher interest rates, higher input costs, stagnant productivity (all of which produce shrinking profit margins) and a very strong currency. Not to mention Trumpian threats to our global trading system!

Expectations aside, the growth in US corporate earnings per share has been declining since 2012, despite stock buybacks, debt refinancings, automation, outsourcing, and accounting gimmicks. Even using the more flattering operating (vs. as-reported or GAAP) earnings measure, stock prices have been running ahead of earnings every year since 2012 (Figure 6), leaving US price-earnings multiples well above those in foreign stock markets (Figure 7). Factoring in the effects of weak currencies, overseas equity markets are trading at fire-sale prices in US$, creating a tremendous opportunity for long-term investors.

Figure 6. US Equity Market Has Been Running Ahead of Earnings

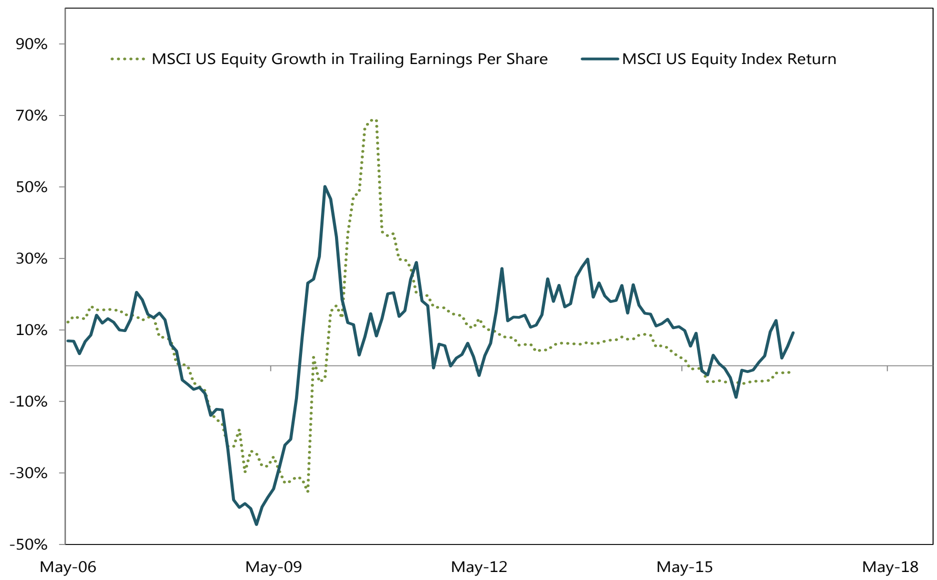
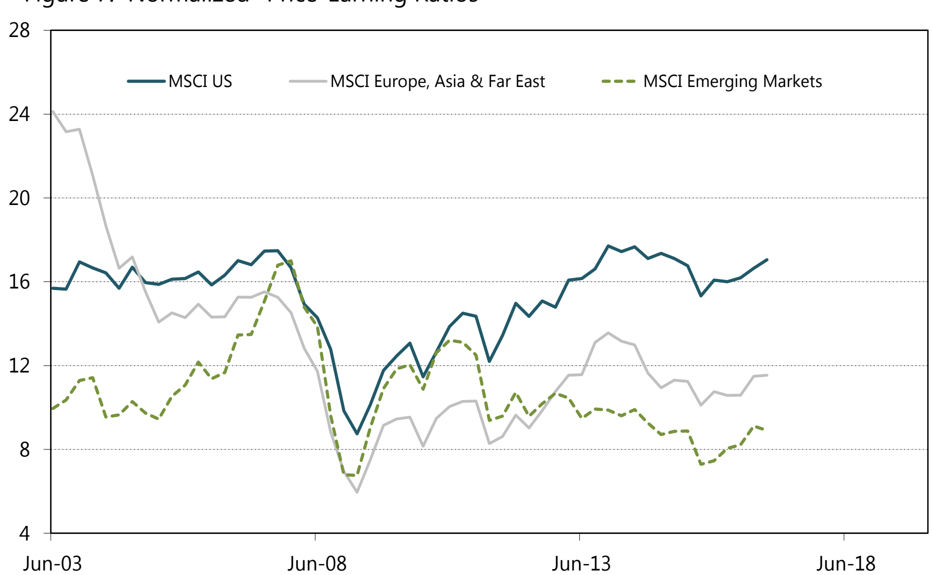


Figure 7. Normalized* Price-Earning Ratios



** Based on rolling 5-year average earnings*

Emerging markets are an unloved asset class, to put it mildly. Some investors worry about the associated business cycle risk, while others worry about the effects of rising interest rates and tightening global liquidity. There are additional concerns about geopolitical instability, domestic mismanagement and exchange rate instability. One can sum up these worries as a "heads they lose, tails the US wins" perspective.

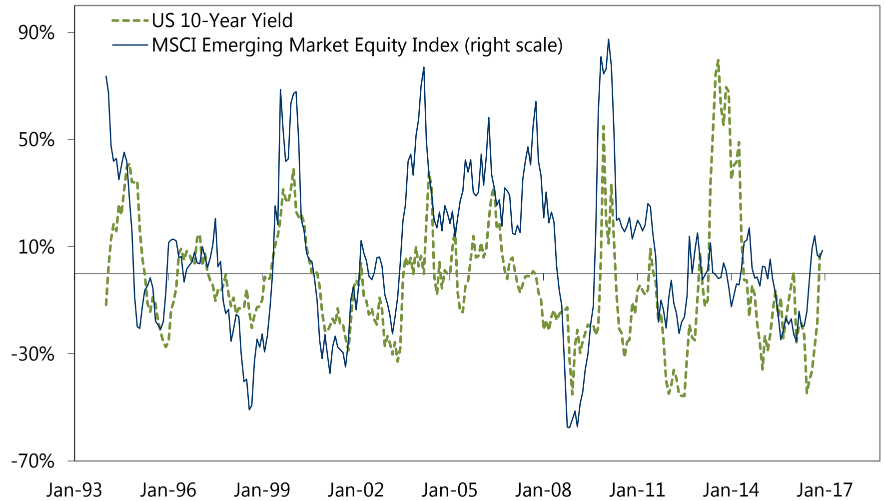
It's important to bear in mind that these risks, however legitimate, are already reflected in emerging market asset prices that are near 2008 (and 2002 and 1998) lows. Moreover, risks are not confined to these countries. In fact, emerging market fundamentals are far superior to those in most mature economies: growth is generally stronger, productivity gains are larger, debt and deficits are lower, and external balances are better. And, as we witnessed in 2016, political drama exists everywhere. Emerging equity and debt markets withstood considerable turbulence last year, delivering superior performance vs. most developed market peers.

Will rising interest rates derail the recovery of emerging market equity and debt? As we described in our Q2 letter, the 30-year rally in government bonds has likely come to an end, and investors should expect higher interest rates in future. Already, we've seen the yield on the US 10-year Treasury bond rise from 1.4% in June of last year to 2.6% earlier this month. Rising interest rates reflect several influences, including stronger US and global growth, rising inflation, a rising risk premium on government debt (given escalating debt burdens), and diminished confidence in the effectiveness of central banks (for reasons both practical and political).

Having said that, the global bond market—the largest and most liquid market in the world—is like the Titanic: slow to adjust to changing conditions. Interest rates will likely go higher, but the transition will not occur overnight. There are powerful countervailing forces, such as heavy public and private debt burdens and public sector interventions to slow the rise in rates. The simple fact is that the developed economies cannot afford higher interest rates, and will do whatever can be done to keep borrowing costs low. For now, liquidity remains ample.

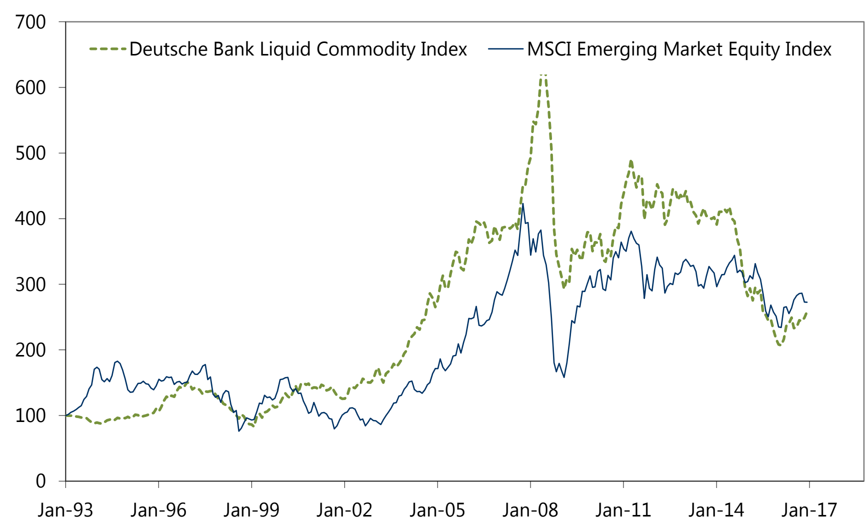
Even if interest rates rise, that should not have a disproportionately negative impact on the emerging markets, since higher yields usually reflect sronger growth and rising inflation. As Figure 8 shows, emerging equity markets are *positively* correlated with US bond yields. Moreover, these investments tend to outperform other asset classes in rising inflation environments, and can therefore serve as a useful portfolio hedge. Since many emerging economies are commodity exporters, their equity markets tend to have a strong tilt toward the materials sectors, which will benefit as inflation rises and/or the US$ turns lower (Figure 9). Emerging market debt, which typically entails higher yields and shorter maturities, are also in a better position to withstand rising interest rates.

Figure 8. Emerging Equity Markets: Not Afraid of the Big Bad Bond
(percent change, year-over-year)



Source: Bloomberg

Figure 9. Emerging Equity Markets are Commodity Markets



Source: Bloomberg

KPF Global Strategy

Over the past year and a half, we have maintained a "barbell" portfolio strategy for our clients. At the safer end of the risk spectrum, we are overweight cash, short-duration fixed income and TIPS. At the other end, we are overweight international equity (with strong tilts toward Japan, non-Japan Asia, and other emerging markets), as well as international real estate. We hold a small position in high-yield bonds and have been managing tactical positions in energy, gold and foreign exchange. We are substantially underweight US equity (large cap and growth especially) US real estate, international bonds, corporate credit and duration risk.

As military strategist Helmuth von Moltke observed, "No battle plan survives contact with the enemy." To a greater extent than usual, the course of economies and markets is being defined by political and geopolitical events. It may be a relief to some that central banks are no longer calling all the shots, but investors may rue the day that we left the frying pan for the fire. A great deal of attention is focused on the policies, polemics and personality of Donald Trump. His is a singular and polarizing figure, to be sure. But Trump manifests a set of broader forces at work in the global economy—forces that will run their course sooner or later. This is a time of great uncertainty and change, and we are disinclined to make predictions and pass judgments. Given the high "beta" associated with emerging market and other cyclical assets, we are proceeding with caution in managing our portfolio allocations, ensuring that the "safe" component of portfolios is sufficiently large to balance the risky portion.

A more fundamental question is whether the emerging markets can withstand the effects of de-globalization, should that occur. The traditional view holds that poor countries rely on wealthy ones for trade, technology and capital in order to develop their productive capacity. Without a doubt, access to large, and relatively affluent, foreign markets is a key source of demand for many emerging companies. However, technological tools and know-how will surely remain available to them, since leading producers will need and want to sell their products abroad. Moreover, emerging markets have long been *exporters* of capital to the mature economies. Indeed, the past three decades have witnessed a vendor-finance scheme of historical proportions; smaller trade surpluses mean less capital to finance the deficits of the wealthy countries, who desperately need the funds. It is unclear that emerging markets stand to lose more than the developed economies from conflicts over global trade. *We all will lose*.