

Katonah Capital Group, LLC

B A L A N C E I N A C H A N G I N G W O R L D

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SECOND QUARTER 2016 INVESTMENT ADVISORY REPORT

“The Best Argument Against Democracy is a Five-Minute Conversation With the Average Voter” – Winston Churchill

The second quarter had the appearance of a “risk-on” quarter as most asset classes appreciated; however, performance was led by the most beaten-down sectors like energy, utilities and consumer staples – typically defensive sectors of the market. Nevertheless, the market has taken on a different tone recently – specifically there have been significant signs of larger institutional buying, and market leadership has been rotating out of the just mentioned defensive sectors and into more cyclically sensitive areas such as technology, industrials, financials and basic materials. As a result, we’ve made significant changes in the overall risk allocation of our portfolios (see more detail below).

Commodities were the biggest gainers last quarter rising by 12.8%,¹ helped again by strength in the precious metals as well as energy. But gold’s rally slowed down a bit to a 6.8% increase², so clearly the commodity gains were broad based. This of course, was paced by a softening of the US dollar (USD). The USD has regained strength in these past “post-Brexit” weeks, but for the past year and a half, it has essentially gone sideways against the major currencies. As measured by the US Dollar Index, the USD is right in the middle of this trading range and at this point, we’re not expecting a breakout in either direction. If this is the case, it should remove a former large headwind against year-over-year corporate profit comparisons. And, the stabilization of crude oil and energy prices should be another catalyst for favorable earnings comparisons. Past reports have commented on the long stretch of weaker earnings. The chart below, from Trading Economics, shows the pronounced downtrend in place for the past 2 years.³ Second quarter earnings are just coming out now, but we believe that we might be turning the corner on the earnings front.

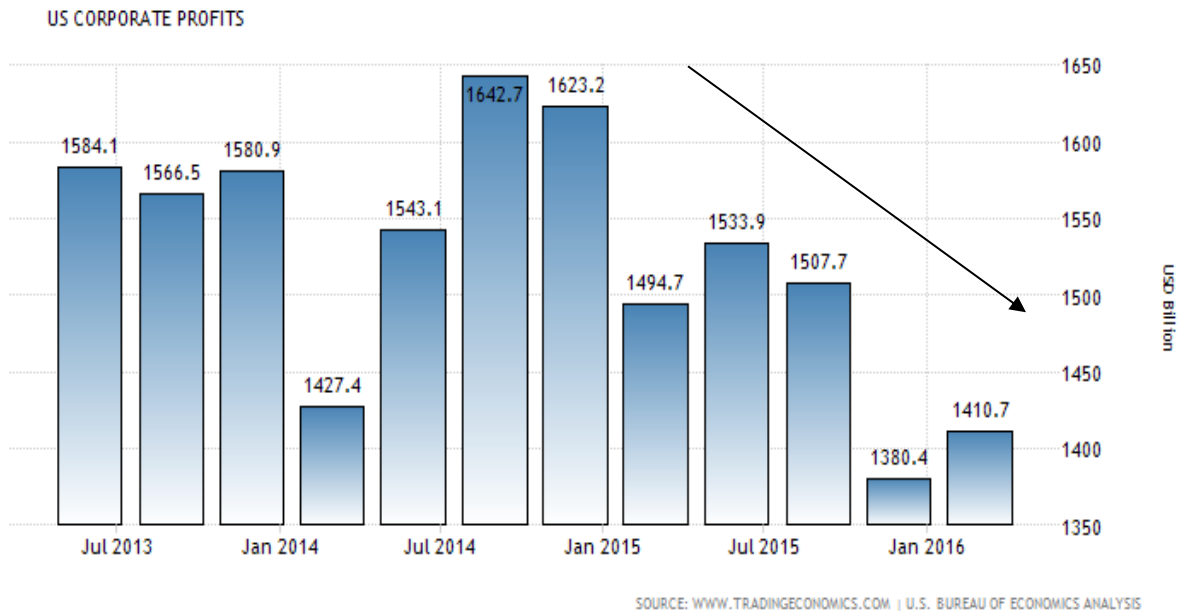
¹ https://www.fidelity.com/bin-public/060_www_fidelity_com/documents/Q3%202016%20Market%20Update_Fidelity.pdf

² Ibid. # 1

³ <http://www.tradingeconomics.com/united-states/corporate-profits>

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REITs were the second best performing sector, rising 7.4%.⁴ But the more striking story was the 6.5% gain from long-term bonds. US large cap stocks were up around 2.5% and foreign stocks declined around 1% - 2½%. Thus, the last quarter was one where you received “equity-like” returns from bonds, and bond-like returns from stocks.⁵ We believe the performance of the bond market and US interest rates will be the essential macro phenomenon to monitor going forward and will discuss this more below.

Overall, the environment was aptly summed up by Jeremy Grantham in his most recent missive. “On the Investment front the equation remains the same: pushing stock prices higher are the twin forces of the Fed’s policy and corporate buybacks. Trying to push prices down is an impressive array of everything else: disappointing productivity, growth, and profit margins together with all our domestic and international political uncertainties...despite brutal and widespread asset overpricing, there are still no signs of an equity bubble about to break, indeed cash reserves and other signs of bearishness are weirdly high.”⁶

We completely agree with Grantham’s observations, including his point regarding excessively high levels of cash reserves and bearishness. We also feel that there are signs that the US economy is showing signs of resiliency (see below). Given this, we significantly reduced our short hedging positions during the past quarter, and increased equity exposure in most accounts. New purchases have focused on more cyclical, US based sectors such as housing, technology, basic materials and industrials. We also feel there’s growing recognition that central bankers are running out of ammunition and efficacy. This could lead to a push towards government/fiscal policy expenditures and we’ve begun increasing exposure to global infrastructure projects. All of this could have significant impact on interest rates.

⁴ Ibid. # 1

⁵ Ibid. # 1

⁶ Immigration and Brexit; Jeremy Grantham; GMO Commentary; July 2016; pg. 1

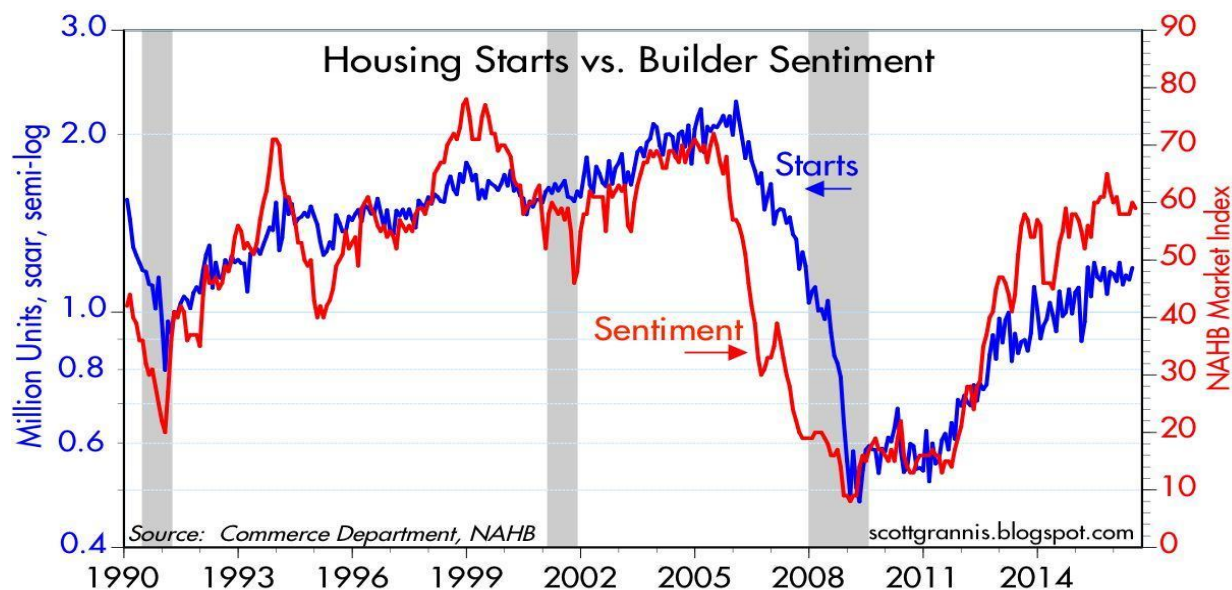
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For years, the overwhelming majority of pundits have been calling for higher interest rates. Now, with rates at historic lows (not to mention negative in many places), the mantra is changing to “lower for longer”. As Gavekal Capital recently observed, “Considering that **only 57% of developed market government bonds have a positive yield** (emph. added), it can be difficult to believe that rates can go lower. However, then you realize that Switzerland(’s) entire yield curve from 3M-30Y is negative and Japan is talking up further QE utilizing “helicopter money” and it is easy to believe anything is possible”.⁷

There are powerful arguments supporting both sides of this argument. As Brett Lewthwaite observed in a recent white paper from Delaware Investments, “...We should be in the midst of accelerated growth in light of the quantitative easings from central banks, the significant reduction in commodity prices, and the low interest rate environment. **Last year alone, major central banks eased 62 times** (emphasis added). All of this should have boosted economic growth. Instead, global growth remains tepid as a result of the debt buildup.”⁸ However, perhaps all the stimulus is finally beginning to “trickle down” into the real economy.

As the ever bullish Brian Wesbury recently noted, “...economic data have clearly turned for the better. The ISM Manufacturing index rose to 53.2 in June from 51.3 in May while the ISM Service index rose to 56.5 from 52.9. Payroll growth surged in June, growing 287,000. And in the past three weeks, new claims for unemployment insurance have remained below 255,000... (after remaining) below 300,000 for 72 consecutive weeks...Worker pay is accelerating. Average hourly earnings are up 2.6% from a year ago...”Core” retail sales...are up 4.3% from a year ago...Single-family housing starts are up 13.4% from a year ago...Meanwhile, price gains and low inventories of both new and existing homes signal plenty of room in the year ahead for a continued increase in home building.”⁹

To this last point, Scott Grannis posted the following charts in his recent blog:



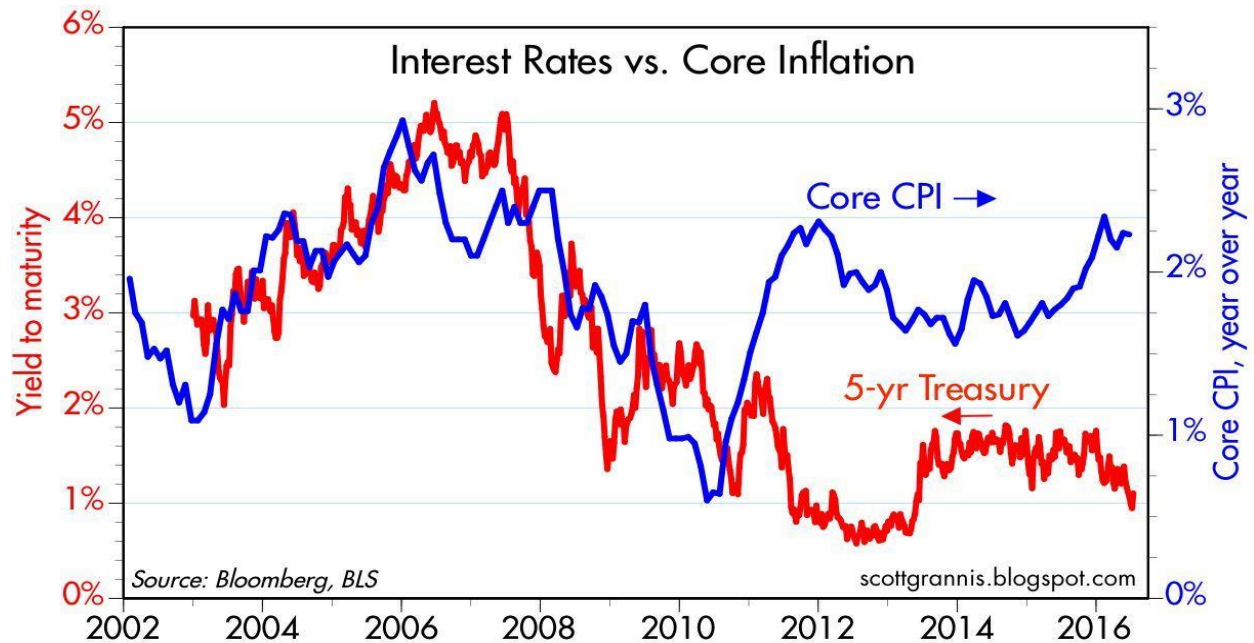
⁷ <http://blog.gavekalcapital.com/?p=11427>

⁸ “Investing In the Debt Supercycle”; Delaware Investments; May 2016; pg. 2

⁹ First Trust Monday Morning Outlook; July 25, 2016; pg.1

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He writes that “Starts are still significantly below what might be considered “normal,” but builder sentiment suggests there is room for improvement. Indeed, starts would need to rise significantly over the next several years just to keep up with scrappage and the ongoing rise in housing formations and population.”¹⁰ He also offers up the next chart plotting interest rates against inflation data, and writes; “This is a market that worries about slow growth and a Fed that is powerless to push inflation up. I think the market is underestimating the Fed’s ability to deliver 2% inflation, since core inflation is already running above 2%, and it has been 2% or better for most of the past decade. I fully expect the headline CPI to register at least 2% by the end of this year. Bonds are definitely expensive at these levels.”¹¹



All of this paints a scenario of a sustained, mid-late cycle upswing in the economy, and argues for a “risk-on” positioning. This is supported by the action of riskier assets such as high-yield bonds which are a good proxy for risk appetite. They have been trading extremely well relative to more stable, defensive assets such as US Treasury bonds. **However, this does not in any way imply that risk in the system is moderating.** To the contrary, Danielle DiMartino Booth described the risk environment, as only she can, in a recent posting. She writes,

“In his latest missive, Deutsche Bank’s Oleg Melentyev, arguably the best in class high yield analyst among his sell-side peers, warned of the perils of investing in this ‘frenzied market’...

¹⁰ http://seekingalpha.com/article/3989655-chart-updates?app=1&auth_param=2a7df:1bou3o3:7dff803c77e864ac08f50c4abc7ad858&uprof=37

¹¹ Ibid. # 10

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Legendary high yield investor Marty Fridson shares Melentyev's concerns and has for some time. By his best estimate, high yield was already in 'extreme overvaluation' territory on June 30th, defined as being one standard deviation above fair value. Flash forward two weeks, and he calculates that the standard deviation has doubled...

...on July 15th the option-adjusted spread on Bank of America Merrill Lynch's High Yield Index was 542 basis points. That compares to 621 bps on June 30th. The lower the spread, the less extra compensation investors are demanding for taking on the added risk of being exposed to, well, junky bonds.

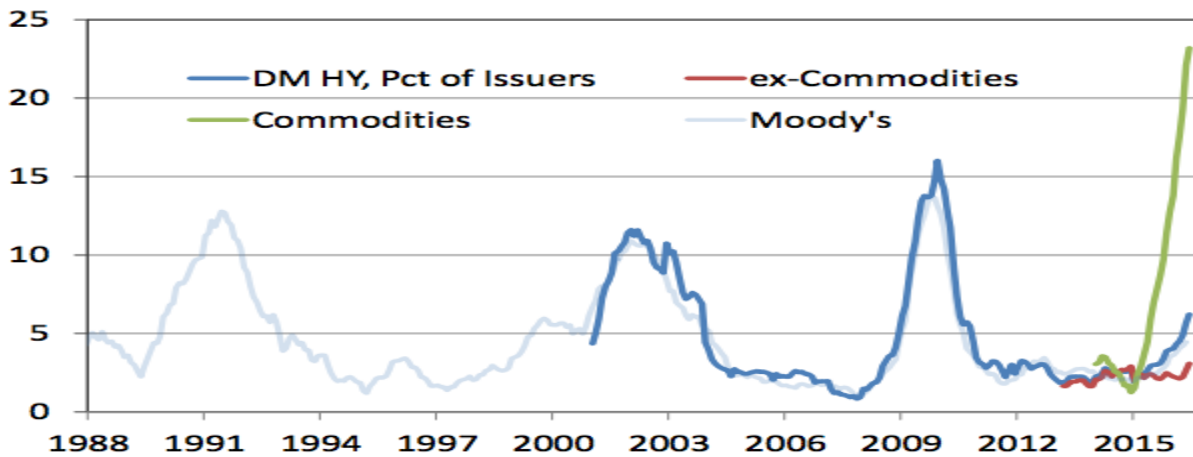
Of the compression in spreads, an incredulous Fridson could only characterize the overvaluation which begat more overvaluation as, 'more staggering'.

Now in light of this, just how did mom & pop investors react to the price increase? Well how else? They poured \$4.4 billion into high yield mutual funds, the second highest weekly inflow on record after March 2nd's \$5.3 billion inflow...

The question is, will investor insouciance ever come back to haunt them? They, as in investors, certainly don't seem to think so."¹²

On the surface, if in fact the economic backdrop is improving, then it makes sense that the economically sensitive high-yield market is performing so well. The problem is that it flies in the face of other fundamentals such as rising default rates. As blogger The Heisenberg recently posted on Seeking Alpha,

Figure 2: DM HY issuer default rates

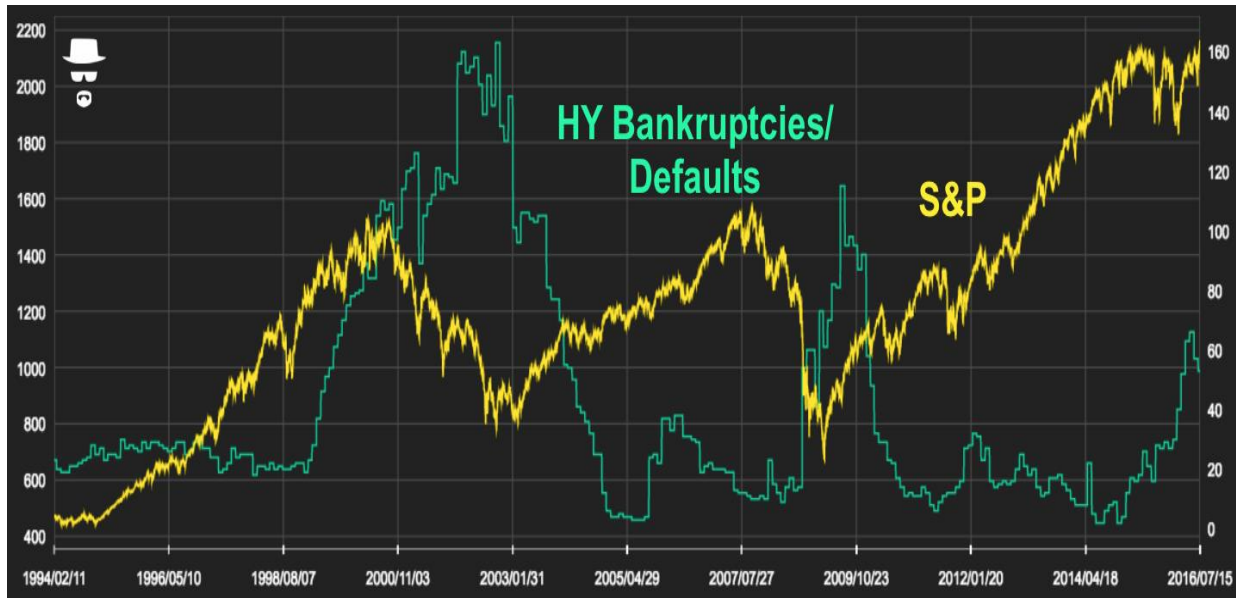


Source: Deutsche Bank, Moody's

¹² <http://dimartinobooth.com/bond-market-beware-junkyard-dogs/>

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“At this point, we have little doubt that our original forecast for 4% ex-commodity HY default rate will be met by late 2016/early 2017. Moreover, we think there are now enough reasons to believe that defaults could rise to 5%, ex-commodities, sometime over the next year or so. Coupled with our 20% commodity HY default rate forecast we are still looking at a 7.25% aggregate HY default rate sometime around mid-2017.”¹³ These are large numbers! He also shares the following:



“What sticks out there is the fact that although defaults are on the rise, stocks don't seem to care this time around. ***This time, apparently, is different*** (emph added).”¹⁴

So, we remain afloat on a sea of Central Bank created debt. And while we know that it's almost never “different this time”, it can remain different for a very long period of time. As Jeremy Grantham observed (see above), ***pushing stock prices higher are the twin forces of the Fed's policy and corporate buybacks. Trying to push prices down is an impressive array of everything else.***, Danielle DiMartino Booth brings this all full circle. Writing in an earlier post:

“...consider the tie that binds the yesteryear of the 1920s to today; that is, debt. According to figures compiled by the International Monetary Fund (IMF), public debt as a percentage of global gross domestic product (GDP) reached its nadir in 1914, at 23 percent. The onset of World War I would alter that economic landscape for generations to come. Global debt peaked at nearly 150 percent of GDP in 1946, following the Great Depression and World War II.

¹³ http://seekingalpha.com/article/3988958-this-defies-reason-wake-defaults-begun?li_source=LI&li_medium=liftigniter-widget

¹⁴ Ibid. # 13

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By all appearances, the global economy has now come full circle – without the World War part that is...

How sweet it would be to report that since 2007 the tide of debt has turned. But instead, an early 2015 McKinsey report documented that global debt had ballooned, with none of the world's major economies taking positive steps toward reducing their debt levels. Such is the disastrous bent of modern-day central banking thinking, with its belief that the only way to alleviate the problem of over-indebtedness is with ever-increasing debt.

In all, according to McKinsey's math, global debt increased by \$57 trillion in the seven years ending 2014. The gold medal winners among creditors were the sovereigns: at 9.3-percent growth, government debt swelled to \$58 trillion from a starting point of \$33 trillion. Corporations came in second place with their debt levels rising by 5.9 percent to \$56 trillion from \$38 trillion. The onus was clearly on these two competitors to offset the relatively weaker growth of financial and household debt which was no doubt dragged down by the collapse in U.S. mortgage availability and the recapitalization of (some) lenders.

Where does that leave us? Apparently angry. Very, very angry.¹⁵

This is readily apparent in the surge of violent shootings recently, as well as in the comedy/tragedy that is our unfolding election process. The outcome should prove interesting.

Enjoy your summer.

Sincerely,

Jason Waxler

¹⁵ <http://dimartinobooth.com/central-banks-rise-extremism/>

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U.S. STOCKS ¹⁶

Total Returns	2Q	YTD
Dow Jones Industrial Average	2.07%	4.31%
S&P 500 Index	2.46	3.84
Nasdaq Composite Index	-0.56	-3.29
S&P MidCap 400 Index	3.99	7.93
Russell 2000 Index	3.79	2.22

INTERNATIONAL INDEXES

MSCI Index	Total Return	
	Second Quarter	Year-to-Date
EAFE (Europe, Australasia, Far East)	-1.19%	-4.04%
Europe	-2.29	-4.61
EM (Emerging Markets)	0.80	6.60

GLOBAL BOND INDEXES

Total Returns	Q2 2016	YTD
Index		
Barclays U.S. Aggregate Bond Index	2.21%	5.31%
J.P. Morgan Emerging Markets Bond Index Global Diversified	5.02	10.31
Barclays U.S. Mortgage Backed Securities Index	1.11	3.10

¹⁶ <https://www3.troweprice.com/usis/iinvestor/en/planning-and-research/t-rowe-price-insights/markets/quarterly-market-review.html>