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BALANCE IN A CHANGING WORLD
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THIRD QUARTER 2016 INVESTMENT ADVISORY REPORT

"It's Tough to Make Predictions, Especially About the Future" – Yogi Berra

The third quarter was pretty much a continuation of "risk-on", paced by strong performance in the Emerging Markets (EM). The Fed's decisions to forestall tightening in their July and September meetings kept the US dollar (USD) subdued and commodity prices firm. This, along with further stimulus from global central banks boosted the MSCI Emerging Markets Index by 9%.[1] Chinese stocks were the leader, aided by fiscal stimulus geared towards supporting their property market. Brazilian stocks were boosted by a hope of change after President Dilma Rousseff was impeached. A 20% jump in the share prices of Lukoil, thanks to stability in the oil markets, helped drive strong gains in the Russian Index.

In the US, it was very much back to a "FANG" market as technology led, aided by an 18.25% surge in Apple shares.[2] However, high dividend yielding "bond-proxy" stocks such as Telecoms and Utilities declined by 6%, while the newly launched S&P Real Estate Sector lost 1%.[3] All in all, the S&P 500 gained roughly 4% and the Dow Jones Industrials rose by almost 3%. This past spring, the technical tone of the markets improved and accordingly, we increased our long stock exposure and reduced 50% of our short exposure. This is not a high conviction shift though, as there is a litany of well recognized concerns remaining, previously discussed in past reports, and the most positive case to be made is that these concerns are in fact probably already fairly well recognized and possibly priced in to the market!

High on the list of concerns is the recession in corporate profits. The Capital Group reports that "Despite stock gains in the quarter, S&P 500 earnings were forecast to decline 2%. It would be the sixth consecutive quarter of year-over-year earnings declines, the longest such streak since such data began being tracked in 2008 by market data provider FactSet."[4]

[1] See Third Quarter Market Index Returns data below.
[2] YahooFinance.com
[3] https://www.thecapitalgroup.com/us/insights/market-commentary/world-markets-third-quarter-2016.html
[4] Ibid. #3

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A recent Bloomberg article entitled "Unlike in 1986, the U.S. Might Not Dodge a Recession…" reported on a Deutsche Bank study citing corporate profits and three other indicators that over the past 30 years have always heralded a recession with one exception – 1986 – which they brand as an outlier.[5] They offer the following graph:

The study acknowledges that in 1986, declining profits did not lead to a recession, however, in every other instance it has. In addition to these headwinds, the study cites a 2% yoy decline in Capex as corporate investment remains weak, and a significant rise in the default rate of US high-yield corporate (junk) bonds to 5.7%. They state that "over the past 30 years, this default rate has pushed notably above 5 percent on only four occasions, three of which subsequently paved the way for a full default cycle and a U.S. recession."

Of course, this is looking in the rear view mirror, and the earnings recession could be nearly over, as the twin headwinds of plunging energy prices and a stronger USD subside. In fact, part of our rational for increasing our stock exposure was based on that premise. As Investor's Business Daily recently reported, "S&P 500 Earnings At Turning Point: Amazon, Chips Soar; Energy Less Sore" …"The third quarter could finally be the bottom, after a year of the embattled, oversupplied energy sector pulling earnings of S&P 500 companies into negative terrain."[6]

The profits recession, however, has been widely reported and is not news at this point. However, there has been no shortage of other bearish, unsettling news. The blogsites currently are full of gloom & doom – "**Barron's Warns Charts Look Ugly as Bears Poised**[7]"or "**Stocks Headed for Rout as Volumes**

[5] http://www.bloomberg.com/news/articles/2016-09-20/unlike-in-1986-the-u-s-might-not-dodge-a-recession-deutsche-bank
[6] http://www.investors.com/news/q3-earnings-overall-not-bad-ex-energy-ex-apple-even-better/
[7] https://finsum.com/index.php/economy/macro/item/4669-barron-s-warns-charts-look-ugly-as-bears-poised?utm_source=newsletter_265&utm_medium=email&utm_campaign=finsum-regular-40k-new-rep

Plunge?[8] Investor heavyweights such as George Soros, David Tepper, Carl Ichan, Ray Dalio, Jeffrey Gundlach, Bill Gross… have all publicly expressed sentiment ranging from caution to outright bearishness.

This is not the atmosphere typically found at major tops in a market. In this environment, it's possible that most participants are already poised for a selloff – the implication being that if a catalyst occurs to spook the markets, the selling will have already mostly been done and further, if a catalyst does not occur then all these sellers and people on the sidelines will have to come in and buy. To this point, Bloomberg recently reported that: "Investor Cash Levels Jump Toward Levels Not Seen Since 9/11".[9] It sites a survey conducted monthly by Bank of America which states "Fears of a bond-market crash, a breakdown in globalization, a new crisis in the euro area?...There were a bevy of reasons for fund managers to push their cash balances to 5.8 percent of their portfolios in October, up from 5.5 percent last month…The share of cash hasn't been higher than that since November 2001, shortly after the terrorist attacks in the U.S. The amount of dry powder in portfolios is above that seen during both Europe's sovereign-debt crisis and the U.S. debt-ceiling debacle…."

And, to be sure, there is a lot that can go right. Jim Paulsen at Wells Capital Management is ever the optimist, yet his missives are always well thought out, as is his most recent one entitled "The Perfect Day?" He notes that after the initial financial crisis in '08, the US has persistently provided stimulus to our economy while the policies of other foreign economies were restrictive. However now, "for the first time in this recovery, nearly all global economic policies have been aligned supporting this expansion and making the odds of a synchronized global economic bounce far more likely than widely perceived."[10]

Paulsen notes too that US corporate and household balance sheets are in remarkably good shape. Typically, at this late stage of an economic cycle that's entering its eighth year, balance sheets would be

[8] https://finsum.com/index.php/markets/equities/item/4666-stocks-headed-for-rout-as-volumes-plunge?utm_source=newsletter_265&utm_medium=email&utm_campaign=finsum-regular-40k-new-rep
[9] http://www.bloomberg.com/news/articles/2016-10-18/investor-cash-levels-jump-toward-levels-not-seen-since-9-11
[10] https://www.wellscap.com/pdf/emp/20161012.pdf

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extended and credit overuse would present a risk to the economy. Paulsen asks, "What if…the US finally adds a little leverage...Could a more normal credit cycle produce another leg up in the stock market?"[11]

Paulsen questions the long stretch of weak productivity growth we've been experiencing and notes that "Because productivity has been so poor in this recovery, even a modest improvement would surprise most forecasters."[12] He notes that capital spending could accelerate. "Several indicators suggest capital spending may accelerate again before this recovery is over. Rising pent-up demands may cause businesses to engage in some catch-up spending should the global economic cycle experience a synchronized bounce. Moreover, with the economy now back near full employment, rising labor cost may spark a new round of productivity enhancing spending.[13] Housing is another sector that could contribute positively, Paulsen notes. Housing typically picks up early on in an economic cycle. However, shifting demographics, student indebtedness, and the after effects of the housing collapse in 2008 has led to an extremely subdued recovery in household formation. As with capital spending, any pent up demand for housing could provide a surprise boost in the second half.

Perhaps most intriguing is Paulsen's questions about money velocity. There are many structural reasons why the velocity of the US money supply might be in a secular decline. However, loan velocity has recently been increasing and Paulsen notes that in the mid '80's and in the early 2000's, a pickup in loan velocity (defined as loan growth / M2 money supply) preceded an increase in the velocity of money. As the chart below depicts, loan growth has in fact been in a steady uptrend since 2010.[14]

[11]Ibid. #10

[12] Ibid. #10
[13] Ibid. #10
[14] Board of Governors of the Federal Reserve System (US), Commercial and Industrial Loans, All Commercial Banks [BUSLOANS], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/EVANQ, October 25, 2016.

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These are all excellent points, and during the course of this recovery, Paulsen has been much more right than he's been wrong. The mind-numbing crux of the issue though, is much more likely a question of timing rather than whether the bulls or bears are right. We suspect that for many reasons, Paulsen is correct and when combined with the pervasive negative sentiment, could lead to the afore-mentioned market melt up. The problem in our mind is that to participate is a much skewed risk/reward endeavor and requires that one dance the "Chuck Prince dance"! [15] And, the warning signs are indeed plentiful!

First, in the more immediate term, the recent rise in the USD is concerning. A recent piece by Charles Smith in Seeking Alpha read "The 'Nuclear Options': Oil Pinned Below $30/Barrel, U.S. Dollar Rising"[16]

If the dollar continues its ascent, this would signal that deflationary forces were once again pulsing across global economies and this would be extremely negative for all risk assets. Not shown in the chart, but as of this writing, the USD is in fact very strong and breaking out to the upside. The flip side to the stronger USD is the Chinese Yuan (CNY) which has been steadily declining.

[15] In 2007, just prior to the financial crisis, Charles Prince, former chairman and chief executive officer of Citigroup famously said ""When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance."

[16] http://seekingalpha.com/article/4011031-nuclear-options-oil-pinned-30-barrel-u-s-dollar-rising?app=1&auth_param=2a7df:1bvl6o5:59b14292c3a49e3f5b8eded00c926060&uprof=37

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A declining CNY, in and of itself, is not necessarily a negative. In fact it can be an indication that China is gradually moving away from being an exporting machine (where goods are exported and in exchange, global capital flows into the country putting upward pressure on the currency) and rebalancing towards a more domestically oriented economy driven by consumption and government spending. The key though, is not the currency levels, but the extent to which the government/central bank (PBOC) is concerned about the decline and the attendant capital outflows from their economy. The below chart from Bloomberg shows the gradual depreciation of the CNY over the past few years (purple line) along with the drawdown in China's currency reserves (white line) as they've attempted to manage the decline and keep it orderly.[17]

As discussed in prior reports, in 2015 the PBOC made a concerted effort to defend the currency which necessitated a nearly $1 trillion drawdown in their FX reserves (see the white line above and blue line in the chart below). This in effect created a huge drawdown in global liquidity and caused large shocks to the global financial markets. The PBOC must be cognizant of this and so it's interesting to note that despite the continued currency weakening and the attendant capital outflows, the PBOC has essentially held pat and not liquidated their reserve holdings to counter the capital flight. These outflow swings are depicted below, along with the recent stability in central bank reserve holdings.[18] Note that when the red dashed line is below zero, there is an outflow, so even a rising red line during the beginning of 2016 meant that the outflow was reduced to "only" $40 billion! The data is reported with a lag of several months, however, it appears that outflows are beginning to accelerate once again. September data shows a continued bias towards FX drawdowns at the PBOC.[19] It is hard to say at this point if that's a result of slower global trade or of central bank liquidation to combat outflows. Neither is a good scenario. We will be monitoring these levels closely in the months to come. If there are signs that China is being forced to once again draw down their reserve stockpile, we will become more defensive.

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[17] http://www.bloomberg.com/news/articles/2016-09-07/china-fx-reserves-drop-to-lowest-since-2011-as-pboc-defends-yuan
[18] http://wolfstreet.com/2016/10/11/whats-going-on-with-new-global-reserve-currency-chinese-yuan/
[19] http://www.tradingeconomics.com/china/foreign-exchange-reserves

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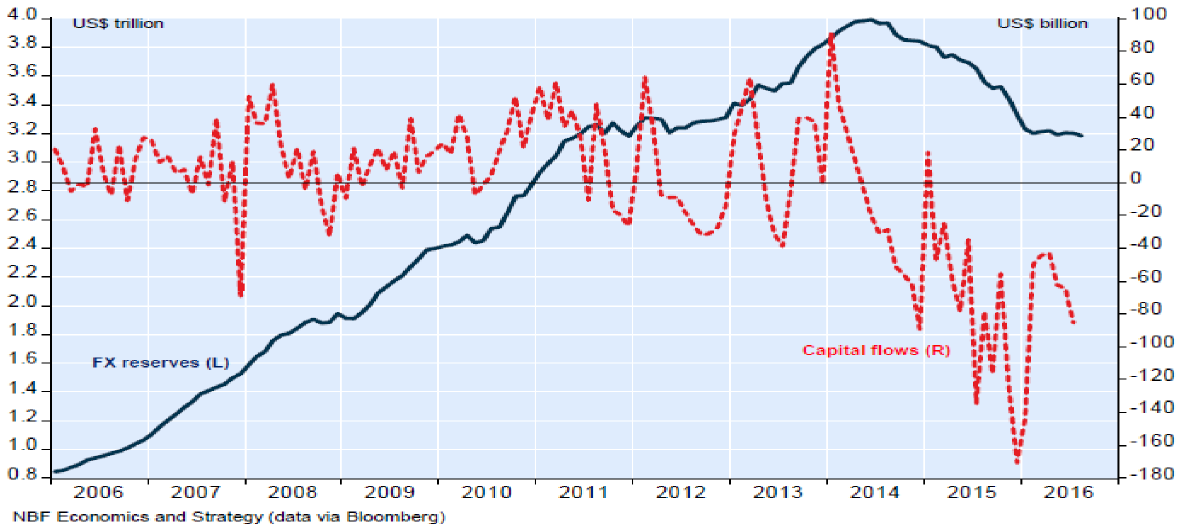
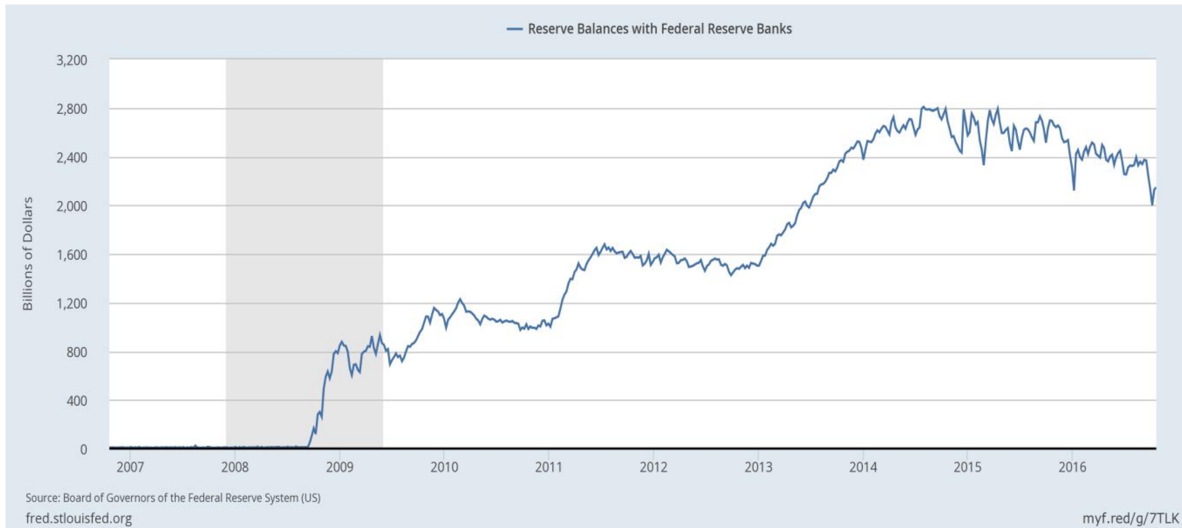


We are also closely monitoring liquidity conditions here at home. The picture here too gives cause for caution. The chart below shows the ballooning holdings of Bank Reserve balances held by US commercial banks at the Fed. Note the stair-step buildup of reserves around December 2008, November 2010 and September 2012, coinciding with QE's I, II and III.[20] Note as well how reserves have plateaued and since last December when the Fed raised interest rates (for the first time in nearly a decade)[21] bank reserves have actually begun to deplete.



[20] http://www.heritage.org/research/reports/2014/08/quantitative-easing-the-feds-balance-sheet-and-central-bank-insolvency
[21] http://money.cnn.com/2015/12/16/news/economy/federal-reserve-interest-rate-hike/

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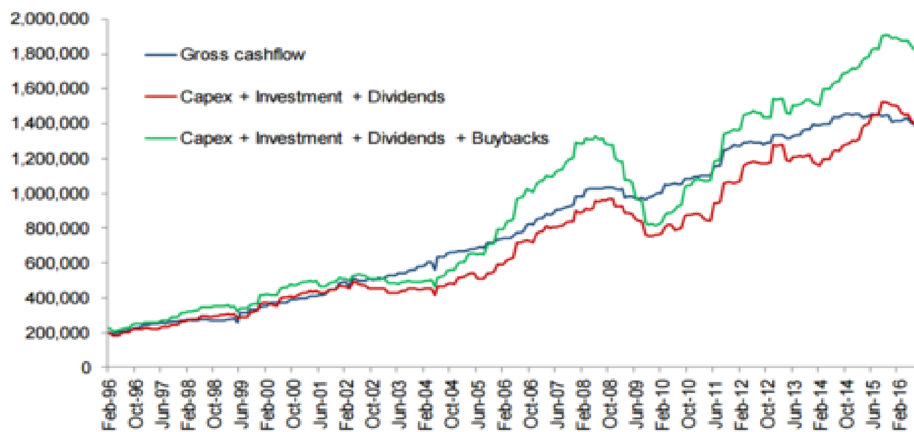
If this is indeed a portent of tighter monetary conditions, it is concerning on so many levels, but we will suggest a few. First, it has been suggested that a significant element of support for the market has been corporations buying back their own shares. And, a significant source of that purchasing power has come from bond issuance. The FT, reporting on a Goldman Sachs study, states "Between 2012 and 2015, US companies acquired $1.7tn of their own stock…counteracting sales by pension funds, foreign investors and households. Indeed, excluding corporate buybacks, net US equity flows would have been negative to the tune of $1.1tn in that period, despite inflows into exchange traded funds."[22]

And, as the inimitable Danielle DiMartino Booth recently wrote; "'From their trough in 2009, corporate earnings have been gussied up by extremely low interest expense, lower tax rates, a reduced share of profits going to labor (fell to the lowest in the post WWII period), reduced depreciation expense due to a slower rate of capital spending and massive stock buybacks,' explained (the Lindsey Group's Peter) Boockvar in a recent chat. 'Thus, the earnings recovery should be considered low quality.'"[23] Citing the above referenced Goldman Sachs study, Booth continues "Goldman Sachs figures that companies in the Standard & Poor's 500 (S&P 500) index directed nearly a third of their cash to buybacks last year. S&P looked instead through the prism of reported earnings and determined that dividends and buybacks have represented an average of 85 percent of earnings since 1998 with the two exceptions of recession years 2001 and 2008." And, in fact, "2014 clocked in as the first in which ***spending on dividends and buybacks exceeded companies' combined net income*** (emph. added). Firms' excessive enthusiasm carried well into 2015."[24] The below graph from a recent Bloomberg article depicts the situation well.[25]



[22] "US Share Buyback Bonanza is Beginning to Run Out of Steam"; FT; September 10-11, 2016; pg. 13
[23] http://dimartinobooth.com/beer_goggles_stock_market/
[24] Ibid. #23
[25] http://www.bloomberg.com/news/articles/2016-10-21/why-corporate-america-s-debt-is-a-major-risk

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There are signs that this is all beginning to reverse as corporations are running out of cash, and possible easy debt financing. The FT reports that "Corporate austerity has come as once-towering cash piles have begun to shrink, both due to falling profitability and recent shareholder generosity. Non-financial companies in the S&P 500 still sit on $825bn, but America's 50 wealthiest companies account for most of the nest egg. ***The median cash or cash equivalent for all S&P 500 companies shrank to $860m in the second quarter of the year, the lowest in three years*** (emph. added) ***according to Bloomberg data***."[26]

Cash flow was a lesser issue as long as companies could just issues 0% debt to finance their share repurchase program. In fact, two European multinationals, Henkel, the German laundry detergent manufacturer and Sanofi, the French drug manufacturer, recently issued corporate debt at ***negative*** yields![27] As long as the central banks cooperate, the music seems to play on. As Barron's reported, quoting Jones Trading's chief market strategist Mike O'Rourke, "'Central banks are the largest blind buyer in the world, accumulating trillions of dollars' worth of assets with no thought of price, valuation or exit strategy.'"[28]

There are signs however, that central bankers are about to become more discerning as it's becoming more and more apparent that the monetary tools available to the authorities have accomplished as much as they can and are arguably creating unintended consequences at this point. Amid cries from the IMF ("IMF Warns Record Debt of $152tn Poses Threat to Global Economy")[29], it appears that an attempt is underway to toss the baton over to the fiscal policy makers. How this will play out will be interesting, to say the least, and was surely best said by Yogi – it is indeed tough to make predictions, especially about the future. As noted above, growth and profits could pick up here and all will end well, but it's hard for us to see how we get there without some level of disruption to the asset markets.

Thanks for reading.

Regards,

Jason

[26] Op. cit. #22
[27] "Negative Yields Pose Questions for Investors"; FT, September 10-11, 2016; pg. 13
[28] Streetwise: "A Labor Day Conundrum"; Barron's, September 5, 2016; pg. 11
[29] "IMF Warns Record Debt of $152tn Poses Threat to Global Economy"; FT; October 6, 2016, pg. 1

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U.S. STOCKS	*3Q 2016*	*YTD*
Dow Jones Industrial Average	2.78%	7.21%
S&P 500 Index	3.85	7.84
Nasdaq Composite Index	9.69	6.08
S&P Mid-Cap 400 Index	4.14	12.40
Russell 2000 Index	9.05	11.46

INTERNATIONAL INDEXES	**Total Return**	
MSCI Index	***3Q 2016***	***YTD***
EAFE (Europe, Australasia, Far East)	6.50%	2.20%
All Country World ex-U.S.A.	7.00	6.29
Europe	5.45	0.58
Japan	8.76	2.87

EMERGING MARKET INDEXES	**Total Returns**	
MSCI Index	***Q3***	***YTD***
Emerging Markets (EM)	9.15%	16.36%
EM Asia	10.64	13.31
EM Europe, Middle East, and Africa (EMEA)	5.85	18.25
EM Latin America	5.41	32.49

GLOBAL BOND INDEXES **Index**	**Q3 2016**	**YTD**
Bloomberg Barclays U.S. Aggregate Bond Index	0.46%	5.80%
J.P. Morgan Global High Yield Index	5.49	15.50
Bloomberg Barclays Municipal Bond Index	-0.30	4.01
J.P. Morgan Emerging Markets Bond Index Global Diversified	4.04	14.77

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