Review & Outlook

FIRST QUARTER 2016

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Review

During the first quarter of 2016, stock prices suffered an unpleasant drop in the first half, only to experience a sharp rebound in the second. At its lowest, the S&P 500 index was a little over ten percent down by mid-February. By quarter-end, stocks had recovered, and were close to flat for the year. This pattern is similar in duration and magnitude to the decline and recovery that took place between August and November 2015, adding to the feeling that we are strapped into a fairly unsettling roller coaster ride.

Two ongoing sources of volatility in the equities markets have been plunging oil prices and the strength of the US dollar. The latter is supported, in part, by the Fed shifting to a cycle of increasing interest rates. The low price of oil placed significant pressure on energy companies and petro-state sovereign wealth funds to shore up financial positions. One short-term source of funds (particularly for sovereign wealth funds, which are funds controlled by Saudi Arabia, Norway, and other oil producing countries) was their holding of US stocks. Once oil dropped below $45 per barrel in price, the correlation between the price of oil and the S&P 500 increased dramatically, with the two low points in the S&P 500 index matching the low points in the price of oil (Jan. 20 & Feb. 11). The pressure on stock prices has eased, as the price of oil has recently rebounded.

Market Index Performance Data: Total Return (%)[1]

Index	As of 3/31/2016 Q1 2016	As of 3/31/2016 Trailing 12 Months
S&P 500 Index	1.35%	1.78%
Barclay's Capital Intermediate-Term U.S. Government/Credit[3]	2.45%	2.06%
Barclay's Capital U.S. Treasury 1-3 Years	0.90%	0.92%

The S&P 500 index had a total return of 1.35% for the quarter, and the yield on 10-year US Treasuries was 1.78% at the end of March. The Federal Reserve raised interest rates one quarter percent in December 2015, with the view that key measures within the US economy were improving. At that time, the 10-year Treasury rate was 2.30%.

Counterintuitively, from the time the Fed moved in December 2015 until Feb. 11, 2016, the 10-year yield actually decreased over half a percent, and remains well below two percent today. Part of the explanation is that the US cannot separate itself from the broader global economy. While interest rates in the US continue at historical lows, in other major countries, like Germany and Japan, economies are struggling and interest rates set by their Central Banks are even lower. In comparison, US Treasuries look pretty good. This drives large flows of capital into US Treasuries, pushing up the price, with a corresponding decrease in interest rates. This flow of capital also provides strength to the US dollar. An increasingly strong US dollar has been causing volatility in the financial markets by: a) making it harder for emerging market countries to pay off $US denominated debt; b) putting further downward pressure on commodity prices, including oil, that emerging market countries and resource countries depend upon; and c) reducing reported earnings of S&P 500 companies that earn revenues in foreign currencies, but report in $US dollars, and experience a significant exchange rate loss.

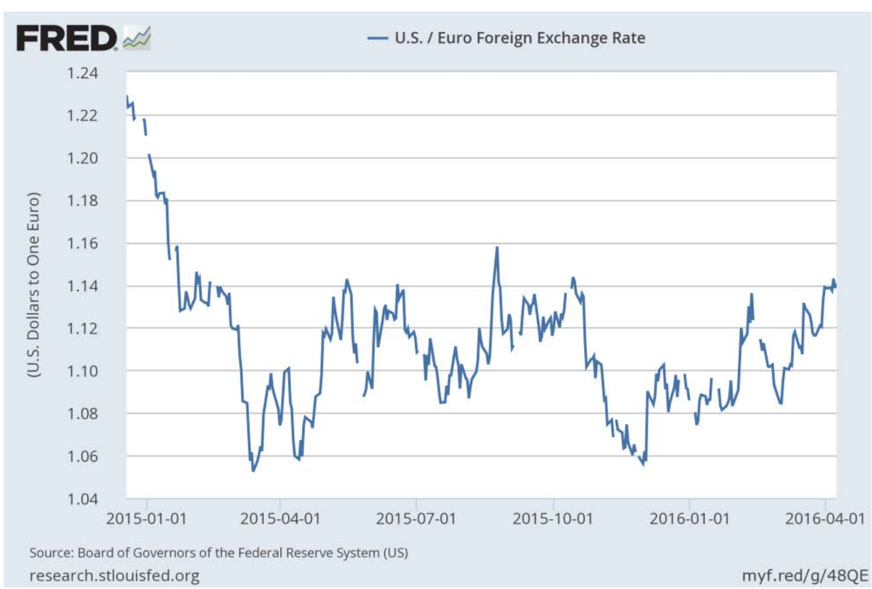
Outlook

The economy continues to grow, albeit at a historically low trend rate. The NABE (National Association for Business Economics) forecast calls for 2.2% growth in GDP in 2016, slightly below the 2.5% we saw in 2015, and a downward revision from the forecast of 2.6% presented in December. If the forecast holds in the 2% range, we will end the year with a tenth straight year of real GDP growth below 3%, a run that is unprecedented in the past century. Looking at the remainder of the year, we don't see a reason for the low trend rate growth to surprise to the upside, or the downside.

Lack of productivity and wage growth continue to be worrisome factors. Savings rates in the US are higher than in recent years, but below historical levels. Current consumer spending cannot be supported for long without additional wage growth, and this will likely require underlying increases in productivity growth.

So, how does is our economic story tied to the equity markets? After a number of years of solid gains in the equity markets, in part spurred by low interest rate policies, price increases have stalled out as valuations have reached relatively high levels and revenue growth has stalled. We don't see an obvious catalyst out of this range before year end, and it is hard to see a way higher unless productivity numbers start to rise significantly.

One potential positive factor this year is that the US dollar has remained relatively constant over the past twelve months in comparison to the Euro, and has strengthened relative to the British Pound. Approximately 7% of the S&P 500's revenues are from Europe. As a consequence, the downward pressure on earnings from currency losses last year will fall out for Europe, and should help year over year earnings growth. The Federal Reserve chart included here shows how the U.S. Dollar/Euro exchange rate has been trending between 1.14 and 1.06 since the beginning of 2015.[2] Also, low interest rates are continuing to allow corporations to buy back substantial amounts their own stock, often with borrowed money. Both points are positive in the short-term, though debt-fueled share buy-backs are troubling in the long-term.



In Focus

A number of clients have asked us how the upcoming Presidential election might affect the economy and their investments. Generally, our response is that given the high rhetoric of the primary campaigns, it is difficult to know exactly what types of policies a new administration might try to enact. We are left with imprecise speculation at this point. However, there are a few useful comments we feel are timely and worth our focus.

First, history shows no strong "party effect" where the markets fare better under republicans or democrats.[3] Second, since we are so early in the election process, and there is so much uncertainty on who might be elected and what policies they might actually pursue, the election "noise" likely has no measurable impact on the broad economy; however, there are a few industry-specific themes where we might identify an election effect.

The main industry under pressure so far is the pharmaceutical space, where remarkable price increases in pharmaceuticals over the past years have created headlines of outrage, both by commentators and politicians on both sides of the aisle. Two quarters ago, this was one theme in our "In Focus"; we argued that a war on drug prices (at least rhetorically) would persist through the election cycle, and perhaps beyond. Any policy that successfully knocks down prices, or the rate of price increases, will likely affect forward earnings projections and consequently pharmaceutical stock prices.

The IBB is an ETF (Exchange Traded Fund) that tracks the NASDAQ biotech index; it is down 15% since Secretary Clinton's famous tweet on September 21, 2015 regarding Touring Pharmaceuticals: "Price gouging like this [by Touring] in the specialty drug market is outrageous." Immediately after her tweet the IBB dropped 4.7%.

Other issues shaping the election are more general to the economy, and not specific to stock prices. In order to think about stock effects, broadly or on a sector or industry basis, one first needs to think through the economic impacts. By far the most dominant issue for both Republicans and Democrats is the past and future effects of trade deals, with Secretary Clinton, Senator Sanders, and Donald Trump all arguing that trade deals have been a bad deal for America. In particular, Senator Sanders and Donald Trump have been the most vocal on this issue, and have indisputably tapped into strong, angry sentiments held by a large number of Americans.

It is only recently that the difference between economic theory and reality has been quantified and acknowledged by the broader academic economic community. A recent, widely cited paper details how millions of American jobs were permanently lost to China, and that many of those affected never recovered, either by income or other gains, such as increased purchasing power through lower prices for consumer goods. In general, it was those with high school and lower levels of education that were most negatively affected.[4] New jobs tended to be at lower wages and many simply left the job market, with increased rates of disability payments through social security, increases in Medicaid and other government transfers tied to unemployment and low income. Theoretically, people were supposed to move to find the new jobs, but, in general, they did not. This paper confirms what everyone already knows.

An aggressive move to roll back trade agreements could potentially have a negative impact on the economy and the earnings of many publicly traded companies. The consequence of increased tariffs would likely be some price inflation and a decrease in GDP, perhaps pushing a long run of low growth into a recession. Even if tariffs did create incentives to move more manufacturing back to the United States, it is likely that new manufacturing facilities would be highly automated, ultimately not creating very many new jobs compared with the output produced.

How current, widespread anger will translate to policy change and legislation by elected officials is not clear. Our view of the most realistic path forward will likely be a combination of strengthened language in trade deals on minimum environmental and labor standards, and a number of new support programs to help affected American workers, both through income supplements and retraining. For example, in his 2016 State of the Union speech, President Obama raised the idea of "wage insurance", where if a person loses a job, retrains, and even then receives a lower wage, "… there should be a system of wage insurance in place so that he can still pay his bills."[5] There are indications that this could achieve some bipartisan agreement.[6]

To date, we see nothing that makes us think we need to make changes to our clients' portfolios based on the expected outcome of the election. The ongoing dysfunction between executive and legislative branches, in part, creates a buffer by favoring the status quo. Nevertheless, while we believe there is nothing currently troubling enough to warrant strategic changes to your investments, we are paying more attention than usual this election cycle.

1. S&P 500 Data: http://us.spindices.com/indices/equity/sp-500. Barclay's Index Data: https://index.barcap.com/Benchmark_Indices/Aggregate/Bond_Indices.
2. Board of Governors of the Federal Reserve System (US), *U.S./Euro Foreign Exchange Rate* [DEXUSEU], retrieved from FRED, Federal Reserve Bank of St. Louis https://research.stlouisfed.org/fred2/series/DEXUSEU, April 12, 2016.
3. https://blogs.cfainstitute.org/investor/2012/08/31/weekend-reading-does-the-us-presidential-election-affect-the-stock-market/
4. Autor, David H.; Dorn, David; and Gordon H. Hanson. (February 2016) "The China Shock: Learning from Labor Market Adjustment to Large Changes in Trade. NBER Working Paper No. 21906. http://www.nber.org/papers/w21906.
5. https://www.whitehouse.gov/the-press-office/2016/01/12/remarks-president-barack-obama-%E2%80%93-prepared-delivery-state-union-address
6. http://www.nytimes.com/2016/03/13/upshot/how-wage-insurance-could-ease-economic-inequality.html?_r=0