Insights: August 2016

Market Overview and Performance

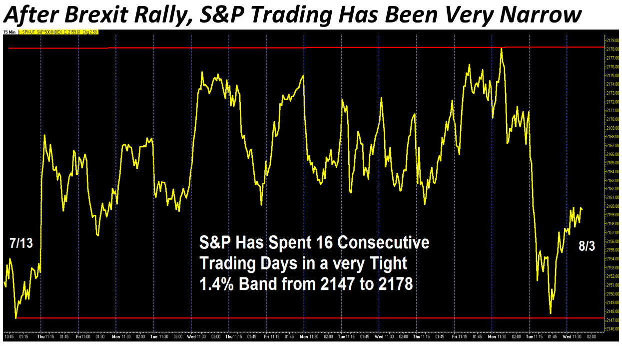
In what proved to be an unexpected outcome to many, the S&P 500 Index closed out July with a positive return of 3.6% while at the same time the yield on the benchmark U.S. 10-year Treasury note hit all time lows indicating a demand for safe haven assets. After some brief volatility following the Brexit vote at the end of June, stocks rallied for the fifth consecutive month (for the first time in two years) and actually marked a new all time high for the first time since May of 2015. But rallies of this sort are typically fueled by strong corporate earnings, a booming economy and reasonable valuations. However, none of those conditions are currently in place and the bond market continues to flash warning signals that all is not well. What gives? In short, the easiest answer is that interest rates and monetary policy globally have left investors with few alternatives. Consider for a moment that $13 trillion of global sovereign debt now sports a negative yield. Just 20 years ago, a portfolio of 100% bonds would return 7.5% whereas today, you would need to triple the volatility to theoretically achieve that return. This does not sit well with many, ourselves included. Since May, well respected voices from the investment world including Stan Druckenmiller, George Soros, Carl Ichan, Jeff Gundlach and Bill Gross have all publically issued warnings suggesting that risk assets are looking extremely vulnerable. The list of concerns in our minds is long and getting longer as we will discuss in our letter this month, but as Nicholas Colas at Convergex reminded us recently. “Never argue about markets with a guy who is much richer than you…successful investors are always more plugged in than the market as whole.” As always, thank you for reading our latest Insights.

	Month to Date	Year to Date
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	3.69	7.66
Russell 2000 Index	**5.97**	8.32
MSCI EAFE Index	5.07	**0.42**
MSCI Emerging Markets Index	5.03	**11.77**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	0.63	5.98
Barclay's U.S. Credit Index	1.31	8.95
Barclay's Corporate High Yield Index	2.70	**12.01**
Barclay's Municipal Bond Index	0.06	4.40
Macro Measures		
Gold	2.79	**27.97**
Crude Oil	**-13.93**	12.31
CBOE Volatility Index	**-24.06**	**-34.82**
USD Dollar Index	-0.46	-3.27

July Themes – Stocks and Bonds Both Climb Higher; S&P 500 Settles into a Historically Tight Trading Range; Oil Enters a Bear Market; Corporate Earnings Deteriorate; GDP Disappoints; European Banks Looking Increasingly Worse; Entering the Most Volatile Months of the Year

Here is the list – 1) A major global economy leaves the EU; 2) Dramatically disappointing first half U.S. GDP; 3) Corporate earnings fall for the 5Th straight quarter; 4) Oil falls by over 20 percent; 5) Global bond yields close to zero or negative; 6) European banks appear close to crisis mode; 7) Stock valuations well above long-term averages; 8) Political acrimony as elections across the globe begin this Fall; 9) A Federal Reserve whose outlook for policy no one believes; 10) Global growth is slowing and central banks are running out of policy options. 10 is a nice round number so we will stop there, but the message is clear. Curious then that the S&P 500 would set a new all-time high in July.

After Brexit Rally, S&P Trading Has Been Very Narrow

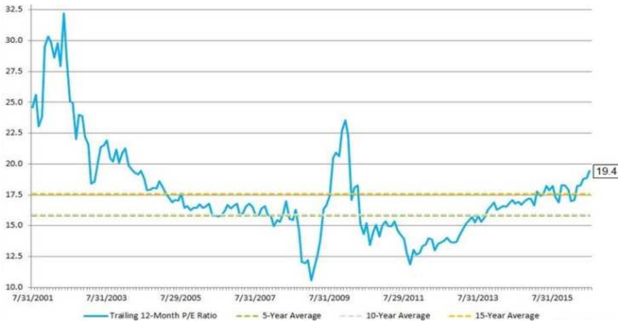


Source: Thomson Reuters

There is an old adage that markets climb a wall of worry and in general a certain level of pessimism is a healthy sign since Bull markets tend to die in a throw of euphoria rather than in a sea of doubts. But the current situation is unusual for a number of reasons. After a relief following the Brexit vote that showed indications of being driven by short covering, the S&P 500 settled into a narrow trading range – very narrow. For 16 trading days beginning on July 13th, the Index was stuck in a 1.4 percent band. For 13 of those days it only moved within a band of 0.74 percent the tightest range since November of 1972 according to LPL Research. That kind of statistic is interesting but what does it mean?

Obviously, it has to be put in context. When a market trades up to new highs and then stalls out investors view this as a decline in conviction and an increase in uncertainty about the future. This is not surprising as the market appears to have "overshot the mark" in some regard. For example, on August 1st, Bloomberg's survey of 20 Wall Street strategists showed an average year end target of 2146. The S&P closed at 2170 that day. Strategists simply aren't seeing evidence of the underlying fundamentals necessary to drive prices higher. And this is a group of people that are paid to be optimistic about stocks. To their credit it is hard to ignore the fact the equity valuations are now some 25-30 percent above long-term historical averages.

The Rise Has Pushed Stock Valuations to Elevated Levels



Source: Factset

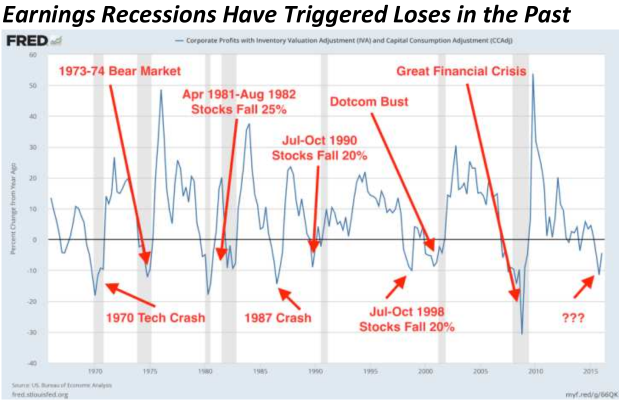
There have been some other unusual quirks from the most recent trading period, things like the fact the Dow Jones Industrials Average traded down for 8 of 9 days, including 5 straight down days while the Nasdaq traded up for 5 straight. These kind of patterns have only been seen at prior cycle tops including 1987 and January 2000.

Earnings Results and Outlook Continue to Deteriorate

Source: Gerring Capital Partners; Standard & Poor's

Again, these facts by no means tell you what *will* happen, however they are indicators of pivot points during past markets which can help with conclusions about future changes in price. High stock prices in themselves are not a bad thing, but growth is driven by earnings and as the previous chart clearly shows, earnings are contracting. In fact, this is the 5th quarter in a row where we have seen earnings declining – an earnings recession. The last time that happened was Q3 2008 through Q3 2009 which happened to have been the Global Financial Crisis. Things are not estimated to improve either. Full year operating earnings were $118 in 2014, $116 in 2015 and estimated to be $115 in 2016 that includes an assumption for a huge snap back in Q4. As the chart below illustrates, earnings recessions have frequently preceded sharp declines in stock prices.

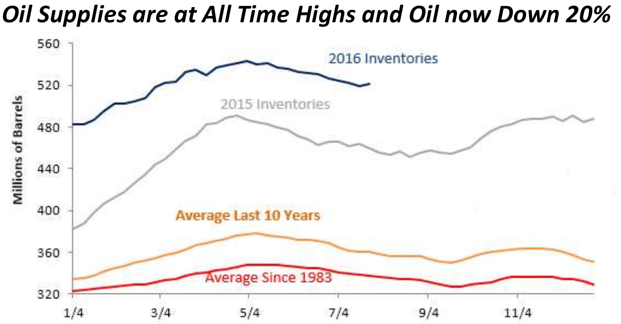
Earnings Recessions Have Triggered Loses in the Past



Source: The Felder Report; US Bureau of Economic Analysis

Another unsettling development this month has been the 20 percent fall in the price of oil. Oil has enjoyed a strong rebound this year, but the sudden drop from $50 to $40 in July has investors worried about global demand softening. This is a legitimate concern given the chart below.

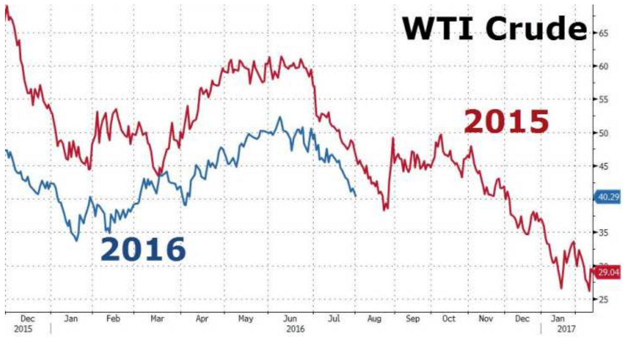
Oil Supplies are at All Time Highs and Oil now Down 20%



Source: Bespoke Investment Group

We were discussing the possible implications of oversupplied conditions in May of 2015 and as you can see from the previous chart, 2016 inventories are significantly above those levels. Beyond the high absolute levels of oil sitting in barrels there is the worry over the trend. Summer is usually a very high demand period that draws down on inventories before a sharp reduction in demand around Labor Day. That has not taken place this year and many fear that we are heading for a repeat of 2015 when slowing global growth pulled down demand.

Path for Oil in 2016 is Looking Very Similar to 2015



Source: ZeroHedge.com

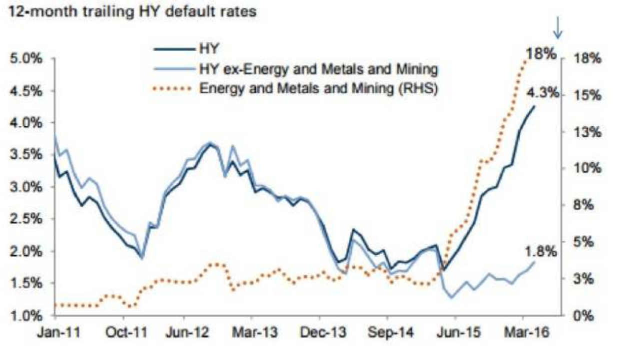
If that happens again and the price of oil stays below $40, a bigger risk this year is the potential for an increase in defaults from the $1.5 trillion high yield space, 17 percent of which comes from the energy sector according to Fitch. As the chart below shows, high yield and oil have been closely correlated since the start of 2015. However, when oil began to roll over at the start of July, high yield bonds continued their climb higher. Many have highlighted this divergence as a major relationship to watch particularly this year when the peak summer driving season seemed to do little to dent the supply overhang.

Correlation Between Oil and High Yield has Broken Down

Source: macro-man.blogspot.co.uk

Some like Goldman Sachs, have suggested that this process is already underway. While the trend has been in place since last summer, large bond investors like Jeffrey Gundlach have observed that default rates are now breaking out, certainly within the energy space, but now outside of the oil patch as well.

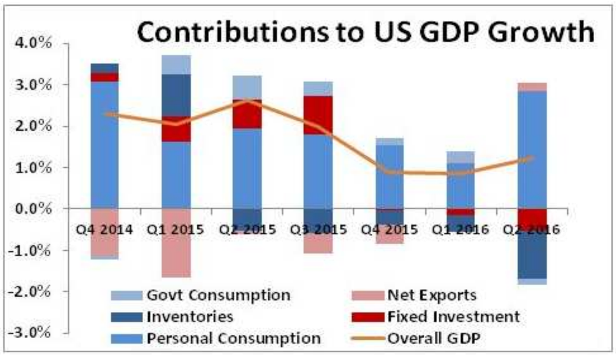
Default Rates are Now Moving Higher in High Yield



Source: Goldman Sachs Global Investment Research; Moody's

In a booming economic environment, creeping default rates could be somewhat forgiven, however, the third disappointment we saw in July was the reporting of Q2 GDP growing at just 1.2 percent.

Q2 GDP Was a Big Disappointment – Growth Stalling

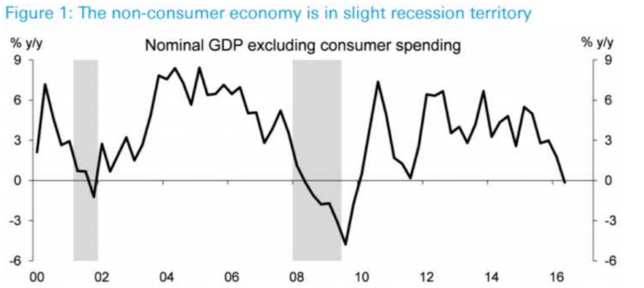


Source: Bloomberg

Consensus was for growth to be 2.6 percent so a wide miss. To make matters worse, Q1 growth was revised down to just 0.8 percent and Q4 2015 down to just 0.9 percent. In other words, since last September the economy has stalled from the decent growth rate of 2.2 percent from 2012-2015 down to a worrying 1 percent rate. Given the amount of stimulus that has been injected into the system over the last few years, this seems like it should not be happening. So, what is driving the change?

In short, the only thing that is keeping the economy growing at all is the consumer. As the chart below from Deutsche Bank shows, when you exclude consumer spending from GDP calculation, the numbers are recessionary.

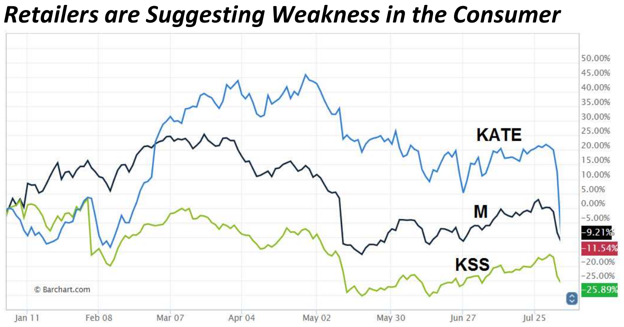
Taking Out the Consumer, the Economy is Contracting



Source: Business Insider; BEA; Haver Analytics; Deutsche Bank

We included a chart last month that showed that business investment is now in decline which typically coincides with a recession. In Q2, business investment shrank again by 2.2 percent. Furthermore, companies reduced their inventory levels for the fifth straight quarter. The last time business inventory-to-sales ratios were at there current levels was in 2000 and 2008. These are not good developments. Additionally, July delivered other discouraging news like construction spending falling to its worst levels since 2011 and factory orders falling for the 20th straight month. As you can see from the big blue bars in the GDP chart, the consumer is doing their part to hold up the bargain, unfortunately July also brought us some signs of fraying on that front as well. Durable goods orders were down -4 percent in June, restaurant spending was down, auto sales which had been on a five year growth tear contracted in July, and finally, forward guidance from earnings by retailers like Kate Spade, Macy's and Kohl's did not paint a good picture.

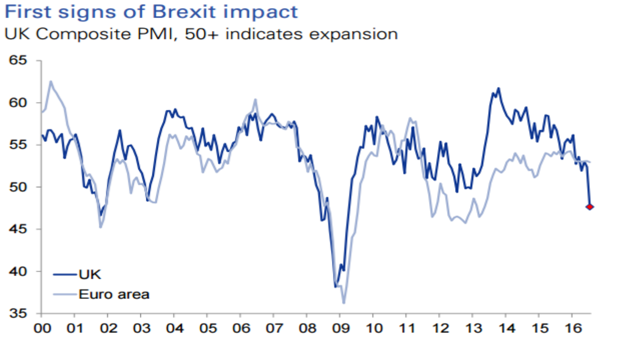
Retailers are Suggesting Weakness in the Consumer



Source: Bloomberg

We are not convinced that the U.S. has entered a recession but the warnings signs for a slowdown are becoming more alarming. And unfortunately, the U.S. economy as a whole is perhaps the strongest in the world right now. Over in Europe, conditions have not improved, and in fact, are getting worse.

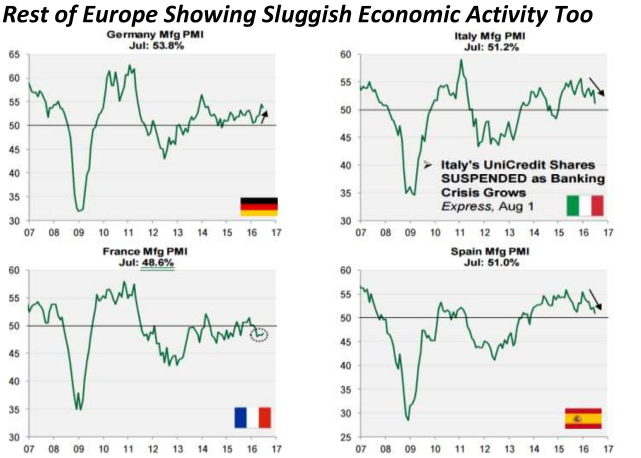
Brexit Consequences Being Felt Immediately in the UK



Source: Goldman Sachs Global Investment Research

As we said last month, the Brexit vote would throw the U.K. economy immediately into recession. Just a month after the vote, the impact is already being felt. As the chart above from Goldman Sachs highlights, business activity in the U.K. is now contracting sharply. Additionally, that activity has historically correlated tightly with that of broader Europe. While the measure for the Euro area has not been impacted as dramatically, indications from major economies like France, Italy and Spain have not been good and look to be trending lower. Sadly, terrorism seems to be playing a role here as well as anecdotal evidence such as Paris hotel occupancy rates have fallen sharply.

Rest of Europe Showing Sluggish Economic Activity Too



Source: Cornerstone Macro

As we discussed in detail in our July Insights letter, the environment surrounding banks in Europe is worrisome. There was hope that the results of the stress tests conducted by the European Banking Authority would reassure investors. Unfortunately, while all banks but one (Banco Monte dei Paschi) met the reserve requirements, the results in fact fostered greater concerns. As a result, European bank shares fell sharply on the day of the report release.

European Bank Stress Tests Not Well Received

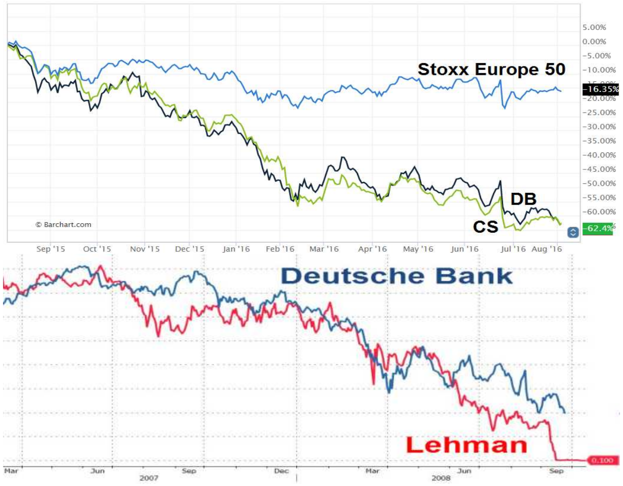
Security	Ticker	Name	%Chg↓
EUROB	GA	Eurobank Ergasias SA	-17.89
UCG	IM	UniCredit SpA	-15.27
UBI	IM	Unione di Banche Italiane SpA	-14.24
PMI	IM	Banca Popolare di Milano Scarl	-13.91
BP	IM	Banco Popolare SC	-13.86
BKIR	ID	Bank of Ireland	-13.16
BPE	IM	Banca Popolare dell'Emilia Rom	-12.53
POP	SQ	Banco Popular Espanol SA	-10.47
BMPS	IM	Banca Monte dei Paschi di Sien	-9.83
CBK	GY	Commerzbank AG	-9.10
SAB	SQ	Banco de Sabadell SA	-6.87
DBK	GY	Deutsche Bank AG	-6.80
SAN	SQ	Banco Santander SA	-6.71
MB	IM	Mediobanca SpA	-6.61
BBVA	SQ	Banco Bilbao Vizcaya Argentari	-5.52
ISP	IM	Intesa Sanpaolo SpA	-5.15
RBI	AV	Raiffeisen Bank International	-4.63
EBS	AV	Erste Group Bank AG	-4.27
BKIA	SQ	Bankia SA	-3.98
CABK	SQ	CaixaBank SA	-2.79
BNP	FP	BNP Paribas SA	-2.64
BKT	SQ	Bankinter SA	-2.32
GLE	FP	Societe Generale SA	-2.29
ACA	FP	Credit Agricole SA	-2.01
BCP	PL	Banco Comercial Portugues SA	-1.46

Source: Bloomberg

Even the announcement of rescue plan for Monte dei Paschi that included shifting its entire $31 billion dollar portfolio of non-performing loans into a securitization vehicle could not distract from the core problem. Namely, that the tests did not include the potential impact from the U.K. leaving the European Union or a prolonged period of zero or negative interest rates. Even if one assumes no negative repercussions from Brexit (unlikely), if rates stay low, interest income for the banks will do little to help their capital base and their financial position will deteriorate further. Additionally, on the same day the stress test results were released, Deutsche Bank and Credit Suisse were removed from the Stoxx

Europe 50 Index, the blue-chip index for European stocks, and Commerzbank warned on profits and the impact of a negative interest rate environment. Investors took notice and continued to sell with Deutsche Bank hitting a new all-time low.

Deutsche Bank and Credit Suisse Still Collapsing



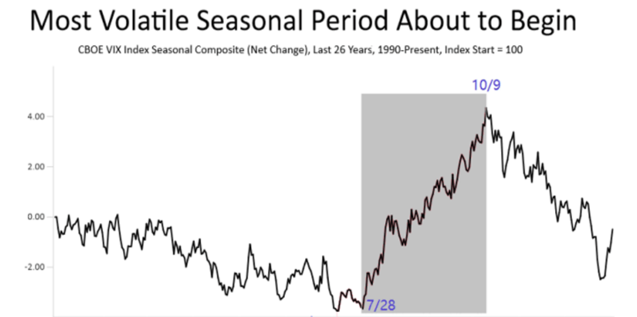
Source: barchart.com; ZeroHedge.com

As we discussed last month, there is a systematic problem here. The European Union has no mechanism in place to address financial distress on a continent-wide basis. Italy is currently the eurozone's weakest link with banks badly in need of capital, a weak economy and an increasingly divisive political environment. Yet under the current system there is basically a "no bailout" clause, and Italy is simply too big to fail. The country has $2.2 *trillion* of public debt, 10 times that of Greece according to Nouriel Roubini.

Something has to change and there were hopes that the stress tests would scare leaders into action. That appears unlikely however with elections in France, the Netherlands and most importantly Germany coming in 2017. In light of those events on the horizon, there is little enthusiasm for leaders to move toward common ground that is unpopular with their voting populace. Essentially, on the German side, there is the desire for the European Union to function more like a club whose members agree to the same set of rules while operating independently. In the Italian and French view, countries within the union should share the risks across borders under a banking union that would share supervision and resolution powers. (This was actually agreed to in 2012 during the last crisis, but was never implemented). So the stand-off continues while the risks only increase.

This obviously is a big part of why we think more volatility lies ahead and August just happens to be a historically common time for bad things to happen. According to Tom Lee at FundStrat Global Advisors, the S&P 500 has fallen an average of 6 percent in the month of August since 2009. Going back further to 1980, August and September are the only two months to have negative average returns according to Factset. Additionally, Nautilus Investment Research found that over the last 26 years, the most volatile period for markets was clearly the window from the end of July until the start of October.

Pullbacks and Increased Volatility Arrive in August



	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEP	OCT	NOV	DEC
Rank	7	6	9	11	8	5	3	1	2	4	12	10
Average	-0.193	-0.177	-0.519	-0.934	-0.309	-0.170	0.939	1.74	1.57	-0.254	-1.38	-0.747
# Up/Down	12/14	13/14	10/17	11/16	10/17	13/14	15/12	14/12	13/13	14/12	9/17	13/13
Significance	-60%	-58%	-79%	-91%	-65%	-58%	86%	94%	94%	-56%	-95%	-80%

Source: Business Insider; Nautilus Investment Research

Given the current macro environment, we don't see any reason why this won't hold true this year as well.

Going Forward

Our outlook has not varied this month despite the rally to all-time highs in U.S. equities. As we approach the historically volatile August and September period, we feel that the likelihood of a pull-back is now more elevated than at any time in recent memory. The issues surrounding European banks continue to become increasingly more concerning. Additionally, the economy data in the U.S., the most appealing option in a low return environment, appear to be telling us that growth is slowing - all at a time when equity valuations are expensive on a historical basis. As a result, we are positioned defensively in our portfolios in anticipation of a decline that we feel will present a good re-entry opportunity for gains toward the end of the year.

Within equities we continue to favor the large cap segment of the U.S. market. Traditionally defensive sectors such as utilities, consumer staples and telecommunications that have dominated market performance in 2016 remain very expensive in our view. Conversely, we feel that the risk/reward proposition in the technology, consumer discretionary and financials sectors is much more appealing due to their lower valuation and higher growth rates.

Outside of the U.S., we have for quite some time argued for an allocation to Europe based on its improving economic environment broadly and the extremely accommodative measures of the European Central Bank. In light of Brexit and more importantly, the banking issues across the continent, we are less constructive on the area and will be looking to reduce exposure. Japan continues its efforts at reforms that are risk-asset friendly and the announcement of fresh stimulative measures announced in both July and early August have boosted investor confidence in the region.

After an extended period of underperformance, emerging markets are becoming more of an interest. As a group they have performed well in 2016 rising almost 12 percent, however headwinds remain in place. Most notably, slowing growth in China combined with slowing growth in Europe and the U.S. could quickly reverse those gains so we prefer to monitor further before increasing exposure.

Traditional fixed income is now very expensive relative to history as a result of the demand dynamics we have discussed. However, we do think it is prudent to maintain exposure to bonds in an uncertain environment. In a rising interest rate environment, we place our emphasis on less interest rate sensitive options available with shorter duration exposures and unconstrained strategies as a focus. We continue to favor our explicit exposure to the muni markets which has provided stable returns in a volatile year.

With regard to commodities, as we have discussed, the oil market is suffering from oversupplied conditions and prices of the commodity have already moved into Bear market territory (-20%) as a result. We think there is more weakness to come and therefore do not favor the sector for time being. Thus far in 2016, gold has been the one asset class to both serve its purpose as a diversifier and provide attractive returns. Given the macro outlook, we are not buyers of gold for fundamental reasons however we have maintained a small position in certain portfolios as a hedge which has performed well year to date.

Thank you for taking the time to read our thoughts and opinions on the markets this month and we look forward to speaking with you soon.