Insights: September 2016

Market Overview and Performance

August has come and gone and no one seems to have noticed much. To characterize the month as quiet would be an understatement. In fact, it was a historically tranquil period. Both stocks and bonds were virtually unchanged, trading volumes were extraordinarily light and volatility remained suppressed. For lack of anything better to highlight, most financial news outlets simply wrote stories about how "complacent" the environment appears. However as history has shown, complacency can be a precursor to unexpected events which frequently prove to be unpleasant. As we have discussed in our Insights letters throughout the summer, we feel that the potential for a reversal of these calm conditions is particularly elevated. Even though the price movements of most asset classes were muted during the month, fundamental factors actually deteriorated noticeably in August. Most concerning is the increased evidence that global growth is slowing and that the U.S. economy is contributing to that slowing trend. On top of that disconcerting development, there is the growing realization among many market participants that central banks are running out of options to stimulate economies after seven-plus years of trying. If you are Janet Yellen, this is certainly not what you want to see at a time when you are trying to raise interest rates in order to buffer the effects of the *next* downturn. With a busy economic calendar and weak seasonal factors, September looks to be setting up for a bit more excitement than we saw in August.

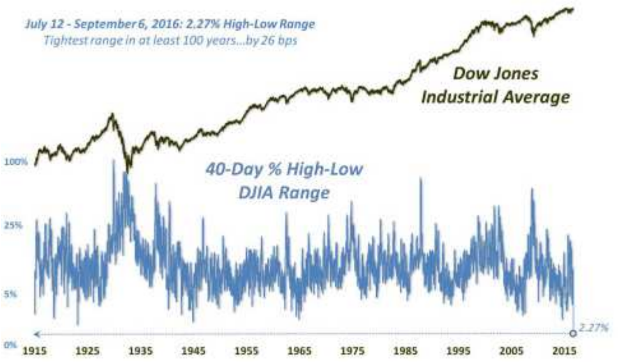
As always, thank you for reading our latest Insights.

	Month to Date	***Year to Date***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	0.14	7.82
Russell 2000 Index	1.77	10.23
MSCI EAFE Index	0.07	**0.49**
MSCI Emerging Markets Index	**2.49**	**14.55**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	-0.11	5.86
Barclay's U.S. Credit Index	0.20	9.16
Barclay's Corporate High Yield Index	**2.09**	**14.35**
Barclay's Municipal Bond Index	0.13	4.54
Macro Measures		
Gold	-3.40	**23.62**
Crude Oil	7.45	20.68
CBOE Volatility Index	13.06	**-26.30**
USD Dollar Index	0.49	-2.79

August Themes – August was Historically Quiet – Markets are Complacent; U.S. Economic Data Disappoints; Stocks Diverge from Fundamentals – Valuations are Stretched; Signs of Stress from the Credit Markets; Global Growth Appears to be Slowing; Central Banks Running out of Options

Last month, we started out our monthly letter with this list outlining the current state of affairs: 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. A month later the concerns surrounding the consequences of these developments certainly have not diminished and in fact, more worrisome trends have emerged. However, the market in general reacted with a seemingly "nothing to see here" posture.

Tightest 40 Day Trading Range in Over 100 Years



Source: J Lyons Fund Management

As the chart above highlights, not only was August a quiet month, it was *historically* quiet. Unbelievably, the Dow Jones Industrial Average spent 40 days (the streak is still going) trading within a very tight 2.2% band. That is the narrowest period for stocks in over 100 years according to J Lyons Fund Management. Similar streaks were observed in the trading action of the S&P 500 and other indices. And it wasn't just stocks. The 10 Year Treasury note spent the month locked in a trading range of less than 20 basis points, the smallest level since 2007 according to Barclay's Research.

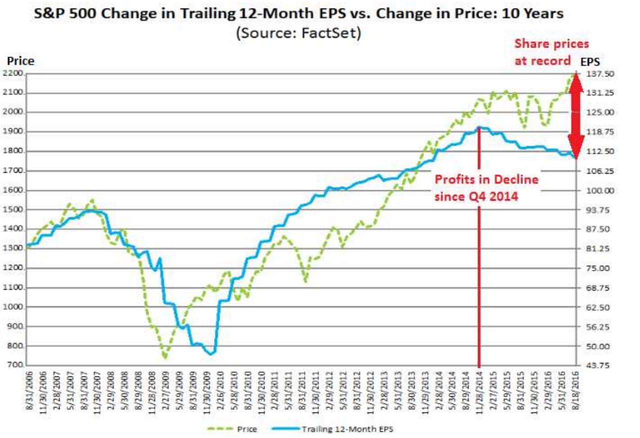
As a result, stocks have now floated up to near all time high levels on very light volume. This is concerning to many. August sluggishness can frequently be brushed off as merely the consequence of summer vacation time, but when the quiet persists for a remarkably long time as it has now on declining volume, it is often an indication of a lack of conviction in the market. In fact, Baron's Magazine just published their Wall Street strategist survey and the mean expectation was for the S&P 500 to end the year at 2138 – we are currently trading at 2180. The last time this consensus reading was below the actual market level was in 2002 when the market fell sharply.

Stock Valuations Well Above Historical Averages

Source: Morgan Stanley

A quiet market in and of itself is not necessarily a bad thing, but one of the larger issues is that prices have risen while earnings have not. As a result, the S&P 500 now trades at close to 19 times estimated 2016 earnings. That is roughly 35 percent above the median level experienced over the past 40 years according to Morgan Stanley. Clearly history, and even the chart above, tells us that valuation levels being high doesn't mean that they cannot go higher – and stay that way for a while. However, one of the market divergences that is becoming more and more clear is the relationship between stock prices and earrings. If earnings are growing sufficiently the market will determine what the correct price level investors are willing to pay for that growth regardless of whether that price is "high" or not. Essentially, stocks can climb higher on both earnings growth and multiple expansion (the ratio of the price paid for earnings). Things ebb and flow, but over time, stocks tend to follow earnings. That is simply not the case right now. In fact, as the graph below from Factset illustrates stock prices have been decoupling from earnings since the fourth quarter of 2014 and if we zoom in to the most recent quarter, earnings estimates are still declining while stocks move higher.

Earnings Continue to Decline While Stocks Rise



Source: Factset

Eventually, the relationship between prices and earnings will revert, but one could easily point out that its been roughly two years running now so what's to say it won't continue? To answer that question, we have to look at other indicators and this summer has also produced some additional divergent relationships between stocks and other metrics.

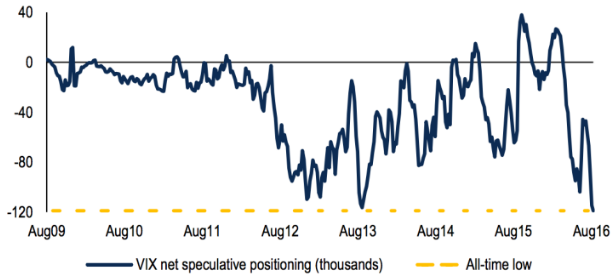
Declining Inflation Expectations Not Good for Stocks

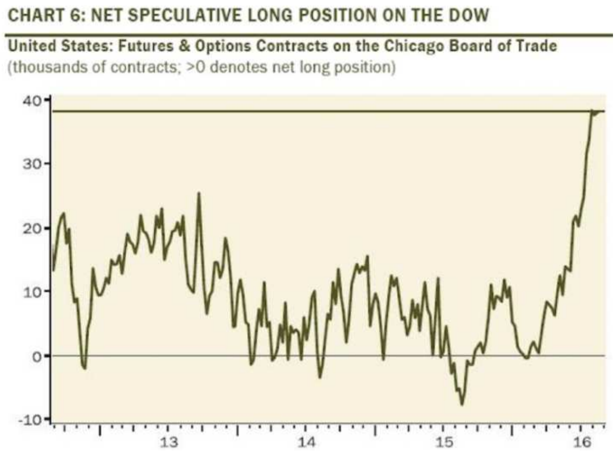
Source: Bloomberg

In large part, the summer rally in stocks can be attributed to the notion that the Fed will keep interest rates lower for longer. But inflation expectations have not been playing along with that narrative as the chart at the bottom of the previous column illustrates. Inflation expectations are highly correlated with risk. Theoretically, if the Fed keeps rates low, inflation expectations should move higher based on the belief that demand will increase fueling growth and pushing stocks higher. But right now, we have exactly the opposite happening – inflation expectations continue to move lower (significantly below the Fed's preferred target of 2%), a move that has been a harbinger of stock price declines in the past.

As we said these distortions can persist for longer than one might think, however, market positioning has moved out to worrisome extremes adding fuel to the notion that a reversion may be approaching. As the two charts below indicate, short positons on volatility via the CBOE VIX Index - meaning that traders expect volatility to go *lower* - and long positions on the Dow - meaning that traders expect stocks to move higher – are at levels not seen before.

"Short" Bets on VIX and Long Bets on Dow at Extremes

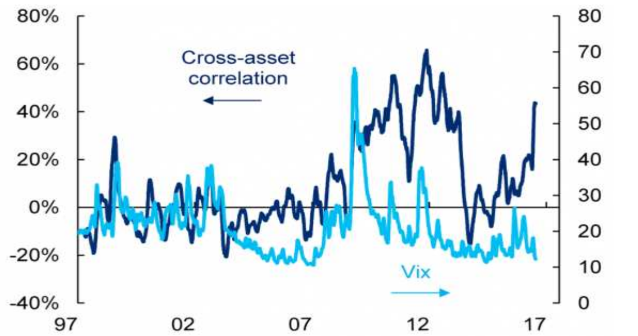




Source: BofA Merrill Lynch; Glushkin Sheff; Haver Analytics

What this means is that essentially everyone is on the same side of the boat so to speak – and it's the "risk-on" boat that has been sailing all summer. When positioning becomes heavily one sided, it is often a sign of changes to come. When that happens and people are caught off guard, positions will be unwound quickly which has many worried at the moment. This is particularly troublesome given the information in the chart below. While volatility has been extraordinarily low, cross-asset correlation has been spiking higher. What this means is that a multitude of assets – stocks, bonds, commodities, currencies, etc., are all moving in the same direction at the same time. Not such an issue when things are moving higher, but a very big problem when selling begins.

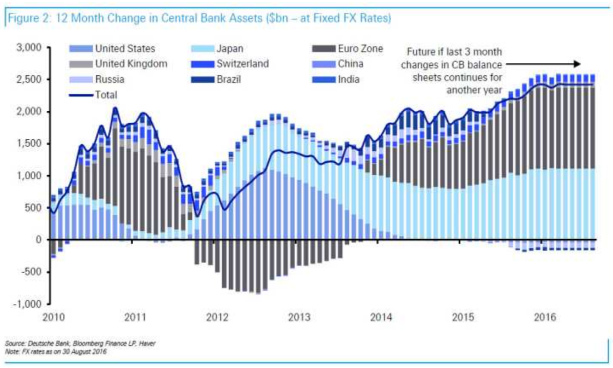
Cross Asset Correlation Moving Dramatically Higher



Source: Citi Research

The reason this is occurring is contained in the chart below. Central Banks have become the "only game in town" purchasing huge amounts of assets ($2.5 trillion) and forcing investors to make buy or sell decisions based on policy actions rather than on fundamental investment metrics.

Central Bank Asset Purchases Now Over $2.5 Trillion



Source: Deutsche Bank; Bloomberg; Haver Analytics

Investors can't be blamed for this. There are now over $13 trillion worth of assets with negative yields. In fact in Europe this week, corporate bonds were issued by companies like Sanofi, a French pharmaceutical maker, with negative yields – you have to pay them to hold their bonds. This is a real shift. Despite the craziness of it, its one thing to buy the bonds of a sovereign country with a negative yield. It's quite another to have that kind faith in the credit of an individual company. Unbelievably, Bank of America has suggested that junk-rated companies like auto maker Peugeot whose bonds yield close to zero now will soon go negative as well. High yield bonds in the U.S. yield over 6.5% to compensate for risk. This is obviously a huge distortion in the market's pricing mechanism.

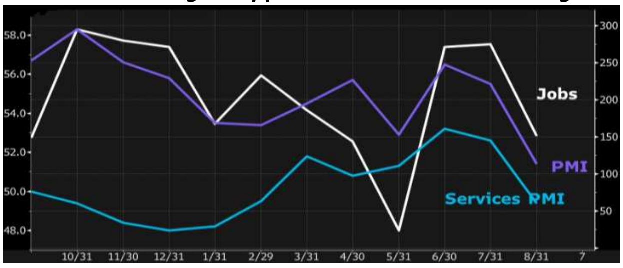
Default Rates are Now Moving Higher in High Yield

Source: Zerohedge.com

As central bank asset purchases continue to balloon, the creeping feeling that there really is no global recovery has begun to take hold. Intervention by Central Banks is meant to inflate asset prices and stimulate economic growth, but as the chart above shows, growth remains elusive which means that record levels of stimulus could in reality be telling us that growth has in fact unfortunately never been weaker. And with the economic data released in August, it is now clear that global growth is slowing. Global PMIs, an indicator of economic activity, faltered last month and are closing in on contractionary levels. In business cycle terms, low economic growth and low inflation have held down earnings which leads to decreased investment spending and employment cuts. This in turn leads to recession. As we have said before, that is not our U.S. base case, but there are several major economies like Saudi Arabia, Russia, Canada and Brazil that are presently experiencing negative GDP.

In general, economic growth in the U.S., although tepid, has proved resilient enough to offset periodic weakness in other parts of the world. August was particularly worrisome from that standpoint given that economic data presented evidence of a slowing growth trend here as well.

Q2 GDP Was a Big Disappointment – Growth Stalling



Source: Bloomberg

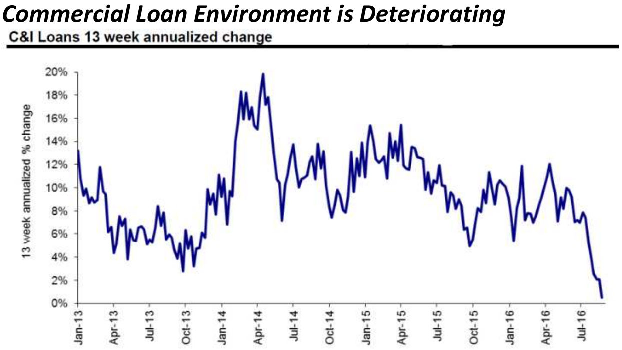
Surprisingly, August delivered a series of consistently disappointing reports on the state of the economy in the U.S. Most notably as the chart above shows, job creation, manufacturing activity and services activity all contracted, catching investors off guard. In particular, the composite reading of both manufacturing and services activity fell to the lowest level since January 2010 and the monthly decline was the worst since November of 2008. That is not all. Consider the additional economic developments that came to light in August: durable goods orders were negative year over year (YoY); vehicle sale negative YoY; pending and existing home sale negative YoY; factory orders were down for the 21st straight month; commercial property prices negative YoY; U.S. productivity has been negative for the past four quarters in a row. There are more items we could list, but it's clear that market participants are concerned that U.S. GDP growth is in jeopardy of breaking down and for good reason as the data charted below illustrates.

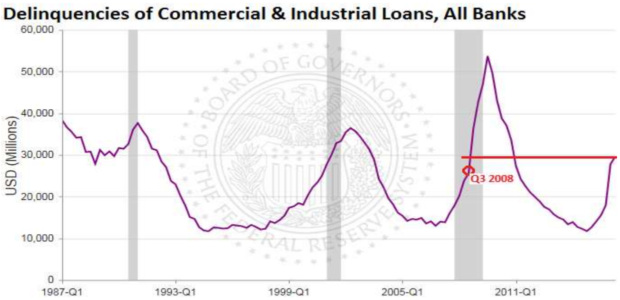
GDP Growth in the U.S. is Now Trending Lower

Source: Trading Economics

None of data points in and of themselves provide any definitive answers about the future, but we are constantly monitoring for indications of a shift in trends that can lead to a pivot in markets. More of these signposts became evident last month as well. For example, commercial and industrial loan growth has virtually ground to a halt while the delinquency rate in the space is now at the highest level since the third quarter of 2008. This is a significant leading indicator of the economy that is perhaps telling us that it may be too late for the Fed to raise rates.

Commercial Loan Environment is Deteriorating





Source: Encima Global; Fed Board of Governor's

Commercial loans are a huge $2 trillion-plus lending market that, along with business investment spending and earnings recessions, has consistently provided reliable warning signals of coming recessions. All this is too say that the environment appears to be fragile at the moment. That is not the ideal back-drop for a Fed meeting on September 20th where the messaging has been that a rate hike is definitely on the table. This would be a shock to the market and an unpleasant one, but a known risk. Unfortunately, other completely unpredictable things have also boiled up recently that could prove disruptive as well. For example, North Korea completed a successful nuclear weapons test on September 8th and perhaps less obviously, South Korean cargo shipping company

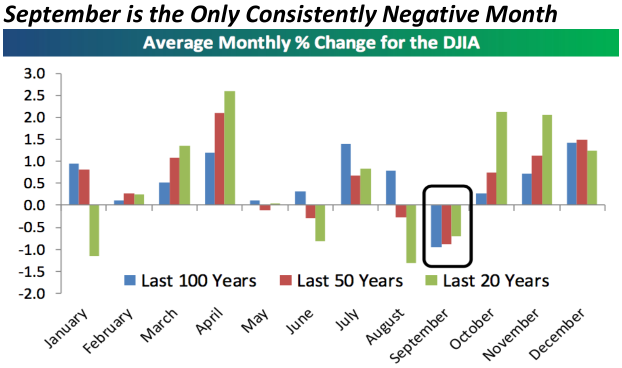
Hanjin declared bankruptcy in late August. While that may sound like somewhat of an obscure news story, consider the chart below.

Hanjin Bankruptcy Highly Disruptive to Global Trade

Source: Hanjin; ZeroHedge.com

Hanjin is the world's seventh largest container ship company that is responsible for a significant portion of global trade transit from Asia to both North America and Europe. With the carrier in bankruptcy, their assets have been frozen and there are now some $14 billion worth of good stranded in cargo ships floating at sea. This is highly disruptive since those goods will not be available to their end customers for perhaps months as the ships sit in financial and legal limbo. Supply chain impacts are being felt immediately as shipping rates jumped 50% within days and the National Retail Federation implored the U.S. Secretary of Commerce to intervene since the bankruptcy "could cause significant harm to both consumers and the U.S. economy" in their view. This is exactly the type of "Black Swan" event that fans the flames of a correction which historically happens to fall precisely in September.

September is the Only Consistently Negative Month



Source: Bespoke Investment Group

Going Forward

In spite of the quiet trading environment in August, our outlook remains the same. As we approach the historically volatile September and October period, we feel that the risk of a market correction is now more elevated than at any other time in last twelve months. The issues surrounding European banks and Eurozone growth in general have not improved in any meaningful way. Additionally, the economy data in the U.S. appear to be telling us that growth is slowing - all at a time when equity valuations are expensive and the Fed is desperately trying to increase interest rates. As a result, we are positioned defensively in our portfolios with cash levels at a high point for the year 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. The same can be said for small cap companies which have benefitted from a "risk-on" posture in the market this summer. Conversely, we feel that the risk/reward proposition in the technology, health care 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, propping up equity prices this year despite the headwind of a strengthening currency. With the Bank of Japan meeting this month, we will be monitoring whether further announcements of simulative action are enough to provide an additional boost to asset prices going forward.

After an extended period of underperformance, emerging markets are becoming more of an interest. As a group they have performed surprisingly well in 2016 rising almost 15 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. Despite their strong move higher this year, emerging market stocks still remain attractively valued when compared to other regions.

Traditional fixed income is now very, very expensive relative to history as a result of the distorted demand dynamics that are the result of central bank asset purchasing actions. 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 year with increased uncertainty levels.

With regard to commodities, the oil market is suffering from oversupplied conditions and prices of the commodity have moved lower from their June peak as a result. We think there is likely more weakness to come and therefore do not favor the sector for the time being. That being said, as energy companies begin to roll off the effects of the collapse in oil that occurred from late 2014 into 2015, their earnings should begin to increase again which could present an opportunity as we look to 2017. 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.