Insights: February 2016

Market Overview and Performance

In what proved to be a very surprising start to 2016, January delivered sharp losses and increased volatility across almost every segment of global markets. While certainly not a pleasant experience for most, it was in fact the severity of the downdraft that was the true source of surprise rather than the driving forces behind the moves and reactions in the market. "The U.S. economic engine continued to gain strength, the U.S. dollar furthered its rise against all other currencies, oil could not halt its downward trend, and volatility remained elevated." That is a quote from our February 2015 Insights describing a January period in which stocks fell, bonds and gold rose, oil fell roughly 10 percent and volatility rose by 10 percent. Other than a lack of a mention about China, that narrative sounds awfully familiar.

Last month we dedicated most of our Insights letter to the challenges presented by slowing growth in China and the relentless downward pressure in oil. Those risks were clearly making their presence felt throughout January, however, the newest worry moving to the forefront is potential stress in the banking sector, particularly in Europe, leading many pundits to start raising the question of a recession on the horizon. For several reasons, we do not see any evidence of a looming recession, however, given global developments, uncertainty and volatility are likely to lead to greater anxiety in the near term.

As always, thank you for reading our monthly Insights.

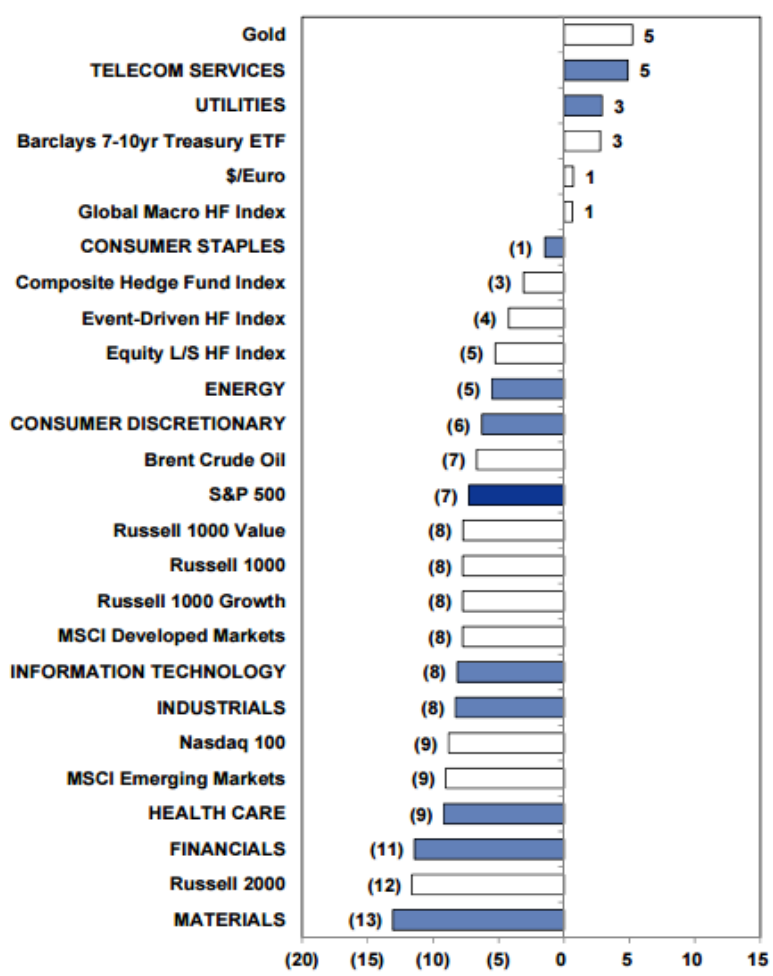
	Month to Date	***Year to Date***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	**-4.96**	-4.96
Russell 2000 Index	-8.79	-8.79
MSCI EAFE Index	-7.23	-7.23
MSCI Emerging Markets Index	-6.49	-6.49
Fixed Income		
Barclay's U.S. Aggregate Bond Index	**1.38**	1.38
Barclay's U.S. Credit Index	0.52	0.52
Barclay's Corporate High Yield Index	-1.61	-1.61
Barclay's Municipal Bond Index	1.19	1.19
Macro Measures		
Gold	**5.24**	5.24
Crude Oil	**-11.92**	-11.92
CBOE Volatility Index	10.93	10.93
USD Dollar Index	0.85	0.85

February Themes – January was a Surprisingly Difficult Start to the Year; Talk of Recession Increases, but There is Little Evidence; European Banks Overtake China and Oil as the "Biggest Risk"

Worst Start to the Year Since 2009

The S&P 500 finished the month of January "only" down 5 percent, its worst start for the year since 2009. However, the severe equity moves throughout the month actually made things feel much worse for investors. The Index effectively tumbled consistently lower for the first 12 trading days of the year, declining almost 10 percent by January 20th and down to a 21 month low that was -12.7 percent away from the previous high of last May. A 2.5 percent rally on the last trading day of the month proved somewhat soothing, but as the chart below illustrates, gold, bonds, and defensive sectors provided the only real shelter.

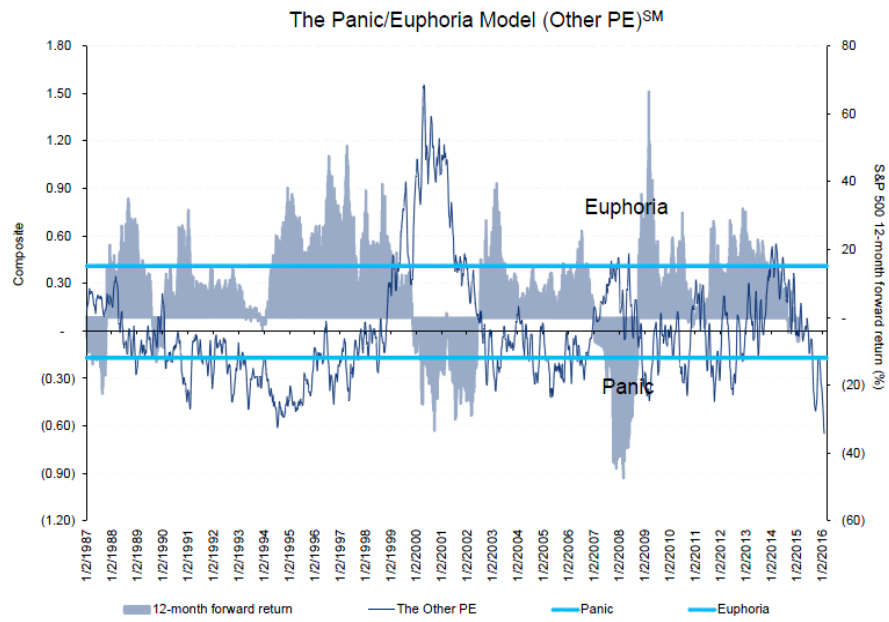
January Was a Historically Bad Start to the Year



Source: Goldman Sachs Global Investment Research

This level of losses is clearly not unprecedented in market history and the root causes of much of the declines were the well established themes of a slowing China and oil's seeming free-fall. So it's seems quite extreme that there are several sentiment readings like the one below.

Citigroup Panic/Euphoria Model at Extreme Panic



Source: 361 Capital; Citigroup

Citigroup's Panic/Euphoria Model is a proprietary model that attempts to measure sentiment in the market. It is a contrarian indicator – when it shows sentiment in the Panic level, forward returns tend to be positive and vice versa. What is remarkable is that the reading is now at all-time panic levels, beyond what has ever been recorded back to 1987 and far below even Financial Crisis levels. There really is very little evidence for this type of behavior other than a rising group-think mentality. In other words, the more the notions of a Bear Market and Recession are discussed the more attractive it is to become part of the consensus thinking that these risks are indeed going to come to fruition.

We will readily acknowledge that risk levels on many fronts are elevated from the beginning of last year, however, even the 12.6 percent pullback we witnessed last August (which happened to exactly match the -12.7 percent move this January) did not generate this heightened level of angst despite being initiated by the same factors – China and slowing growth broadly. Volatility is not pleasant but time horizons are exceptionally important when assessing these kinds of conditions.

As long-term investors, we have continually professed the belief that short-term volatility is temporary and (even expected) if you have a committed long term orientation. However, behavioral finance tells us that this is hard to achieve in practice. There was a great piece of research published this month by a group called Alpha Architect. They conducted an experiment where beginning in 1926, they ranked the largest 500 companies by forward five year return and "invested" in the top 10 percent. Further, they shorted the bottom 10 percent performers. This process was then repeated every 5 years. The "Ultimate Hedge Fund" as they called it since it had perfect foresight. Below are the results.

"Ultimate Hedge Fund" Not A Smooth Ride

Summary Statistics*	5 year High MOM VW_L/S	SP500
CAGR	39.74%	9.63%
Standard Deviation	24.11%	19.40%
Downside Deviation (MAR=5%)	25.82%	14.44%
Sharpe Ratio	1.39	0.39
Sortino Ratio (MAR=5%)	1.24	0.42
Worst Drawdown	-69.80%	-84.59%
Worst Month Return	-54.84%	-28.73%
Best Month Return	23.87%	41.65%
Profitable Months	77.81%	61.45%

Rank	Date Start	Date End	5 year High MOM VW_L/S	SP500
1	6/30/1932	6/30/1933	-69.80%	168.60%
2	2/28/2009	9/30/2009	-54.59%	45.01%
3	9/30/2002	1/31/2004	-49.36%	42.33%
4	6/29/1935	2/29/1936	-43.59%	46.96%
5	12/31/1974	2/29/1976	-38.07%	52.51%
6	12/31/1933	2/28/1934	-37.08%	7.79%
7	12/31/1930	2/28/1931	-36.01%	17.73%
8	12/31/1990	3/31/1991	-28.56%	14.71%
9	6/30/1939	9/30/1939	-28.20%	22.56%
10	3/31/2000	2/28/2001	-25.49%	-16.16%

Source: Alpha Architect

First, this fund would have grown at an astonishing rate of almost 40 percent per year, however more interesting is the amount of downside involved. The price you would have to pay for the "perfect foresight" portfolio where you know exactly what the winners and losers would be is almost -70 percent in the worst case. Even if you throw out 1933 and 2009 as anomalies, the worst declines would be a gut-wrenching 25- 50 percent. The point here is obviously that you absolutely must have conviction in a long-term strategy to achieve long term success.

Recession Looming? Not Likely

The one real change between the January pullback and other recent sell-offs is the emergence of the belief that we are heading into a recessionary period. We do not share this view, but others have put the probability as high as 20-30 percent. Some would argue higher and some lower, but as the chart below from Goldman Sachs highlights, the U.S. (and in fact Developed Markets as a whole) are sitting below their long-term average probabilities of recession since 1980.

Recession Probabilities Remain Below Average

	Latest Recession Probabilities					
	1Q		4Q		8Q	
	Current	Average*	Current	Average*	Current	Average*
Australia	4	14	13	23	21	35
Canada	55	19	84	35	93	58
Switzerland	76	28	90	45	95	62
Denmark	2	24	9	40	16	55
Euro area	7	19	24	33	38	49
Japan	8	22	42	39	62	57
Korea	1	8	8	12	18	18
Norway	50	14	81	33	88	48
Sweden	1	18	6	25	14	35
UK	1	14	3	19	3	26
US	7	15	18	24	23	34
DM	9	17	25	28	34	41

* 1980-2015

Source: Goldman Sachs Global Investment Research

While that is encouraging, we would not rely solely on probabilities alone. Rather, the economic evidence we have been seeing consistently in the U.S. simply does not support a view that the economy is contracting. Many of the arguments put forth regarding a coming recession tend to focus on a few selected economic data points. That will always be the case. We think the real reason for the anxiety over the future is of course the "unknowns", but in this case, will the unknowns turn out to be the same problematic ones we have experienced in the past?

It is legitimate to worry about the lessons from prior periods. As a direct comparison, the environment compared to the last recession that began in 2007 is much improved.

At that time, personal savings were collapsing (now rising), Housing was in a bubble (now housing affordability is very attractive), energy related spending was increasing (now oil has collapsed that measure) and consumer balance sheets were stretched (now de-leveraged).

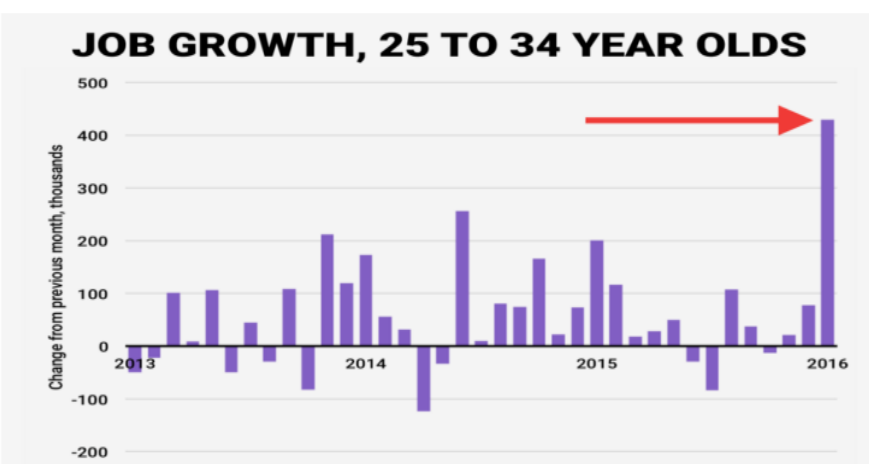
2016 Does Not Resemble the 2007 Recession Period

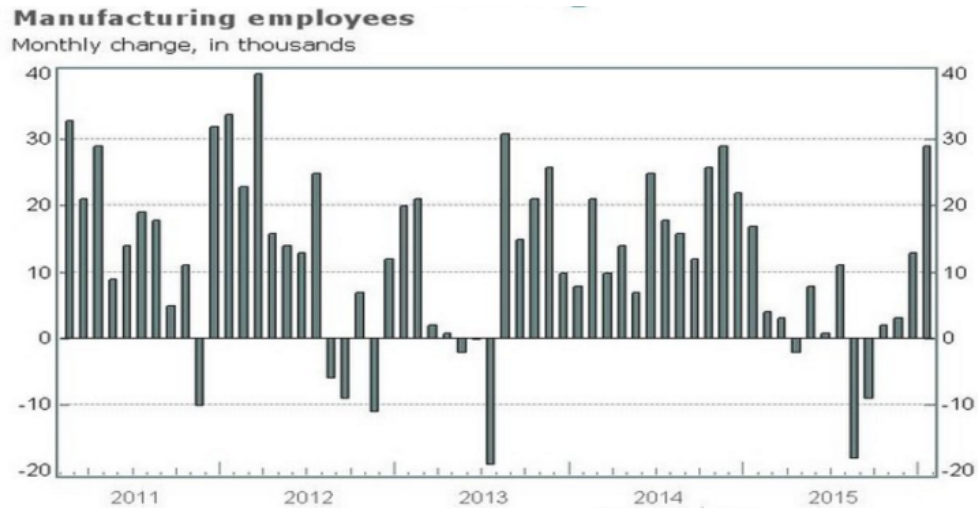
	2007	2016
Fed Rate Hikes (Prior 4 Years)	425 Basis Points	25 Basis Points
30-Year Mortgage Rate	6.75%	3.96%
Yield Curve (10-Year Treasury Less 3-Month T-Bill)	-40 Basis Points	+200 Basis Points
Consumer Spending on Energy (% of Disposable Income)	4.9% and Rising	3.2% and Falling
Household Debt-to-Income Ratio	All-Time High and Rising	Above Average, But Falling
Saving Rate	2.5% and Decreasing	5.5% and Increasing
Housing Affordability	20-Year Low and Below Average	Above Average
Real Wage Growth	-0.8%	+2.0%
Oil Prices (Prior 4 Years)	+185%	-62%

Source: LPL Research

We discussed at length in previous Insights why we are believers in the U.S. growth story. The data being reported simply does not match up with a recession. Despite January's asset sell-off, the economic picture domestically only got stronger. The real backbone of the recovery has been labor. The January jobs data punctuated not only the healthy trend but also improving trends. We have cited several measures in the past, all encouraging, like consumer confidence, vehicle sales and small business outlooks which each paint a robust environment, but we thought we'd share some specific labor charts that are not as widely distributed. Job creation remains very high, the unemployment rate fell to amazing 4.9 percent and yearly wage growth was 2.5 percent in January, but also consider the following:

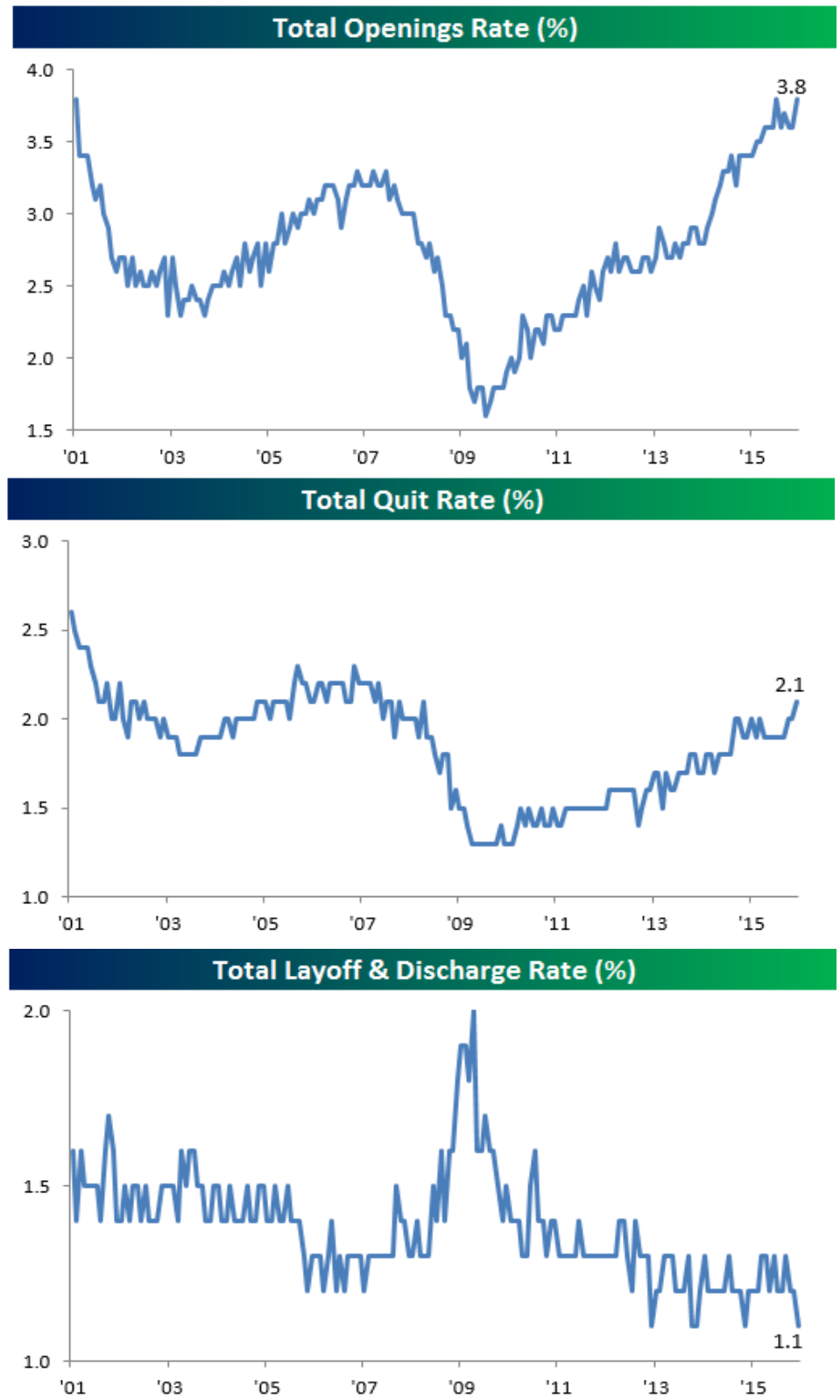
Jobs for Millennial and Manufacturing Jumped in Jan.





Source: Bureau of Labor Statistics; Business Insider; CBS Marketwatch

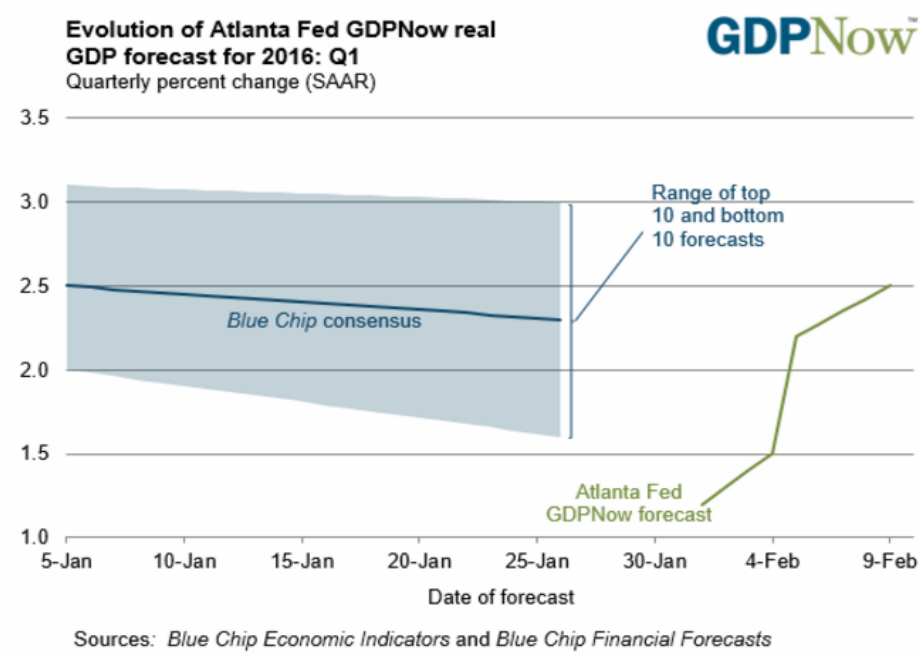
Job Openings, Quit Rate & Layoffs All Strong in Jan.



Source: Bespoke Investment

These are in no way contractionary figures and in fact, demonstrate growth in areas where there have been concerns. Perhaps the most powerful rebuttal to the recession call right now is the Atlanta GDPNow measure. Its is a combination of factors that has been remarkably accurate at predicting the soft, below consensus GDP numbers we saw last year. Now their indicators are showing above consensus growth of 2.5 for the first quarter – in no way a "recessionary" economy.

First Quarter GDP Estimated to be a Solid 2.5%

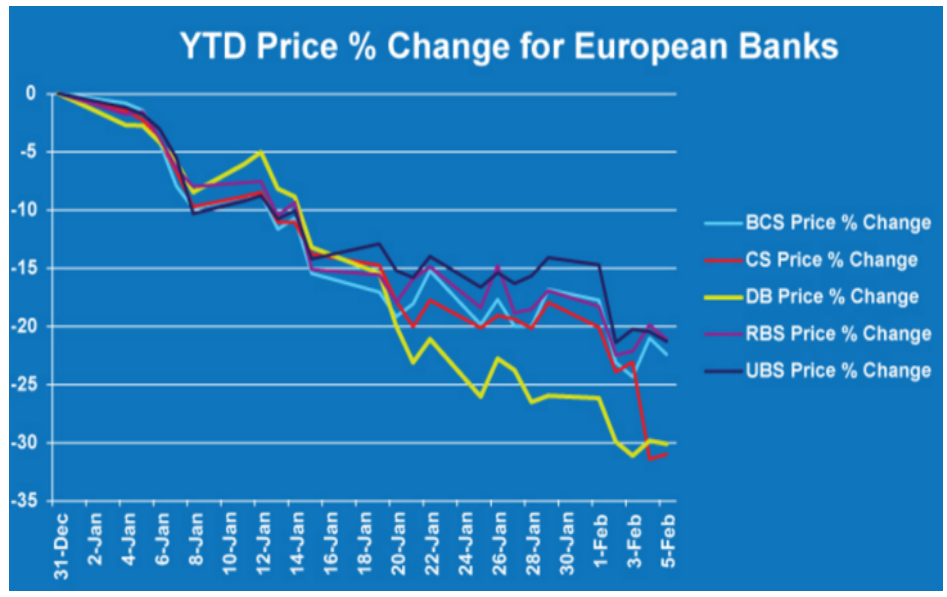


Source: Atlanta Federal Reserve

European Bank Worries

While we feel that recession concerns are overblown here in the U.S. the larger concern right now is the situation that has developed in the European banking system. As can clearly been seen below, European banks have been sold aggressively in 2016.

European Banks Have Declined 20-30% in 2016



Source: Business Finance

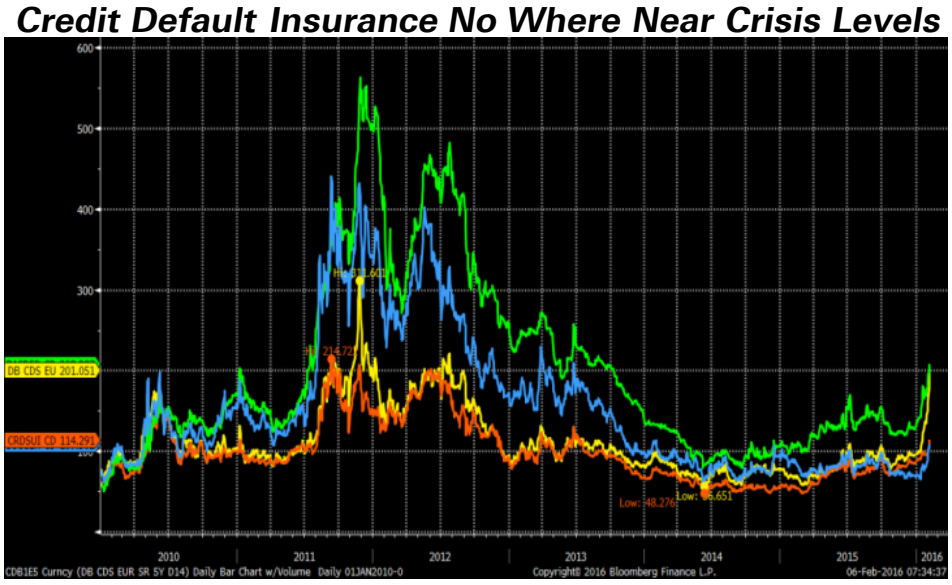
But the usual suspects of free-falling oil prices or emerging market troubles are old news so to speak, so why the declines now? There are several things going on, but initially the weakness started at the end of 2015 when a Portuguese bank called Novo Banco seemed to have arbitrarily decided which of its debt holders would be junior and which would be senior. This was an unsettling precedent to broader European debt holders. On the back of that news, Deutsche Bank reported very weak earnings results and large re-structuring charges that included the statement, "We believe we have sufficient general reserves available to cover any shortfall". While meant to be re-assuring, this comment actually served to spark concerns.

Cost of Insurance Against Default Has Doubled in 2016

Source: Bloomberg; Markit

As result, credit default swaps for Deutsche Bank and in fact all 30 major financial institutions virtually doubled. Taking a step back, it should be noted that these levels are no where near the peaks they reached during the Financial Crisis.

Credit Default Insurance No Where Near Crisis Levels



Source: @MktOutperfom. Charlie Biello; Bloomberg

In truth, the banks both in the U.S. and Europe are massively capitalized when compared to 2007 and a multitude of backstops are now in place to thwart another crisis. But the lingering question remaining is how are these guys going to make money going forward? Banks make money in part by charging interest on deposits, however, with interest rates in Europe having gone negative, this has become more challenging. Perversely, low rates designed to loosen credit can actually force banks to charge more for loans to cover their costs which is essentially a de facto tightening of credit.

Additionally, as banks like Deutsche Bank restructure their model to meet the changing environment, the inevitable costs combined with a potentially slowing growth environment may make it increasingly difficult to meet the ECB's stringent capital requirements. This has investors on edge. If banks cannot meet the requirements in the future, regulators may force them to cut dividends or suspend payments on certain junior convertible bonds. This is a real risk. The banks are very well capitalized at present but the future growth picture needs to be supportive for their profitability. This is something that we, along with many others, will be watching.

Going Forward

As outlined, we continue to believe that U.S. economy is robust and improving as we move forward in 2016, however, we also believe that 2016 will represent a continuation of an increased level of volatility across markets. Uncertainty around the globe does have the potential to create a negative feedback loop and we are therefore faced with very poor market sentiment at present. As long-term investors, these types of extreme sentiment levels have historically proved to be indicators of an inflection point, which in this case could lead to a surprise to the upside in markets. That being said, potential warning signs are elevated and we therefore are closely monitoring indicators for signs of meaningful fundamental changes.

Within equities we continue to favor the large cap segment of the U.S. market. We would prefer to achieve our exposure through cyclical areas of the market such as the technology, selected health care and consumer discretionary sectors which stand to benefit the most from a strong U.S. economy. Those areas have been hurt thus far in 2016 but are still well positioned for growth. Additionally, given the fact that we have now entered a rising interest rate environment selected securities in the financial and energy sectors have been a focus for us since these sectors historically have done well when rates begin to climb higher.

While we are believers in the strong U.S. growth story, we think that international diversification through allocations to Europe and Japan in particular appears attractive for the coming year. Both of these global regions are firmly entrenched in a very accommodative policy environment which provides a tailwind for risk assets generally. Additionally, given the relatively low base from 2015 earnings, growth in both of these regions is likely to be robust in both absolute terms and relative to other markets. As discussed, Europe is currently being impacted by concerns over the banking sector for legitimate reasons, however, we believe financial conditions are much improved from the previous banking crisis and many layers of backstops have been put in place by the European Central Bank which serves to limit extreme events. Japan has had a difficult start to the year as well as a flight to quality temperament in the market has driven their "safe-haven" currency higher which presents challenges for their export oriented economy.

We remain underweight traditional fixed income. As the Fed begins the process of slowly increasing interest rates, we continue to advocate an 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 continue to perform well relative to other asset classes.

Commodities remain structurally challenged in our view. The Bloomberg Commodity Index remains near the lowest recorded levels in its 25 year history. With regard to oil, the fundamental outlook for the next 12 to 18 months is not likely to improve with sentiment extremely poor and inventories historically high. However, we believe that high quality names within the sector represent good long term value. As discussed in detail in our January Insights, the potential for sharp swings in the price of oil is one of main factors we will be watching in 2016. 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.

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