Investment Commentary: 2/2015

After a strong rally to close 2014, U.S. stocks sputtered in early 2015 as volatility jumped and investors took some risk off the table. The S&P 500 fell 3% in January and smaller company stocks declined by a similar amount. Large macroeconomic shifts that are strengthening the U.S. dollar and leading to falling commodity prices have raised uncertainty about earnings growth and the economy. At the start of earnings season, stocks moved lower amidst some high-profile reports that ongoing strength in the U.S. dollar crimped results for U.S. multinationals. In economic news, the first release of fourth quarter 2014 GDP data came in below expectations and marked a decline from higher growth rates in the second and third quarter. However, lower oil prices continued as a positive influence for consumer confidence and spending, though lower oil has been a negative for energy-company earnings and stock prices.

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Central banks continued to generate news throughout the month: The European Central Bank launched a much anticipated, though larger than expected, bond-buying stimulus plan. The Swiss National Bank surprised markets by removing the Swiss franc from its euro peg (leading to a sharp rally in the franc). And the U.S. Federal Reserve released what most viewed as a balanced statement that indicated no meaningful change in their outlook.

Foreign stocks had better results, with developed international stocks up slightly and emerging-markets equities were only slightly negative. In Europe, investors' positive reception of the ECB's large quantitative easing was somewhat offset by worries over a potential Greek debt default (and exit from the European currency union) as the anti-austerity Syriza party was elected. While the Eurozone is in much better shape than it was during the prior talk of a "Grexit" in 2012, this would nonetheless represent an extreme and likely disruptive outcome.

Treasury yields again defied general expectations and fell during the month. The core bond index rose 2%—its best January return in 27 years. Once again, very low bond yields around the world boosted the relative attractiveness, and falling inflation expectations served to boost the attractiveness of U.S. Treasuries. Gains were led by higher quality fixed income sectors as a flight to quality was sparked due to increased volatility.

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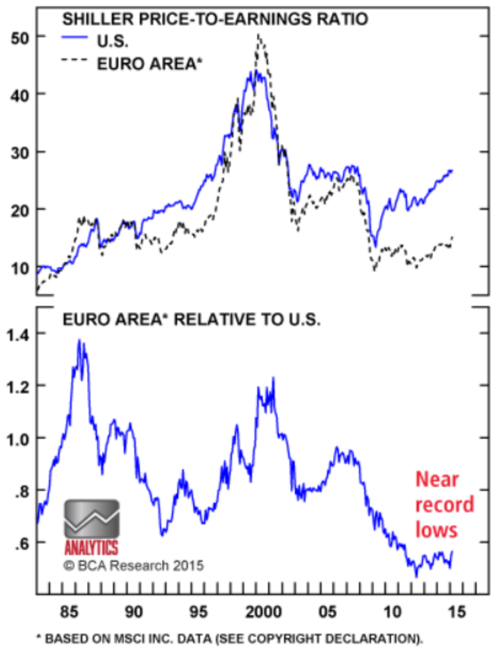
Recently we have received several questions about the outlook for foreign stocks and real estate investment trusts, below we provide some insights on our outlook for both asset classes.

Foreign Stocks

The concerns about foreign stocks are widely known, slowing economic growth, deflationary concerns and weak profit growth. For example, according to the investment firm GMO profit growth in the Eurozone the past four years have compounded at -6% in U.S. dollars and real GDP has grown at a mere 0.3% rate. The emerging markets haven't been much better with profits averaging 1.3% the past four years and economic growth slowing rapidly in commodity producing countries like Russia, Brazil and others. In comparison, the U.S. looks like a much better place to invest with economic growth accelerating and profits averaging double digits. The challenge, of course, is deciding at what point the good and bad news has been assimilated by markets and is reflected in the respective valuations.

In our opinion, a lot of the "bad news" in foreign markets as well as the "good news" in the U.S. has already been assimilated by the financial markets. Leaving foreign markets with lower stock valuations and better prospects for returns over the next five years. We recently increased our exposure to foreign markets for the first time in several years with the belief they are positioned to outperform U.S. stocks over the next full market cycle. Although our timing may not be perfect, we believe long-term investors will be rewarded by gradually shifting their allocations to the foreign markets. Below we highlight a few of the reasons why we decided to increase our foreign market exposure in January.

1.



- Valuations in Foreign Markets are more attractive than in the U.S. (chart 1); valuation is not a great short-term predictor of performance, however, longer-term valuation almost always wins.

- Investors often mistakenly assume that countries with faster economic growth automatically generate better stock performance. In fact, it is the growth relative to expectations that matters when it comes to the performance of stock markets. The chart below (chart 2), from GMO, shows that historically faster economic growth has in fact not lead to better returns. The next chart (chart 3) shows that what actually drives outperformance is "economic surprises" that exceed current expectations built into

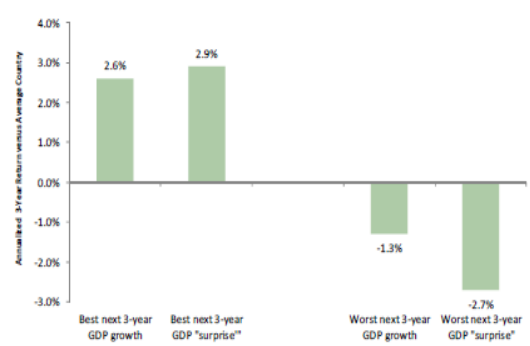
Stock Market Returns and GDP Growth for Developed Markets (1980 – 2010)

2.

Source: MSCI, S&P, Datastream

Future GDP Growth and GDP "Surprise" to Explain Equity Returns (1984 – 2014)

3.

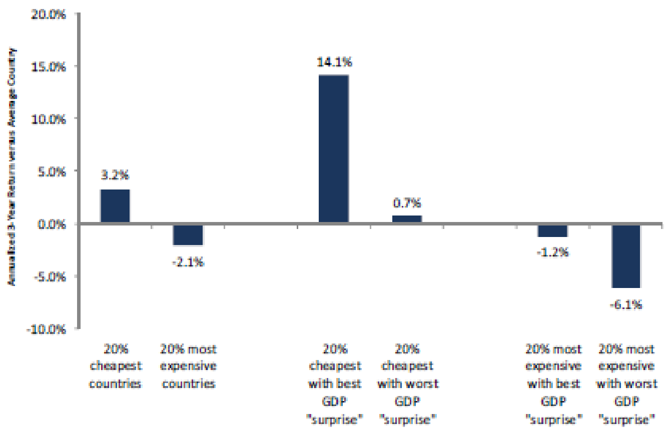


Source: GMO, MSCI, S&P, Datastream

the markets. We believe that given currently very low expectations for foreign market economic growth they have a greater chance to "surprise" to the upside.

Value and GDP "Surprise" to Predict Future Equity Returns (1984 – 2014)

4.



Source: GMO, MSCI, S&P, Datastream
Note: "Cheap" and "Expensive" determined by GMO Multi-Factor Valuation Model

- Better valuations in foreign markets provide a greater "margin of safety". The last chart (chart 4) from GMO clearly shows that countries with the best (lowest) valuation tend to outperform whether there are economic surprises to the upside or the downside. This may sound obvious, but it is easy for investors to forget after a six year bull market in U.S. stocks.

In summary, we believe that low expectations, better valuations and more aggressive monetary policy in foreign markets increase the likelihood they will outperform U.S. stocks over the next five years. No one knows what will happen over the next 6 to 12 months, however for patient investors with a longer time horizon the odds are favorable for outperformance in the foreign markets.

Real Estate Investment Trusts (REITs)

REITs have been great performers the past year as interest rates (10 year) have dropped from 3% in early 2014 to their current rate of around 1.9%. Our view of REITs factors in a gradually improving domestic economy, and improving fundamentals in the form of higher demand, higher rents, still-limited supply and low borrowing costs, etc.. Our biggest concern regarding the asset class is high valuations, and is why we have limited to our exposure to a select group of individual REITs focused in the healthcare sector (i.e. Ventas and HCP). Nearly all of the valuation metrics we look at—implied cap rates, forward-adjusted funds from operations multiples, etc.—indicate REITs are expensive. Our impression continues to be that broad valuations are being driven less by fundamentals and more by investors seeking yield in an ongoing low-rate environment. Supporting evidence is that dividend-yielding utility stocks were up 27% in 2014. To us there seems to be a disconnect between REIT fundamentals and their stock prices. As an example, in the first half of January of this year, amid global economic growth concerns, there was a flight to quality, and bond yields declined, while the S&P 500 slid 2.5%. At the same time, REITs were up almost another 7%, and there was no supporting fundamental news that we could find to explain the move, except for lower rates.

When we look back to late May 2013, when interest rates started to rise, REITs began to meaningfully underperform the broader equity market; REITs ended 2013 with a low single-digit gain, lagging the S&P by nearly 30 percentage points. We are not saying that REITs will underperform again by such a substantial margin should rates start to rise, but we do believe that REITs will again lag stocks in a rising-rate environment. With REITs up 30% last year we do not believe, in general, now is good time to be adding to the asset class and investors with exposure may want to review their existing positions. Making sure their REIT positions are consistent with their overall risk and return objectives.

—AWM Investment Team