Investment Commentary: 8/2015

Most stock markets posted gains for the month, despite a generally sluggish economy, flat earnings growth, the Greek debt crisis and upheaval in China's economy and stock market. The S&P 500 was up 2.1% and international stocks (MSCI EAFE) were up 2.08%. The Russell 2000 (small-caps) diverged from large caps, declining 1.16% for the month, though they are slightly ahead for the year to date. **Growth stocks continue to lead the way, with the Russell 1000 Growth index up 3.39% vs. the Russell 1000 value at only 0.44%**. Emerging market stocks were the biggest loser, down (6.87%), as China failed to contain its market plunge, and weakness in global commodities weighed heavy on resource dependent countries. In fixed income markets, the yield on the 10 year Treasury declined more than 20 basis points, contributing to both the Barclays Aggregate Bond index (core bonds) and Municipal bonds being up about 0.7% for the month.

Economic reports for the month were mixed, with housing and labor showing signs of improvement, while retail sales and consumer spending were down. **Oil prices fell to their lowest level in several months, with crude falling well below $50 (NYMEX) a barrel.** Falling prices are largely attributable to Iran's anticipated reentry into the oil-producing market, as well as lower demand from China as its economy slowed and stock market dropped. Looking ahead, investors continue to focus on monetary policy. Following comments in June and July, it appears the Federal Reserve is on track to raise rates sometime later this year, for the first time since 2006. **However, history suggests the beginning of a federal funds rate hike is unlikely to trigger a bear market, especially if the increase is gradual and anticipated**. Below we discuss the impacts that an increase in the federal funds rates can have on the stock market.

Earnings Trends

As we write, S&P 500 second quarter earnings are near the half-way mark and it looks like they will be down (1%) compared to last year. Divergences amongst the sectors have been large, with health care, technology and consumer discretion posting strong results, while energy and telecom earnings dropped sharply. Based on earnings reports to date, a few themes have emerged:

Strong dollar- for companies that lagged estimates, a stronger U.S. Dollar was widely cited. A strong dollar acted as a headwind to exporters and contributed to the decline in commodities, which negatively impacted energy and material companies. Assuming the Fed raises rates later this year, this trend is likely to continue.

Chinese slowdown- the slowdown in Chinese economic growth was often cited as a contributor to slower economic growth in the quarter. The biggest impacts were felt by commodity and industrial based companies that sell directly into the Chinese markets.

"Divergences amongst the sectors have been large, with health care, technology and consumer discretion posting strong results, while energy and telecom earnings dropped sharply."

With profit margins near all-time highs and the economy growing at modest levels, it seems clear that earnings are likely to grow more slowly than we've seen for many years. This should perpetuate the trend for increased share buybacks as corporate leaders look for ways to keep earnings on a growth trajectory, and the continued outperformance of growth stocks relative to value. Investors simply are more willing to pay up for growth when it becomes scarce, which leads to higher prices and valuations (i.e. Netflix, Amazon, etc.).

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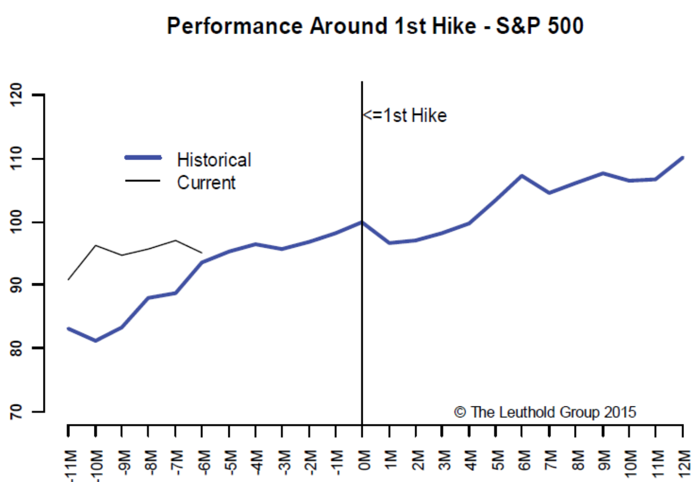
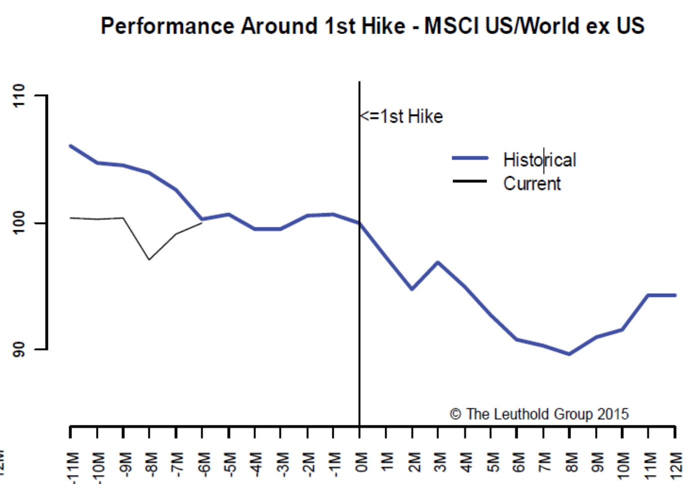
Impact of Fed Rate Increases

With a growing number of Fed speakers making it known they would like to raise the fed funds rate this year, **it seems increasingly likely that we will see a rate increase by the December meeting**. The caveat being that economic and job growth will need to stay on a growth path for a data dependent Fed to take action. Regardless of timing, the potential of an increase has led to an increase of questions from our clients about the impact it will have on the stock market. Given the limited number of data points for rate increases, we find it interesting to look at historical relationships, but tend to agree with Mark Twain, “history doesn’t repeat itself, but it does rhyme.” Every cycle is unique, so “averages” can be misleading. That being said, below are a few charts courtesy of the Leuthold Group that illustrate some of the historical relationships between Fed rate increases and stock performance going back to the 1970’s.

> “Historically, the first rate increase creates some volatility and stocks tend to pull back. However, if you look out beyond the first few months, stocks are likely to be higher.”

U.S. vs. Foreign Markets





Historically, the first rate increase creates some volatility and stocks tend to pull back. However, if you look out beyond the first few months, stocks are likely to be higher. More interestingly, the above chart to the right shows that international stocks tend to outperform U.S. stocks once the Fed starts raising rates. Given more attractive valuations and aggressive monetary policy in foreign developed markets, we would not be surprised if this historical relationship continues. However, we would be more hesitant to make any big moves in the emerging markets just yet, since higher U.S. rates and currency changes often create liquidity and economic challenges in those markets. **It’s a good time to be patient and look for opportunities to increase exposure.**

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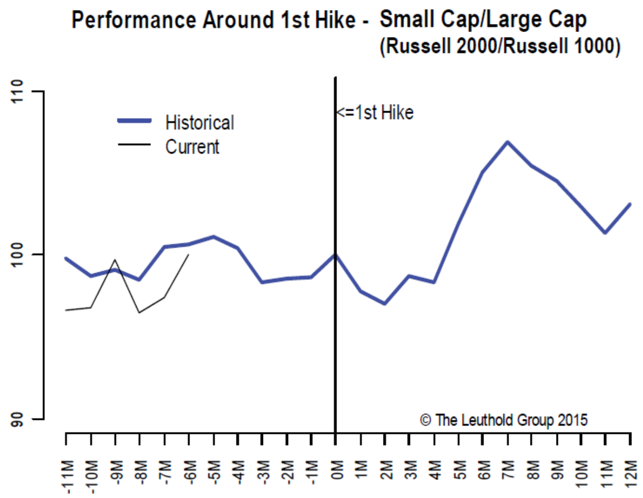
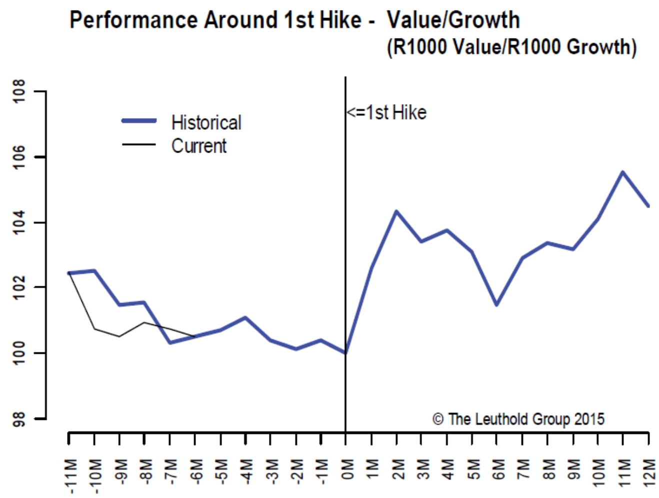
Growth vs. Value





The above chart (left) shows historically small cap stocks tend to underperform large cap stocks the first few months after a rate hike, however beyond that they tend to outperform. In our opinion, given high valuations in small-cap stocks and that we expect the economic recovery to be slower than the typical recovery, we're not confident this historical relationship will continue. The next chart (above right) shows that post the first rate hike, value stocks tend to outperform growth rather sharply. We are more confident this historical relationship will likely hold, although value outperformance is likely to be more muted than suggested due to relatively weak economic recovery.

Industry Group Performance

The table to the right shows the performance of the best and worst industry groups before and after a rate hike. Our individual stock selection is focused on the quality of each business, their management and valuation, so although we review these studies and find them interesting, we don't rely on them.

	Leuthold Groups Performance Before and After 1st Rate Hike				
	6M Before	3M Before	3M After	6M After	6M BFR - AFT
Best 10 Groups					
Electronic Components	23.9%	19.5%	-4.4%	14.8%	49.9%
Steel	23.9%	12.4%	-5.2%	6.7%	36.4%
Commodity Chemicals	16.9%	12.4%	-1.3%	9.5%	33.9%
Cable & Satellite	7.7%	-1.9%	-1.1%	28.9%	32.7%
Semiconductor Equipment	37.4%	22.9%	-16.3%	6.2%	29.7%
Diversified Metals & Mining	23.3%	22.7%	4.7%	19.9%	27.7%
Wireless Telecommunication Services	16.9%	10.8%	-1.7%	14.1%	27.0%
Casinos & Gaming	18.0%	3.0%	-10.6%	0.5%	25.6%
Consumer Finance	6.2%	0.5%	-1.6%	17.5%	25.2%
Construction & Farm Machinery & Heavy Trucks	22.5%	11.7%	-6.2%	-2.6%	22.7%
Average Group	7.9%	5.8%	-7.2%	-0.3%	7.7%
Worst 10 Groups					
Agricultural Products	1.2%	-0.2%	-8.4%	-8.5%	-7.3%
Health Care Facilities	-0.8%	13.3%	-18.2%	-7.0%	-7.5%
Restaurants	3.0%	-0.3%	-9.7%	-13.3%	-7.8%
Multi-Line Insurance	-2.1%	2.9%	-7.1%	-3.2%	-7.8%
Oil & Gas Refining & Marketing	-1.4%	0.8%	-3.9%	-6.9%	-8.2%
Real Estate Management & Development	-0.7%	-0.7%	-9.0%	-8.1%	-8.3%
Water Utilities	-7.8%	0.1%	-0.7%	-7.6%	-10.7%
Property & Casualty Insurance	-3.6%	1.7%	-8.1%	-7.6%	-13.9%
Electric Utilities	-6.7%	-1.6%	-6.7%	-5.3%	-14.8%
Homebuilding	-9.0%	-1.5%	-19.5%	-16.2%	-20.4%

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Big Picture thinking

As investment managers, we believe it is crucial to step away from the day-to-day noise of the market and think about the "big picture" and long term trends. Our time spent thinking about long-term trends that will impact the economy and society is often where our best and most valuable ideas come from. Goldman Sachs recently published a report titled "Fortnightly Thoughts" in which they interviewed 15 leading experts and authors from the corporate, academic and investor fields on a wide range of topics. Below is a short recap of a few of the interviews we thought were interesting:

Prof. Raj Rajkumar, of Carnegie Mellon University, on the future of autonomous cars

Professor Raj Rajkumar discussed the tremendous progress made in driverless car technology. He predicts that completely driverless cars will be feasible in developed countries in the 2020's, with major technological milestones only 3-5 years away. This revolution hinges on wireless technologies that allow cars, smartphones, and traffic signals to communicate with each other in real time. Benefits of this technology would include reduced accidents, traffic delays, pollution, all while ramping up consumer productivity. On traffic collisions, Rajkumar notes that over 90% of the hundreds of millions of traffic-related injuries and fatalities are the result of human error. With federal and state regulation and infrastructure already being assembled for driverless cars, Rajkumar envisions a major long-term impact for this technology. Two industries that will be largely impacted are insurance and auto-sales, as Rajkumar predicts this technology will fundamentally alter their business models, where only the most forward-thinking companies will survive and thrive.

Paul Brody, IBM Global Business Services, on the shift to software heavy manufacturing

Paul Brody was recently interviewed about the various ways technology is changing manufacturing. He believes a major theme in this space is that manufacturing is becoming increasingly software defined. This implies that in the future, physical changes in the manufacturing process will be replaced by simply rewriting code or instructions for a machine. This is cheaper, more efficient, and could fundamentally alter product lifecycles. Brody believes these changes hinge on two major technologies: 3D printing and advanced robotics. As manufacturing is increasingly controlled by these technologies, cost will decrease and complete customization of product will become the new norm. The implications are far-reaching for both companies and consumers. Larger companies who compete on scale will be at a massive disadvantage moving forward, while smaller firms can adapt and innovate at a much faster rate. Similarly, as costs of manufacturing get increasingly lower, firms will have to focus more on the value addition of good customer service, marketing and especially design. This bodes well for economies who foster creativity and entrepreneurship and poorly for those whose competitive advantage lies in low labor cost and creation of scale like many emerging market economies.

Howard Marks, Chairman, Oaktree Capital on his investment philosophy

In a recent interview, chairman of Oaktree Capital Management Howard Marks spoke on the psychology and behavioral aspects of investing. Marks believes that investor emotion plays too large a role in investing, but believes there are opportunities to be had from overly cautious or overly greedy investors. He argues that the bandwagon and herd mentalities can get investors in a lot of trouble, and rather, that investors should buy when the market is cold, not hot. A cold market is indicated by low capital availability, low eagerness of lenders and investors, and harder ease of entry to new funds. He states that as long as human nature is a part of the investment process, there will always be crashes and bubbles. A person's desire to believe in things that will make them rich leads to greed which can be an investor's downfall. We tend to look at past performance and jump onto solid performers instead of being forward-thinking. Sensing the big picture for markets and prices is crucial to being a good investor. Understanding history and interpreting it correctly coupled with understand investor behavior is a very strong tool.

Howard Marks packed a lot of wisdom into his interview and we couldn't agree more with his insights and philosophy!

—AWM Investment Team