Investment Commentary: 12/2015

Following strong gains in October, global markets took a pause last month as investors digested uneven economic data and awaited more clarity on central bank policies. As has been the case for some time now, diverging monetary policy between the United States and the rest of the world continues to be a major theme in the financial markets. ***It's widely expected that the Federal Reserve will increase interest rates for the first time in more than nine years in the next few months***, probably starting with the Federal Open Market Committee meeting on December 16. As the United States approaches tighter monetary policy, other central banks around the world continue to move in the opposite direction. The European Central Bank recently cut interest rates again and extended their QE (bond-buying) program in an effort to boost inflation across the Eurozone, while the Bank of Japan is likewise expected to begin easing more aggressively. However, expectations around monetary policy movements seem to have been discounted by the markets, to a certain extent, as evidenced by a sharp rise in the U.S. dollar, which rallied more than 3% in November versus a basket of other major currencies.

U.S. large-cap stocks were able to generate a marginal gain of 0.3% in November despite the fact that third quarter earnings and revenue growth were down 3.3% and 4.4% year over year. ***The stronger dollar is partly responsible for the decline in earnings growth, but so too is the fact that profit margins have come under pressure after years of hovering near all-time highs.*** Smaller-cap stocks, which are more domestically focused (and therefore not as heavily influenced by a stronger U.S. dollar), performed better, finishing the month up 3.3%. However, they continue to lag on a YTD basis.

Developed international stocks as a whole finished the month down 1.5% (though they were up in local-currency terms). In Europe, markets were rattled following the terrorist attacks in Paris, but were able to recoup losses as investors focused on improving economic and company fundamentals. Stocks were further supported by the prospect of additional monetary stimulus, though this also drove down the euro, diminishing returns for U.S.-dollar-based investors.

Emerging-markets stocks were negative for the month, losing 3.9%. Concerns over slowing global economic growth, the prospect of rising U.S. interest rates, and the continued decline in commodities markets weighed heavily on the minds of investors.

The environment for fixed-income markets in November was similar to what we've seen over the past few months. Interest rates on the 10-year Treasury rose slightly but were capped in part by extremely low yields across the rest of the world. As a result, core bonds experienced a modest loss of 0.3%. High-yield bonds and other credit-sensitive assets performed poorly in the month (down over 2%) amid a renewed fall in commodity prices and the prospect of tighter monetary policy.

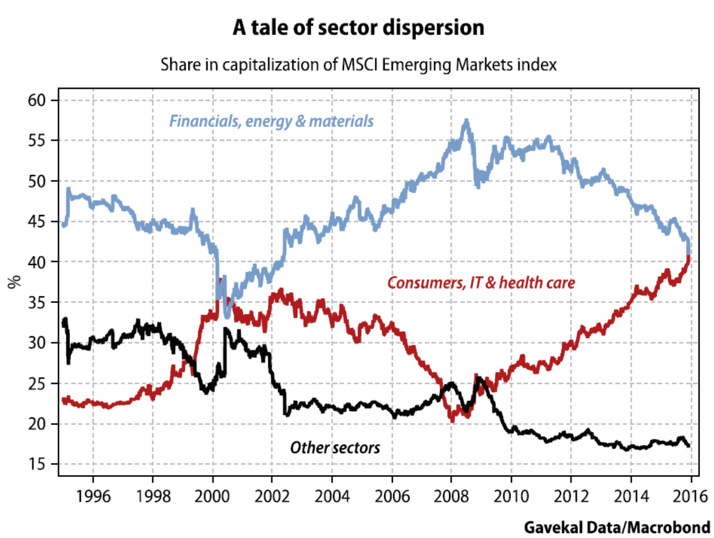
The "Yellen Call"

For years the Federal Reserve has been perceived to be acting as a "back-stop" to equity prices; originally referred to as the "Greenspan put" and later known as the "Bernanke put." The belief was the Fed had a heightened sensitivity to equity price declines and would aggressively use monetary policy to inspire the animal spirits of economic growth, which effectively would lead to an increase in asset prices. This may have been effective policy in the midst of economic crisis when the fear of deflation was high, however seven years hence it is becoming harder for the Fed to justify the funds rate at zero. ***Going forward the markets anticipate a long (and slow) cycle of rate increases,*** **and any strong increases in equity prices are likely to be perceived as positive signals for growth and inflation.** Which may encourage the Fed to tighten policy more aggressively than normal when stock prices rally. On the flipside, the Fed has historically been reluctant to reverse course once a hiking cycle has started, we believe this will make them more likely to "pause" than actually cut rates if stocks decline. **This change in Fed psychology combined with P/E multiples at historically high levels will serve as overhead resistance to stock markets. Hence the transition from the "Bernanke Put" to the "Yellen Call."**

Are Emerging Markets Cheap?

Emerging markets (EM) have declined roughly 30% from their 2011 highs, and the forward P/E ratio has dropped to 12, leaving EM valuations about a third cheaper than the S&P 500. ***The valuation discount for EM relative to developed markets is close to the biggest it has been in more than ten years.*** Begging the question, are emerging markets too cheap to ignore? However, the question is not easily answered because valuation comparisons are distorted by the difference in sector weightings between emerging and developed indices. Emerging market indices have a much higher weighting in financial and commodity stocks, sectors that are going thru a structural de-rating of valuation multiples. According to Gavekal Research, if sector weightings are adjusted to account for the differences, the valuation discount of emerging markets is much smaller. On an equally-weighted sector basis the emerging markets have a P/E ratio of 18.7%, compared to the developed markets at 20, not much of a discount.

The chart below shows the large divergence in sector performance in the emerging markets. Several sectors like healthcare, technology and consumer driven have performed well and are trading at full valuations, while the financial, energy and materials sectors have been decimated and are trading at crisis levels. ***The reality is that a bet today on the broad emerging markets is really a bet that commodity prices will recover.*** With the Fed potentially raising rates in December and the Dollar trending upwards, we prefer to wait for a clearer signal that commodities have bottomed or better valuations before buying directly into emerging markets.



Mean Reversion Candidates

As we write this commentary, the S&P 500 is relatively flat on a YTD basis, insinuating a relatively benign environment for stocks. However, below the surface of the market's apparent tranquility, there has been a lot of turmoil and variation in returns. Here are some examples of parts of the market that have sold off drastically relative to the market.

Energy stocks have cratered this year due to over-supply concerns and a strengthening dollar, leaving the sector down almost 20% for the year. In a year of slow economic environment investors have favored companies that can demonstrate revenue and earnings growth, and we have seen the Russell 1000 Growth index outperform the equivalent value index by close to 10%. ***Master limited partnerships (MLPs) have been pressured as investors question the viability of the MLP business model and begin to expect dividends to be cut, leaving the index down over 40% on a YTD basis.*** Other areas that have been hard hit are emerging markets, which are down close to 30% since their peak in 2011. ***All of these investable areas may be subject to further downside as investors begin to capitulate and take advantage of year-end tax-loss selling.*** For now, we are happy to be on the sidelines, however we recognize that the best investment opportunities are created when fear is the highest and markets are cratering. We will be watching these areas closely for signs of true capitulation and potential buying opportunities!

Gundlach Interview

Lastly we would like to share an interview one of our research providers, Litman Gregory, recently conducted with Jeffrey Gundlach, chief executive and chief investment officer of DoubleLine Capital. The discussion covered a wide range of topics, including Gundlach's macroeconomic outlook, his views on Federal Reserve policy, and investment insights pertaining to global fixed-income markets. We have tremendous respect for Gundlach's investing acumen and think his opinions are worth sharing with our readers. Given the length of the interview we have attached it as a separate document labeled "Gundlach Interview."

--AWM Investment Team (12/15)