Investment Commentary: 2/2016

January got off to a rough start with U.S., developed international, and emerging-markets stocks all dropping more than 10% intra month before rebounding to finish January down 5%, 5.5%, and 5.7%, respectively. The late-month turnaround was in part due to announcements of expanded monetary stimulus from global central banks. First, the European Central Bank announced that risks are rising and further monetary easing may be needed. Not to be outdone, the Bank of Japan then announced they would cut their deposit rate to negative 0.1%, in an effort to boost the Japanese economy and equity markets. **Increasingly began to question whether the U.S. Federal Reserve would follow through on its plan to raise rates several times this year.**

Investors also had to contend with oil prices falling to their lowest level in more than 12 years. While lower energy prices may eventually benefit consumers and the economy, at present they're contributing to uncertainty in the financial markets as investors try to determine whether and to what extent problems in the energy space could spill over to the broader economy.

Core bonds were the main beneficiary of the volatile environment, generating a solid 1.4% return as investors rotated out of risk assets. As a result, bond prices rallied, driving yields on the 10-year Treasury below 2%. The more credit-sensitive sectors of the bond market fared worse than core bonds as high-yield bonds and floating-rate loans fell 1.6% and 0.65%, respectively.

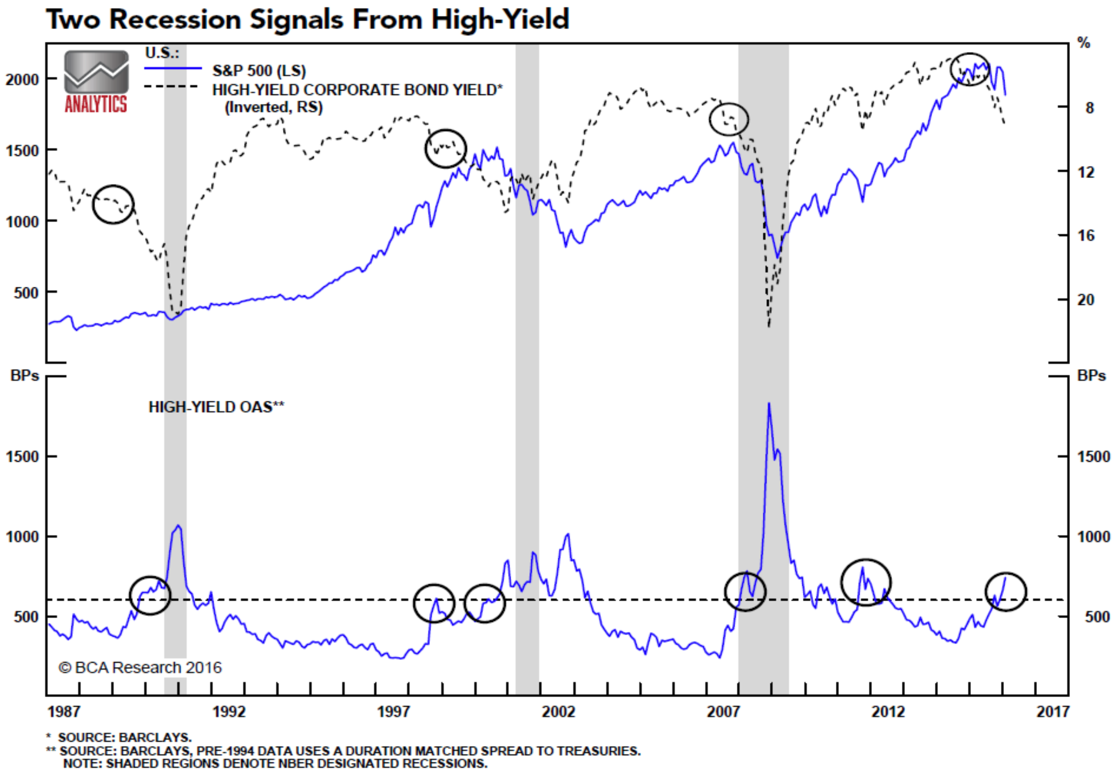
From an economic perspective, data was decidedly mixed in January. Fourth quarter 2015 GDP was announced, and the anemic 0.7% growth rate fell below most analyst expectations. However, the services sector of the economy remains relatively strong and appears supportive of the overall economy. Outside the United States, investors continue to weigh economic developments in China in particular, attempting to determine what they may imply for the global economy and the financial markets.

Stretching Too Far For Yield

For several years we have watched skeptically as investors (and advisors) chased higher yielding investments without due consideration to the risks involved. In our opinion, investors became far too complacent in the belief that aggressive monetary policy by central banks would give them a "free-ride" to load up on aggressive income securities. However, investors that replaced treasury and investment grade bonds with high-yield (junk) bonds, master-limited partnerships MLP) and emerging market debt in pursuit of higher yields have learned a painful lesson over the past year. Namely that many of the aggressive income strategies have the same risks as stocks, and don't provide the same diversification and risk management benefits of high quality bonds in a portfolio. The performance numbers over the past year (as of 2/8/16) speak for themselves: high-yield bonds down 9.2%; MLP's down 48% and emerging market debt down 14.5%. In contrast the Barclays Aggregate was up 1.5% and municipals did even better up 3.9%. Our preference, has been to stick with higher quality investments for the time being and patiently wait for better valuations that would justify the risks associated with more aggressive income strategies. **Investors should remember that total return of income securities is more important than simply chasing the highest yields. There are no "free-rides" in the financial markets, at least that we know of!**

Are High-Yield Bonds Signaling a Recession?

High-yield (HY) bonds have significantly underperformed treasury bonds the past year, causing their yield spread relative to treasuries to jump significantly. Performance in the HY market is important to watch because big sell-offs are often considered a reliable predictor of recessions. The chart below from BCA highlights the recessionary signals HY bonds have given over the past few decades. Correctly signaling recessions in 1990/91, 2001 and 2008/09, however giving false signals in other periods.

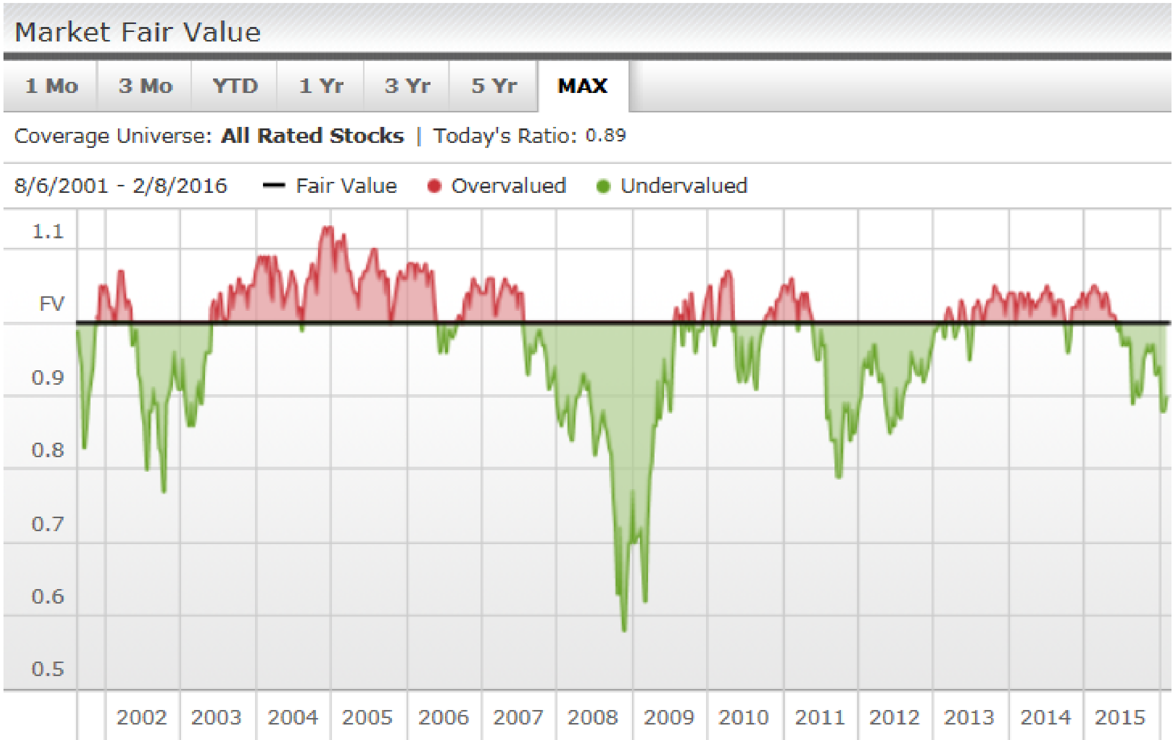


Clearly, high-yield bonds in isolation are not a perfect predictor of recessions, however there is evidence that when yield spreads spike above 600 basis points the conditions for a recession are increased. **To improve on the reliability of high-yield signals other indicators should be considered.** Some of the indicators we are watching closely for signs of a recession are: **a down-turn in leading economic indicators, an inverted yield curve, deterioration in the financial health of corporations, tightening bank-lending standards, growing economic imbalances, excessive use of leverage and potential financial shocks.** Although we are not forecasting a recession, when we evaluate these indicators we believe the odds of one have increased to their highest level since 2009 and bears watching. **If the evidence of a recession continues to grow it may also warrant a more conservative positioning in portfolios.**

The Brightside of Higher Volatility (Corrections)

No one enjoys seeing their stock prices go down, however **as long-term investors a correction provides a great opportunity to buy quality stocks at bargain prices and reallocate portfolios**. We've written over the past couple of years that stocks were overvalued, which made it challenging to buy quality stocks at reasonable prices. The recent correction, we believe, has for the first time in a couple of years has selectively taken valuations down to levels where we are finding attractive opportunities to buy the high quality companies we like to own. The chart below is a summation of the fair value estimate for all of the stocks covered by Morningstar's analysts. When the chart is green it indicates the aggregate value of stocks covered by Morningstar are below fair value and when red it is above fair value. The current reading is 0.89 or 11% undervalued, which is a significant improvement over the past couple of years.

Investment Commentary: 2/2016



Source: Morningstar

The above estimate of fair value is just one of the indicators we look at, however we think it has been historically accurate and is reflective of the better long-term investment opportunities we are seeing in the market today. **The best values and opportunities are being created in parts of the market that sold off the hardest last year: energy, materials, financial, industrial, transportation and healthcare sectors. We will be selectively searching in these areas to find the best long time investing opportunities.** As always, our focus will be on identifying world-class companies that are positioned for sustainable growth and possess the characteristics needed to generate superior long-term performance. We like to invest in companies that have a long history of outstanding business results, are well managed and trade at values below their long-term fair value. Staying disciplined and investing in companies that have sustainable advantages over their competitors, allows our holdings to consistently grow and generate value for shareholders. **In sum, as long-term investors we are focused on the 'brightside' of this correction and view it as a good opportunity to buy quality stocks and add value to portfolios, you should too!**

AWM Investments (2/10/16)