Investment Commentary: 3/2016

February got off to a rocky start as stock markets dropped sharply, extending January's decline. Stocks in the S&P 500 began to climb shortly before mid-month and rallied nearly 11% to finish the month with a slight loss of 0.1%. Smaller-cap stocks had a similar descent/ascent and finished the month down just 0.2%.

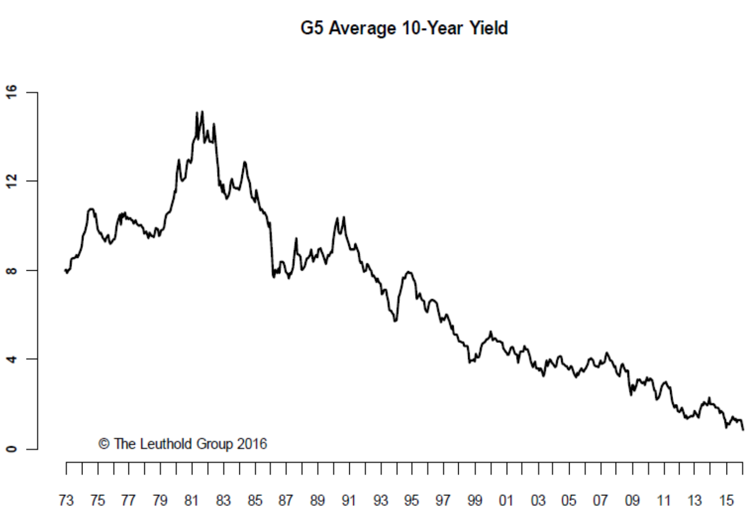
Stock market performance improved in the back-half of February as investors took comfort from improving economic data. Fourth quarter real GDP was revised slightly upward, while new data released in February suggested that the year is off to a decent start as consumer spending, personal income, and core inflation data all came in higher than expected. Oil also staged a dramatic rebound, rising 25% to close the month at $35.10 after hitting a low of $26.05 on February 11. Both the rebound in oil prices and the short-term data seemed to reduce investor fears of an economic recession in the United States, at least for the time being.

Economic results in Europe remained sluggish and investors continued to worry about the sustainability of the Eurozone's economic recovery and the health of the European banking system, both of which weighed on markets. Developed international stocks fell 3.1% for the month. Emerging-markets stocks fared a little better and finished with a slight loss of 0.3%. The short term outlook for emerging markets continues to be weighed down by a combination of commodity price declines, currency weakness versus the U.S. dollar, high debt levels and overall risk aversion. Longer-term the emerging markets are trading at reasonable valuations and we will be watching for attractive entry points to begin accumulating positions.

In the fixed-income markets, core bonds added to January's gains with a positive return of 0.7% and are up 2.1% year to date. The Federal Open Market Committee is scheduled to meet in March; however, market opinion (both qualitative and as reflected in the futures market) suggests it is unlikely to raise interest rates in the face of economic and financial market uncertainty around the globe. **With yields on core bonds at such low levels we expect absolute returns to be low over the next few years, however they still provide value in terms of diversification and risk management**.

From ZIRP to NIRP

Central banks around the world are increasingly resorting to negative interest rate policies (NIRP) in an attempt to increase economic growth and avoid deflation. In fact, according to Citigroup 25% of all global bonds (and 40% of all European bonds) now have negative yields. The chart below clearly shows that February was a historic month for bonds, with G5 10-year average yields registering a new all-time low!



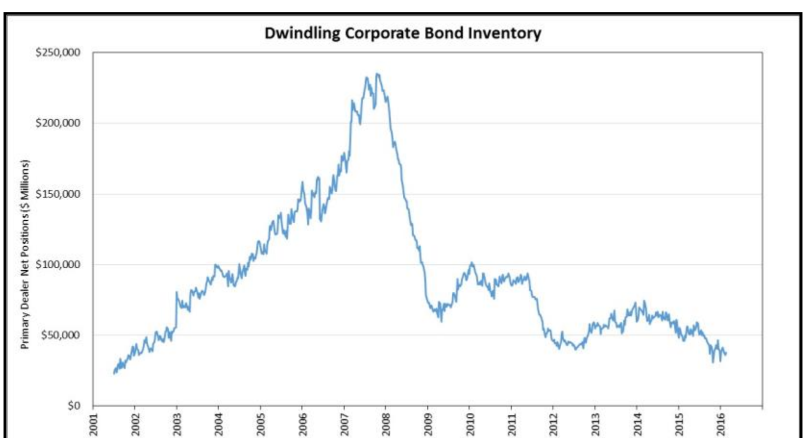
The rationale for central banks to pursue NIRP is that it will encourage banks to lend excess reserves, push down real market interest rates, support asset prices, boost consumer confidence and depress their currencies. Whether or not NIRP policies will work or if they are simply a desperate act on the part of central banks is yet to be answered. However, as investors we have to acknowledge that NIRP can lead to unintended and negative consequences. **Here are some of the potential negative consequences of NIRP that can impact financial markets:**

- Increased volatility from NIRP may actually tighten financial conditions by widening credit spreads and equity risk premiums, and reducing credit availability from a less profitable and more stressed banking system.
- There is a belief in the economic community that NIRP could actually reduce inflation expectations, which would be the exact opposite of what central banks are trying to accomplish.
- Consumers may hold more physical cash and money market funds could shut down, both outcomes could reduce liquidity and credit availability.
- Negative rates would be painful to retirees and institutions such as insurance companies, pension funds and entitlements. Note that low or negative rates increase the present value of future liabilities while returns on their assets will decline.

In the short-term negative interest rates may be able to stimulate "animal spirits" and give a boost to economic growth and inflation. However, longer-term it is easy to see a scenario where these policies do more harm than good and lead to some of the negative outcomes mentioned above or other unintended consequences.

Bond Market Liquidity

Bond market liquidity has been of increasing concern to investors as the trend in lower dealer inventories continues, while bond prices have been in decline sparking outflows from credit-sensitive bond funds. The concern being that if they try to sell their bonds in an illiquid market they will substantially drive down prices which could result in a negative loop of further outflows and declining prices. The term "liquidity" is simply a broad measure of how quickly someone can buy or sell a position without having a big impact on price. If dealers have meaningful inventory, in theory there's a higher likelihood that a buyer or seller can execute their trade without seeing a meaningful impact on price. With depleted dealer balance sheets, bond market liquidity concerns are legitimate. But we should note that while dealers can provide liquidity to the market, they are not underwriters. Dealers are brokers and get paid by earning the spread between the price that a bond is bought and the price that a bond is sold. When the credit markets are in a sharp decline, dealers don't blindly buy. This is especially the case today. Previously, dealers could buy bonds and hedge downside price risk using liquid single-name credit default swaps until buyers could be found. Today, the single-name CDS market is much smaller than just a few years ago, and because of regulation, requires dealers to hold some collateral such as cash to back their CDS exposure.



Source: Federal Reserve Bank of New York. Data as of 2/17/2016.

Several of the bond fund managers we follow are reporting that nothing has been immune to mark-to-market risk, not even the healthier credits, which we are defining as bonds priced 90 and above. The managers say that while bonds priced in the 90s are *generally* stickier, they are seeing some situations where sellers of meaningful size come to the market and a healthy credit will suddenly trade down meaningfully. Investors who want to sell bonds trading in the 70s and 80s have been getting markdowns of 10 points or more below the current market price in the current environment. **We believe liquidity is an issue that investors should consider when evaluating their bond portfolios. Our preference is to stick with highly experienced and talented bond managers that can navigate this environment and to limit exposure to illiquid high-yield and emerging market debt, especially in an exchange traded fund structure.**

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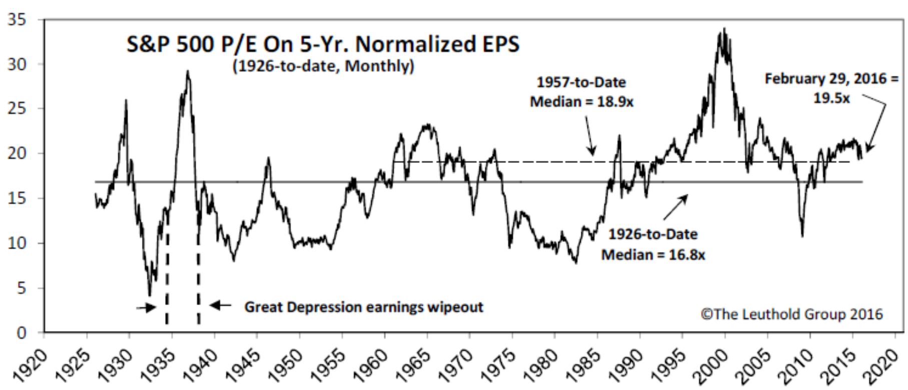
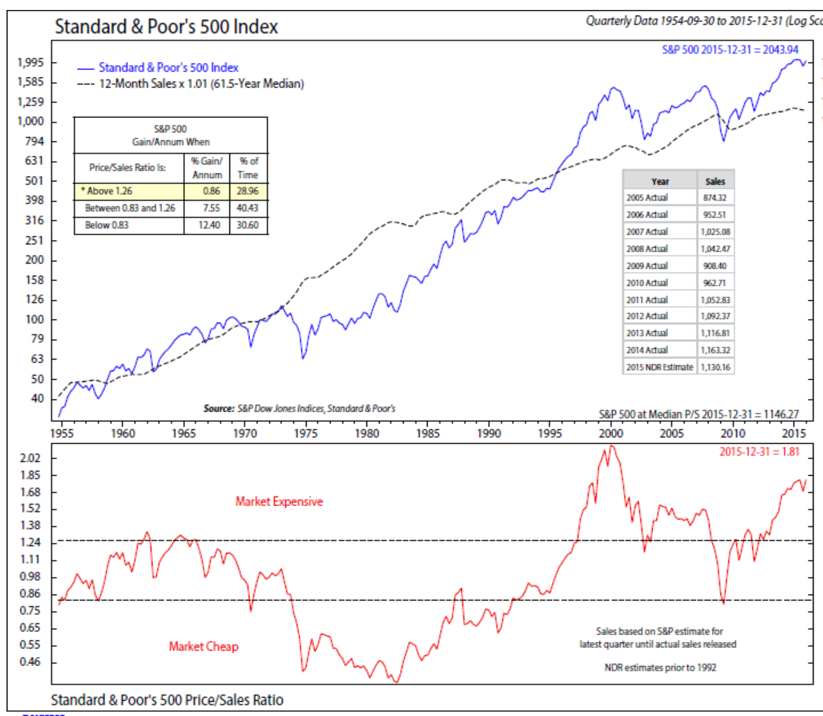
Stock Market Valuation: Both Art & Science

Last month we discussed how increased volatility in the stock market had created some good valuations at the individual stock level. In contrast, we believe that the market as a whole is somewhat overvalued, especially after the rally in stocks over the past month. **When considering valuation for the general market our preference is to look at metrics that are not distorted by short-term fluctuations in earnings or price**. Below are a couple of key indicators that we follow and believe provide a true picture of valuation in the stock market. The first is a 5-yr normalized P/E ratio for the S&P 500, using a normalized P/E ratio helps to filter out the short-term noise of earnings that can occur in any given year. At a P/E of 19.5 this metric is above both its short and long-term median. The Shiller CAPE ratio, not shown, provides a 10 year normalized view of earnings and is trading around 25, again towards the high-end of its historical range.



Another valuation tool we monitor is the price to sales ratio for the S&P 500. We like this ratio because sales tend to be less volatile than earnings and it provides a "less noisy" view of valuation. Below is a chart from Ned Davis Research that shows the current price to sales ratio at 1.81. A level that is near its highest range ever and was only exceeded by the tech bubble of the 1990's.



As investors, it is important to understand valuation, but also recognize that valuation and performance in the short-run have a low correlation. In the short-term, markets are driven by "animal spirits" or cycles of fear and greed and are impossible to predict (in the short-run). In the long-term, valuation is good predictor of future performance and based on current valuations we should expect future returns to be lower than their historical norms. A good guess would be in mid-single digits or around 5% give or take a couple of percent over the next 5 to 10 years. As experienced investors, we know that there is a balance between the "Art & Science" of valuation. The best investment outcomes always come when we avoid the noise of short-term price fluctuations and stick to our investment process, while maintaining a strong valuation discipline. Sticking to our process and "keeping our head" while other investors lose theirs greatly increases our chances of outperforming over the full market cycle. **If anyone tells you they have a "scientific" spreadsheet or model that can predict what stocks will do over the next few months or even a year, you should probably run!**

AWM Investments (3/10/16)