Wealth Management Group Newsletter

Secure Your Future With Confidence | Summer 2016 Edition

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YEAR-TO-DATE 2016 FINANCIAL MARKET OVERVIEW

Equity market returns started 2016 with a resounding thud, with the early return numbers solidly in the red across the spectrum. The S&P 500 was down a negative 5 % at the end of January, and then moved to correction territory by February 11 with a then year-to-date return of approximately -10.5 %. So what then happened to the stock market sell-off and the growing fear of imminent meltdown circulating at the time? Globally, the world's central bankers once again rode to the rescue and the European Central Bank, the Bank of Japan, and China's central bank all furthered their talk and efforts in support of each of their existing monetary easing programs. And, while the U.S. Federal Reserve maintained its higher over-night fed funds rate target established in December 2015, the Fed's language became noticeably more dovish and allayed fears of the probability of as many as four more rate increases through early 2017. In addition, our stock market and the price of oil has recently moved in

Financial Market Total Returns
As of April 30, 2016

Equity	1st Qtr 2016	April 2016	YTD 2016
S&P 500 Index	1.35	0.39	1.74
S&P Mid-Cap 400 Index	3.79	1.22	5.06
S&P Small-Cap 600 Index	1.17	2.65	3.86
MSCI EAFE Index	–3.01	2.90	–0.20
MSCI Emerging Mkt Index	5.71	0.54	6.29
Fixed Income			
Barclays Capital Intermediate Govt/Credit Index	2.45	0.27	2.72
iBoxx High Yld Index	3.32	3.36	6.79
Real Estate			
Dow Jones US Real Estate Index	5.15	–1.70	3.36
Commodities			
Bloomberg Commodity Index	0.34	8.49	8.86

All returns shown as percentage

positive lock-step; and on February 11 the price of a barrel of oil hit a bottom of $26.21, the lowest point since 2003, but has now rallied to the mid-$40's. Very quickly, following February 11 lows, global investors moved to a more risk assuming investment posture and the results can be seen in the return numbers year-to-date through April. Smaller U.S. companies, emerging market stocks, and lower quality high yield fixed income securities outperformed relative to other asset classes. The rebound since early-mid February has left the S&P 500 within four percentage points of its all-time high.

O GROWTH, GROWTH, WHEREFORE ART THOU ECONOMIC GROWTH ?

Economic growth is a hard item to find in today's developed world. U.S. Gross Domestic Product (GDP) for the 1st quarter of 2016 was recently revised to 0.8%, Euro area GDP expanded 0.3% in the latest quarter, and Japan's GDP grew – 0.3%. The International Monetary Fund recently lowered its global growth estimate for 2016 by 0.2% to 3.2 % down from 3.4 %, and in the same report called for structural reform and fiscal policy changes to be added to easy monetary policy measures. Central Bankers have gone so far as to take the extreme position that ridiculously low interest rates will provide the stimulus needed to promote growth and inflation, by actually offering negative interest rates. The European Central Bank (ECB), the Bank of Japan (BOJ), and the central banks of Sweden, Switzerland, and Denmark have all got on board the negative interest rate policy (NIRP) train. Can this economically unnatural and illogical monetary policy work? Or will the long-term record show it to have caused more harm than benefit by creating greater volatility in economic cycles carrying the likelihood of greater instances of financial market bubbles. One can certainly make the argument that the economic environment following 2008 could have been much worse, and that through massive liquidity efforts, our Fed and other central banks prevented what might have been a much more severe downturn (or perhaps collapse). But, one result is that we now have an environment that seems to continually beg for more of the same. Will this work? The truth is no one knows. Central Banks, including ours, are sailing in unchartered waters. And now many, as previously mentioned, have broken the zero interest rate sound barrier and moved to negative rates to feed the need. The time to realize and acknowledge the limitations of using insanely easy monetary policy measures long-term to keep the world's developed economies afloat is now...prior to the onslaught of an economic storm of the century. How? Responsible fiscal policy and serious discussions surrounding structural reform, while difficult, would appear to be the only sensible path toward normalcy. Central bankers have done all they can, now it is time for elected officials to take measures. Mohamed El-Erian (Allianz Chief Economic Adviser, and formerly with PIMCO) perhaps recently said it best: "Central banks are like doctors, they can never walk away from the patient. Even though they haven't got the right medicine, they will continue prescribing."

U.S. CORPORATE EARNINGS

The earnings of U.S. corporations, as measured by the S&P 500, have been in a recession that goes back to the 2nd quarter of 2015. The most recent estimate for 1st quarter 2016 earnings growth is -8.9 % with 2nd quarter estimates now at -4.9 %. A minor bright note is that analyst expectations call for the 1st quarter to be the trough and for positive earnings growth to begin with the 3rd quarter. Companies in the energy, materials, and financial sector are expected to provide the largest negative impact to the aggregate for the 1st quarter. If 2nd quarter 2016 earnings do end up negative, it will have been at that point a full five quarters of decline.

As this Newsletter is written, 373 companies of the S&P 500 have reported for the 1st quarter. Of the 373 companies reporting, 76 % have delivered a positive earnings surprise. Said another way, 76 % of the companies have delivered an earnings report that has exceeded analyst expectations. As for sales revenue, of the 373 companies, 56 % have delivered numbers which have exceeded estimates. As mentioned in past editions of our Newsletter, corporate finance officers in conjunction with Wall Street analysts have an uncanny ability to guide expectations so the bar is purposely set at a low level.

Despite seeing a somewhat weaker U.S. dollar relative to other currencies in the month of March, the negative impact of dollar strength remains a concern and one of the reasons cited by companies for weak earnings. These company notations of the negative impact of a strong dollar are not baseless. According to recent report by Factset: For companies that generate more than 50 % of sales inside the U.S., the blended (reported and estimated for the 1st quarter) earnings decline is -3.5%, and for companies that generate less than 50 % of sales inside the U.S., the blended earnings decline is -18.9 %.

Consumer spending typically accounts for around two-thirds of economic activity (GDP) in this country. A rebound in the demand for consumer goods is vitally important for this economy to exhibit improving economic growth. And consequently, for corporate earnings to grow. And furthermore, for continued labor market improvement and wage increases... with eventually all leading to the economic circle of life necessary for sustaining a healthy economic existence. One can certainly understand why an improving and healthy employment picture is first and foremost on Janet Yellen's list of priorities, even to the exclusion of at some point having the economy run a little hot and pushing inflation above the Fed's target for a period...which is in no way in the cards at the moment.

OUR OUTLOOK

We have mentioned in the past that liquidity, corporate earnings, and current valuation measures all play an important role in developing expectations for the stock market. Central banks have more than satisfied the liquidity piece, and company and analyst estimates call for 1st quarter 2016 to be the low point for the decline in earnings currently being experienced. As for stock market valuation: The S&P 500 at a price level today of 2050, with aggregate trailing 12 month earnings of approximately $118, produces a Price/Earnings (P/E) ratio of 17.4 times. The average P/E for the S&P 500 looking back 40 years is 16.7 times. Over that time period, the P/E ratio saw a peak of 30 times at the height of the tech bubble and a low of 7 times in the inflationary and high interest rate period of the early 1980's. So, 17.4 times does not appear excessively high, given the very low inflation and interest rate environment now. We do believe however the numbers call for a closer look.

Adjusted earnings reports have become the norm, especially in industries that are experiencing extraordinary circumstances such as the energy and material sectors. Companies make the argument that some costs or write-offs are non-recurring and should be excluded. The problem can be further magnified when the designation reasoning becomes somewhat creative and consistent. These earnings do not meet generally accepted accounting principles (GAAP) and are called non-GAAP or adjusted earnings. Wall Street analysts are aware of these and adjust their estimates and assessments of earnings reports accordingly. If the P/E ratio, in our earlier analysis, is recalculated to reflect non-adjusted earnings or GAAP earnings, the earnings number falls from $118 to $91.5 and this produces a P/E of 22 times...a higher number that should be taken into consideration. In addition, the difference between GAAP and non-GAAP earnings is the highest it has been since 2008. Explainable? Yes. The majority of the difference in 2008 was due to the financial industry and the majority of the difference today is due to energy and mining companies. Cause for alarm? Not necessarily, the full economic impact of the pain felt by oil and mining is unlikely to bring the economy to the brink of collapse like the financial crisis did. However, it is certainly further evidence that a more robust economy, solid revenue growth, and improving operating earnings are badly needed.

We have positioned equity portfolios in a defensive posture for this environment by implementing a tactical equity cash reserve of 10 % of the size of a portfolio's strategic equity weighting. The intention is to be in position to take advantage of the opportunities presented in the near-term that the volatility of the stock market offers, within the context of a portfolio's long-term strategic asset allocation.

STUDENT LOAN DEBT...THE NEXT FINANCIAL CRISIS ?

The current state of student loan debt is not pretty. According to Business Insider, national outstanding student loan debt now tops $1.3 trillion, and grows another $2,725 every second that passes. Student loan debt is now the second highest level of consumer debt, behind only mortgages. It is greater than auto loans and credit card debt. Approximately 40 million Americans hold student loans with approximately 70 % of undergraduate degree recipients graduating with some amount of debt. According to the Consumer Financial Protection Bureau, the great majority (approximately 85 %) of the debt is held by the federal government. Most alarming, according to a report by the Federal Reserve Bank of St. Louis, is the 15 % delinquency rate on all outstanding student loans. That 15 % number however, does not come close to reporting how grave the repayment situation is. Since only 55 % of student loans are in repayment (the remaining 45 % are in deferment or forbearance) the 15 % delinquency rate implies a true delinquency rate of 27.3 % for those borrowers with loans in repayment status...a delinquency rate much higher than for any other type of debt.

Student loan debt cannot be easily discharged in bankruptcy. According to the U.S. Government student aid website, discharge will only occur in an adversary legal proceeding in bankruptcy court which finds that repayment would impose undue hardship on the borrower or dependents, and which satisfies all steps of a rigorous three part test. How serious is the federal government regarding repayment? In 2013, approximately 36,000 Americans lost a portion of their Social Security benefit due to an unpaid federal student loan, according to the U.S. Government Accountability Office.

Is student loan debt another financial bubble that threatens the U.S. economy? Most likely not. Student loan debt is growing at an annual rate that rivals the growth of mortgage debt during the period that lead to the last financial crisis in the housing market. However, the similarities end there as reported in a report by Vanguard Investment Strategy Group. The Vanguard analysis points out the absolute size of the two problems in relation to our economy are completely different. At the peak of the housing crisis, mortgage debt represented two-thirds of U.S. GDP, whereas student loan debt now represents about 7 percent. Also, there are no exotic derivatives or complex securitized products magnifying the problem tied to student loans that could trigger a sudden, unexpected collapse which would threaten the financial markets. And as previously mentioned, borrowers cannot simply walk away and go through a foreclosure process as in the real estate area.

There is plenty of evidence available to support the argument that a higher education is likely to have a positive effect on an individual's earning stream throughout life. However, given the size of total student debt outstanding, its continued growth, and the fact that it is widely held certainly has a painful and negative impact on young Americans. Substantial debt, especially in a slow growth economy which has not seen wage gains for many years, prevents young individuals from undertaking large purchases such as houses and autos, which are so important in driving our economic growth. And in the long term, this burden negatively impacts the ability to save in preparation for retirement, which in itself appears to be yet another crisis in the making.

OUR CORE PHILOSOPHICAL BELIEFS

As we have stated many times in past editions, our core philosophical beliefs rest on a foundation of discipline and diversification and our message to our clients is:

- Stay fully invested in line with appropriate client specific asset allocation weightings. There is no evidence that market timing works.
- Stay fully diversified across all recommended asset class and sub-asset class category weightings.
- Monitor and control risk through periodic portfolio rebalancing back to strategic asset class and sub-asset class weighting targets.