Walker & Associates

First Quarter 2016 *Key Takeaways*

It was a tale of two halves in the first quarter of the year for global financial markets. Stock markets plunged early on, falling 10% to 16%. Broadly speaking, the decline was due to ongoing fears of a hard landing in the Chinese economy, a continuing plunge in oil prices, weaker-than-expected U.S. economic data, growing fears of a global recession, and a contagious loss of market confidence in the ability of global central banks to stimulate real economic growth with increased concern that current monetary policies (e.g., negative interest rates in Japan and Europe) are now causing more harm than good.

Then, beginning on February 12, everything changed. Oil prices spiked higher, stock markets rallied, and the dollar declined (serving as a tailwind for foreign equity returns). In a welcome change for our portfolios versus recent years, emerging-markets stocks were among the highest-returning asset classes. Core bonds, which had rallied earlier in the year, fell and the 10-year Treasury yield moved higher.

The rally continued in March, on the back of better economic news in the United States and the Federal Reserve's decision to not raise the federal funds rate and also to lower its projection for the number of rate hikes for the remainder of the year. Markets also reacted positively to dovish European Central Bank actions during the month, as well as additional monetary and fiscal stimulus in China.

Looking ahead, however, with consumer price inflation and market inflation expectations rising, stock and credit markets and oil prices rebounding, and the dollar no longer appreciating, the Fed may soon turn more hawkish again. (In fact, just a few days after the March announcement, several Fed governors suggested the Fed could raise rates at the April meeting.) This could trigger market reactions that reverse these recent reflationary trends.

More generally, we'd note that global monetary policy is moving deeper into uncharted, historically unprecedented territory, bringing with it unknown and unintended consequences. How and when will the current extreme monetary policies be "normalized" and how will they impact the global economy and financial markets? No one knows.

The extreme market turmoil we experienced in the first quarter vividly illustrates why we construct diversified investment portfolios for our clients. It also points out the unpredictability of short-term market movements. Our approach is to carefully analyze long-term risk and return potential and build portfolios that balance these considerations and are resilient across a variety of market scenarios.

First Quarter 2016 Investment Commentary

Our investment outlook—both in terms of potential return drivers and risks—has not materially changed over the past quarter. But in the context of the market's recent gyrations, we'd like to highlight reasons that the recent relative performance trends *may* be sustained for a while, to the benefit of our portfolios.

We often talk about cycles when discussing our investment philosophy and tactical asset allocation approach. This is because financial market and economic history is a series of multiyear cycles—albeit in the case of most stock markets and economies it is cycles within a very-long-term (secular) growth trend. These cycles, we believe, are driven by natural human group or herd behavior. And since we don't think human behavior is going to evolve much over the next few decades, we expect markets will also continue to behave cyclically.

The existence of market cycles creates significant risks for investors who ignore them (i.e., the "this time is different" syndrome) and great opportunities for disciplined long-term investors. But while this time is rarely different when it comes to investing, neither do history and cycles repeat exactly in terms of timing, duration, or magnitude.

Howard Marks, co-founder of the hugely successful investment firm Oaktree Capital and the author of many insightful investment memos over the past 25 years, often emphasizes the importance of understanding cycles. He uses the metaphor of a pendulum to describe market behavior, as summarized in the following excerpt from his 2011 book, *The Most Important Thing*.

> Investment markets follow a pendulum-like swing:
> - between euphoria and depression [greed and fear],
> - between celebrating positive events and obsessing over negatives, and thus
> - between overpriced and underpriced.
>
> This oscillation is one of the most dependable features of the investment world.

Marks notes that the oscillation of the investor pendulum is similar to the up-and-down fluctuation of economic and market cycles in that while the occurrence of the pendulum-like pattern is extremely dependable in most markets, one never knows exactly how far the pendulum will swing, how long it will stay at one extreme or another, or what might cause it to reverse.

It is impossible to consistently and accurately predict exactly when a cycle will turn or when the pendulum will start to swing back the other way or how far it will go at the extremes. But with our longer-term analytical framework and forward-looking assessments that are informed by and grounded in market history, we believe we can position our portfolios to benefit from the cyclic swings of the pendulum.

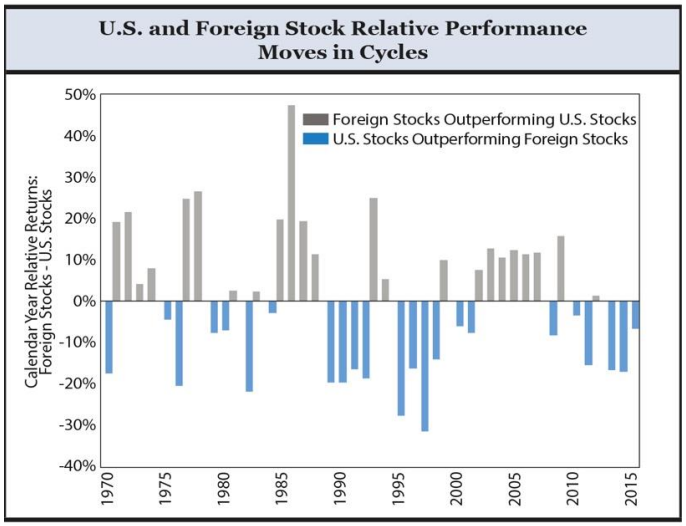
Market Cycles and Portfolio Positioning

In recent years, our portfolios have been positioned for a turn in some market cycles that haven't yet changed course, namely our tactical underweight to U.S. stocks versus foreign stocks, and our exposure to value or cyclical stocks (i.e., businesses that are more sensitive to the broader economic cycle). While this has impacted our short-term performance, we remain confident the current market cycle will turn.

U.S. Versus Foreign Stocks: Over our five-year investment horizon, our view is that U.S. stocks are likely to deliver underwhelming returns (low single digit), while developed international and emerging-markets stocks are poised to produce much higher returns. This has been a headwind to our portfolio performance as the current cycle of U.S. stock outperformance versus foreign stocks now ranks as the

longest relative performance streak for U.S. stocks since the inception of the international stock index in 1970. However, we believe this cycle will eventually turn in our favor.

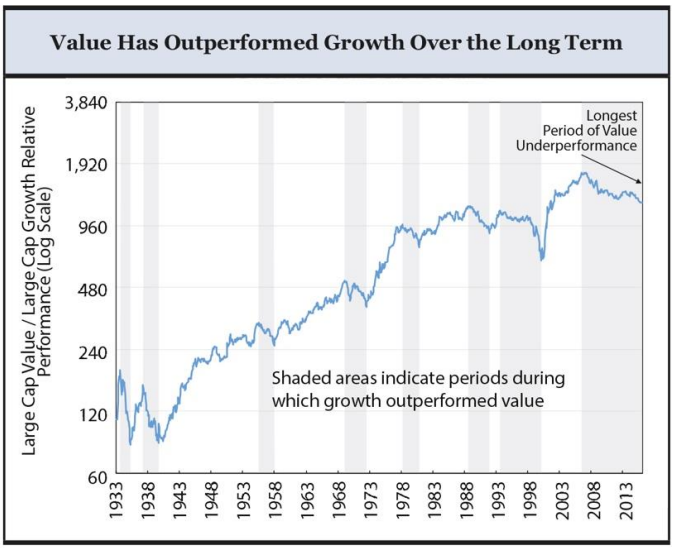
U.S. profit margins (and earnings growth) have been coming down, as we expected. But margins are still high relative to history and are likely to continue lower if and as wage pressures continue to build as the labor market tightens. Higher interest rates (and therefore higher corporate borrowing costs) would also be a negative for margins. Current corporate profit margins have been negatively correlated with future earnings growth. That is, historically high profit margins are associated with low five-year forward earnings growth and vice versa. If topline revenue growth remains subpar and profit margins decline, earnings growth will remain under pressure.



Source: Morningstar. Data as of 2/29/2016. Foreign stock returns tracked using the MSCI World ex USA Index from 1970 to 1987 and the MSCI ACWI ex USA Index from 1988 onward.

Meanwhile, on the valuation side, we see little room for market-multiple expansion in the United States. The 12-month trailing price-to-earnings ratio for the S&P 500 is 24x, and the 12-month forward P/E ratio is 18x (using analysts' consensus forward earnings estimates). These are both historically high levels. Our base case scenario assumes the P/E multiple contracts over time, bringing it in line with longer-term historical averages. Putting it all together, it means poor expected returns for U.S. stocks.

In contrast, developed international and emerging markets are almost a mirror image of the U.S market, with below-normal earnings and the potential for faster earnings growth from current levels. We also expect valuation multiples to expand somewhat from current levels as earnings improve. On this point, one additional supporting factor is that foreign markets have already suffered a steep decline, as if the markets expect a global recession even though it isn't at all clear we are in such a recession or about to fall into one—although that's one reasonable near-term scenario.



Source: Morningstar and Kenneth French. Data as of 2/29/2016. Data prior to 1979 is from Kenneth French's database. Value is defined as high book-to-market ratios and growth as low book-to-market ratios. From 1979 onward we use the Russell 1000 Value Index and the Russell 1000 Growth Index.

<u>Value (Low-Multiple) Versus Expensive (High-Multiple) Stocks:</u> In another unusually long market cycle, this has been the longest run of underperformance for value stocks on record going back to 1930, at nearly 10 years (outlasting the six-and-a-half years of the Internet/tech stock bubble). The flipside has been that on the other end of the style spectrum, expensive growth and momentum stocks have had unusually strong returns.

Over the long term, a value investment approach has meaningfully outperformed a strategy of buying expensive (high-multiple) stocks. But there are cycles. Value investing has had several periods of significant

underperformance. The inability of most investors to stick with a value approach during such cyclical reversals is likely what enables the "value premium" to persist over the long term. And the short-term performance-chasing tendencies of most investors pushes the pendulum still further.

So both of these cycles have been headwinds to investors like us who are valuation-driven and look at things on a longer-term "normalized" basis. As such, we have been underweight (expensive) U.S. stocks and have found (cheaper) foreign stock markets more attractive in terms of their expected returns relative to risk.

Consequently, the reversal in the markets starting in February may mark a change from a cyclical headwind to a tailwind for our tactical positioning, as well as for many of our active equity managers. From the February 11 low, the MSCI ACWI ex USA Index is up 13.2% beating the S&P 500 by 21 basis points. Emerging-markets stocks have rebounded 17.7% (and are up 21.9% from their January low). The MSCI ACWI ex USA Value Index has jumped 14.5%, beating the MSCI ACWI ex USA Growth Index by more than two-and-a-half percentage points. European and emerging-markets stock indexes also have larger exposure to cyclical and traditional value sectors (such as financials, materials, and industrials) than the S&P 500. Our flexible and absolute-return-oriented fixed-income positions have also performed nicely since the market lows, gaining anywhere from 2% to 7%, while the core bond index returned less than 1%.

Will Recent Market Trends Sustain?

We have started to see references by several market strategists and investors to the potential for a so-called reflation cycle to kick in. James Paulsen, chief investment strategist at Wells Capital Management, recently laid out a scenario in which the recent market reversals may be the beginning of some new cyclical trends.

Paulsen argues that if oil prices have bottomed and the current rebound to around $40 per barrel (or higher) is sustained, it may have significant repercussions on a wide range of financial markets. Because the U.S. dollar has been inversely correlated with oil prices for the past 15 years, higher oil prices imply a weaker dollar (or at least minimal further appreciation). In addition, Paulsen hypothesizes that with the U.S. economy near full employment, wages and inflation are likely to continue to rise (barring a recession), thereby pressuring corporate profit margins, earnings growth, and U.S. stock valuations. This should also lead to higher inflation expectations and higher U.S. interest rates. Rising rates would not be good news for core bond prices, but would likely be positive for non-core fixed-income funds.

This reflation scenario also suggests many of the most popular investment themes of the post-financial-crisis U.S. bull market—such as defensive and growth stocks outperforming cyclical value stocks, and U.S. stocks beating foreign stocks—could be reversed during the balance of this recovery.

To be clear, this isn't a prediction of what will happen over the near term, but we think it is one plausible scenario among many that could play out. And while we use a short-term (12-month) time frame to run "reasonable worst case" stress-test scenarios as we manage our portfolios against various downside risks, it is nice to sometimes look at a "reasonable best case" and acknowledge the shorter-term "upside risks" to our portfolios as well. —*Walker & Associates (4/8/16)*