Fourth Quarter 2015

Economic Update: Raising interest rates when normally they would cut interest rates

The Federal Reserve raised rates in December by 0.25% for the first time since 2006. It is widely expected that the Fed will raise rates further this year, perhaps 4 times, each time by 0.25%. Whether economic strength will justify more rate increases remains to be seen. Interestingly, the only other significant Central Bank expected to raise rates is the United Kingdom. All others are expected to continue to lower rates.

Purchasing Managers' Indices (PMI) are economic indicators derived from monthly surveys of private sector companies. US manufacturing PMI for December was reported to be 48.2. A reading less than 50 indicates contraction and December's reading is the lowest reading since June 2009. Services was 55.3, down 0.6 from November but still indicating growth. Approximately 15% of US economic output comes from manufacturing & mining and 85% is attributable to the service industries[1]. Interestingly, the manufacturing PMI has proven to be a good indicator of nominal GDP and the trend is down. In fact over the past year, there have been 10 (of a possible 12) month-over-month declines in Industrial Production. Going back to 1919, such a high number of declining months has never been observed except in the context of a U.S. recession[2].

Capital Markets: Buy the Dip or Run for the Hills?

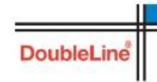
We have long been advocates of caution in the stock markets due to elevated valuations and low prospective long-term returns. The stock market high was May 2015. Since then we have experienced two 10% corrections, one in August and one in January of 2016. Two 10% corrections in such a short time span has only happened 3 other times in the last 100 years – 1929, 2000 & 2008[3]! Now is not the time to "buy the dip" and hold.

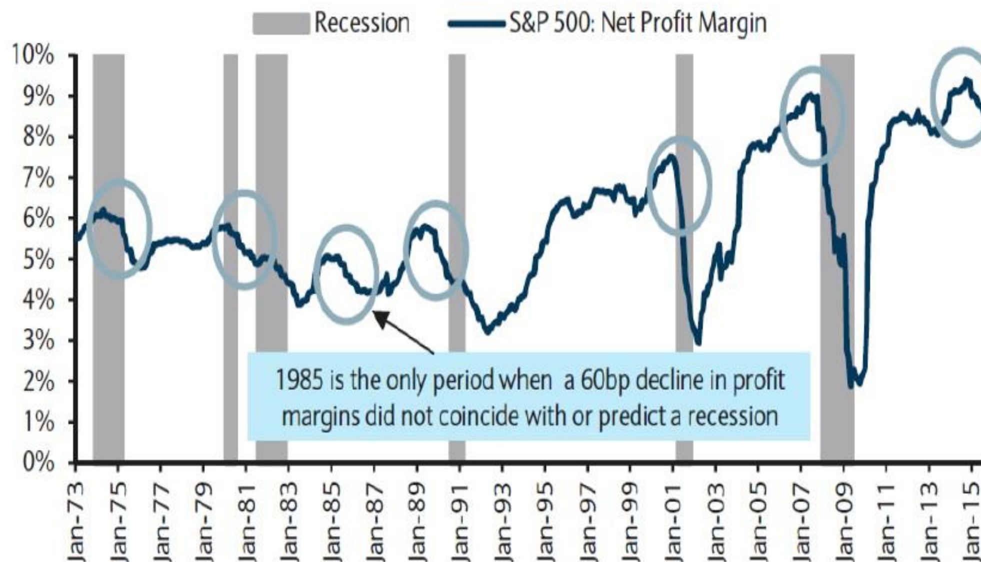
What has changed? After 6 years, the market uptrend has broken and turned down. Why?

S&P 500 earnings, otherwise known as corporate profits, have declined the past four quarters. September 30, 2015 is the last full quarter of reported corporate earnings. Cumulatively corporate profits are down -14.3% when compared to earnings a year earlier. For the same

[1] Financial Times 7/25/13
[2] Hussman Weekly Commentary 1/18/2016
[3] Per Jason Goepfert of the SentimenTrader

period, the S&P 500 price was down only -2.6%. Furthermore, when corporate profit margins decline 0.60%, the odds are very high that a recession is imminent (see chart below). We believe that this decline in earnings is a key factor in the recent market declines.





We are already in a "stealth bear market". As of January 6, the average distance individual stocks in the S&P 1500 (which includes large, mid, and small cap stocks), are trading from their respective 52-week highs was a whopping -24%; that's bear market territory! Not surprisingly, small cap stocks have been hit the hardest as the average stock in the S&P 600 Small Cap Index is down 27.6% from its 52-week high. In the midcap S&P 400, the average decline is 23.6%. For large cap stocks in the S&P 500, the average decline from a 52-week high is not quite bear market territory, but at 19.9%, it's pretty darn close[4]

Portfolios

During the fourth quarter, our fixed income and alternative investments were collectively flat. Our core stock positions gained a bit but were held down by our resource investments. Our three-pillar investment approach (stocks, bonds, alternatives) continues to smooth out our overall performance. For the year, our alternative pillar was the best performer, followed by our bond holdings and then stocks. During the fourth quarter, our stock market risk indicators briefly

[4] Barrons on-line 1/7/16 – Bespoke Investment Group

turned to "risk-on" during November, but then returned to "risk off" in December where they remain today. Accordingly we have maintained a conservative stance toward risk assets such as stocks and high yield bonds.

The first week of 2016 has been the worst stock market start to a new year ever with the S&P 500 down -5.87% through the first 5 days of trading. Importantly, our three pillar approach has fared well and is weathering the storm just fine. If indeed a bear market (20% declines or more) is imminent our portfolios are well positioned.

Thank you for your continued trust and support.

Trevor K. Holsinger and Steve Small

Disclosure:

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