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Market Commentary

The oldest and strongest emotion of mankind is fear, and the oldest and strongest kind of fear is fear of the unknown.

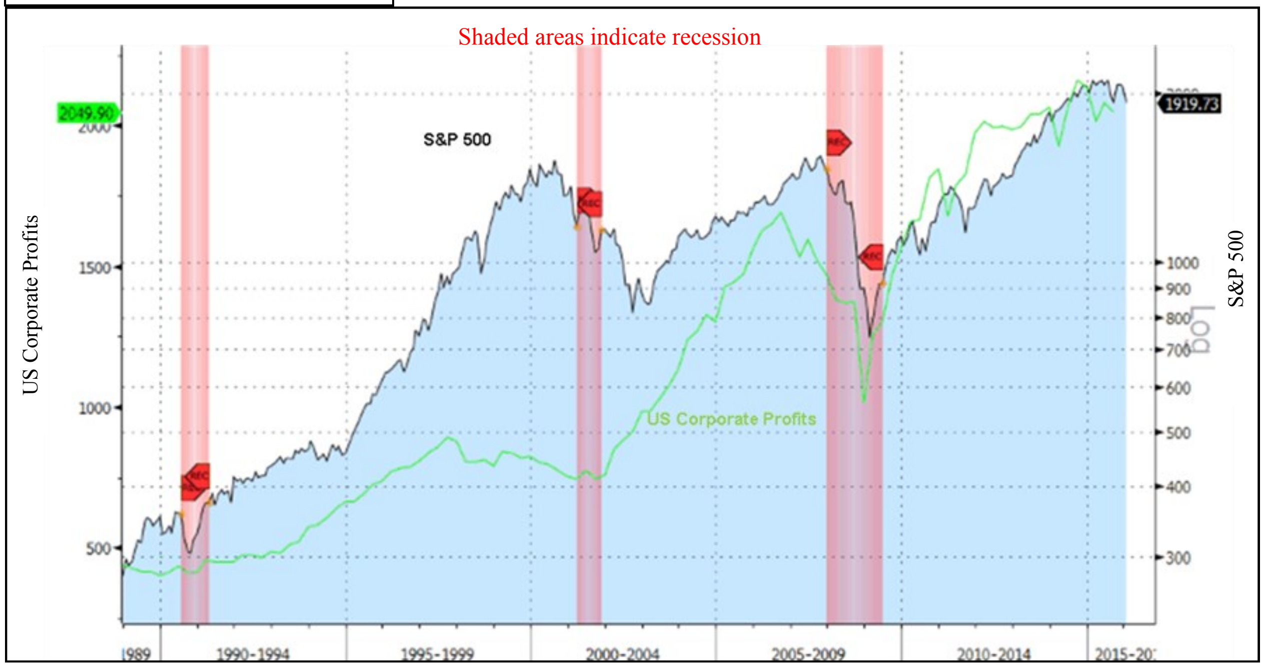
–H.P. Lovecraft

Volatility and risk aversion returned to the financial markets last year. Concern over energy, industrial commodities and emerging markets began to spread to other assets. Large cap companies with growth opportunities in the US fared best. The S&P 500 returned 1.4% in 2015, but the average stock in the index returned -2.2% as a narrow group of large cap growth stocks drove performance. Small cap stocks lagged and growth performed better than value. High quality stocks generally outperformed. Emerging markets that export commodities were the worst performing countries while commodity importers such as China and India fared better. A selloff in high yield bonds began with the hundreds of billions of debt issued by lower tier oil and gas producers. This debt at its peak comprised over 15% of the junk bond market. It appears that a third or so of these issues will default, and investors will generally recover very little in the reorganizations.

The memory of 2008 still serves to reign in risk-taking before it becomes a systemic issue that puts the economic expansion at risk. The silver lining of the subpar recovery from 2008 is that very few excesses have been created. In 2008, a spike in oil prices and slowdown in housing shattered the brittle, overleveraged financial sector and ignited the worst economic collapse since the Great Depression. It would be a mistake to project the experience of 2008 onto current downturns in energy, industrial commodities and emerging markets. Today, we have mostly unlevered investors risking their own money and suffering the consequences of their own decisions. Countries and sectors cycle without their financial contagion disrupting the broad economy. Volatility in financial markets cannot be eliminated, as it is the manifestation of markets attempting to price new information. The goal is to limit its impact on the real economy and, so far, this appears to be the case.

What is Happening in China?
China, while the second largest economy in the world and a greater contributor to global economic growth than the US for the past several years, remains too isolated from the global financial markets for any downturn it may experience to cause a new global financial crisis. After the 2008 Financial Crisis, China redirected its economy from export manufacturing to domestic investments in real estate and infrastructure. As a dictatorial, centrally planned economy it faced little difficulty in ordering the state-run banking sector to lend money to state-owned property development companies. This

S&P 500 and Corporate Profits



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activity generated a tremendous demand for steel, copper and other raw materials related to construction. Commodity-driven booms followed, particularly in other emerging markets that export commodities, such as Brazil. As most of this Chinese construction was debt-financed, debt levels in China grew by nearly 80% from 2007 through 2013. As the Chinese government recognized the dangers of an out-of-control real estate boom, it began taking steps to slow the growth of construction and steer the economy toward higher end services and household consumption.

Recent data suggests that China succeeded in driving increases in household consumption. Auto sales have been increasing by 10% year over year as have movie tickets and other indicators of middle class spending. However, household consumption accounts for only about a third of the Chinese economy, whereas it accounts for 70% of US GDP. The Chinese face considerable difficulties moving from their dependence on investment in real estate, factories and other heavy industry. However, as China is such a large economy with so little of it available for investment by Westerners, what really matters is the performance of the Hong Kong-listed Chinese companies, which primarily lie in the Services and Technology sectors, along with any spillover to China's trading partners.

This year, China tentatively began to let its currency float against the dollar. Maintaining a US dollar peg became costly given the dollar's appreciation against other world currencies over the past few years. So far, the depreciation of the Chinese renminbi totals just over 6%. Bloomberg Economics estimates that a further depreciation of 10-15% could add nearly 1% to GDP growth as Chinese exports became more competitive. While currency depreciation promises mostly positives for the Chinese economy, the government's seemingly inept handling of the country's stock market boom and bust has led many to question the continued ability of the Communist Party to manage the economy, as it becomes more complex and less reliant on simple manufacturing and fixed asset investment. China bears also point to dangerously high levels of debt within the corporate and financial sectors and unfavorable future demographics resulting from 35 years of its one-child policy.

So far, the data supports the view that while slowing and encumbered by debt and poor governance, **China's slowdown and economic repositioning will occur gradually over the next 5-10 years**. China remains a vibrant economy that has produced many world-leading businesses. While analogies to Japan in the 1980s can be made, China's immense and still mainly poor population will continue to generate demand for goods and services far above Japan's smaller and wealthier population. Very little of the problematic sectors in China's economy are directly investable to Westerners and China's closed financial system prevents the sort of contagion that marked the 1997 Asian Financial Crisis or the 2008 Financial Crisis.

This market resembles 1998 with its similar collapse in emerging markets and commodity prices against a backdrop of relatively stable US growth. Too many investors took the wrong lesson in 1998 – shedding underperforming asset classes and concentrating their portfolios on a small group of large cap US growth stocks that continued to perform. They drove these stocks into a record equity bubble which collapsed shortly thereafter and set up a lost decade of equity returns where the S&P returned, on an annualized basis, -1.0% from 2000-2009. Large cap stocks, the best performing major asset class over the past five years, appear to us to be priced for 4-5% returns after inflation. While not a new lost decade, if valuations revert to more historical levels, the next five years may well see negative returns for the S&P 500.

MLPs are OK

Concerns about weak oil prices and the "death of the MLP model" are overblown. 70% of the sector's asset base transports and processes natural gas. Daily volatility of the Alerian MLP Index is now worse than indexes of mid-size oil producers which face the full brunt of declining commodity prices. While the outlook for oil prices over the next few years remains bullish from these levels, \$60-70 oil is not a prerequisite for the MLP sector to recover. The collapse of any buying response to the current wave of selling typifies market bottoms. All selloffs eventually come to an end, and the current bear market for MLPs will be no exception. The assets remain core infrastructure, financed with a conservative mix of equity and debt. Long-term contracts remain in place. The sector prospered through the weak commodity price environment of the 1990s. This selling simply constitutes a liquidity-driven panic subject to a potentially equally sharp recovery in value.

Surviving volatility requires liquidity and an understanding of economic fundamentals. There will always be a certain level of cognitive dissonance surrounding holding long-term assets that are repriced hundreds of times each second. Purchase and sale decisions should be made from a multi-year outlook, not in reaction to short term price movements. When fundamental outlooks deteriorate then sell, if the outlook still harmonizes with the original investment thesis then one should hold. With MLPs and most high yield issues outside of energy, the outlook remains intact. Portfolios should maintain adequate liquidity in high quality fixed income instruments equal to several years of cash flow needs so that these intermittent periods of volatility do not result in forced sales at distressed prices.

- Stephen C. Browne, CFA
Chief Investment Officer
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