Market Commentary

The investor of today does not profit from yesterday's growth
-Warren Buffett

Pessimism about the global economy peaked in early February, with the S&P down 14.2% from its high in 2015. Equity markets then reversed course, rallying 12.6%. China showed signs of stabilization, and fears of a debt-fueled economic collapse in the country waned. Driven by a rebound in oil prices back to around $40 / bbl., the energy sector appeared to begin its long recovery back to health. In a reversal from the last few years, value outperformed growth, and emerging markets outperformed developed markets. High quality stocks continued to outperform. Biotech stock indexes shed a quarter of their value over concerns of increased regulation, taxation of foreign earnings and the scandal surrounding Valeant Pharmaceuticals. Of 2015's technology winners - Facebook, Amazon, Netflix and Google – only Facebook had positive performance for the quarter. High yield corporate bonds staged a significant recovery from last year's declines. However, many oil and gas producers remain financially distressed and more producer bankruptcies loom. The euro and yen appreciated against the US dollar, but equity indexes in these regions delivered negative returns. The MSCI EAFE Index of developed non-US stocks returned -2.9% in US dollars but returned -7.2% in its constituent local currencies.

Recent data releases suggest that the global slowdown in manufacturing may have reached bottom. Industrial companies around the world have essentially been in a recession over the past few years. As the world's largest manufacturer, China's economy suffered the largest impact. In the US, where manufacturing comprises a smaller part of the economy, the impact was subdued. Over the time period of 2014-2015, the S&P 500 Industrials Index lagged the S&P 500 by over eight percentage points. On a global basis, the underperformance of industrials was worse, with the S&P Global Industrials Index underperforming the S&P 500 by over seventeen percentage points. The first quarter of 2016 saw pronounced outperformance of the industrial sector, another sign that a recovery may be occurring.

The Fed wants to see better global economic growth before it raises rates. While the strength of recent employment data meets or surpasses the target levels that the Federal Reserve provided as triggers for raising interest rates, observers point to economic weakness outside the US as the primary reason the Fed has not raised rates further.
While loathe to admit it publicly, the Federal Reserve understands it holds the role of central bank to the world, not just the US, as the dollar serves as the global reserve currency. Accordingly, a recovery in the global economy needs to occur before the Fed would be comfortable moving short term interest rates toward the target of 0% real (net of inflation) which would translate to a nominal rate of about 1.5% at current levels of inflation.

The predicted economic benefits of lower energy prices in the US and Europe failed to materialize. Consumers in rich countries so far have tended to save rather than spend the extra disposable income created by lower energy prices. While it is true that every dollar lost by commodity producers is a dollar saved by consumers, when that dollar is taken from poor economies or soon to be unemployed energy industry workers in rich countries and used to pay down debt by its recipient, overall economic activity will contract. Only in emerging markets, primarily India and China, have lower energy prices made a significant positive economic impact.

While the selloff in MLPs stabilized during the quarter, valuations remain depressed. The larger investment grade companies are increasing their distributions this year. While the financial press gave considerable attention to the potential impact of producer bankruptcies on MLPs, the actual exposure remains modest. A recent study by Energy Income Partners took an overly pessimistic case where 50% of the oil and gas producers go bankrupt. In this scenario, operating income attributable to these producers was decreased by 50%. The result was an overall decline in the combined operating income of the Alerian MLP Index of 4.5%. In reality only 11% of US production is from non-investment grade public companies; the remainder is from private and investment grade public companies. Only a small fraction of contracted income from potentially bankrupt producers is at risk in a restructuring.

The MLP sector simply needs time to stabilize. Distributions for the Alerian MLP Index are expected to grow at about 2% in 2016 with substantially higher growth in operating income. Midstream MLPs survived a 'perfect storm' scenario with a surprise crash in commodity prices hitting the industry at a vulnerable moment when many of the key players had stretched themselves financially to meet consolidation and growth objectives. The investor base at the time was flush with new investors, many of them margined, who did not understand the industry. However, MLPs compare favorably to past drawdowns of other types of real asset equity securities when they suffered downturns in their respective industries. The -48.5% return in MLPs over 2014-16, while painful, remains significantly better than the -70.5% drawdown experienced in Real Estate Investment Trusts (REITs) during the real estate bust that accompanied the 2008 Financial Crisis or the -63.7% decline in the utilities sector after the implosion of Enron in the early 2000s. The key difference between MLPs in 2014-16 and past drawdowns of REITs and utilities lies in the fact that no investment grade MLPs went bankrupt or were forced to dilute shareholders due to financial distress. MLP valuations declined, but the income stream remained intact.

Beginning in October, money market reform goes into effect. The key change is that investors which are classified as 'institutional' by the new rules will no longer be able to invest in money market funds with a guaranteed $1.00 share price unless the funds only hold US Treasury bills and other short term obligations of the federal government. Individuals (including IRAs and revocable trusts) can continue to invest in money funds holding corporate and municipal issues at a fixed $1.00 share price. However, these funds are potentially subject to redemption penalties and suspension of liquidity. Most clients are invested in US government money market funds that will not be impacted by these rule changes. Very few clients, if any, will need to take any action. We will include an individual review and any recommendations in your first quarter report.

The S&P 500 was the best single investment for the past several years, but likely will not be going forward. For three and a half years – from 2012 through June 2015, the S&P 500 compounded at a 17.6% annualized return. During this time period the P/E ratio of the S&P 500 increased from 14.1 to 18.5, an 8.1% annualized rate of increase. Earnings per share grew at 5.4%. This easy return environment appears to have ended and markets entered a new period of volatility during the second half of 2015. Earnings of the multinational companies that dominate the index now are under pressure from a strong dollar and rising regulatory, tax and labor costs. After a long run of abnormally high returns in a particular asset class, too many investors make the common error of basing investment decisions on regret and hindsight – dumping underperforming strategies and asset classes and doubling down on what worked best over the prior three or five year period. The correct strategy consists of maintaining a disciplined allocation strategy and rebalancing into investments that may have lagged but offer the potential for future outperformance. Developed non-US stocks, emerging markets, MLPs and select alternative investments, we believe, offer this potential.

- Stephen C. Browne, CFA
Chief Investment Officer
Chief Compliance Officer

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April 26th - 11:30AM CST—Transitioning Family Wealth with Kristen Keffeler

May 19th—11:30AM CST—Emerging Markets with Wasatch Advisors

July 12th—11:30AM CST—3rd Quarter Lunch & Learn