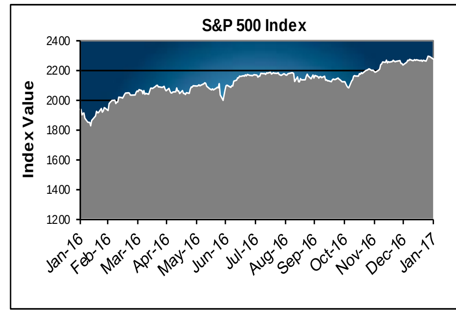
This Month in the Markets

January 2017

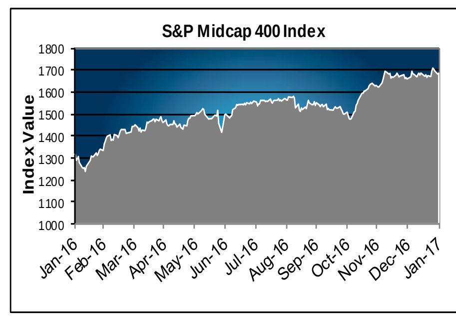
EQUITY COMMENTARY

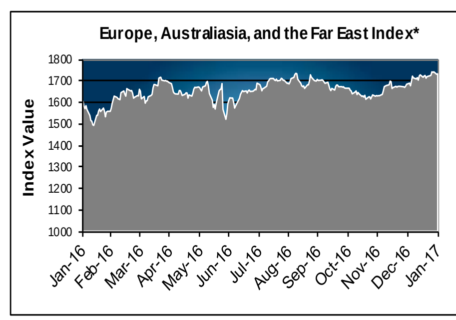
Trump Trade Soldiers On

Despite a bounce following the U.S. elections in November, global equities continued to move higher to start 2017. Since the close on November 7th the MSCI World Index (MSCI) has rallied 8.0% on the prospect of the reflationary policies outlined by Donald Trump. After several years of deflation fears, the global focus has shifted towards inflation. Global growth expectations have strengthened which has spurred equities higher. After turning positive in the third quarter of 2016, corporate profit growth for the fourth quarter has accelerated to 10% over the fourth quarter of 2015. Overall, the MSCI ended the month up 2.35%. Materials and technology companies led the way in January returning 6.7% and 4.5% respectively. Following a big surge to end 2016, energy companies were the big laggards dropping 3.0%. The weak dollar led to international stocks outperforming U.S. stocks with the Europe Asia Far East (EAFE) Index returning 2.9% compared to the S&P 500 Index return of 1.8%.

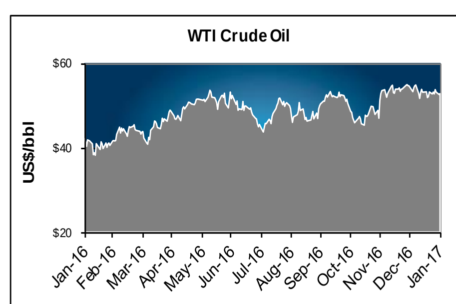


As portfolio managers, our job is not to opine on the appropriateness of political policy but to find companies that can grow earnings and are attractively priced in the current environment. After an eight year bull market where valuation multiples have expanded significantly, our job has become more challenging. With that said, many companies will be able to grow into their multiples if corporate earnings accelerate. While the overall market trades at a premium to its history, an acceleration in earnings growth should normalize much of this premium and provide further upside. The strong dollar and the crash in oil prices led to earnings for the MSCI to drop 13.4% in 2015 and another 3% in 2016. At $80.34 per share in earnings, the MSCI trades at 22.3 times 2016 earnings. This is significantly higher than the average multiple of 16.6 times over the past 60 years. With the rebound in energy prices (and a return to earnings of energy companies) and a flattening of the U.S. dollar, earnings are expected to rise a whopping 34% to $107.32 in 2017. At this level of earnings the MSCI trades at 16.7 times, in line with its long-term average. In the U.S., looking specifically at the S&P 500 Index, earnings declined 3.0% in 2015 and 1.0% in 2016. At $108.02 per share in earnings the S&P 500 trades at 21.1 times earnings, again higher than the average of 16.6 times earnings since 1954. Earnings are supposed to grow 20% to $129.76 per share this year, on the back of a return to growth in the energy sector and a stabilization in the dollar. At this level of earnings the S&P 500 would trade at 17.6 times earnings. While slightly above the long-term average it would be just the 62 percentile. Furthermore, the EPS yield relative to the 10 year government bond yield remains attractive.





While we are always mindful of the investment environment and the overall market, our focus will always be on finding individual companies that are underpriced. We like companies that have relatively stable operating margins, high returns on invested capital and free cash flow yields after adjusting for leverage throughout the cycle. Our portfolios are made up of a basket of such names, all of which are trading below their intrinsic values. The composition by geography and sector may change over time but the core principles underlying our holdings stays the same. At present our equity portfolio trades at 21.1 times 2016 earnings and 13.7 times 2017 project earnings compared to 22.3 and 16.7 times for the MSCI, respectively. The return on invested capital of our portfolio is 9.1% compared to 5.1% for the MSCI.



*MSCI EAFE Index

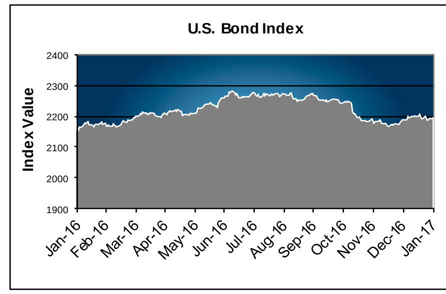
FIXED INCOME COMMENTARY

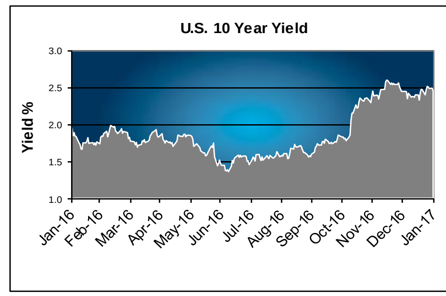
Cyclical Upswing

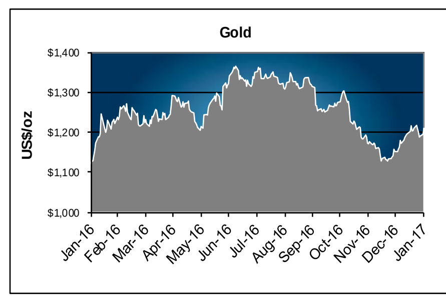
The month of January turned out to be fairly quiet for the fixed income market. Government and high-grade corporate bonds were slightly higher, while the riskier high-yield and preferred securities appreciated by 1.3% and 2.7%, respectively. There was more action in the foreign exchange market with the U.S. dollar losing ground on a broad basis – versus developed and emerging market currencies. The star performers were commodity currencies, with the Australian and New Zealand dollars appreciating by 5.2% and 5.5%, respectively, during the month.

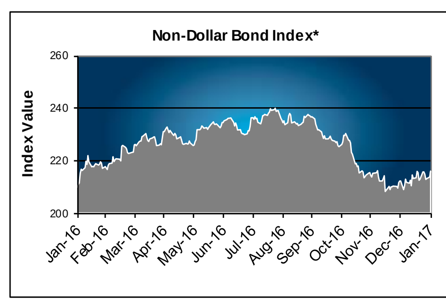
Asset price volatility was subdued in January since most market participants seemed to wait for Donald Trump's inauguration and because there were not any significant policy surprises during his initial days in the office. The first hundred days are usually crucial for the incoming administration and its actions will weigh on bond yields and exchange rates immediately while policy changes can take months to impact the economy. The latter is expected to improve in 2017 from its meager growth rate of 1.6% in 2016 to 2.3% based on the most recent consensus forecast. Several economic indicators support a pickup in activity in the U.S. and globally for this year. For example, the Citi Economic Surprise Index for major economies is close to its highest level in ten years and global leading economic indicators and the global Composite Purchasing Managers Index have accelerated sharply and are well in expansionary territory. Based on recent economic data, the U.S. is outperforming its peers. Especially strong readings from small- and medium-sized businesses and new orders data from the manufacturing and service sectors of larger companies bode well for a strong start into the year. Improving confidence, the proposed corporate tax reform, a reduction in regulation and a stabilization in the energy sector are expected to finally lift overall capital expenditure. On the consumer front a tightening employment market has raised wages and rising financial asset and real estate prices have supported consumer confidence and spending. While the cyclical economic picture has improved tremendously since the U.S. elections in November, it is not clear how structural deficiencies can be resolved for a more encouraging longer-term outlook. Trump's and other countries' policies are not really addressing negative demographic trends, high and still rising debt-to-GDP levels and the retreat of globalization. The rise in the 10-year U.S. Treasury bond yield from its bottom of 1.32% in July of last year to 2.45% at the end of January is a reflection of the cyclical economic uptick. However, the long-term bond yield is more dependent on structural trends and the extremely low interest rates in Europe and Japan. All those factors are limiting a further rise in the long-dated government bond yield for now.

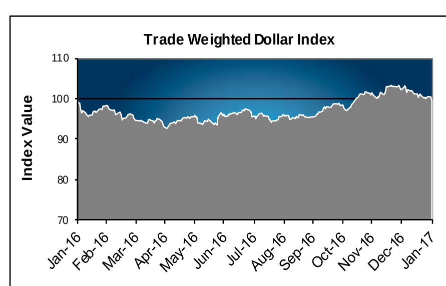
Despite the sell-off in the U.S. dollar in January, the outlook for the greenback remains constructive. Neither the European Central Bank nor the Bank of Japan will raise interest rates anytime soon. Rising inflation expectations in both economies will push the real interest rate further down which will reduce the interest rate differential to the U.S. In addition, the Federal Reserve is expected to raise rates by 50 basis points this year, although it is conceivable that Trump's proposed fiscal stimulus, trade protectionism and immigration restrictions may force the Fed to raise rates higher than anticipated. This will increase the rate differential with other nations by more than currently priced into the market which is supportive for the U.S. dollar.











*Merrill Lynch Global Broad Market, Ex US Dollar Index