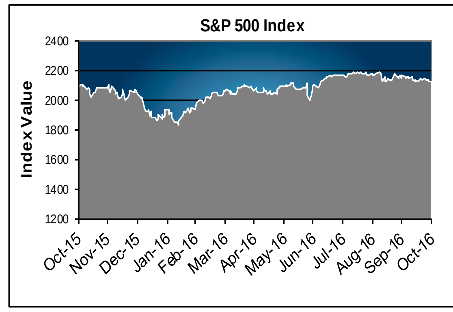
This Month in the Markets

October 2016

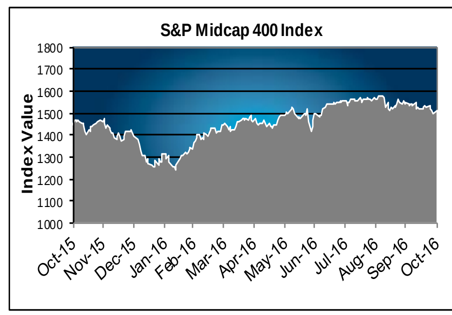
EQUITY COMMENTARY

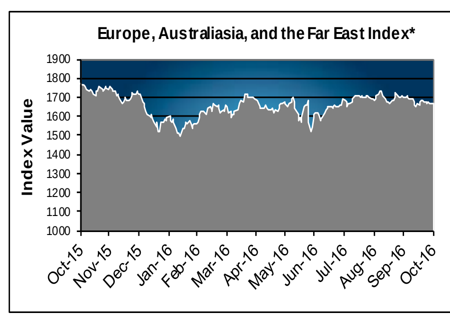
Rising Rates Leads to Equity Weakness

After a strong third quarter, global equities pulled back in October. Despite an improving earnings environment, the key theme over the course of the month was rising interest rates and the impending U.S. election. The yield on the U.S. 10 year Treasury rose 24 basis points from 1.59% to 1.83%. The hardest hit areas of the market were the companies that investors had bought as bond substitutes. Real Estate Investment Trusts (REITS) were down 5.0% while telecoms fell 4.9%. Healthcare companies were also weak due to increased focus on health care costs heading into the election. On the other hand, financials saw continued strength as higher interest rates will reduce the pressure on net interest margins. The financial sector ended the month up 2.1%. Overall, the Morgan Stanley Composite Index (MSCI) was down 2.0% for the month with both international (MSCI EAFE Index) and U.S. stocks (S&P 500 Index) down by about 2.0%. Year-to-date the MSCI is now up 1.7% with U.S. stocks up 4.0% while international stocks are down 2.9%.

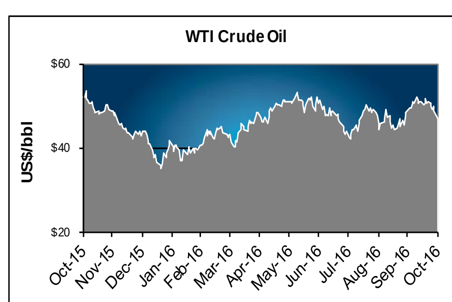


Over the past year and a half much of the focus of equity investors has been on perceived safe, low volatility companies: household names with decent dividend yields but very little in the way of earnings growth. With little profit growth for the overall market and declining interest rates, investors piled money into these “safe” stocks with little concern for valuation. Since the end of the second quarter of 2016, the yield on the U.S. 10 year Treasury dropped nearly 1.0% from 2.35% to 1.36% by July 6, 2016. Over that same period the S&P 500 low volatility index increased 20.3% compared to the total return on the S&P 500 return of just 4.0%, a difference of 16.2%. The rush to safety was compounded by the Brexit vote and higher market volatility. This significant outperformance pushed valuations of most of these “safe” companies to historically high levels. As value managers, we saw little upside, and in many cases significant downside in this area of these traditional safe havens sectors. With volatility falling and interest rates bottoming on July 6th, the tide appears to have turned. The yield on the 10 year Treasury has increased from 1.36% to 1.83% while the S&P low volatility index has declined by 5.2% compared to an increase in the S&P 500 index of 1.8%.





Despite the selloff in October, the earnings environment has actually improved. After seven consecutive quarters of earnings declines, third quarter earnings for the MSCI should come in at about $23.3 per share, up 12.6% from the $20.69 reported in the third quarter of 2015. Sales growth over the same period is expected to be about 2.75%. On a trailing 12 month basis, earnings should turn positive in the fourth quarter with 2016 earnings of $89.65, up 6.1% from the $84.53 reported in 2015. The two main factors for the “earnings recession” experienced over the last two years seem to have abated. From the end of the second quarter of 2014 to January 21, 2016, the U.S. dollar gained nearly 24% on a trade weighted basis. As a result, earnings for companies outside of the United States were worth that much less when converted back into dollars. Since that point however, the dollar’s ascent has stalled and is down about 2.0%. The other main culprit for falling earnings was plunging commodity prices, headlined by oil. Since the end of the second quarter of 2014 to February 12 2016, the Thompson Reuters/Core Commodity CRB Commodity Index plunged 50% pushing most commodity and energy businesses into the red. Since then commodity prices have recovered over 20% which has stabilized earnings for commodity producers. Overall, at about 18.8 times 2016 earnings and with earnings growth accelerating into next year we remain cautiously optimistic on global equities and more opportunistic with the embedded value of our portfolio holdings.



*MSCI EAFE Index

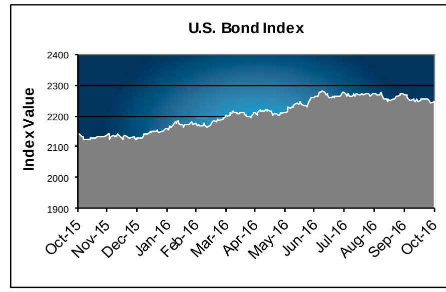
FIXED INCOME COMMENTARY

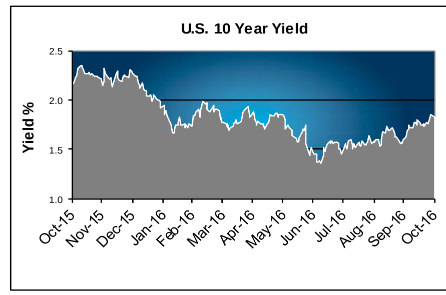
Divergence

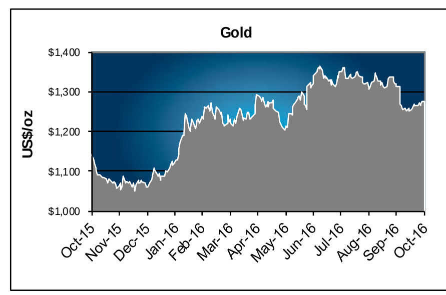
Government, high-grade corporate bonds and preferred securities weakened by 1.2%, 0.8% and 0.6%, respectively, in October due to higher inflation expectations. High-yield bonds were nonetheless able to post a small gain of 0.3% during the month. The biggest moves occurred in the federal funds futures and currency markets, with the British pound's flash crash on October 7th adding significant volatility. During the course of the month the odds have risen that the U. S. central bank (Fed) will raise its target rate at its meeting in December. At the same time the European Central Bank (ECB) is expected to announce the extension of its quantitative easing program. This divergent monetary policy outlook propelled the U. S. Dollar Index to a 3.1% monthly gain reversing declines in the first half of the year.

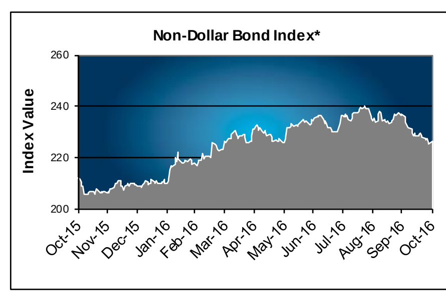
October saw an increased focus on the upcoming U. S. presidential elections with economic data moving to the sidelines for now. Nevertheless, it was encouraging to see that recent releases have pointed to an ongoing moderate economic growth environment in the U. S. The Fed's Beige Book, for example, indicated that the economy maintained a "steady growth pace" and that most districts saw a "modest or moderate pace of expansion". The description of the job market mirrored the monthly non-farm payroll data, which was seen as tight, as nascent wage pressures were observed. It is still too early to call for a sustainable rise in wages since the broader based unemployment rate U-6 (which includes persons marginally attached to the labor force and people employed part time for economic reasons) is still elevated at 9.7%. However, the trend is in the right direction and rising inflation expectations have also been reflected in market-based indicators. In this regard, the BofA Merrill Lynch US Inflation-Linked Treasury Index outperformed the US Treasury Index by 64 basis points in October. Inflation expectations remain low in historic comparison and based on the projected economic outlook. This will provide support for Treasury Inflation-Protected Securities (TIPS) in the near term. The Fed has to tread carefully with any signaling of further rate increases beyond 2016. Currently, there is only one hike in 2017 and another one for 2018 priced into the fed funds futures market. If the U. S. central bank decided to hike rates at a faster pace than anticipated, inflation expectations could be quelled and today's moderate economic growth may slow down once again. On the upside, the agendas of both presidential candidates appear to be mildly stimulative from a budget perspective, but we would argue that fiscal support would make monetary policy stimulus more effective.

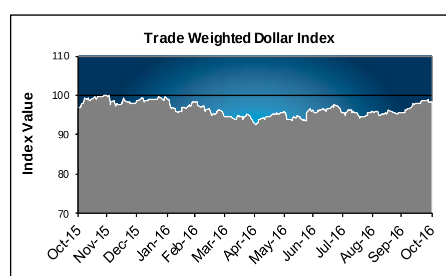
The potential of fiscal stimulus to supplement monetary policy is especially important in the Eurozone. The region's budget balance has improved from -8.1% in March 2010 to -0.9% in June 2016. This is a remarkable accomplishment, especially considering that the average pace of real economic growth and inflation were a meager 1.1% and 1.2% p. a., respectively, during this period. While the fiscal improvement has been applaudable, it has also had the effect of dampening economic growth and has put most of the burden on monetary policy. The European Central Bank (ECB) has already cut its main refinancing rate to -0.4% and is involved in large scale asset purchases. At its meeting in December, the ECB is expected to announce an extension of its quantitative easing program beyond March 2017 and possibly until the end of the year, which would increase the central bank's balance sheet to about 25% of GDP. The easing stance of monetary policy in the euro area at a time when the Fed is contemplating with raising interest rates, has provided solid support to the U. S. dollar.











*Merrill Lynch Global Broad Market, Ex US Dollar Index