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Client Newsletter – Quarter Ending March 31, 2016

Uncertainty Prevails. Stay Tuned.

U.S. equity markets hit an all-time high in May of 2015; this occurred after a long recovery from the Great Recession. The recovery was slow and weak. Incomes have barely reached the levels before the Recession. Unemployment rates have returned to about 5%, but are uneven throughout the country. The labor participation rate has only recently begun to recover. Then in May 2015, markets began a decline. A confluence of factors led to the decline. The economy of China began to slow. This slowdown led to a collapse of commodity prices, especially oil, throughout the world. Normally lower oil prices would be considered good news, a tax cut really. But in this case, the drop was so significant and rapid, that producers were caught off guard. Commodity producers of all kinds had expected the Chinese economy to continue to grow; they invested and created overcapacity. In the case of oil, the U.S. became a net exporter, which had not been the case for decades. Emerging markets began to falter. Banks were under pressure again. Equity markets decided to steer clear of all this risk. Central banks throughout the world cut interest rates, some into negative territory. Currencies weakened as central bankers tried to reflate their economies with a weak currency. Into this witches brew stepped the U.S. Federal Reserve with a benighted policy to raise interest rates. They forecast four rate increases for 2016. Then having painted themselves into a corner, they did raise rates in December of 2015. The markets responded immediately tumbling more than 10% in the worst start ever to a new year. Remember the adages, “As January goes, so goes the year” and “Don’t fight the Fed”. Investors fled the market.

“Whoa!” said the Fed. That’s not what we wanted to happen at all. This rate raise was supposed to be a reflection of how strong the economy is. The problem is that only the Fed saw the bright spot, and they were wrong. The economy was weak, barely growing at all. In fact, in the fourth quarter of 2015, GDP grew only 1.4% down from the previous quarter’s 2.0%.

The global economy was also weak. Christine Lagarde warned the Fed against a rate rise. Germany, Japan and others were opting for negative interest rates. Emerging markets were generally a basket case. So, at the January meeting, where a rate increase was again on the table, “All meetings are live”, said Chair Janet Yellen, the Fed whiffed and did not raise rates. The market took this as a sign the Fed was back in the game, not working against the frail economy. So on February 11, 2016, the market began to rise. The greenback weakened, the price of oil gained, and the market began an ascent, eventually wiping out all year to date losses in a ferocious rally. But where do we go now?

1. Stocks gained 13.3% in seven weeks. Historically the market gains a bit over 9% annualized over long periods of time. That is a reason to pause.

2. The outlook for profits is weak. Analysts forecast a 7% decline in profits, versus a 2.3% gain at the start of the year. If profits are down, that would be the third straight quarter of down profits; surely a sign of a weak economy. Much of the EPS gain has come from share buy backs.
3. The market is not cheap. The long term average price to earnings ratio is 14.7, but currently the market is trading at more than 17 times forward earnings, which is well above the 15 times earnings of the market low in February.
4. Federal Reserve policies are uncertain. Fed speakers take to the rubber chicken circuit each weak to espouse their point of view about rates. Some are for increases and some for steady to down. In any event, this babble confuses the markets and the world economy. What is the Fed doing? Janet Yellen seems to have a point of view, but she has a split board. On any given day it is hard to know what the Fed is really going to do.
5. Government policies do not favor business and the economy. Government policies have added costs to doing business, which causes business to pare other costs, and hold back salaries for working people. New jobs are not created. Regulations are favored over job growth.
6. The election is a wild card. Money runs from uncertainty and this election has been about uncertainty. Two candidates currently appealing to the majority of voters are definitely out of the mainstream. If either of them are elected, there could be dramatic changes in policy and economics. Investors prefer a more nuanced approach.

But when faced with investment options, investors still have to feel that equities are the place to be. Cash returns nothing, bonds return little more. Alternative investments have their own set of problems and haven’t been doing all that well anyway. So, in spite of all the problems with stocks, and their high price, equities remain the place for investors to put their money.

Best,

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