Equity Market Update

As of March 31, 2016 / Volume 5, Issue 1 / FFTAM.COM

The first quarter of 2016 was one for the record books. After sharp declines in January and February, the stock market staged an impressive rally in the final six weeks of the quarter. In mid-February, the market was down over 11% year-to-date, yet it finished the quarter slightly in the black. The size of the reversal from the lows to finish the quarter in positive territory was the second largest in history, slightly behind the moves seen in the fourth quarter of 1933.

To begin the year, investors feared the US economy could fall into recession due to weakening conditions overseas. As the quarter progressed, data indicated the fears were overblown. Regardless, investors continue to fret about six major headwinds: 1) plunging commodity prices; 2) a strong US Dollar; 3) slow global economic growth; 4) weak corporate earnings growth; 5) above average valuations for stocks; and 6) the Fed's desire to raise interest rates. These issues have plagued investors for over a year now, and they do not appear to be any closer to being solved. As a result, markets have been very volatile, with little-to-no return as compensation.

The S&P 500 finished March with a total return of 6.78%, which was 12.95% better than the February 11th low. Year-to-date, the S&P 500 is up 1.35%. The Dow Jones Industrial Average was up 7.21% for the month and is positive 2.20% year-to-date. Even the NASDAQ saw massive buying in March, up 6.98%, reversing a tough January and February. After being the darling of the stock market last year, it is down 2.39% thus far in 2016 as investors have gravitated towards value names instead of growth.

Stocks outside of domestic, large cap did even better last month. The S&P 400 Mid-Cap index gained 8.51%, while the S&P 600 Small-Cap index advanced 8.20%. Year-to-date, the indexes are up 3.78% and 2.65%, respectively.

The international parts of the market did very well in March after the ECB pumped more stimulus into the system. The MSCI EAFE index gained 6.58%, while the MSCI Emerging Markets index zoomed 13.23% However, the bulk of the bad news continues to come from these regions. The ECB and Bank of Japan are plunging interest rates further into negative territory. Currently, trillions of dollars' worth of bonds are trading at negative interest rates; therefore, markets have become worried that policymakers may have run out of ammo since the negative rates have produced little evidence of improved economic growth. Year-to-date, the MSCI EAFE index is down 2.86%, while the MSCI Emerging Markets index is up 5.69% after the massive rally in March.

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The economic tea leaves tell us the US economy is still improving, albeit slowly and unevenly. We continue to see improving labor market conditions, modest debt burdens, low energy costs, and strong housing activity. This data is good for consumer spending, which makes up 70% of US GDP. However, consumers have elected thus far to save the bulk of the energy decline, with the US personal savings rate as a percentage of disposable income hitting 5.4%, its highest level since early 2013. As employment growth continues into the future, we expect consumers to deploy a portion of their savings, which would serve as an economic boost.

Despite these good readings, manufacturing continues to struggle. In fact, we are currently sitting at a record gap in GDP contribution between the services and manufacturing portions of the economy. Manufacturing is mired in a weak environment that began in late 2014. Most of the woes are attributable to massive capex cuts by the energy sector, along with export declines due to the US dollar being at its highest level versus international currencies in 13 years. Investors were encouraged in March as ISM Manufacturing PMI provided its first reading above 50 since September.

These items make investors nervous about the Fed's plans to continue raising interest rates in the face of all these headwinds. It is fair to say, the Fed is probably the most influential force in the markets at the current time. Their decisions on interest rates will be the single leading factor for equity total returns in 2016 as can been seen by the large rally in stocks after the Fed announced they reduced their estimated number of rate hikes for the year from four to two.

The health of the US labor market probably warrants higher rates; however, the Fed showed in September and again last month, they are willing to delay tightening to prevent another rally in the dollar that could force China to devalue the yuan or exacerbate economic weakness overseas. At the current time, the equity market is pricing in little chance of an interest rate hike until the second half of the year. This "lower for longer" mentality should keep interest rates in a tight box along the interest rate curve.

Although markets are slightly higher in 2016, valuation has gotten worse. Upcoming first quarter earnings are seen dropping for the fourth straight quarter on a year-over-year basis. Most of the drop in earnings is attributable to the sharp fall in energy and commodity prices. This has the S&P 500 trading at 17.5x 2016 estimated earnings, which is above the 5-year and 10-year averages. The current multiple even exceeds the long-term historical average of 15.7x.

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A premium valuation is warranted, in our opinion, given the extremely low interest rate environment; however, it also means there is limited upside to equities. At the current time, we believe the future returns for stocks are asymmetric, meaning the amount of upside is far less than the potential downside from this point. As a result, we believe stocks are vulnerable to unexpected short-term events, like the sell-offs seen to start the year, especially since we expect earnings growth to remain subdued. However, we view those pullbacks as temporary given the lack of attractive opportunities in other asset classes. All these forces, when viewed in totality, indicate that stock total returns will be below historical average, while volatility remains above average.

Currently, we are more cyclically positioned versus the benchmarks in the Equity Income and Core portfolios, although we have reduced the exposure by a large margin this quarter. It has impacted performance thus far in 2016 as the rotation into defensive sectors has been extreme. The level of outperformance in telecom and utilities is similar to the amounts seen during the financial crisis of 2008, the terrorist attacks of 2001, and the collapse of Long-Term Capital Management. This indicates investors are positioned for a near term economic crisis, which is something we view as unlikely in the United States. Given that we do not expect a large economic improvement either, we have used the rally in cyclical sectors over the past six weeks to get closer to benchmark allocations.

In Strategic Growth, we remain more value oriented than the benchmark. This has aided performance in 2016 as value has far outpaced growth. As the performance disparity continues to widen between growth and value, we look to capitalize on the pullback in growth names by increasing our exposure to the healthcare, technology, and consumer discretionary sectors.

In closing, we have included a few graphs as exhibits that support our thoughts and clearly depict the current volatility and challenges facing stocks.

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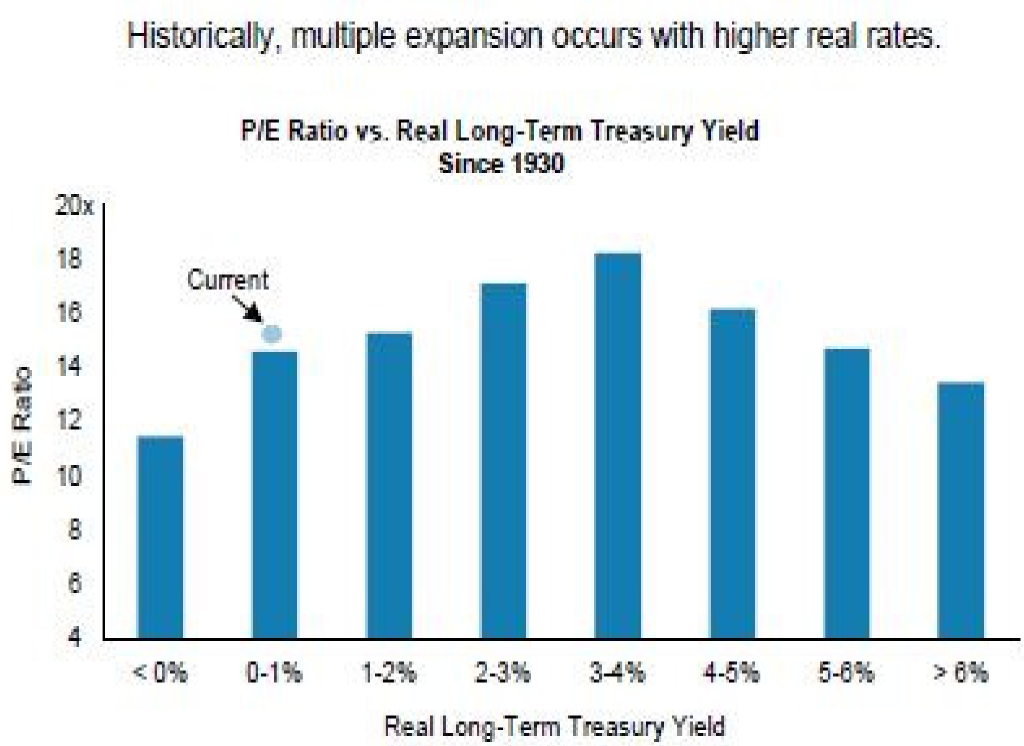
Exhibit 1: Morningstar's proprietary model indicates stocks are near fair value at current levels.

Exhibit 2: Given the weak economic environment, PE multiples cannot expand much further according to historical measurements; therefore, stocks need earnings growth to move meaningfully higher from here.



Source: Morgan Stanley

Exhibit 3: Stocks have continued to march higher despite earnings estimates falling. At the current time, all of the earnings growth for 2016 is embedded in the second half estimates.

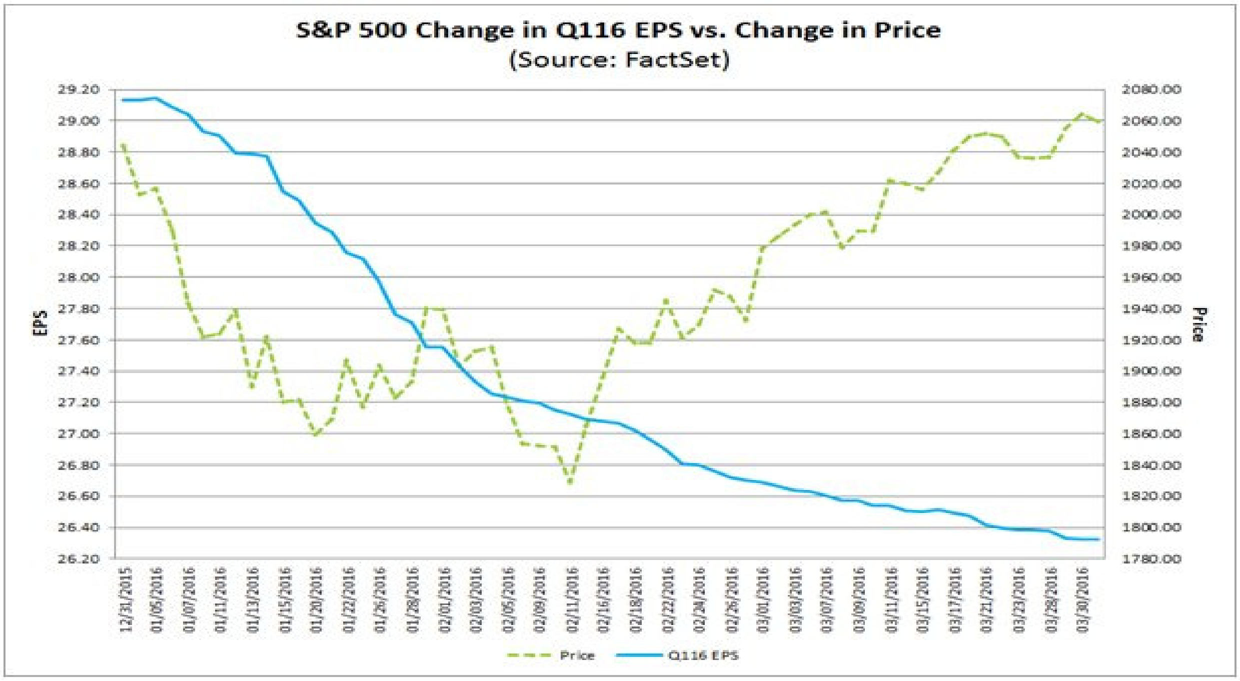


Exhibit 4: Higher stock values, along with falling earnings, has stocks trading above historical valuations.

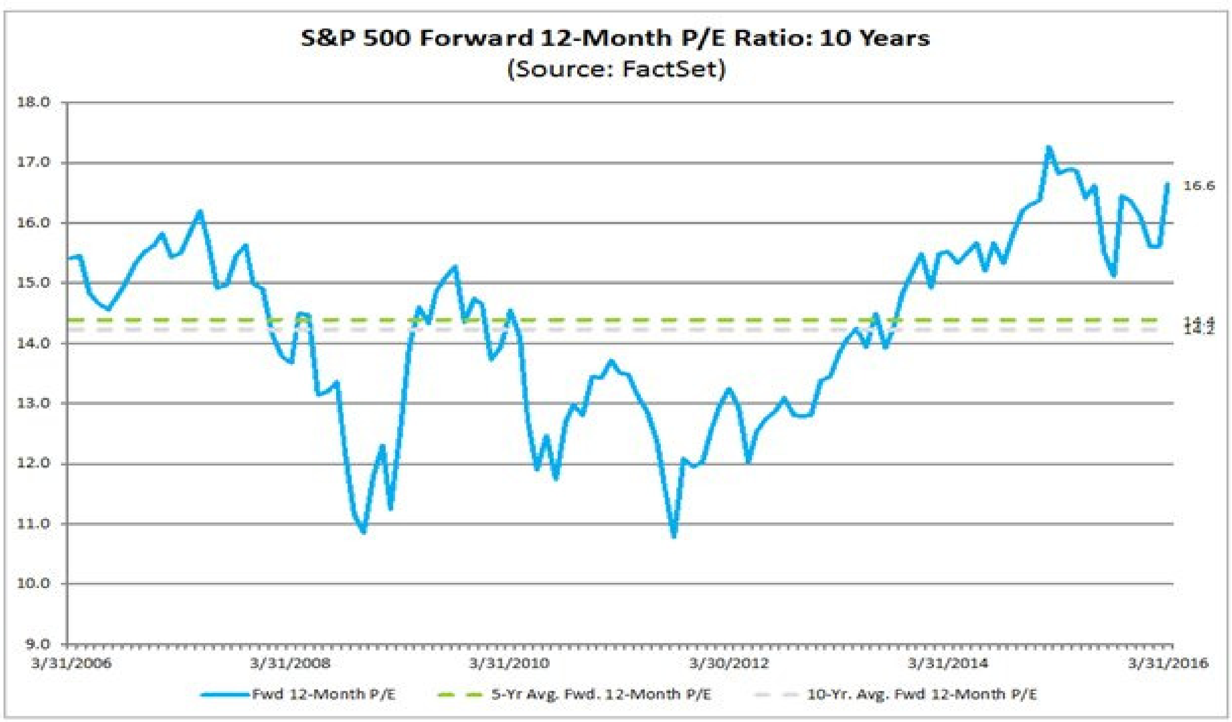
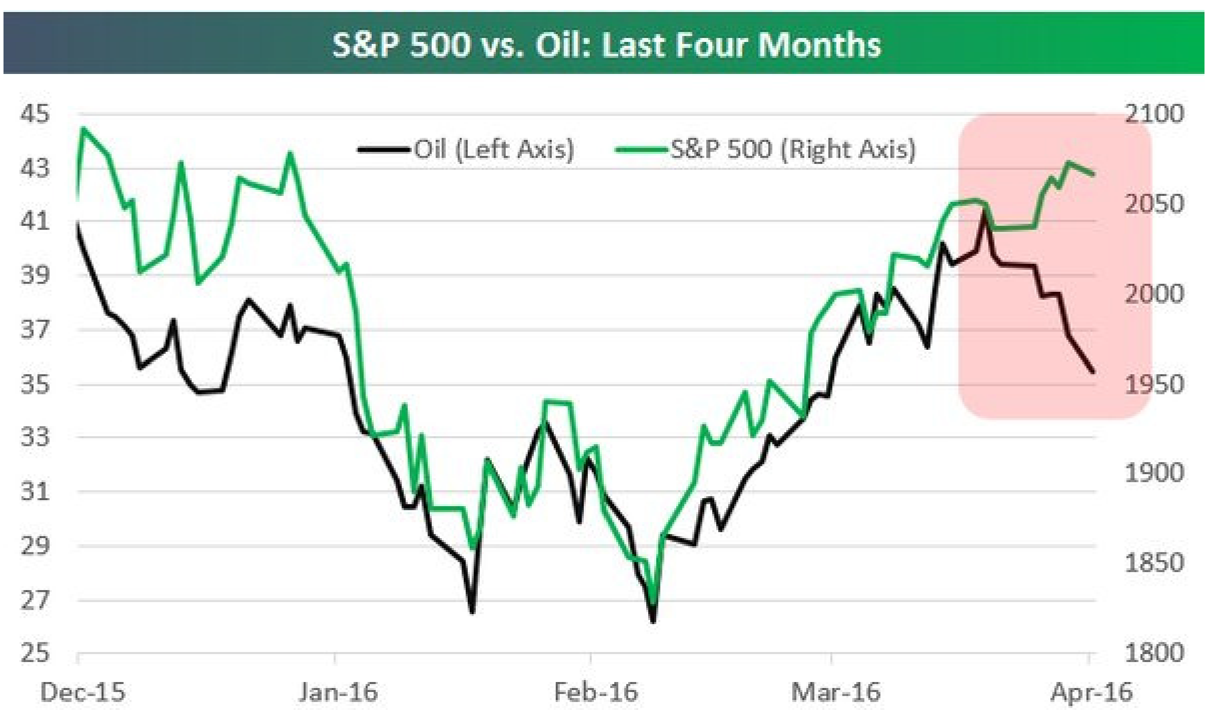


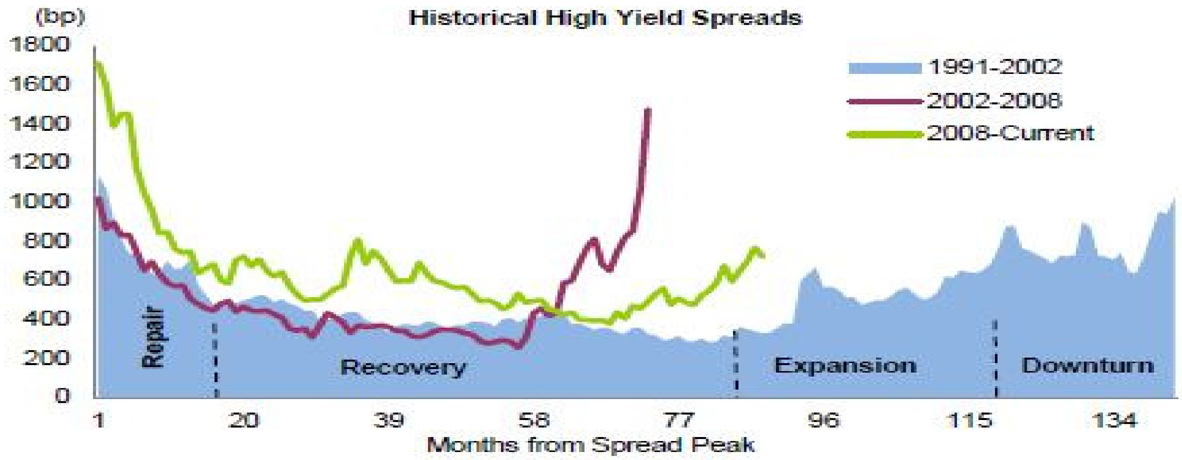
Exhibit 5: For five months, stocks have traded in tandem with moves in oil. Basically, whatever oil does, stocks follow suit. However, the chart from Bespoke shows the relationship has broken apart in the last two weeks as stocks climb higher, yet oil is heading down again.

Source: Aspen graphics/Bloomberg; March 02, 2016



Source: Bespoke

Exhibit 6: The widening of high yield bond spreads has many wondering if we are nearing a recession. According to history, this looks more like a bump in the road of economic recovery than the end of a cycle.



Source: Morgan Stanley

Exhibit 7: In the last three months, defensive sectors (i.e. telecom, utilities, and staples) have far outpaced the market. The chart shows in the last six weeks, they have begun to underperform as cyclical sectors (i.e. energy, financials, consumer discretionary, and tech) have gained investors' favor.

Source: Bloomberg LP