The Long & Short of It

Quarterly Newsletter
Second Quarter 2016

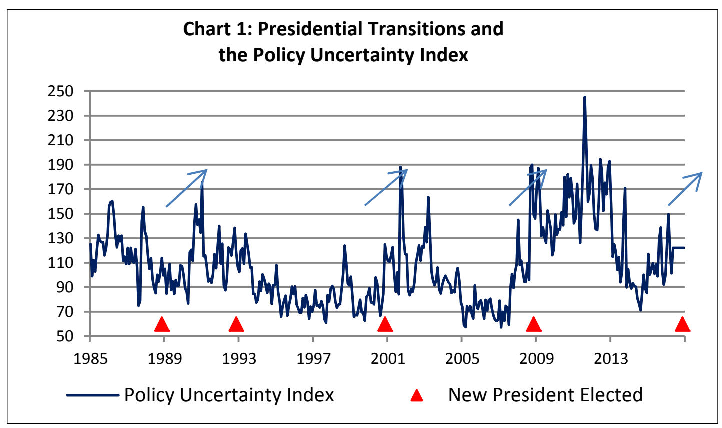
Uncertainty Ascending

The second quarter of 2016 felt a bit like roulette. The ever-manic Mr. Market perceived Mrs. Clinton, peace, and European unity as a reduction of uncertainty (up days) while Mr. Sanders, Mr. Trump, violent attacks, and Brexit increased uncertainty (down days). Also at the table was the Federal Reserve attempting to raise the Fed Funds rate in its bid to help America land in the black. However, with each turn of the economic wheel, investors pulled money off the table rather than doubling down on their bets.

This day-to-day volatility was reflected across equity and bond markets. Led by a rebound in mining and energy stocks, the S&P 500 rose 2.5% during the quarter while small caps did a bit better. However, the NASDAQ Composite Index lost -0.2% for the quarter and has lost -2.7% so far for the year as this bull market's leadership continued to falter. Globally, stocks continued to lag as the MSCI EAFE Index lost -1.2% this quarter and is down 4.0% for the year. Low-to-declining inflation expectations and a desire for safety produced solid returns in long–term US Treasury bonds. The Barclays Capital Long US Treasury Index returned 6.4% for the quarter and 15.1% year-to-date. Yield spreads narrowed some but mostly moved back and forth as global governments worked to stay ahead of recurring economic fears. At quarter's end, the 30 year Treasury offered a paltry yield-to-maturity of 2.30%--down another 24% below December 31, 2015's level.

Uncertainty drives risk aversion. On the Friday after the Brexit vote, the interest rates on "riskless" US Treasury notes were down while junk bond interest rates were up. The primary difference between the two is investor perceptions of risk and uncertainty. Among the stocks we follow, those with clean balance sheets generally held up well in the Friday decline while those with more leveraged balance sheets (those carrying more debt) fell more dramatically.

As investment advisors, we view events not only from the point of view of "better or worse" but also "more or less uncertainty." After eight years of any president, no incoming president will seek to be the "Continuator" in Chief. Regardless of who wins in November, we will likely begin 2017 hearing about his or her "mandate" from the American people. Be ready for greater uncertainty (see Chart 1). Internationally, Brexit throws fuel on the fire because many of the terms of engagement between the United Kingdom and the rest of the world will need to be renegotiated. Other countries may also vie for redefining their relationship with the European Union (EU) which only adds to the uncertainty.



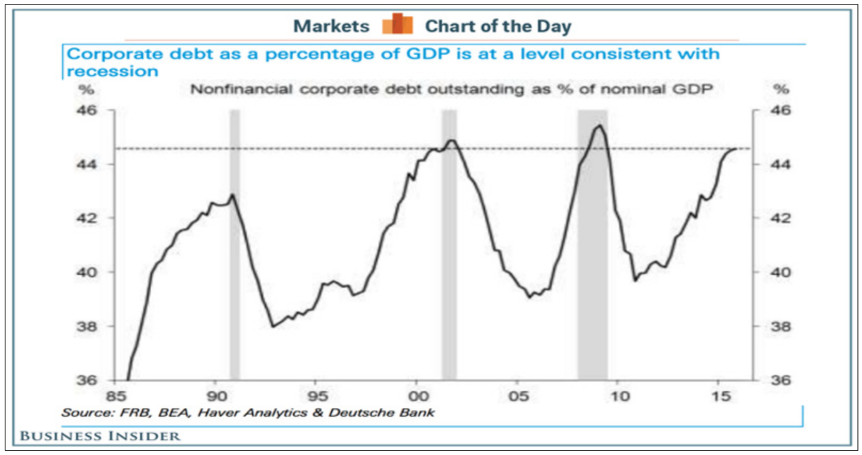
Source: "Measuring Economic Policy Uncertainty" by Scott Baker, Nicholas Bloom and Steven J. Davis at www.PolicyUncertainty.com.

Stacking the Chips

Setting aside the market noise generated by politics, we prefer to focus on individual investment valuations and long-term determinants of economic growth. One item to note: Corporate profit margins have plateaued. Profitability appears to be at unsustainable levels and there is a lot of talk in the media about giving some of that profit back to workers through higher wages. Rising wages have historically presented a significant challenge to bull markets.

Secondly, although the US has moderated its massive US Treasury and US Agency debt purchases (Quantitative Easing), the European Central Bank (ECB) is now fully committed to their own brand of Quantitative Easing, purchasing €80B per month of their own covered bonds, asset-backed securities, and sovereign debt. The ECB has bought more than €800B of government bonds since March 2015. Strikingly, in June 2016 the ECB began to purchase up to €5B per month in investment-grade corporate debt, thus taking the EU's balance sheet well off the reservation of "unassailable credit." Up until the last decade, central bankers would not allow the central banks to own assets other than cash, Treasury bills, and short-maturity Treasury bonds. Now, with long maturities, agency, and corporate bonds, central bankers blaze new trails in oversized, overly risky balance sheets.

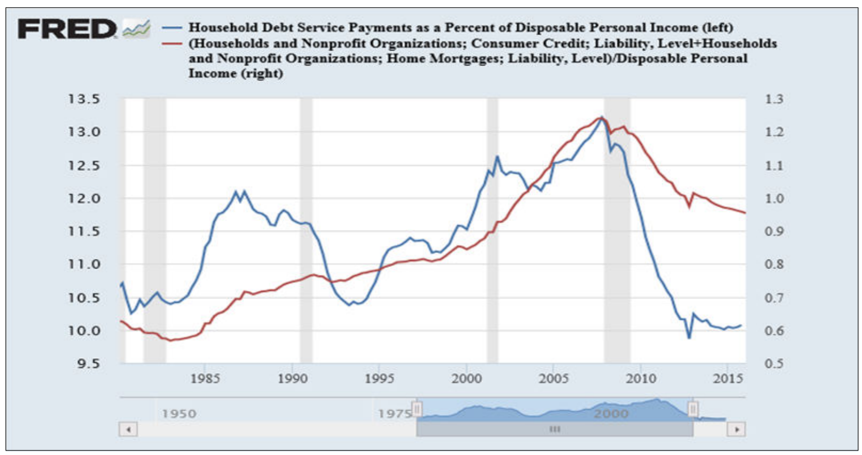
In the prior quarterly letter we observed that economic growth is currently dependent on debt expansion. There are few other sustaining drivers of growth in the economy today. Further growth will require interest rates to drop more, which they did during the second quarter, allowing greater levels of public and private sector debt. Among borrowers (i.e. investors, government, corporations, and consumers), few are able to resist taking on more debt as interest rates decline to historically low levels.



The debt level we looked at last quarter was NYSE Margin debt (for investors), which had reached historically high levels and stalled. Similarly, US government debt levels remain very high. More recently, corporations have ramped up their debt exposure, adding $2 trillion in non-financial debt since fourth quarter 2010, and are now moving closer to levels that will begin to restrict growth (see Chart 2) as it becomes difficult to add more debt.

Not yet at the Table

The only sector of the economy not yet "at the casino" is the American consumer, who apparently is still in shock from the last credit crisis. With consumers comprising 70% of U.S. economic activity, the potential for economic growth is significant if they decide to begin borrowing again. (see Chart 4) Will they? Will they be allowed to? U.S. regulators still seem intent on not repeating their prior mistakes, during last quarter capital requirements and restrictions on lending increased yet again for the eight largest banks.



The path of least resistance for interest rates over the next year is down, with or without the Fed taking further action. With policy uncertainty in Washington and Europe growing, investors will be cautious, further reducing growth and increasing deflationary pressures. Recession is certainly possible, though eventually lower interest rates will stimulate some borrowing and modest nominal economic growth. Real progress will not come until consumers get some confidence about whom the new leaders will be and increasing clarity about their policy. Although bull markets can last longer and go higher than any can imagine, individual stock valuations remain elevated. Significant headwinds and ascending uncertainty could quickly steer investors from caution to fear.

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