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Hiding Out in Equities – July 2016
By Scott P. Noyes, CFA® CFP®

In spite of Brexit, election politicking and mixed economic data, the U.S. stock market rallied to a new all-time high in early July. A breakout is typically a very good sign and we hope the markets will follow-through with another 6-8% move to the upside by year-end. While the S&P 500 has gained 3.8% for the year, European and Japanese stock markets still show substantial declines. Emerging markets, which lagged significantly in 2015 have recovered nicely and have posted a 6.4% increase for the year. Most surprising, the turmoil surrounding Brexit has led to substantial declines in U.S. long-term interest rates which have dropped to cycle lows. U.S.10-year Treasuries now yield 1.52% compared to a 2.1% yield for the S&P 500. Financial markets doubt that the Federal Reserve will tighten at all this year due to global concerns. With interest rates below the core CPI inflation rate of 2.2%, real interest rates are now negative. The lackluster income opportunities in the bond market have made income generating U.S. stocks appear to be a better place to invest.

Chart 1 – New Stock Market Highs in July 2016

Easing Economic Fears Lead to Market Resurgence

After starting 2016 with a full blown recession panic, financial markets found their footing and rebounded back to year-end prices by April. The markets took a breather and traded sideways during most of May and June as a result of mixed economic data. But as economic fears eased, U.S. stocks rallied late in the second-quarter and into July (Chart 1).

Three key concerns have been mitigated:

1) The U.S. economy is not slipping into a recession and is expected to grow at a 2.0 % rate;
2) The Chinese economy is slowing, but not collapsing, the Yuan continues to weaken;
3) Oil prices rebounded from a panic low of $28 back to $50 per barrel and provided support for energy bonds and global equities.

Negative Real Interest Rates

The Brexit crisis has helped drive global interest rates to new lows. Federal Reserve Chair Janet Yellen signaled that the Fed would not be raising interest rates anytime soon due to "global uncertainty." The risk of increased interest rates risk is currently off the table. With core inflation running at 2.2%, current interest rates offer negative real rates of return (Chart 2). Central bank manipulation has given us an artificial level of rates that will be hard to sustain. While rates may remain low for a while, I believe that investors will be hurt trying to sell long-term bonds in the future.

With negative real interest on U.S Treasuries we have four choices for the income portion of our portfolios:

1) Take more credit risk with high-yield bonds;
2) Buy longer-term bonds with greater maturity risk;
3) Invest in income equities;
4) Wait for a better fixed income opportunity.

With interest rates extraordinarily low and inflation on the uptick, there is nowhere to hide in the bond market. We have chosen to maintain our credit and maturity risk at normal levels but have increased our exposure to income equities and more speculative emerging market bonds.

Chart 2 – New Lows in Interest Rates in July 2016

Prospects for the U.S. Economy Remain Positive

Leading economic indicators such as employment, business confidence, retail sales and new home sales all suggest the U.S. economy is on a modestly positive growth track. Relatively speaking, it is the shining star of the global economy. In the recent JOLTS jobs report, job openings have increased to economic-cycle highs and new hiring remains positive (Chart 3). Although home sales are only growing at a 5%-10% pace, home prices have rebounded over 30% since 2011 (Chart 4). Overall, the U.S. economy appears to be plugging along at a stable 2% pace.

Chart 3 – The Details behind Employment Remain Constructive

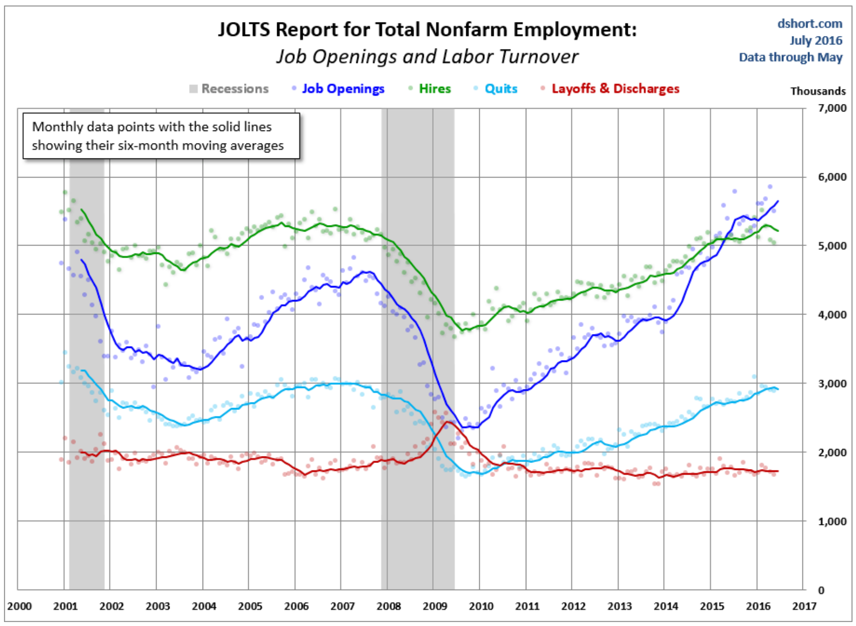
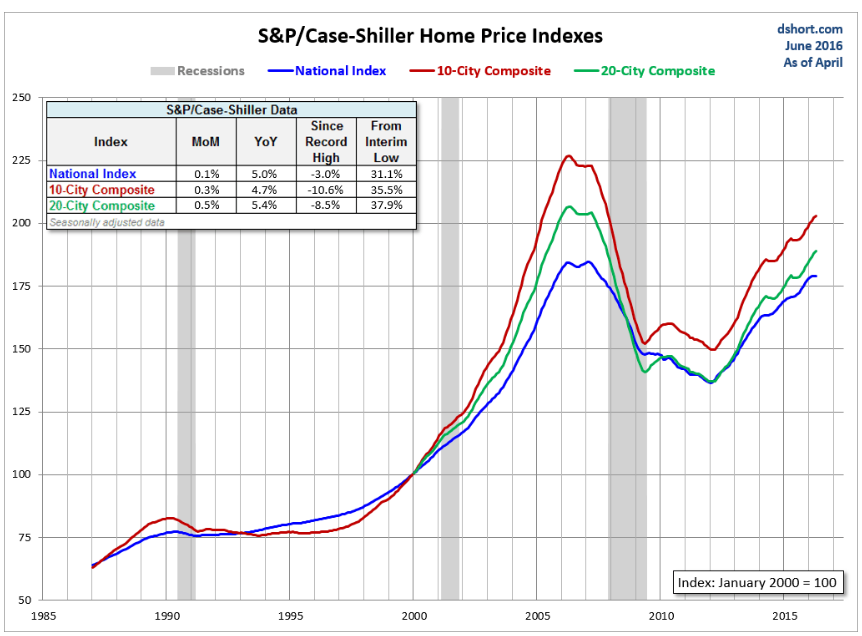


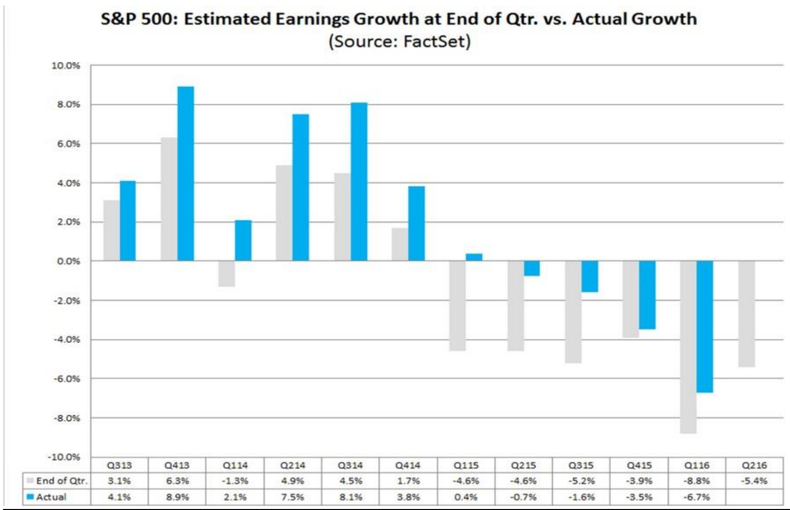
Chart 4 – Home Prices have rebounded over 30% since 2011



The S&P 500 Remains in an Earnings Funk

For the fifth quarter in a row, analysts project that estimated earnings for the S&P 500 will decline by 5.4% on a year-over-year basis for the second quarter of 2016. Profit margins continue to be squeezed. Two sectors are projected to report a year-over-year decline in revenues: Energy and Industrials. Eight sectors are anticipated to report year-over-year earnings growth, with the Health Care, Telecom Services and Consumer Discretionary sectors leading the way. Hopefully, many of these companies are lowering expectations to make it easier to beat analyst estimates as described in Chart 5.

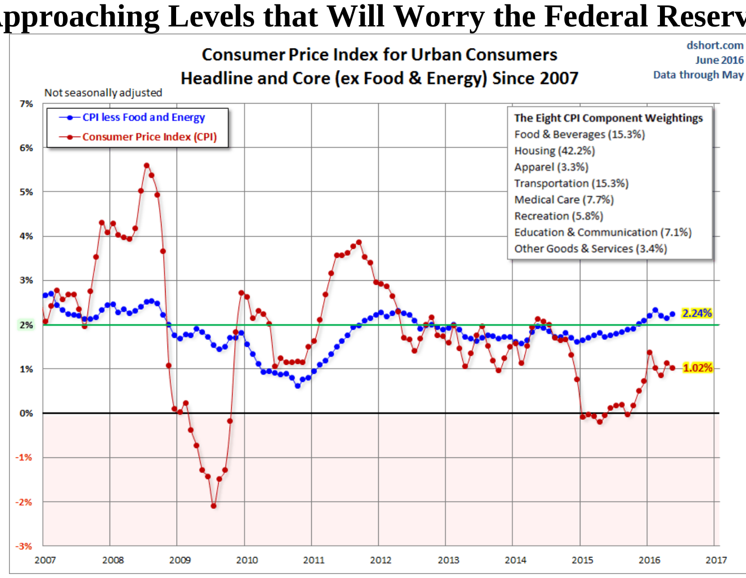
Chart 5 - Actual Earnings Growth Typically Exceeds Analyst's Projections



Inflation is Forgotten and on the Rise

To the surprise of many, the U.S. is undergoing a modest reflation in price levels with Core CPI running at 2.2%. (Chart 6). With unemployment at or below 5%, labor market conditions are poised for wage increases in the future. Unemployment rates for those with college degrees remains well under 2.5%. It may be time to end the discussion about deflation and low inflation. When trailing energy price changes reverse, I suspect the Federal Reserve will be forced to restart the discussion about raising interest rates.

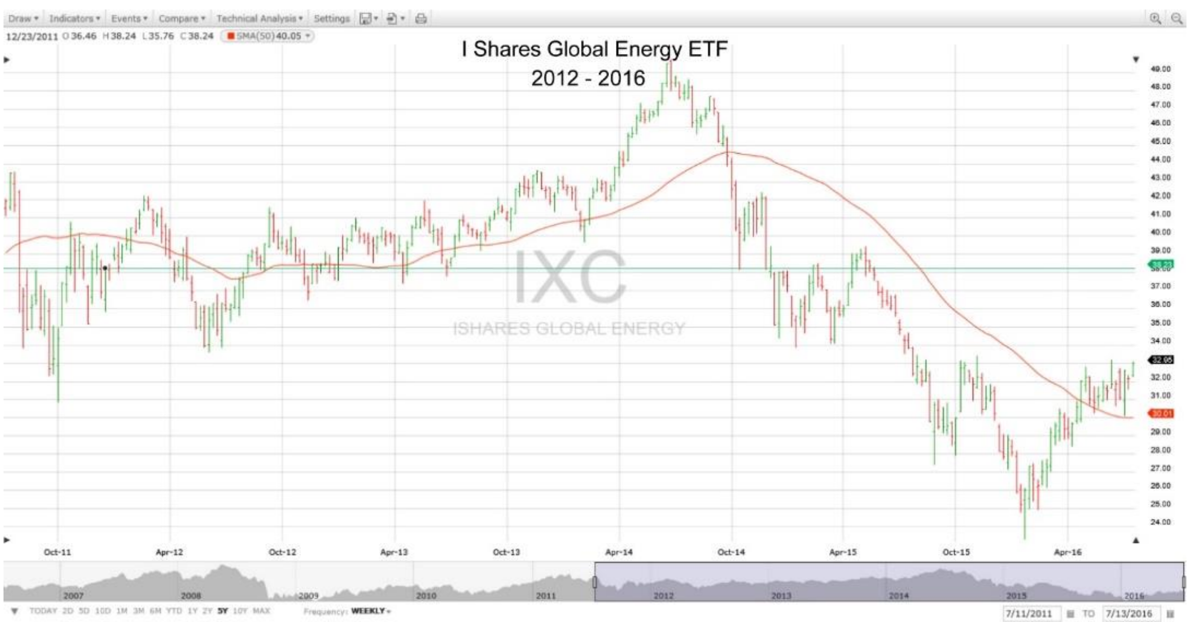
Chart 6: Inflation is Approaching Levels that Will Worry the Federal Reserve



Rebound in the Energy Sector

The commodity-glut panic seems to have bottomed in January of this year. Oil prices rebounded from $28 a barrel back to the $50 range. We believe that oil prices are capped at $60 and supported at $40 for the foreseeable future. Stocks of commodity-based companies in energy, materials and many emerging market countries have rebounded nicely as a result of the uptick in commodity prices. The Global Energy ETF described in Chart 7 has rebounded 37% from the lows and is likely to improve further in the year ahead. While commodity related stocks and countries (Canada & Australia) may bump along sideways for a while, I believe that the bottom is in place for the next few years and should remain a component of your portfolio.

Chart 7 – Energy ETF is up 37% from the January Lows



Becoming Constructive on Latin America

When I visited Argentina in March, I was extremely surprised at the potential for economic improvement. The young people are educated and technologically savvy. Resources are plentiful. The missing ingredient appears to be the free hand of capitalism and smart government. Years of socialistic/populist governments in Argentina, Brazil, and Venezuela have drained the countries of entrepreneurship and investment capital. My personal bet is that the pendulum is starting to swing away from Socialist governments toward ones which reward capital and investment. Also, global capital allocators will likely shift money out of Europe and the U.K. with Latin America being a potential beneficiary. If so, we could see a 5-10 year rise in Latin American stock markets with an increase of several multiples. Although considered speculative, I am comfortable investing in Mexico, Argentina, Peru and Chile. I am still waiting to see the outcome of the political conflicts in Brazil before making any investments. In the big picture, I believe that investments in Latin America have a far more attractive risk/reward than in Europe or even the U.S. (Chart 8).

Chart 8 – Latin American Stocks have bounced off of 2009 Lows

Foreign Political Problems Remain a Major Concern

There is a long list of foreign issues that have been causing market concern:

- In June, the British voted to pull out of the European Union. The major issues were immigration and sovereignty from Brussels and the European Parliament. However, the cost of leaving could be quite high. Foreign investors will likely avoid new investment or hiring in the U.K. until the relationship with the E.U. is clarified. London is at risk of losing its appeal as a major world financial center. Overall, it appears that the barking dog caught the car and will get thumped for a while. The future for the U.K. is likely to be fairly difficult for the next year or two.

- The European Union is being challenged from multiple directions. Several other countries are dissatisfied with central control and the current immigration policies established in Brussels. Both Italy and Spain have simmering banking problems, France and Germany have presidential elections in the next twelve months and multiple countries are experiencing immigration problems. The risk of a breakdown in the E.U., while still unlikely, has increased. Capital is leaving Europe for the U.S. and other safer corners of the world.

- Brazil is in the midst of a massive kickback scandal which could lead to the impeachment of the current president, Dilma Rouseff, while the economy remains in a serious recession. Good luck to the Olympics.

- Islamic terrorism is occurring randomly throughout the developed world. The recent attacks in Brussels and Pakistan are examples of the ongoing discord in the Middle East.

All of these issues create ongoing uncertainty which usually translates into negative moves for the financial markets. In spite of the problems in the U.S., we remain the most stable, growing force in the world economy.

Market Outlook

I remain constructive on U.S. equity markets for the balance of the year. The case is not that equity fundamentals are improving but that fixed income alternatives are less attractive. With interest rates at new lows, capital is forced back into all forms of equities. While valuations remain rich relative to earnings, the path of least resistance is to be invested in equities.

The U.S. has become the safe haven for all global investors. U.S. equities are now the global "gold" standard. I remain concerned about investments in the U.K. and Europe due to major elections in Germany and France in 2017. I prefer to reduce overall international exposure and direct more into North America (Canada and Mexico) and Asia. Even speculative emerging market stocks and bonds are now attractive relative to Europe.

In terms of sector rotation, we are probably seeing the end of commodity deflation. There may be another test of the bottom in oil, copper and gold prices, or there may not. I suspect that owning hard asset providers such as energy and material stocks may be a constructive strategy as we move into 2017 and beyond.

With interest rates at exceptionally low levels, there is no alternative to stocks. However, with a neutral market outlook, we seek income and safety at a reasonable price. Equities and funds with strong dividends are emphasized in our portfolios.

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