Investment Tally & Perspective

2016 Half Time – Economic and Financial Market Assessment

This month marks the seven-year anniversary of the economic recovery and expansion following the Great Recession in 2008-2009, and while the world may appear in disarray, stock indices have reached new high levels after trading sideways for much of the past two years. All asset prices, including stocks, bonds, real estate and collectibles, have been pushed and supported by the stimulating policies of the Fed and other central banks. With the objective of resuscitating no-growth or slow-growth economies, these institutions have deployed trillions of dollars purchasing bonds to suppress interest rates. Though their efforts are well intended and they have partially achieved some of their goals, we expect the scope of market intervention to result in misallocations of capital and unintended consequences over time (the process is analogous to Newton's Third Law of Physics "For every action, there is an equal and opposite reaction"; in this case the action of government intervention in free market functioning will produce price distortions in "equal and opposite reactions").

Stock Markets at Record Highs and Interest Rates at Record Lows – What's Wrong with This Picture?

Fact 1 - The S&P 500 stock index is at an all-time high; Fact 2 - The 30-year Treasury yield has dropped to a 70-year low; Fact 3 - The equity dividend yield is now almost exactly equal to the 30-year bond yield. So we have stocks at record high levels, interest rates at or near record low levels, and average stock dividend yields nearly equal to the current yield on long-dated (30 year) Treasury bonds which begs the question – "Is this normal?"

The simple answer is "No", this is quite abnormal. For perspective, in the past 50 years the average equity (S&P 500) dividend yield was nearly 4% lower than the 30-year Treasury yield (technically, the average differential was minus 380 basis points or -3.8%). While this is certainly odd, a similar comparison of stock and bond markets around the globe show even more extremes given the prevalence of negative interest rates.

Is the world really this "topsy-turvy"? Well, Yes. As noted by former Fed Chairman Ben Bernanke over eleven years ago, there is a global surplus of savings which combined with three other factors - central banks pressuring interest rates lower, global economic activity ranging from recession to moderate growth, and businesses being reluctant and cautious on expanding - is a recipe for low interest rates.

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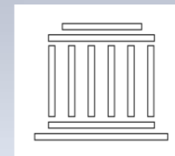

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MAJOR INDUSTRIALIZED COUNTRIES

	2016 Est. GDP	Unemployment	Consumer Prices	Budget Balance (as % of GDP)	Int. Rate 10-Yr Gov't
Britain	1.5%	5.0%	0.7%	-3.6%	0.98%
Canada	1.4%	6.9%	1.6%	-1.7%	0.97%
France	1.4%	9.9%	0.3%	**-3.5%**	**0.14%**
Germany	1.5%	6.1%	0.4%	**0.5%**	**-0.17%**
Italy	0.9%	11.5%	0.1%	**-2.5%**	**1.24%**
Japan	0.5%	3.2%	-0.1%	-6.1%	-0.24%
Spain	2.8%	19.8%	-0.4%	**-3.5%**	**1.17%**
Switzerland	1.0%	3.5%	-0.5%	0.3%	-0.60%
United States	1.8%	4.7%	1.4%	-2.5%	1.36%

Note: Interest rates in bold are Euro currency rates.

Data from The Economist, July 9, 2016

MARKET INDEX RETURNS

Fixed Income	2nd Qtr. 2016	1 Year	3 Year	5 Year
Citi Treasury Bill 3 Month	0.06%	0.14%	0.07%	0.06%
Barclays US Aggregate Bond Index	2.21%	6.00%	4.06%	3.76%
Barclays Global Aggregate Bond Ex US	3.40%	11.24%	1.85%	0.35%
Stock Indices				
S&P 500	2.46%	3.99%	11.66%	12.10%
Dow Jones Industrial Average	2.07%	4.50%	8.99%	10.41%
NASDAQ Composite	-0.23%	-1.68%	13.85%	13.18%
MSCI EAFE Index	-1.46%	-10.16%	2.06%	1.68%
MSCI Emerging Markets	0.66%	-12.06%	-1.56%	-3.78%
Russell 2000	3.79%	-6.73%	7.09%	8.35%
Other				
Bloomberg Commodity Index	12.78%	-13.32%	-10.55%	-10.82%
S&P GSCI Precious Metal Index	8.10%	12.91%	1.62%	-4.40%

*Data obtained from Morningstar; period ending 06/30/16

*All figures are stated as trailing total returns, and returns over 1 year are annualized

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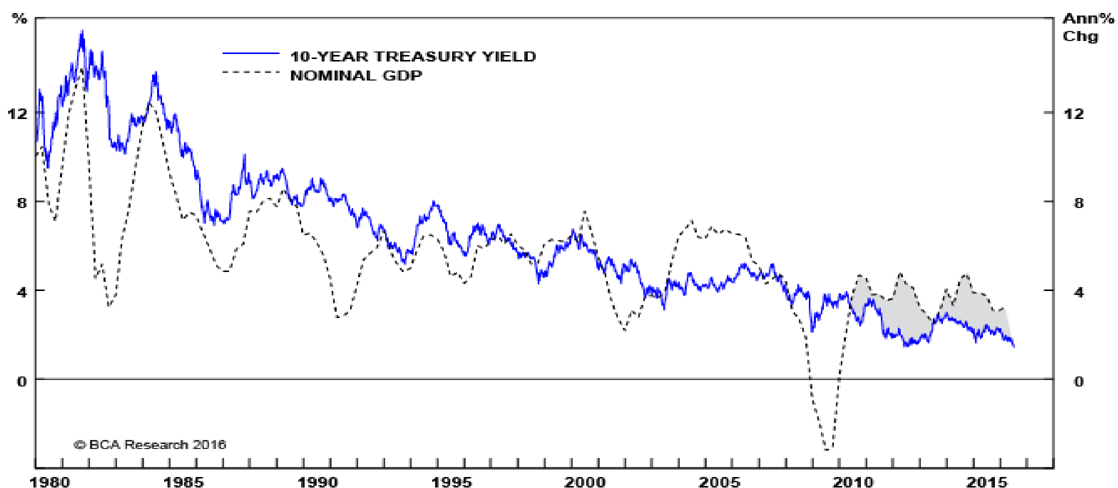
Stated differently, the current level of bond yields is consistent with a low-growth, low inflation world. We believe and agree with many of the reasons listed for lower yields, the exception being inflation which we believe has room to move higher (an out of consensus view at the moment). Many investors agree that globally, central banks will ensure lower rates if the current environment persists. A real concern, though perhaps unwarranted given a lack of historical precedent, is central banks losing their ability to control markets. However, glimpses of this may be occurring today as the Bank of Japan has aggressively eased and promised more can be done, yet the Japanese economy remains dormant.

Can interest rates move lower? Yes, but there is a limit to how low they can go, that point being where it becomes advantageous to hold cash (which carries a real cost) over investing at negative yields. Also, investors may purchase bonds at negative yields with the expectation of more central bank stimulus to provide shorter term gains (rather than holding the bonds to maturity), this activity will further drive rates down. However, in our opinion, the risk reward for holding long duration fixed income (i.e. bonds longer than 20-years) is unfavorable as yields can move down some, but they can move higher by much more. The following example shows the sensitivity of long bonds to interest rate changes:

Let's assume an investor had purchased a 30-year Treasury bond with a 4% coupon at a price exceeding its maturity value (premium) so that its total return to maturity was 2.3%; if interest rates declined to 0% one year later, then the price of the bond would increase providing a one-year total return of 61% (great!). However, if bond yields moved back to their historical relationship to dividends (4% higher), then the price of the bond would decrease producing a one-year total return of -46% (ouch!).

While forces are presently aligned to maintain relatively low interest rates for the foreseeable future, the sustainability of the multi-decade decline in interest rates appears limited and merits attention.

Treasury Yields Persistently Below Nominal GDP Growth



<u>The 35 Year Bond Bull Market – The Seeds of Reversal</u>

BCA Research issued a report (July 11, 2016) that reviewed the decline in interest rates from double-digits in the early 1980s to current levels (near zero to low single digits). With bond prices moving in the opposite direction of interest rate changes, this 35-year decline in interest rates produced a strong bull market in bonds

which had enormous impact on prices and rates of returns of virtually all assets (stocks, real estate). While not predicting an immediate change, BCA expects a reversal in the direction of interest rates in the years ahead and

cites detailed analysis of the "factors that are slowly making long-dated Treasury bonds less compelling to hold, specifically, value, politics and policy".

The Investing Dilemma – Record Low Interest Rates and Stocks at Record High Levels

We expend a great deal of time, effort and resources contemplating questions like:

"Is it time to place more emphasis on preserving capital versus seeking returns on capital?"

"After going sideways for nearly two years, will economic growth surprise on the upside leading to new high levels for stocks, or will central banks and governments reach their support limits with market turmoil and painful asset price declines following?"

With the preface that no one truly knows how this will unfold, our general investment outlook and strategy are:

- the U.S. economy will most likely continue to grow at moderate rates with the potential to surprise on the upside in the next one to two years
- huge sums of global savings combined with central bank liquidity will support and drive asset prices higher until…. they don't

In sum, the preferred investment strategy is balance and diversity with:

- a portion of assets invested with emphasis on preservation of capital (just accept low or no returns)
- a portion of assets invested in high quality equities with the ability to hold these assets through market declines and with a time horizon measured in years.

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