—New Albany—
Investment Management

May 4, 2016

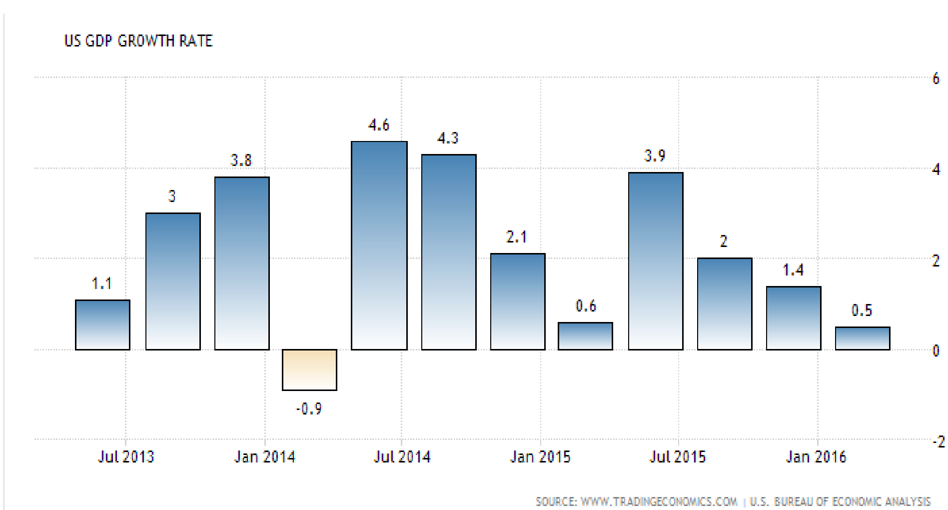
Market Insight: Back to the Chart Room

Though the markets have managed to regain most of the losses seen earlier this year, the economic underpinnings remain weak. Much of the price gain was short covering due to a rebound in oil and a surprise change by the Fed to stand pat. But will the market be able to hold on to these gains? What will be the catalyst to propel the market higher? Central Banks appear confused, earnings are poor, and global growth continues to fall short of forecast. The market is looking for direction but the investment landscape is opaque and difficult to decipher. What's an investor to do? Head to the chart room to refocus on the big picture.

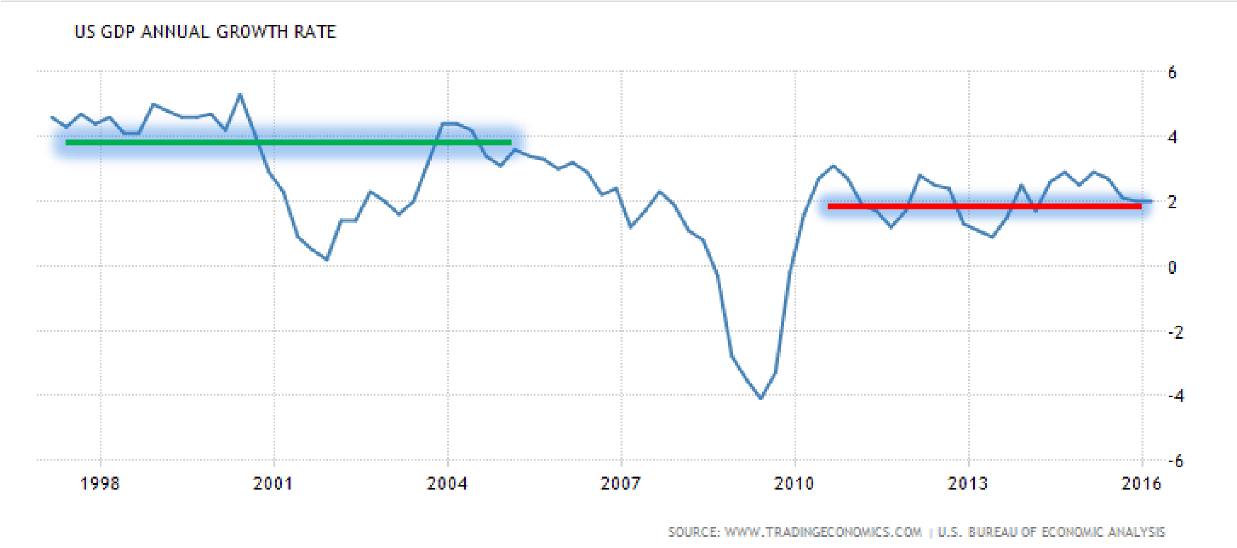
This addition of Market Insight uses charts to tell the current state of the Economy and Markets. Key takeaways are:

- Global growth continues to fall short of forecast. Central Banks' stimulus effect is waning. US GDP has stalled at 1.9%, making it increasing difficult to grow earnings.
- Slow wage growth and declining business fixed investment continue to be a drag to GDP. A challenging regulatory environment encourages business to abstain from capital investment. Fiscal reform is needed to push economic and earnings growth out of the current tepid pace.
- Earnings and profit margins have declined the last 4qtrs and are not expected to increase until 2nd half of this year. S&P 500 EPS forecasted growth for 2016 revised to only +0.8%.
- Markets holding near highs on hopes of stronger earnings in 2nd half of year.
- Markets likely to trade in a wide range until post-election. Income assets key to return.

Global GDP Slowing: Recent economic indicators for China, Japan, Europe and the US point to slower growth ahead. In the US, GDP expanded at an annualized 0.5 percent in the first three months of 2016, lower than a 1.4 percent expansion in the previous period, and below market expectations of 0.7 percent growth. Consumer spending slowed; trade and business inventories worsened; and business investment declined. The chart below shows the annualized US GDP rate by quarter.



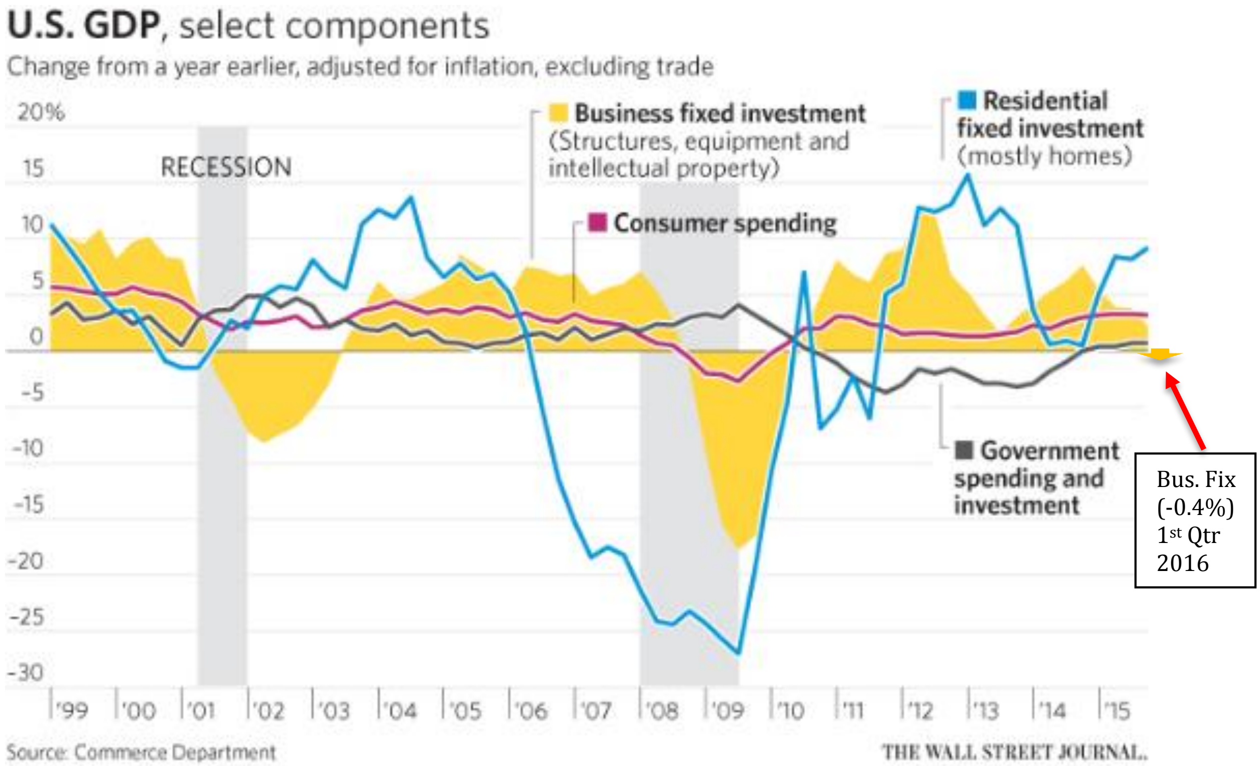
US GDP- New Lower Average: Prior to 2007, the annual US GDP range was 3-5% (green line) with an average growth rate near 4%. Since 2007, growth range is 1-3% (red line) and the average annual growth rate is 1.9%. **With growth this low, it is very difficult for companies to grow earnings**.



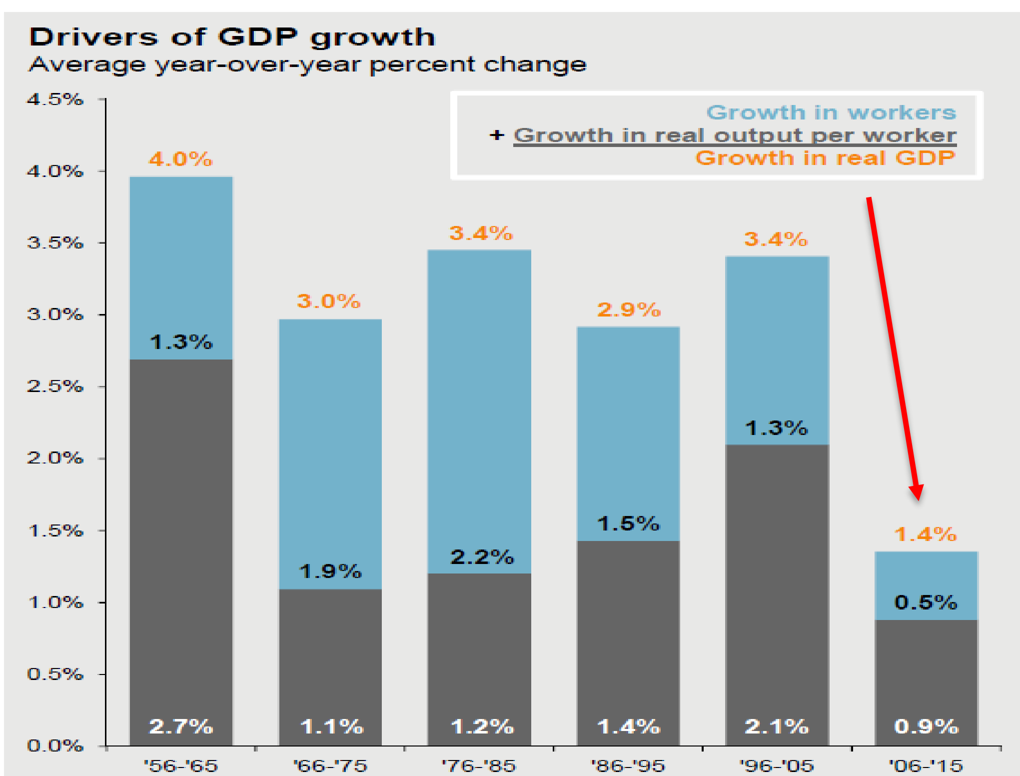
Wealth Effect of little effect: The massive stimulus injected by the Fed into the markets had the effect of creating wealth for those who own stocks but it has had little effect on the broad economy. Yes auto and home sales have benefited from lower interest rates but it has not helped wage growth and capital expenditures - two key ingredients to growth. The chart below shows the unemployment rate and wage growth. The unemployment rate has fallen back to 5%, a level which in the past has led to strong wage and economic growth; however, today wage growth has only modestly recovered.

Source: BLS, FactSet, J.P. Morgan Asset Management.
Guide to the Markets – U.S. Data are as of March 31, 2016.

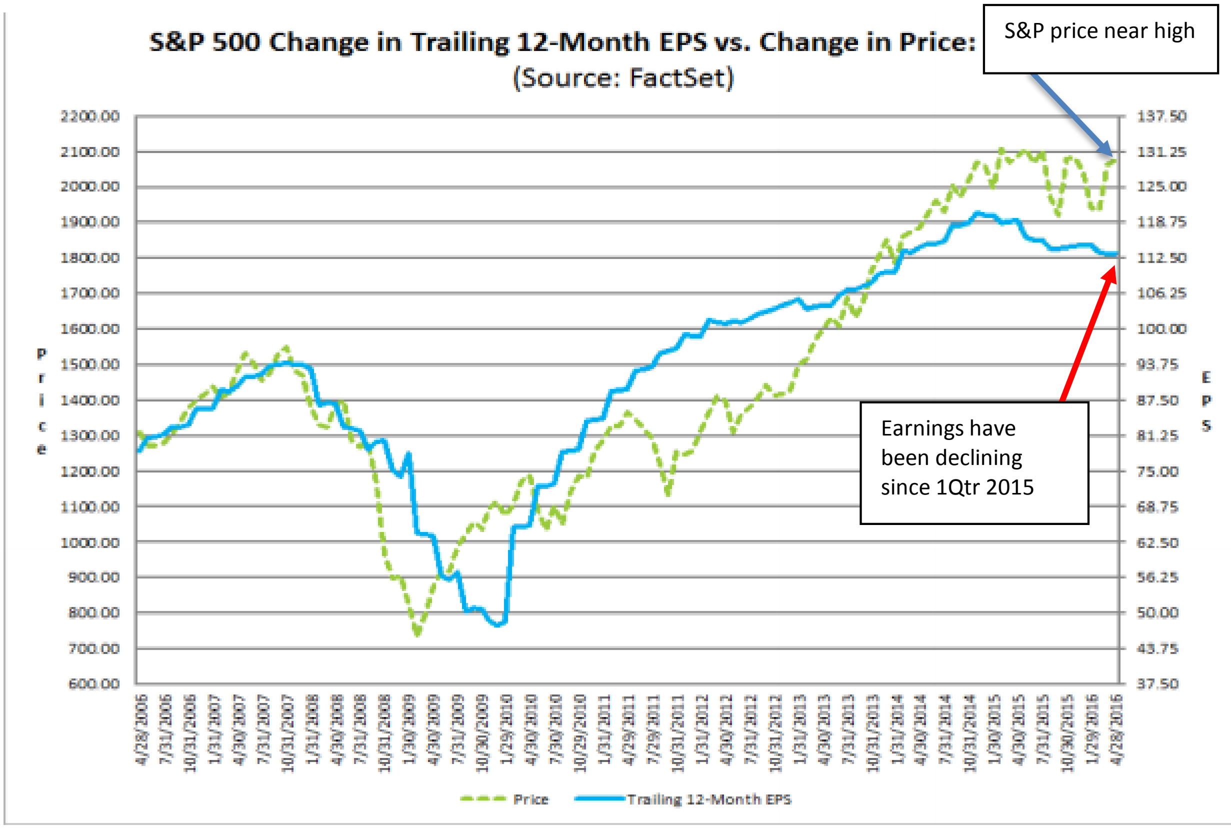
Business Fixed Investment Declining: The chart below shows the components of GDP. Business fixed investment (yellow) is a key ingredient to growth. The growth rate has been declining since the beginning of 2015, and now is negative (-0.4%) for the 1st qtr of 2016.



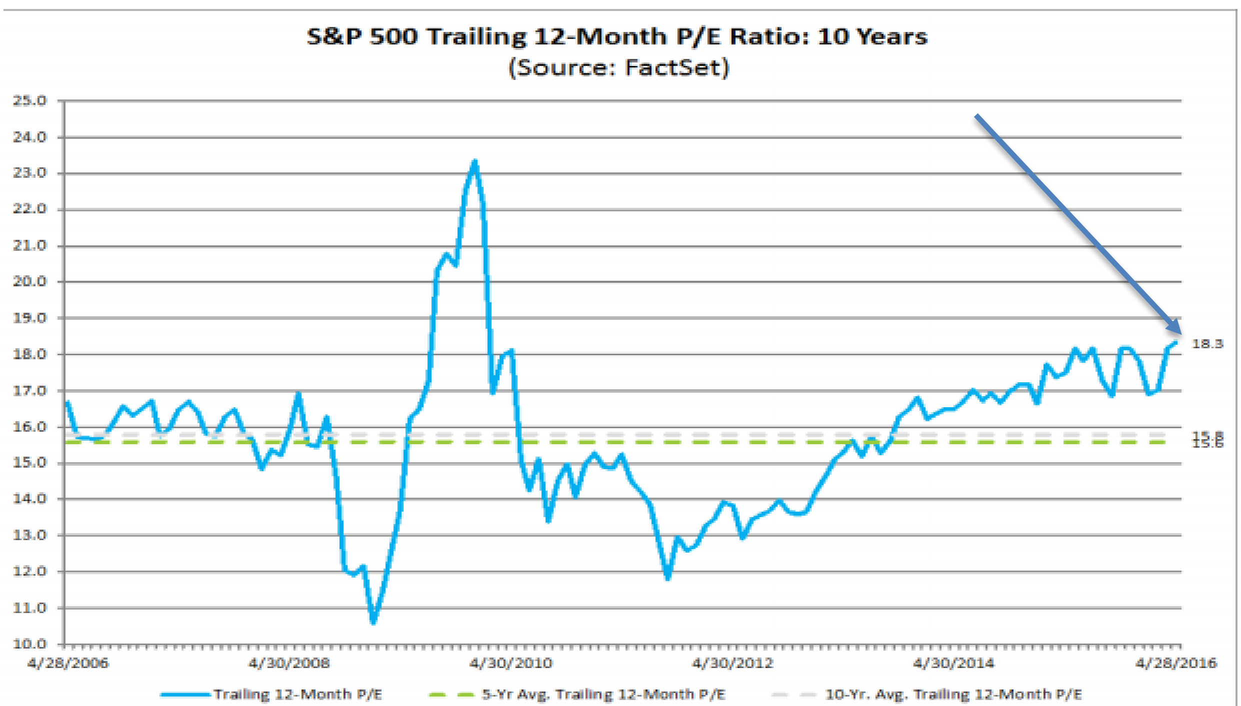
Growth of output (productivity) and workforce has declined and is a drag to GDP.



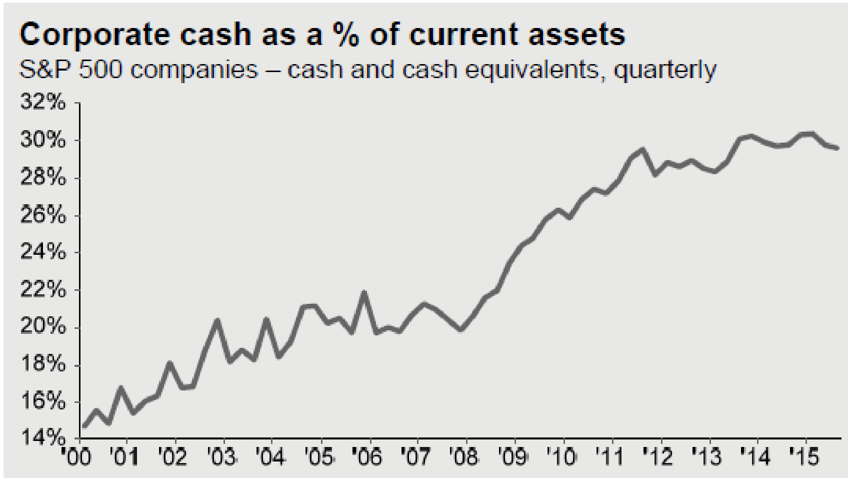
Earnings Growth & the S&P 500: EPS (blue line) has been contracting since 1Qtr 2015, yet the S&P 500 (green line) is nearly back to its all-time high. **For the year, EPS is expected to grow at +0.8%.** The market is looking past the current data and expecting a significant rise in earnings in the months ahead.



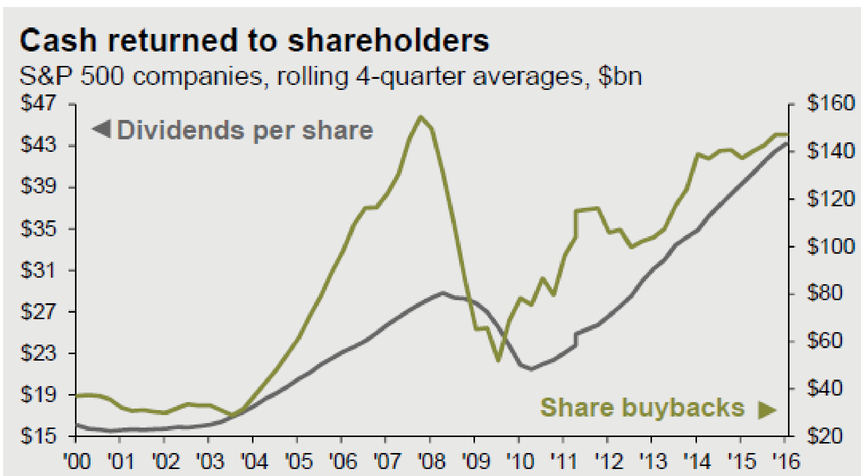
Valuation is on the upper end of historical range. Current P/E is 18.3 verses 15.5 average.



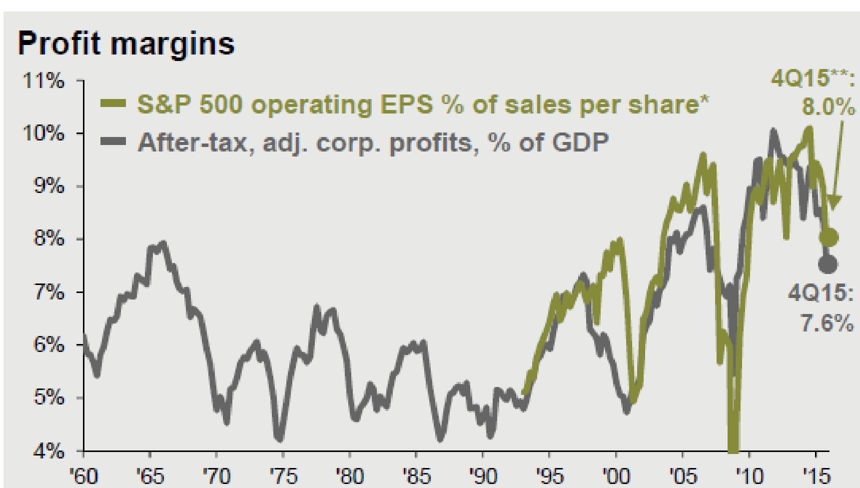
Corporate Cash remains high because Businesses are holding back on capital spending:
(source for next #3charts: JPM Guide to Markets)



Businesses are using cash for share buybacks and dividends instead of capital expenditures:



Profit Margins are declining:



Summary: The investment environment is stagnant for the moment. The good news is that the likelihood of a recession is low; the bad news is growth remains stuck in low gear. With the effect of monetary stimulus diminishing, new initiatives for growth must start from the fiscal side that will encourage business to spend their cash on investment and job creation. Of course with the Presidential election on the horizon, any fiscal reform is unlikely until the start of 2017. So how do we make money between now and then? Income producing assets are the way to go.

Investment Strategy: Given the market is near the upper end of the trading range, it is prudent to reorder the investment objectives of capital preservation first, then income and growth. Risk has been reduced to the lower end of the range through rotating out of growth and into value and income generating assets.

As always, please contact me with any questions or concerns.

Happy Mother's Day to you Moms!

Barbara

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