—New Albany—
Investment Management

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Market Insight: A Sea Change is Underway

The price action of the financial markets since the start of the year has been nothing short of chaotic, and many would classify it as the beginning of a bear market. Traders, Investors, Economists, and all the talking heads on Wall Street have attempted to identify the cause of the sell-off. Weakness in China, falling oil prices, rising dollar, and rising interest rates have been the major factors sited. But all of these factors have been well known and thoroughly hashed out since the end of the 3rd qtr of last year. Recall the big sell off in August, when the market dropped 6% in one day? It managed to recover over the next month and even some sectors made new highs. So what has changed? Why has the market fallen so hard, so fast this year?

I do not pretend to be any smarter than all the market pundits. In fact, in my 35years of experience, I have learned that the market tends to make a fool out of anyone who has tried to identify the specific cause of a market shift or thinks they know when it will be finished. Instead of listening to all the chatter, it is wise to listen to the price action of the markets. Technical indicators are saying the market is tired and a possible sea change is underway.

New Landscape: It is never just one factor that changes the broad trend of the market, but an accumulation of many factors that builds up overtime, and like an avalanche, the weight causes a major shift in investor confidence and market direction. From a market timing perspective it is very difficult to predict when the avalanche will occur, but once it happens, it is important to take notice of a new investing landscape. The bullet points and discussion below give the progression of the shift underway to a new investing environment:

- **The massive stimulus programs by Central Banks for the past 6 years has reflated stocks but has failed to create sustainable economic growth**. Global growth remains subdued and earnings growth is slowing.
- **Strengthening dollar is not only a headwind for US companies' earnings but is suffocating many emerging economies and is causing more drag to global growth.**
- **Further implementation of negative interest rate policy by Central banks is a sign of deflation and a red flag for stocks.** Central Bank credibility is in question.
- **Zero and Negative interest rates policies have encouraged stock prices to rise faster than earnings**. Valuations are above historical averages.
- **Quality of earnings is deteriorating**. Margins are declining. Companies are using cheap debt to buy back shares to boost EPS. Earnings growth continues to decline.
- **Investor confidence in and support for buying equities is shifting back to the fundamentals of valuation and earnings growth**. With the effect of monetary stimulus waning, it is no longer a reason to buy.
- **Market Indicators signaling it will either take time and/or price decline to realign valuation with slower earnings growth.**

Brief Lookback: In 2008, the collapse of the real estate bubble and massive deleveraging of the private sector pushed the global financial markets to rapidly reprice, falling 35-50% (depending on the sector). Huge wealth was lost. The Fed, along with major Central banks, reacted by embarking on a massive stimulus effort, dropping interest rates to zero. The goal was to reflate assets, create wealth, and in doing so, jump start the economies around the world. By the end of 2014, the Fed alone, had juiced the markets by purchasing over $4.5 trillion in bonds, which had the effect of pushing money into financial assets (stocks) and housing, and caused prices to rise significantly. With coordinated global Central Bank action supporting the markets, all markets rose. The environment was an investor's paradise.

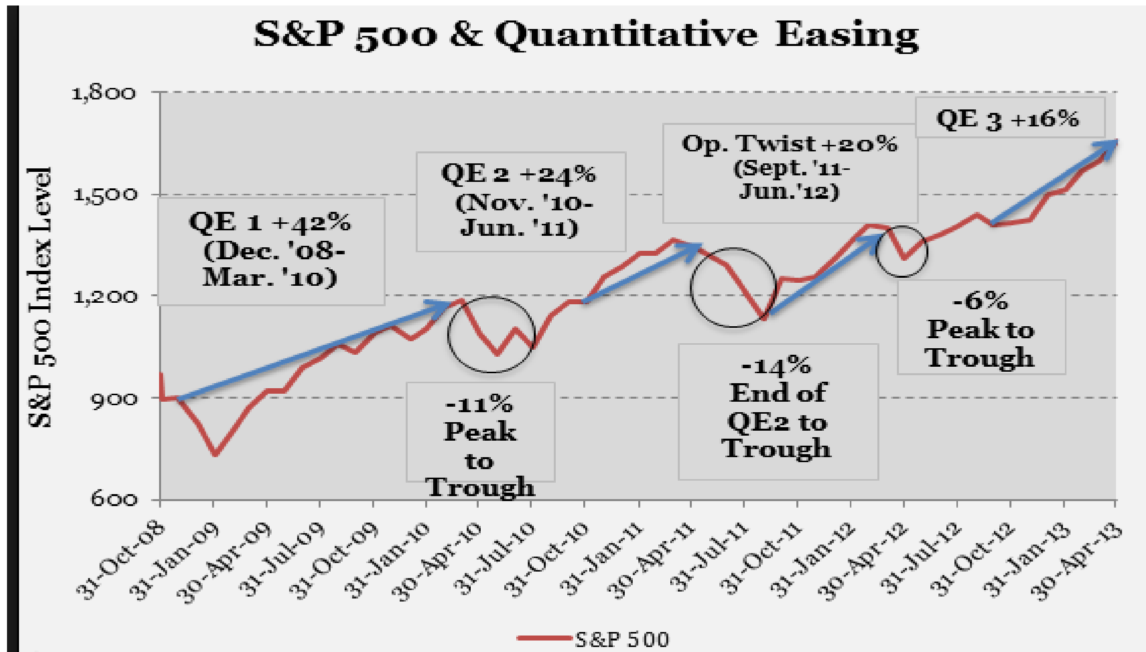
A year of transition: 2015 was the beginning of change. Outside the US, other economies like Japan, China and other emerging countries, began to falter and each specific Central Bank responded with further attempts of stimulus. Many resorted to using negative interest rates to force spending. Meanwhile, in December, the Fed finally delivered on its promise to raise rates and justified their move by stating the economic growth was solid and improving. This divergent in Central bank monetary policy has pushed the dollar higher which in turn has created a vicious cycle of slower economic and earnings growth.

Dollar Strength Suffocating Emerging Economies: A great explanation of the effects of a strengthening dollar by: Ian Bezek/Seeking Alpha. *'For better or worse (mostly worse), the dollar has become oxygen for many of the world's economies. When the dollar is priced too dearly, the borrowing nations (like all emerging countries) suffocate. It's easy for Americans to say, "Too bad, that's not our problem." But as recent months have shown, the problem eventually comes home to roost. Given the interconnected nature of the too-big-too-fail banks, problems overseas will eventually rattle confidence in the United States*.'

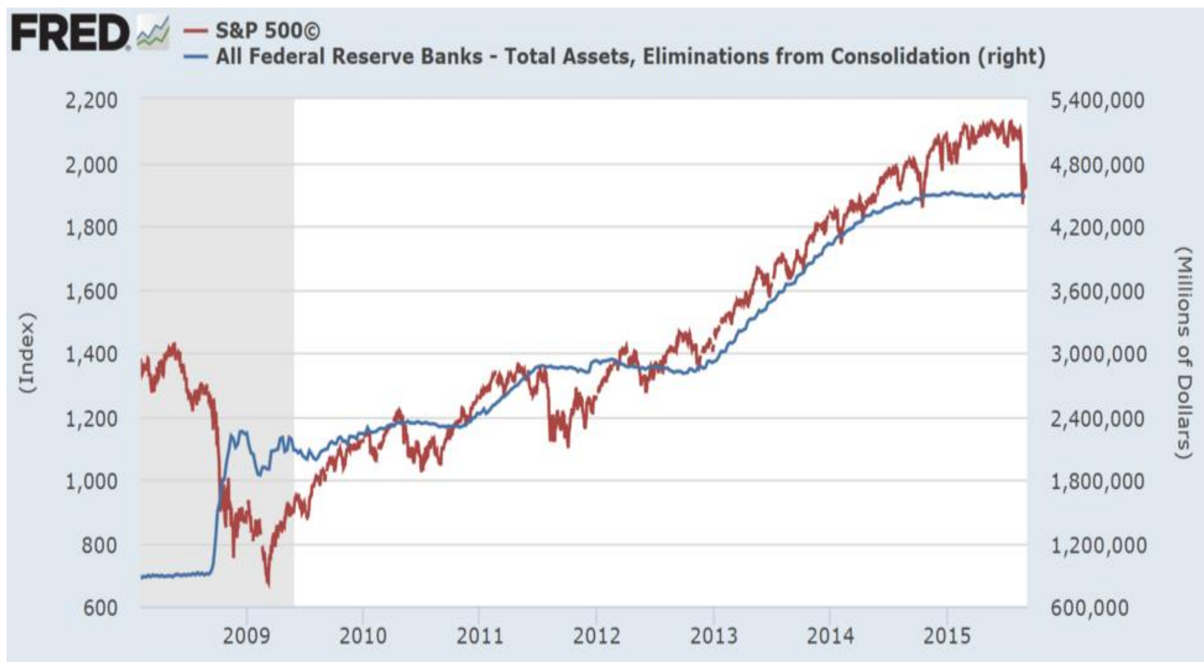
Usher in 2016….The recent economic news has been lukewarm. It is becoming increasing apparent that the reflationary efforts of the Central Banks' stimulus is wearing off. Despite the massive global stimulus effect, economic growth is mediocre at best and even declining in some parts of the world. Current forecasts show growth of only: US +2.4%; Europe 1.7%; China +6.5%; and Japan -0.4%. Central Bank's credibility and their ability to stimulate (reflate) the markets is being questioned. Without some new round of stimulus by Central banks and/or intervention by government, economic **growth is once again dependent on the collective initiative of businesses' ability to increase productivity and stock prices will reflect those opportunities**.

Confidence & Valuation: Investors will only be willing to take risk when valuations are compelling and confidence about the future is high. The 2008-2014 period is a perfect example of this. In 2008 the market fell hard when financial institutions began to fail. The S&P valuation had fallen to a P/E of 10.5, cheap by historical standards, but not compelling enough to change investors' confidence about the future, and thus, the market kept falling. It was not until the Fed starting pouring massive amounts of liquidity into the market, that investors' confidence returned and the market reversed course and began moving higher. In fact every time the market stumbled, the Fed came to the rescue. As more and more liquidity was added investors became even more confident such that prices have now run up faster than earnings. Today the P/E stands at 16.

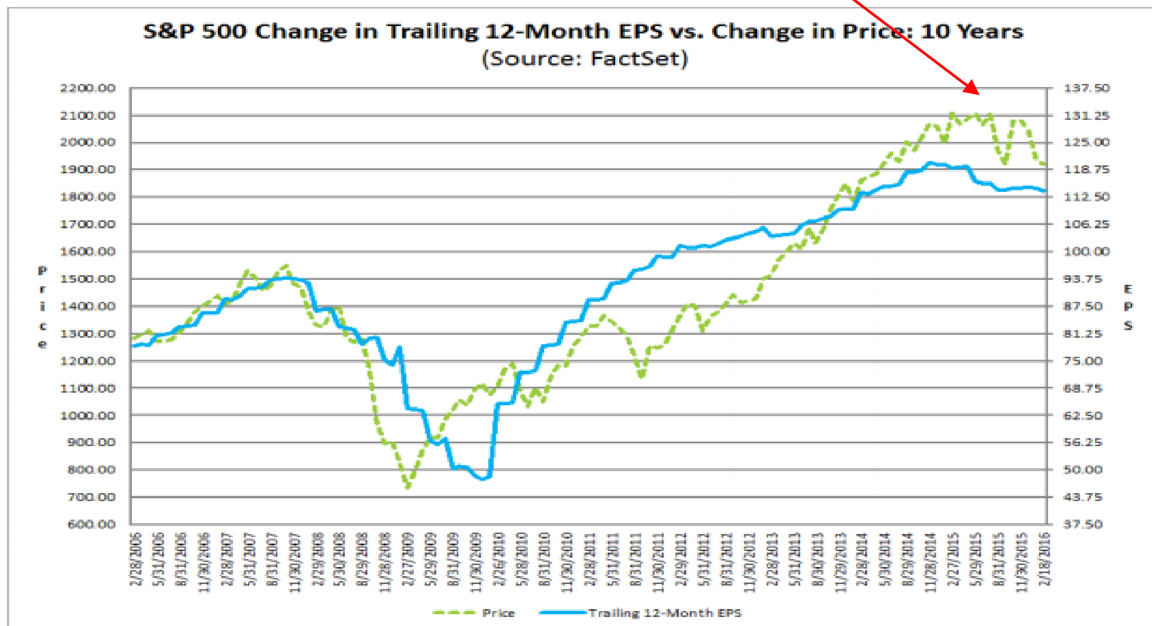
The chart below shows the market response each time the Fed stepped in.



The next chart shows the S&P (red line) and the total cumulative stimulus by the Fed (blue line). Though the Fed stopped adding liquidity in late 2014, the markets kept rising. **With a total of $4.6 trillion of liquidity added, it is understandable why investors' became so confident!**



Valuation Got Ahead of Earnings: The chart below shows the S&P (dotted green line) and trailing 12mo EPS (blue line). In 2015, prices kept rising but earnings began to fall.



Earnings and Revenue Growth Not Expected to Return Until 2nd Half of 2016: Earnings have declined the last four quarters, but forecasters keep promising better days ahead. Thus, much of the recent volatility is due to the continual adjustment lower of forecasted future earnings. Analysts currently do not expect earnings and revenue growth to return until Q3 2016.

The chart below shows quarterly earnings growth since 2014, and the old (gold) and new (black) forecast for 2016. Notice how the new forecast (black bars) pushes growth further out.

Quality of Earnings Growth Deteriorating: Cheap financing has allowed companies to issue debt to buy back stock which in turn has boosted earnings per share. But revenues from core business has not grown. For 2015, earnings fell by -0.5%, while revenues fell by -3.5%. **For all of 2016, analysts are projecting EPS to increase by +3.4% and revenues to increase by only +2.0%.**

Forecast for 2016 by quarter revenues and earnings: (source (Factset)

	Q1	Q2	Q3	Q4
Revenues:	-0.4%	-0.4%	+2.1%	+4.6%
Earnings:	-6.5%	-1.1%	+5.1%	+10%

Looking Ahead: Though there is still an abundance of liquidity today, the Fed is no longer giving investors' the shot of confidence in terms of further stimulus. In fact without any new Fed initiatives supporting the market, investor confidence must now be supported with the economic fundamentals. With economic growth flat and the dollar strengthening, it will be increasingly difficult to grow corporate earnings. And given this is an election year, it is unlikely any new (positive) fiscal policy initiatives will be forth coming**. Valuation needs to align with this new investment environment which means the market is likely capped for now and is at risk to further downside. Volatility will remain elevated.**

Investment Strategy: The new investment environment warrants lower risk. Portfolios must rely more on income than growth for return. Risk is being reduced into market strength through three initiatives: rotating to higher quality and less volatile assets; moving out of growth and into value & dividend paying stocks; reducing high yield and moving to corporate and mortgage backed bonds.

This is a new environment for investing and you may have further questions. Please do not hesitate to contact.

All the Best,

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