July 2016

Economic Comment and Market Outlook

After a sharp correction to begin the year, US stock market averages rallied back to finish the first half of 2016 with a small gain. The S&P 500 delivered a 3.8% total rate of return, finishing only 1.5% from the record high it established in May 2015. Continuing the pattern it has exhibited since that May, the US equity market is flirting with its all-time high while simultaneously dealing with obstacles to further gains, including weak economic growth, stalled profit growth, political uncertainty, and the threat of terrorism. These factors have introduced greater volatility into the markets since the summer of 2015, and some of them will undoubtedly continue to present challenges. However, while volatility will probably remain elevated, we expect improving profit growth at our portfolio companies and in the S&P 500 overall will create a better environment for capital appreciation in the second half of this year and into 2017.

Also continuing a trend exhibited in the past several years, most foreign equity markets proved a disappointment, and fixed income returns were surprisingly robust. The MSCI EAFE Index fell 6.8% in local currency and 4.0% in dollars over the first half of the year as markets declined broadly in Europe and also in Japan. Both the European Central Bank and the Bank of Japan have been trying to revive economic activity in their regions with aggressive monetary stimulus, but neither area has gained traction. Then, right at the end of the second quarter, voters in the United Kingdom surprised the world by voting to leave the European Union, introducing considerable uncertainty into the picture for Europe overall. Already harboring concerns about sluggish economic activity around the globe, investors further reduced their expectations for growth and for the path of inflation and interest rates. Yields on government bonds all around the world plunged. Over the first six months of 2016, the yields on US, German, and Japanese 10-year bonds fell by 80, 76, and 48 basis points, respectively. Finishing the first half yielding only 1.47%, US ten-year Treasury bonds stood out as a relatively enticing income alternative compared to the investor effectively paying the government 0.13% and 0.22% annually in German and Japanese ten-year government bonds! Driven by the performance of the Treasury sector, the Barclays US Aggregate Index of fixed income instruments returned 5.3% in the first half. At this point, income investors have increasingly slim pickings from which to choose; according to figures compiled by Bianco Research, only $2.2 trillion of the $35.1 trillion of outstanding government debt around the world is trading at a yield greater than 2%. Approximately 77% of the total outstanding yields less than 1%, with some $12.7 trillion trading at a negative interest rate.

Even though the recent performance of the US economy leaves much to be desired, the current situation of slow, steady growth combined with low interest rates and glum sentiment actually offers a fairly supportive environment for equity returns for the time being. According to the US Bureau of Economic Analysis, GDP growth for the first quarter of 2016 was only 1.1%. If this year is like the past two years, that growth rate will accelerate somewhat during the remainder of the year. However, over the past decade, our economy has grown at less than 2% compounded annually. The recovery from the Great Recession has been painfully slow. Economists cite many possible causes for this sluggish performance, such as high levels of debt outstanding, aging demographics, lower savings and investment, weak productivity growth, and greater regulation. The Federal Reserve has attempted to support the economy with aggressive monetary stimulus, characterized by over seven years of interest rates close to zero and sizable purchases of fixed income instruments, also known as "quantitative easing" or QE programs. While many members of the Federal Reserve might like to raise interest rates to return them closer to normal levels, economic growth has not been strong enough to allow them to increase short-term rates more than a single 25 basis point increase in December 2015. At this point, with a weaker employment report in June and the UK's vote for "Brexit," it appears the Fed will be back on hold for a longer period of time. Futures markets point to only a 9% chance of a rate increase in the remainder of 2016.

Weak growth and ultra-low interest rates are not the desired characteristics of the US economy, but corporate executives and investors have lowered their expectations accordingly. Along with operating expenses, executives have scrutinized capital spending closely in recent years. With the recent downturn in the energy sector, which had been the main source of growth in capital spending, corporate capital spending for the non-financial sectors of the S&P 500 shrank 4.9% over the twelve months ended in March. Instead, executives have concentrated more on returning cash flow to shareholders via share buybacks and dividends. Based on data compiled by FactSet Research Systems, these same firms have grown buybacks by a cumulative 232% since the beginning of 2010 versus a 90% increase for dividends and a 59% rise for capital spending over the same time period. Operating with a similar logic, many equity investors have remained distrustful of the environment. At the end of June, approximately 29% of investors describe themselves as bullish in the AAII Sentiment Survey, ten percentage points less than the average for the past thirty years; Investment Company Institute data show that domestic equity mutual funds, including ETFs, have exhibited outflows of $175 billion since the beginning of 2015. Typically, economic cycles end when firms invest too much or build too much capacity or inventory or when the Fed raises interest rates to slow inflation. Similarly, market cycles often end when investors are overly optimistic. At the present time, companies and investors are behaving conservatively, which should prolong the economic and market cycle.

An incipient resumption in earnings growth for the S&P 500 augurs for improving prospects for stock price appreciation. Two headwinds—the substantial appreciation of the US dollar relative to foreign currencies and the fall in the price of oil—emerged in the fall of 2014 and conspired to stall profit growth for the S&P 500 and a typical Sarofim portfolio. The resulting difficulty in growing profits has been the most substantial contributor to the inability of the equity market to advance. It appears that the first quarter of 2016 may have been the bottom in terms of earnings growth and that the level of S&P profits will begin growing again in the second half of the year. Using estimates from David Bianco at Deutsche Bank, an earnings decline of 5.4% in the first quarter will improve to year-over-year growth of 7.2% by the fourth quarter. His estimates also suggest that growth in earnings for the S&P 500 could be approximately 10% in 2017, from a level of approximately $118 per share in 2016 to $130 per share in 2017. Along with a fairly steady performance on a currency-neutral basis outside of the energy sector, the cessation of the two headwinds is one of the main reasons for the improving trend. Oil prices dropped as low as $26 per barrel in February, clearly influencing the market correction underway at that time, before rebounding to $48 to close the second quarter. Supply and demand in the

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oil market is coming back into balance, and the producers have cut costs and capital expenditures dramatically, which should lead to higher profits. With regard to the dollar, its value against other currencies has been largely stable since the end of January 2015. At that point, the ICE US Dollar Index reached 94.85 compared to the present value of 95.96, which was inflated almost three points in the last week of the quarter by the flight-to-quality triggered by the Brexit vote. Recognition that the Fed is unlikely to raise US interest rates should keep the currency's appreciation in check. These improving trends are likely to have a bigger impact on a typical Sarofim portfolio due to its higher percentage of overseas profits and greater exposure to the energy industry. Coupled with stronger growth inherent in many of our portfolio companies, we currently estimate weighted average profit growth of 16% in 2017 for a typical Sarofim portfolio's earnings stream.

Clearly, a challenging and concerning environment has faced investors in recent years. A world characterized by weak growth, volatile markets, and record low interest rates makes it more difficult to achieve the goals that most investors are targeting. Monetary policy may have succeeded in preventing a depression in the aftermath of the 2008 financial crisis, but it has left us collectively in a decidedly frustrating position ever since. The advanced economies of the US, Europe, and Japan have failed to deliver improving living standards for much of their population, leaving a tremendous sense of dissatisfaction that is evident in political rhetoric and recent election results. We are monitoring the implications of these trends and the risks to our clients' portfolios. Our investment portfolios emphasize companies with strong balance sheets, stable demand characteristics, high levels of profitability, and resilient dividend and capital allocation policies. Furthermore, we have recently increased our emphasis on companies whose growth plans are more structural and less dependent on the overall level of economic activity. In a volatile market environment, we remain committed to adhering to our time-tested investment philosophy and to delivering superior risk-adjusted returns over market cycles for our clients. As always, we welcome your questions and thank you for the trust that you have placed in our firm.
