# 1Q16 REVIEW & 2016 OUTLOOK

Commonwealth Bank & Trust Company

4350 Brownsboro Rd.
Suite 210
Louisville, KY 40207

p (502) 259-2500
f (502) 259-1501
www.cbandt.com

## 2016 MARKET SUMMARY: No Recession, No Bear Market?

**U.S. Stock Markets:** The S&P 500 stumbled out of the gate on its first day of trading and continued falling for the first six weeks of the year. The market plunged 11% before reversing course on February 11, rallying in the last six weeks of the quarter to finish up 1.35%. In our opinion, the sell-off was mostly sentiment driven by specific market data such as falling oil prices, a lower Chinese renminbi (RMB), and the expectation for a stronger dollar, if the Fed continued to raise rates. For all but three trading days, the market moved in the same direction as the price of oil until the February 11 bottom. A lesser discussed impact on markets, has been the sale of assets by Sovereign Wealth Funds (SWFs). About 2/3 of SWFs are tied to oil-producing countries. Saudi Arabia and Norway disclosed large asset sales during the quarter. Many of the investments sold were stocks of European banks and consumer staples companies, which resulted in a larger sell-off of European stocks than U.S. stocks. The market and oil prices began to rally in February as OPEC members discussed the possibility of a supply freeze and the RMB started to rebound. Improving economic data in the U.S. and abroad as well as comments made by Central Bankers sustained the rally through the end of March.

Table 1

| Index Returns ending 3/31/2016 | 1Q16 | 1-YR. |
|---|---|---|
| S&P 500 | 1.35% | 1.77% |
| Russell 2000 (Small Cap ) | -1.53% | -9.76% |
| MSCI EAFE (International) | -2.88% | -7.87% |
| MSCI EME (Emerging Markets) | 5.75% | -11.70% |
| Barclay's Bond Aggregate | 3.03% | 1.96% |
| Oil bbl. Price Change | 3.51% | -23.50% |

**Global Stock Markets:** International equity markets were mixed during the quarter. The global MSCI EAFE index fell almost 13% through February 11, but recovered to lose a little under 3% for the quarter. The MSCI Emerging Market index made a surprisingly strong recovery after finishing 2015 down almost 15%. Emerging Markets (EM) rallied to finish the quarter up 6%. We believe that these markets over-corrected last year as many EM currencies fell 30% against the dollar. While attractively valued, we think EM may take some time to regain ground from current levels. The dollar weakened about 4% during the quarter, which helped emerging markets returns. About half of the move in the dollar came after Fed Chair Yellen held rates steady in March. The exchange rate action this year between the dollar and the euro continues to puzzle investors. Despite a weaker economic outlook for Europe that led to another quantitative easing announcement by Mario Draghi of the European Central Bank, the euro gained against the dollar. One theory is that funds are flowing out of the U.S. markets to European equities, because valuations are more attractive.

**Bond Markets:** The Barclays Bond Aggregate Index rallied strongly, returning 3.03% in the quarter. As the stock market fell in January, bonds rallied as investors sought safety. Bonds rallied further in March, when the European Central Bank (ECB) announced it would push cash rates further into negative territory while the Fed announced it would hold rates at the same level. Markets inferred that future rate hikes may occur later in the year, if at all, when Yellen made dovish comments suggesting additional rate increases would be delayed until global markets stabilized.

**2016 Market Summary:** Our comments last quarter now seem understated. We declared that economic factors impacting markets in 2015 would continue to impact markets in 2016, but volatility would be more extreme. Oil prices and the movement of the dollar will continue to drive volatility this year. We believe the seesaw market action during the first quarter represented a market trying 1) to re-price higher market risk expectations via lower Price/Earnings multiples for stocks and 2) to determine whether 2016 earnings estimates need to be adjusted downward to reflect a strengthening dollar, falling oil, and rising interest rates. The market has responded positively to improving economic data from the U.S. and China. The data seems to have shelved investor concerns that global growth would fall into recession, enabling oil prices and the RMB to rebound.

We are adjusting our Bull/Bear market odds to 90/10 from 75/25. We place a 90% probability that oil, the dollar, and equity markets stabilize in 2016. We see a 10% probability that oil/dollar concerns push markets into Bear market territory (S&P 500 <1708, represents a 20% decline from the May 20 market peak of 2135). In our opinion, current U.S. economic data and the structure of interest rates do not support a bear market this year. All but two bear markets since 1950 were associated with recessions (1961 and 1987). Nevertheless, we think data flow will show weak improvement leaving the threat on the table that global growth could slide into recession. Oil still appears to be in oversupply and the Fed would like to see rates return to normalized levels. A rate increase should send the dollar higher, which could, in turn, spike market volatility again.

While market sentiment suggests the worst may be over, we believe we are in the final innings of the business cycle and the bull market. Monetary policy seems to be running out of gas, while political gridlock between conservatives and populists worldwide has resulted in an era of perma-austerity. Innovative monetary policy leading to zero and negative interest rates has nursed a global economy in financial crisis to a slow and feeble recovery. The post-crisis business/market cycle is the third longest at 81 months. No Central Banker knows whether this brave new world of monetary policy will end abruptly with a market crash or enable markets to limp along for a few years with subpar returns. Monetary policy may continue to prop up global growth rates to the 1%-3% level. We

4350 Brownsboro Rd.
Suite 210
Louisville, KY 40207

p (502) 259-2500
f (502) 259-1501
www.cbandt.com

think the global markets may move sideways for a few years before slipping into recession and a bear market. Please see more details on our market outlook and valuation in the following sections.

## 2016 ECONOMIC OUTLOOK

Economic forecasters lowered 2016 GDP estimates from 2.5% to 2.1% after certain U.S. leading indicators for first quarter GDP, such as retail sales, fell below estimates. First quarter 2016 GDP estimates were also revised downward from earlier forecasts (lowered from 2.4% to 1.5%). Weather was relatively mild during the quarter and gas prices were lower, yet consumer spending (2/3 of GDP) was relatively subdued as auto sales fell from record highs in 2015. Despite the disappointing retail sales headlines, deeper analysis shows that core retail sales grew almost 7% during the quarter accelerating from prior quarters. Furthermore, consumer credit also rebounded to higher levels after a drop in the fourth quarter. While growth estimates have been lowered, the U.S. economy is on solid footing and the possibility of a U.S. recession seems unlikely in 2016. Unemployment is falling, wages are rising and household finances are favorable (please see Figure 1).

Figure 1


*Source: National Federation of Independent Business and US Department of Commerce, Bureau of Economic Analysis.*

The IMF also lowered its 2016 global growth forecast from 3.4% to 3.2%, which is almost unchanged from 2015 growth of 3.1%. Despite the lower IMF estimate, several important global leading economic indicators improved in March, leaving us more positive about the global economy than in January. The global manufacturing Purchasing Managers Index (PMI) moved into expansion last month. More than 2/3 of the largest 35 economies are expanding and the breadth of the expansion posted its largest monthly gains since July 2009.

Consumer sentiment and other leading economic indicators in the U.S. remain strong, while global indicators are improving. Overall the U.S. economy is healthier than it was in 2010, 2011, 2012 and 2013, when the stock market was posting large gains, but it is showing signs of deceleration versus 2014. We believe we are in the 7th or 8th inning of the business cycle based on fundamental and economic indicators. The big question for markets is whether Central Bank QE and stimulus efforts in China, Europe and Japan will be enough to let the U.S. business cycle wind down in 2017 or 2018 naturally as fundamentals suggest (soft landing), or will the cycle end abruptly (hard landing) as markets lose faith in monetary policy?

## 2016 MARKET OUTLOOK

As previously mentioned, we think the U.S. economy is on solid footing albeit growing slowly and the global economy is improving. Of the seven bear markets since 1950, all but two were associated with recessions (please see Figure 2, recession periods shaded in gray).

Currently the dollar is trading in a stable range vs. other currencies and the Fed does not look like it will push it higher with a rate increase later this year, if at all. Oil seems to be stabilizing in a range of $30-$45 bbl. Emerging markets are rebounding sharply coinciding with improving economic data from China and a stabilization of the RMB. Consumer sentiment is strong and increasing, while market sentiment is neutral, sitting between bullish and bearish levels. The gap between leading indicators and the S&P 500 earnings is widening, while the market is currently starting to break out (please see Figure 3). Therefore, we are adjusting our Bull/Bear market probability from 75/25 to 90/10.

4350 Brownsboro Rd.
Suite 210
Louisville, KY 40207

p (502) 259-2500
f (502) 259-1501
www.cbandt.com

Figure 2

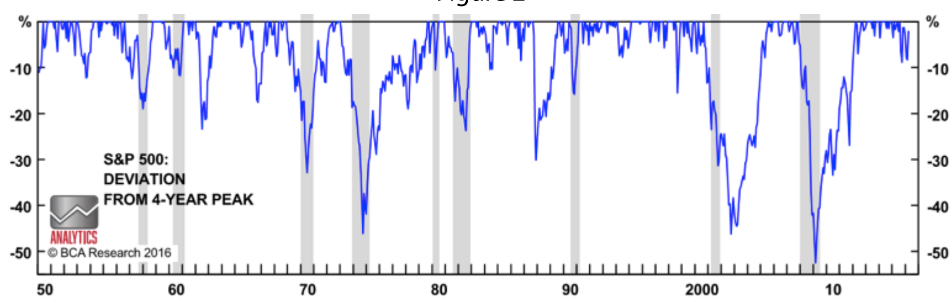
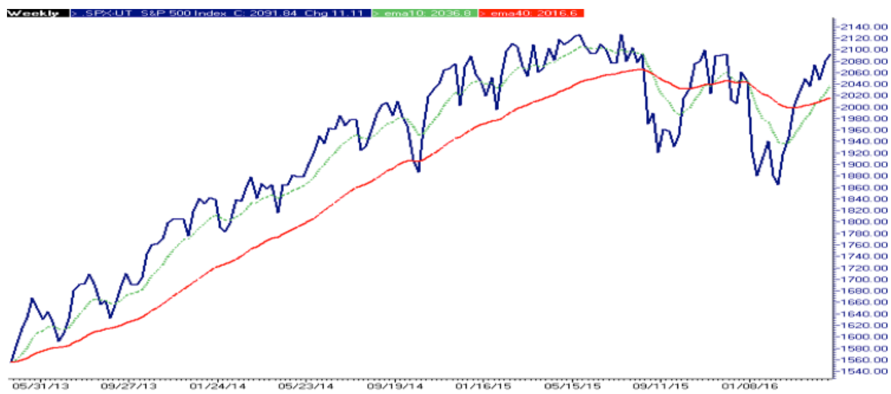



Figure 3



**U.S. Dollar**: The dollar unexpectedly fell during the quarter and the Euro increased in the face of a December Fed rate hike, falling oil prices, a devaluation of the RMB and a new quantitative easing program in the EU (please see Figures 4 & 5). The dollar is beginning to moderate. We believe it will likely rise from current levels, but remain in a trading range established last year between \$1.07 - \$1.15 EUR/USD. This will take incremental pressure off of U.S. exporters, making future earnings and sales comps easier for U.S. multinationals in coming quarters.

Figure 4: Dollar/Basket of Currencies YTD

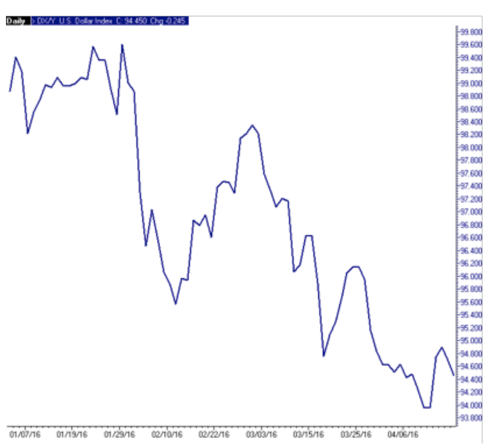
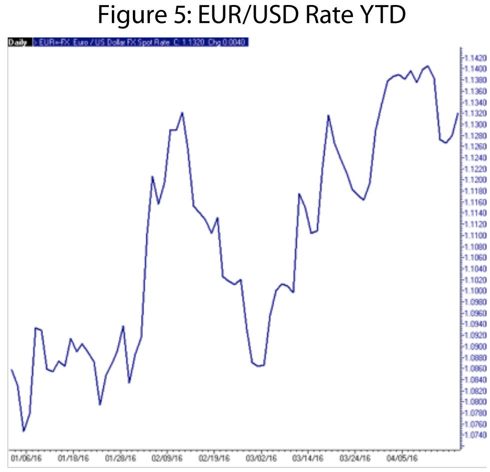


Figure 5: EUR/USD Rate YTD



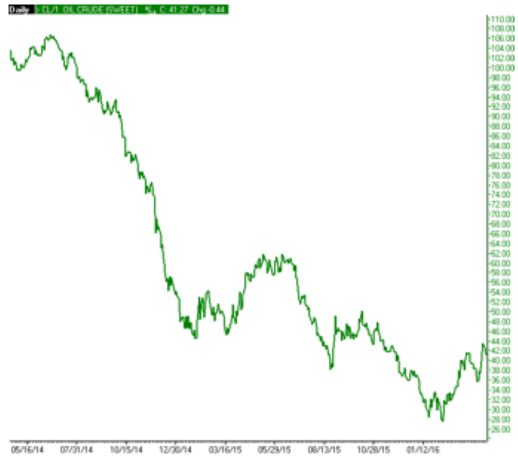
**Oil**: Oil storage and production remain near an all-time high and we do not see a material reduction in supply in the near future. Pipeline stoppages in Nigeria and Iraq removed incremental supply from markets helping oil push to the \$40 bbl. range (please see Figure 6). Additionally, talk among OPEC leaders of production cuts helped oil find a bottom in February. OPEC leaders met in Doha the weekend of April 15 to discuss or negotiate potential production cuts. Saudi Arabia stated it would cut production if Iran held their production steady, which Iran contested. A failure to agree to cuts at Doha, reinforce our belief that Saudi Arabia or other OPEC

4350 Brownsboro Rd.
Suite 210
Louisville, KY 40207

p (502) 259-2500
f (502) 259-1501
www.cbandt.com

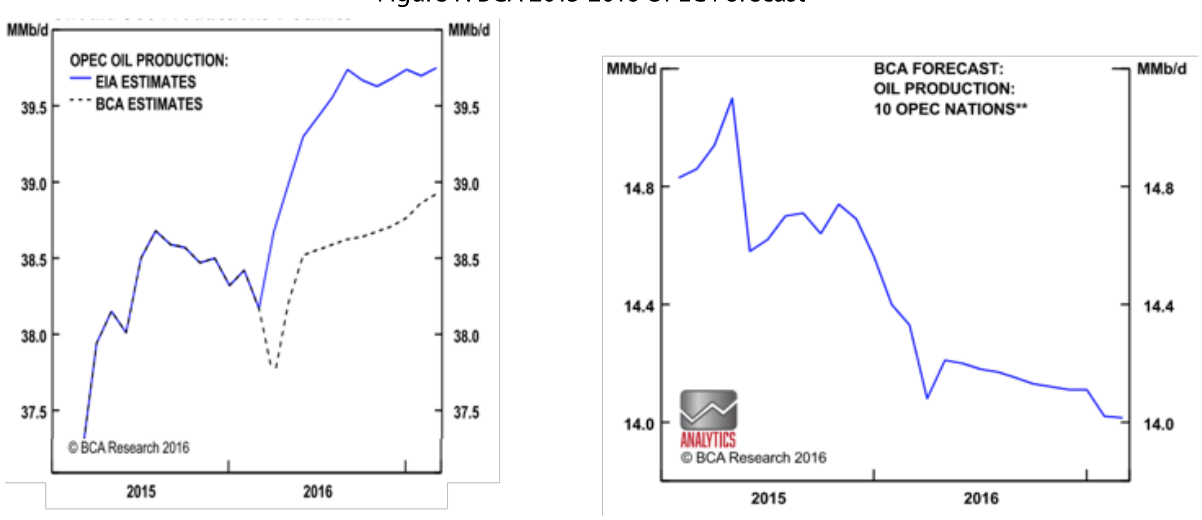
members will not cut production in the near future. BCA Research's energy team is taking a contrary position, however, forecasting a cut to production by the three largest OPEC countries (Iran, Iraq and Saudi Arabia) as production slides in the 10 smaller OPEC countries (Algeria, Angola, Ecuador, Indonesia, Kuwait, Libya, Nigeria, Qatar, UAE and Venezuela). (Please see Figure 7)

Figure 6: Oil prices last 2 years



Oil supply pivots around Saudi Arabia's actions. We believe that Saudi Arabia is financially stressed, because the high costs of its social programs require $70-$90 oil to maintain a balanced budget. As a result, the country has redeemed foreign investments, floated more debt, and is considering selling assets, such as the stock of state-owned oil giant, Aramco. The country's sovereign debt was recently placed on watch for a downgrade. We believe the market downturn in the first half of the first quarter was exacerbated by selling from the secretive SWFs of oil nations. Saudi Arabia and Norway disclosed redemptions and sales of investments. The top 25 SWFs control roughly $6T in investments. Almost $4T or 2/3 of these funds represent the investments of oil and commodity based economies, which needed to withdraw funds to shore up local currencies and fund fiscal deficits. These funds are among the largest investors in European banks and consumer products companies. European stocks in both sectors experienced extreme selling pressure during the quarter. For a few trading days during the quarter, a large selloff of Deutsche Bank shares started rumors of its possible failure, which caused other markets to selloff over contagion fears.

Figure 7: BCA 2015-2016 OPEC Forecast




**China**: Less discussed, but perhaps a greater contributor to volatility during the quarter was the role of the Chinese economy and the RMB. As discussed in prior quarterly newsletters, Chinese growth is slowing and market intervention by the Communist Party has resulted in capital overcapacity, inventory build-ups, and a flood of inter-company, inter-bank and inter-agency lending. Chinese Fiscal and Monetary policy appear to be less efficient than in the past and may have led to policy bungles in the last two years resulting in stock market volatility and outflows of capital. For instance, a large stimulus package initiated at the end of 2014 had to be increased in 2015 and is just now showing signs

Figure 8: USD/RMB Exchange Rate Last 2 Years

4350 Brownsboro Rd.
Suite 210
Louisville, KY 40207

p (502) 259-2500
f (502) 259-1501
www.cbandt.com

of traction. The party decided to devalue its currency last summer after maintaining a tight peg to the U.S. dollar. Chinese trading partners in emerging markets saw their currencies fall 30% against the dollar and the pegged RMB last year. The surprise devaluation in August pushed volatile markets to lower levels. Additional devaluation in January contributed to volatility in January and February and resulted in large capital outflows for China. The drop in the RMB reversed in late February and capital outflows turned to inflows in March ending seven months of a significant drawdown of foreign reserves. A Reuters article earlier this month discussed the possibility that a secret deal was struck at the G20 finance minister meeting held in Shanghai February 26-27. According to the article, China threatened a further 15%-20% devaluation of the RMB unless the Fed agreed to postpone additional rate hikes. Former Treasury official, Larry Summers, refuted the possibility of such an arrangement. A quick review of Figure 8 suggests that if there was an agreement it happened before the February G20 meeting.

## MARKET VALUATIONS & RETURNS

We believe the economic backdrop for the market remains constructive enough to keep it out of bear territory for the year. Nevertheless, markets will likely remain range-bound through year end between the 1950 and 2125 range with a reasonable likelihood of posting a loss for 2016.

- **S&P 500 Earnings Revisions:** During the first quarter, analysts lowered EPS estimates of S&P 500 companies by roughly 10%. We believe analysts overshot these negative earnings revisions for all sectors except energy and financials. While GDP estimates fell during the quarter, we think EPS estimates were unduly penalized. We think companies are likely to beat estimates during the first quarter earnings season, but management teams may not be ready to raise full-year guidance until later in the year when they can confirm that market conditions are stable for their businesses. Additionally, there is a significant gap between key economic indicators and forward earnings, which further suggests estimates may be overly negative (Figure 9). To further illustrate that EPS estimates are significantly understated for the first quarter please see Figure 10 from Ned Davis Research. Analysts cut first and second quarter estimates, but maintained their annual EPS estimates at roughly the same level by back loading earnings growth for the third and fourth quarters to ridiculous levels. Now year-over-year earnings growth is forecast to be slightly negative in 1Q16, but accelerate to 38% growth in the fourth quarter. Not likely. We expect significant adjustments to quarterly earnings for 2016 coming out of the first quarter earnings season. We think estimates for energy and financial companies, however, may need additional adjustments downward.
    - **Energy:** We believe estimates for energy companies do not fully reflect $30 - $40 bbl. oil prices nor lower natural gas prices for the long-term.
    - **Financials**: We think a portion of bank and financial estimates have higher net interest margins for 2016 reflecting expectations that the Fed would make 2-3 rate increases in 2016 starting earlier in the year. Most economic forecasters expect only one more rate increase later in the year.
- **U.S. Stock Valuations:** To reach the 1700 bear market level on the S&P 500, market EPS estimates need to drop significantly lower. As previously mentioned, the current economic data does not fit

Figure 9: Gap between S&P 500 EPS vs. Lending Indicators

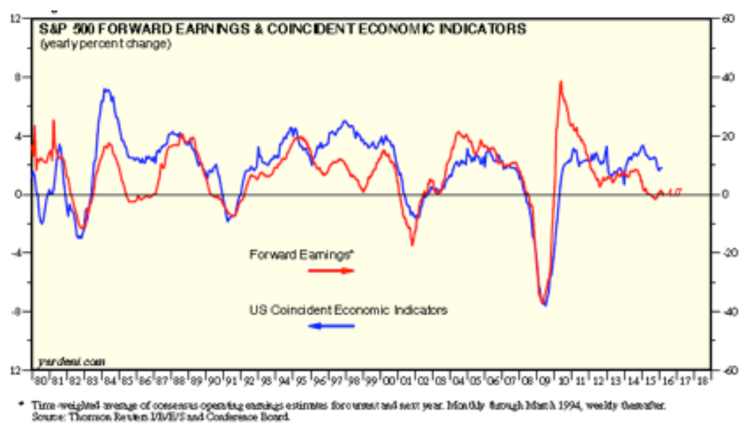
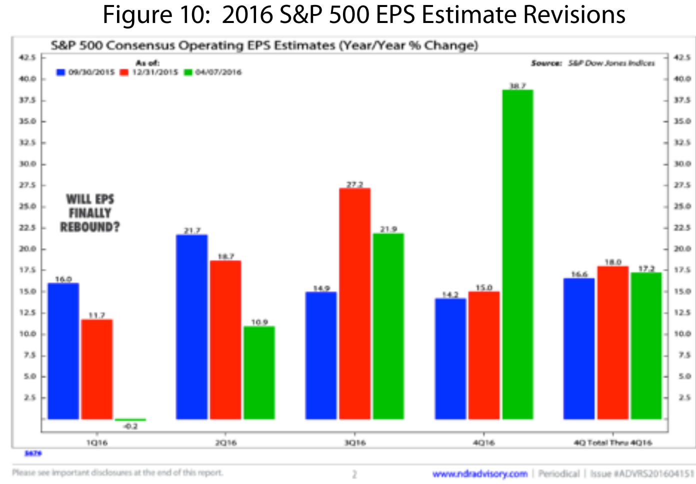



Figure 10: 2016 S&P 500 EPS Estimate Revisions



4350 Brownsboro Rd.
Suite 210
Louisville, KY 40207

p (502) 259-2500
f (502) 259-1501
www.cbandt.com

with a scenario where companies would make large cuts to their earnings guidance, which we think is required to push the market into bear market territory. The U.S. or EU would likely need to fall into recession to revise EPS to the level required for bear market. It is possible that negative sentiment could push the market below 1700, but that should be short-lived unless accompanied by a major downward shift in economic and corporate fundamentals. We believe the market has a 90% chance of remaining out of bear territory, because we expect earnings to be revised upward in 1H16, except for energy and financials. As a result, we forecast the S&P 500 could finish in a range from 1950 -2125 for a total return with dividends of -2.5% to +5.0% in 2016 (please see Table 2). We place a 10% chance that the market finishes in bear territory in 2016 (S&P 500 <1708). Nevertheless, with the market near 2080, we believe the market has about 3% upside unless investment sentiment becomes much more bullish (multiple expansion) or earnings are revised significantly higher.

Table 2: S&P 500 Valuation

| | | | |
|---|---|---|---|
| - S&P 500 Forward Multiple 16E: | 17.2x | - 2016 Estimate: | $121 |
| - S&P 500 Price 4/15/16: | 2,078 | - 2017 Estimate: | $129 |

**Implied S&P 500 Valuation**

| | $125 | $130 | $135 | $140 |
|---|---|---|---|---|
| 14.0x | 1,750 | 1,820 | 1,890 | 1,960 |
| 14.5x | 1,813 | 1,885 | 1,958 | 2,030 |
| 15.0x | 1,875 | 1,950 | 2,025 | 2,100 |
| 15.5x | 1,938 | 2,015 | 2,093 | 2,170 |
| 16.0x | 2,000 | 2,080 | 2,160 | 2,240 |
| 16.5x | 2,063 | 2,145 | 2,228 | 2,310 |

**Implied S&P 500 Price Change**

| | $125 | $130 | $135 | $140 |
|---|---|---|---|---|
| 14.0x | -16% | -12% | -9% | -6% |
| 14.5x | -13% | -9% | -6% | -2% |
| 15.0x | -10% | -6% | -3% | 1% |
| 15.5x | -7% | -3% | 1% | 4% |
| 16.0x | -4% | 0% | 4% | 8% |
| 16.5x | -1% | 3% | 7% | 11% |

Source: CB&T. Note add ~2% in dividends for S&P 500 total return

- **Investment Strategy:** Despite the lackluster stock market outlook, fixed income markets look even less attractive. The Barclays Bond Aggregate index has already moved 3% in the first quarter as the Fed became more dovish and rates fell. The 10-year Treasury has remained ranged bound between 1.70% and 2.40% for about two years. Near the low end of the range at 1.75%, more than 60% of S&P 500 stocks offer a higher yield than the 10-year Treasury. Since cash offers a real return of -2.00%, we view lower risk, high quality equities and alternative strategies with low correlations to the market as more attractive asset classes in the market.
  - We have been incrementally lowering the risk of client portfolios since 2014. We significantly reduced exposure to emerging markets as well as materials and energy equities. We lowered the duration of fixed income investments in the face of rising rates.
  - We may miss part of the energy rebound by underweighting the asset class, however, as we demonstrated during the financial crisis with a tactical underweight to financials, we have been able to invest elsewhere to more than make up for the lost exposure to a recovering sector.
  - Our shift in alternative strategies to managed futures and market neutral investments paid off extremely well during the first quarter as these investments were up 5% when the market bottomed at -11% in mid-February.
  - We tend to be pruning portfolios of profitable higher beta equities as the market rallies. We are having trouble reinvesting these profits, because there are fewer quality companies available at reasonable prices currently. Nevertheless, we have been able to park extra cash in alternatives while we wait for the next bout of market volatility to offer quality companies at cheaper prices.