Smith Group
ASSET MANAGEMENT

MARKET PERSPECTIVES

MARCH 2016 | Volume 22, Issue 1

A Thrilling Ride that Goes Nowhere

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Market participants had to really hold onto their hat during the roller coaster ride of the first quarter. In January, sentiment dropped to the lowest levels since 2009 as concerns rotated between falling oil prices, Chinese economic slowing, and the possibility of a Fed tightening mistake. Then oil prices turned back up, economic data in China improved, and the Fed stretched out expectations for rate rises. The market responded accordingly with a painful selloff in January, followed by a dramatic rise over the rest of the quarter.

At the Smith Group our focus is on earnings, which continue to be a bit troubling given disappointing sales reports and the continued downward pressure from negative analyst revisions. Expectations for S&P 500 earnings growth began the year at +6.8%, but

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Total Return	1Q16	1 Year
Russell 1000	1.2%	0.5%
Russell 1000 Growth	0.7%	2.5%
Russell 1000 Value	1.6%	-1.6%
Russell 1000 Cons Disc	1.8%	4.8%
Russell 1000 Cons Stap	5.5%	10.4%
Russell 1000 Energy	3.7%	-17.7%
Russell 1000 Financial	-4.2%	-4.0%
Russell 1000 HealthCare	-6.1%	-6.3%
Russell 1000 Industrial	4.9%	1.6%
Russell 1000 Info Tech	1.8%	6.0%
Russell 1000 Materials	4.7%	-5.5%
Russell 1000 Telecom	15.3%	17.0%
Russell 1000 Utilities	15.6%	15.3%

Total Return	1Q16	1 Year
Russell 2000	-1.5%	-9.8%
Russell 2000 Growth	-4.7%	-11.8%
Russell 2000 Value	1.7%	-7.7%
Russell 2000 Cons Disc	2.5%	-12.7%
Russell 2000 Cons Stap	3.0%	0.0%
Russell 2000 Energy	-8.0%	-43.0%
Russell 2000 Financial	0.3%	-1.6%
Russell 2000 HealthCare	-17.0%	-20.0%
Russell 2000 Industrial	4.5%	-11.2%
Russell 2000 Info Tech	-1.4%	-3.8%
Russell 2000 Materials	5.1%	-19.5%
Russell 2000 Telecom	5.9%	5.5%
Russell 2000 Utilities	11.9%	9.6%

Total Return*	1Q16	1 Year
S&P 500	1.3%	1.8%
MSCI AC World	-1.5%	-4.9%
MSCI AC World Ex U.S.	-4.1%	-10.3%
MSCI World (Developed)	-2.0%	-4.6%
MSCI Emerging	2.7%	-7.7%
MSCI Europe	-4.9%	-10.6%
MSCI Pacific Ex Japan	-2.1%	-10.2%
MSCI Japan	-12.7%	-12.9%
MSCI China	-4.7%	-18.8%
USD/EUR	4.9%	6.1%
USD/Yen	7.0%	6.7%
USD/MSCI EM FX	3.0%	-4.3%

* in local currency, net of tax withholding

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Is A Decline In Corporate Profits A Precursor To An Economic Recession by Bill Ketterer, CFA
Implications of Excess Cash on the Balance Sheet by Stephanie Jones, CPA

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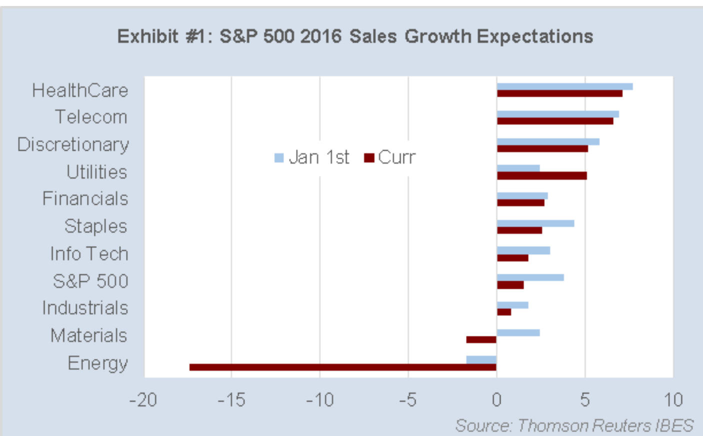
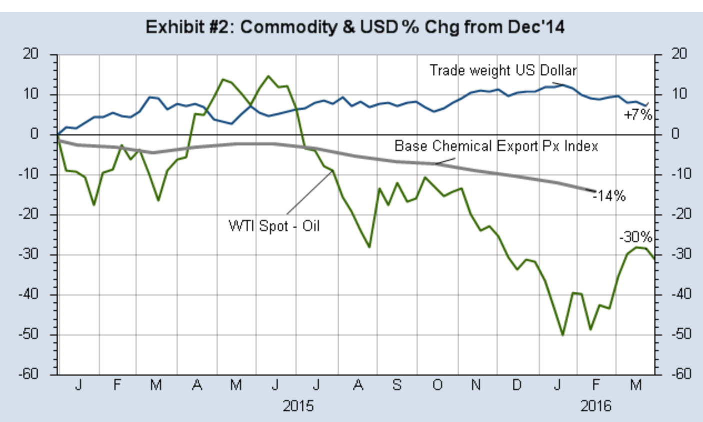
have now fallen to +1.5%. While EPS growth expectations do normally fall, the downward trajectory in the first quarter was steeper than normal. A big culprit has been sales expectations, which have dropped from +3.8% to +1.5%. As such, it is easy to see why some strategists are projecting a sales and earnings recession in 2016.

Does a corporate sales contraction make sense when both the domestic and global economies are expected to grow about +4% in nominal terms? Taking a closer look at sales expectations in Exhibit #1, it is very apparent that the biggest downgrades have taken place in resource companies, leading to an expectation of falling sales in materials and energy. This is not the result of falling volumes in either case, but in falling prices (Exhibit #2). The dramatic drop in commodity prices throughout 2015 and into February has resulted in a flood of earnings downgrades. But the questions then become, "how much further can prices fall?" and "have analysts fully reflected the selling price drop in estimates?". The answer to the first question is often quite





difficult. But given the fact that commodity prices have rebounded nicely since February, when most of the earnings downgrades took place, it seems likely that prices may have found a bottom. The answer to the second question is about the psychology of analysts. Quite often resource analysts wait to update earnings models to reflect higher selling prices until they are sure the new price is going to stick. In contrast, when they experience an extended period of sharply negative selling price change, which caused them to make multiple estimate revisions, they can start to anticipate the next leg lower. At this juncture the lowest price is almost assuredly in their earnings models. If these two questions can be answered in the affirmative then a big driver of negative earnings revisions may be about to stabilize or reverse itself.

Another driver of negative revisions has been the strong U.S. dollar, also illustrated in Exhibit #2. Through its peak in January of this year, it was +12% higher than it started in 2015, but has since dropped back to where it is now only +7% higher. During earnings reporting season it was common for management of multi-national companies to highlight the negative effect of the strong dollar and issue guidance that they expected that to continue. During the upcoming earnings season might we see some unwinding of that guidance? Yes, the dollar was still on average higher during the quarter than it was a year ago. But as of this writing it is at the same level as it was a year ago, which if these levels hold means it is no longer a drag on year-over-year earnings growth going forward. During the last reporting season it appeared the U.S. dollar was a one-way trade to the upside. Projecting currency levels is difficult, but the rate of U.S. dollar ascent slowed in 2015, then rolled over in the last couple of months. It may resume its upward trajectory, but as with most secular price moves, the early surge slows and the impact moderates. This may be another downward driver set to stabilize or improve.

The only other sector with expected sales growth below the broad average is the Industrials sector. This group has significant overseas sales and therefore has been hurt by the strong U.S. dollar (see previous paragraph), but is also suffering from of a lack of investment here at home. The

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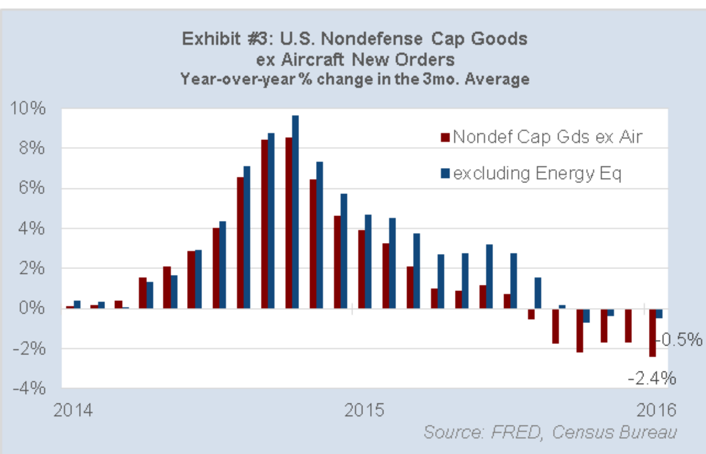
Information presented is supplemental. Please see Disclosures for further information.

drop off in new orders for nondefense capital equipment excluding aircraft (as reported by the Census Bureau) illustrates the recent tepid level of capital expenditures. At the last peak these orders were growing about +8% in the third quarter of 2014 (Exhibit #3). Over the course of the next twelve months however, growth slowed and then turned negative in the third quarter of 2015, and orders are still falling in the current quarter. The weakest portion of these data are investments relating to the mining and energy industry, which are falling much faster than in the rest of the categories. In fact, if this subindustry is stripped out, capital equipment orders are mostly flat on a year-over-year basis. However, that negative impact cannot continue because energy equipment orders are practically at zero. At the peak they were 5% of the order series, but have fallen to less than 1%. Thus this is another drag on business output that has run its course and is set to stabilize or improve.

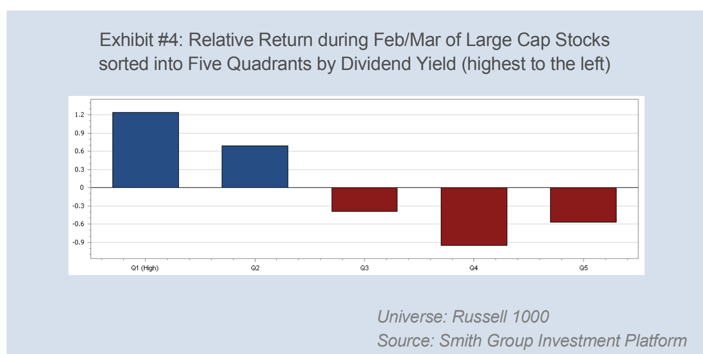


Shifting the focus to the overall economy, it is difficult to believe a recession is at hand. With two-thirds of U.S. economic activity coming from consumption and the ingredients for further expansion of consumer spending, a contraction in the immediate future seems unlikely. Job growth continues to be better than average, debt service ratios are at historically low levels, wages are beginning to grow, and confidence is once again rising. That sounds more like a recipe for at least modest expansion.

With earnings expectations starting the year so low, the normal trend downward in the face of a high number of downgrades, it is easy to view the earnings outlook with some trepidation. However, the negative drivers seem to be abating. We acknowledge the risk of an earnings recession in 2016, but suspect we have seen the worst of the negative revisions. If that is the case, modest to flat earnings growth is the most likely outcome.

The current market surge has been described as a relief rally and there is little explicitly said about earnings. But the correlation with the U.S. dollar weakness and commodity price bounce implies that investors are recognizing that these drivers are important to the outlook for profits. Yet the rally has driven valuations back to modestly expensive levels. With a tepid to flat earnings growth outlook a move to higher valuations would require a catalyst.

One inconsistency that we have noted is the behavior of safe haven assets like gold, dividend stocks, and treasury bonds. In January during the “risk-off” market these investments were strong relative performers. But in the “risk-on” rally that followed they did not lose their luster for investors. In fact, stocks with high dividends continued to be the best market performers (See Exhibit #4). This is an anomaly that may have some significance. But these are times when anomalies are not uncommon. For instance, stock and oil prices are not normally correlated, but that has been the case for much of the last year.



A friend of the firm recently pointed out that twenty plus years ago extended sideways markets were not uncommon and we could be in another period like that. The evidence is beginning to mount that 2016 may be another modest year for U.S. equity returns as was 2015.

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Smith Group Economic Scorecard

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Economic Concept	Asset, Liability, or Neutral	Key Indicators
Consumer Spending		Consumer Confidence (YOY), Retail Sales, Consumer Confidence (10YrMA), Real PCE, Disposable Income, Confidence
Consumer confidence is down YOY, but is still well above its 10 yr ave. Real personal consumption growth and real disposable income growth are both running at a pace well above the 2% threshold. Retail sales growth has rebounded and is no longer a liability. With three indicators better than the asset threshold this concept is still an asset.		
Credit Environment		Loan officer credit conditions survey, Small Business Credit Availability survey, Consumer Credit growth, C & I Credit growth
All of the credit availability and growth indicators are assets. However, demand has dropped in the most recent loan officer survey. Small Businesses are finding credit easy to get, although, it is modestly tighter than last quarter. Growth in loan balances is expanding better than asset thresholds for both consumers and businesses.		
Employment		New Jobless Claims, Change in Private Employment, Job Openings, NFIB Hiring Plans
All employment indicators are strong making the concept a positive driver in the scorecard. New jobless claims may have reached a trough, but are still exceptionally low. Job openings relative to the employment pool has leveled off, but at a very high rate. Growth in private sector employment is well above the asset threshold at 2.3%. Small business hiring plans are moderating, but are still well above asset threshold.		
Energy		WTI - YOY, WTI vs 10yr MA, Pump Prices, Nat'l Gas, Energy Intensity, Energy Imports
While the near term capex impact and credit default risks are not captured in our metrics, the rebound in prices has relieved some pressure on the most troubled portions of the energy business. Energy prices are still down YOY and are well below the 10yr ave. and will act as a tailwind for the economy. Energy intensity of the economy has leveled out and is a neutral. Oil imports have begin to rise in 2016, but not by a significant amount.		
Housing		Housing starts, Case-Shiller prices, NAHB Survey, Mortgage applications, Mortgage rates
Almost all housing indicators are an asset. There is a brisk pace of mortgage applications for purchase. Mortgage rates are below the 3 year average, but not meaningfully. House price appreciation has re-accelerated making it an asset. New home sales on average have leveled off, but are the still at best levels in the recovery. Housing starts have accelerated, but have much further to go to reach LT averages.		
Interest Rate Environment		Fed Funds Rate, Yield Curve, Change in 10-year Treasury rate, Change in Fed balance sheet assets
Despite the angst created by talk of a Fed Funds rate rise, interest rates and liquidity are still exceptionally accommodative. Market interest rates are still low. The one caveat is a flattening yield curve.		
Household Wealth		Net Worth (YOY%), Net Worth (% of Peak), Debt Service Ratio, House Prices, Stock Prices
While household net worth is at all time highs, the rate of increase has moderated making this concept a neutral. An extended period of flat (on average) stock prices means net worth is mostly driven by rising house prices.		
International		JP Morgan Global PMI, CESI Europe, CESI EM, CESI Japan, Baltic Dry Index, Currency
The trade weighted USD peaked in January and has steadily fallen since, yet it is still up 4.5% on a YOY basis (compared to 12% at the end of the year). The baltic dry index has bounced in the last couple months off of very low levels. The composite Global PMI index fell sharply in February, but is not showing a contraction yet. Global economic surprises have been worse than expected, especially in Europe and Japan. Emerging markets data has been worse than expected, but not by a wide margin. The higher dollar and slowing global economic data are troublesome, but indications are for a global slowdown, not a contraction.		
U.S. Debt and Budget		Interest Payments on National Debt, Maturity Distribution, Deficit & Total Debt, Debt-to-GDP
Debt-to-GDP has pretty much leveled out. The portion of the federal budget going to interest payments remains flat. While the average maturity is rising, which is a positive, we still worry that once interest rates start to rise this could become a larger issue. For now the concept is a neutral.		
Business Spending		CAPEX Orders, CAPEX Shipments, CAPEX Surveys, NFIB Small Bus CAPEX Plans
Business investment continues to be disappointing. Surveys still indicate that businesses plan to invest, but the portion of companies indicating an increase has trended sideways over the last couple years. Actual orders and shipments have actually been falling on a year-over-year basis for most of the last year, making the overall concept a liability.		

Smith Group Market Scorecard

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<table>
<tr><th>Market Concept</th><th>Asset, Liability, or Neutral</th><th>Key Indicators</th></tr>
<tr><td>Liquidity</td><td></td><td>Fed Balance Sheet (FRED-WALCL) (YOY%), BOJ Balance Sheet (FRED-JPNASSETS) (YOY%), ECB Balance Sheet (FRED-ECBASSETS) (YOY%), Cash in Money Mkt Funds v. 5yr ave</td></tr>
<tr><td colspan="3">While the Fed balance sheet is flat on a YOY basis, the BOJ and ECB are still expanding assets by about 25%. Money market fund assets are also rising again. The expansion of foreign liquidity and maintenance of high liquidity in the US make this concept an asset.</td></tr>
<tr><td>Asset Flows</td><td></td><td>Mutual fund flows, Institutional Searches, foreign purchases of U.S. securities, ETF flows, ICI DomEq Flows,</td></tr>
<tr><td colspan="3">Equity mutual funds continue to experience outflows. Positive flows into ETFs offset those mutual fund redemptions up until January (most recent data), when the combined flow turned negative. In March the MF outflows have abated. Foreigners are still modest buyers of US equities.</td></tr>
<tr><td>Geopolitical Risks</td><td></td><td>Disruptive global events</td></tr>
<tr><td colspan="3">International headlines have evolved. Fear of a Chinese meltdown have abated. The risk of a BREXIT is now rising, while terrorist attacks and the refugee debate is tearing at some of the basic principles of the European Union. While the market is currently handling these risks well, watching them closely is prudent.</td></tr>
<tr><td>Macro</td><td></td><td>Citi Econ Surprise US, Citi Econ Surprise G10, Citi Econ Surprise China, ISM New Orders Manf, ISM New Orders Services</td></tr>
<tr><td colspan="3">Economic Surprise index in the US and G10 have recovered and are neutral. The Chinese CESI index has deteriorated and is a liability. The ISM New orders for Manufacturing recovered back above 50. The Services New orders index is down from high levels, but still above the 55 threshold that makes it an asset.</td></tr>
<tr><td>Sentiment</td><td></td><td>AAII Bull/Bear (contrarian), Inv Intel Bull/Bear (contrarian), Retail AA (ICI DomEq/Total), AAII Allocation Survey</td></tr>
<tr><td colspan="3">The negative sentiment extremes reached in January were very bullish signals, but the surveys have returned to a more neutral level in March. Both the AAII survey bull/bear ratio and the Inv Intelligence survey are now neutral. AAII allocation survey shows retail equity allocations are down but still slightly above average. Sentiment moved to an asset then back to back to a neutral concept at the end of the quarter.</td></tr>
<tr><td>Valuation</td><td></td><td>S&P500 F12M PE v 10 yr ave, S&P500 F12M PE v 20 yr ave, S&P 500 PB v 10 yr ave, S&P 500 F12M EY v BAA, Graham & Dodd CAPE</td></tr>
<tr><td colspan="3">Valuation metrics are mostly full, but in neutral territory. Even the Graham & Dodd CAPE is moving down closer to our neutral threshold. The S&P 500 forward P/E and P/B relative to the 10-year ave. are just below the liability threshold, while the P/E is close to the 20-year average. EY relative to bond yields is still an asset.</td></tr>
<tr><td>Earnings</td><td></td><td>F12M YOY EPS Growth, FY2 Diffusion, Guidance, FY2 Diffusion (4-wk change), S&P 500 F12M Expected Growth, % Pos Surp (Latest Report)</td></tr>
<tr><td colspan="3">While earnings surprises during reporting season were pretty normal, our other indicators are more troubling. The diffusion ratio (#positive to #negative revisions) was quite negative during reporting season, but returned to almost normal in March. Trailing earnings growth has been a negative input. Forward expectations have dropped below 5%, making it a liability as well. Negative pre-announcements are quite high, weighing on expectations, but that improves the odds of positive surprises during reporting season. On balance, low growth expectations and negative diffusion make this concept a modest liability.</td></tr>
<tr><td>Revenues</td><td></td><td>FY2 Diffusion, FY2 Diffusion (4-wk change), S&P 500 F12M YOY%, % Pos Surp (Latest Report)</td></tr>
<tr><td colspan="3">After forward sales growth expectations firmed in the fourth quarter, they have deteriorated again to below the 3% liability threshold. Reported sales for the last quarter were particularly disappointing. Sales diffusion spiked to its lowest level since 2009 during reporting season, but has since recovered to neutral territory. The disappointing reported sales coupled with deteriorating expectations make this concept a liability.</td></tr>
</table>

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