

# The Tug-of-War Persists



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# 2016 Outlook: The Tug-of-War Persists



<b>BULL SIDE</b>	<b>BEAR SIDE</b>
No US recession	Global growth
Few attractive alternatives	Profits weakening
Low oil prices	Low oil prices
Global stimulus	Fed transition
Low expectations/last push	China/EM troubles

# An Economy on the Edge

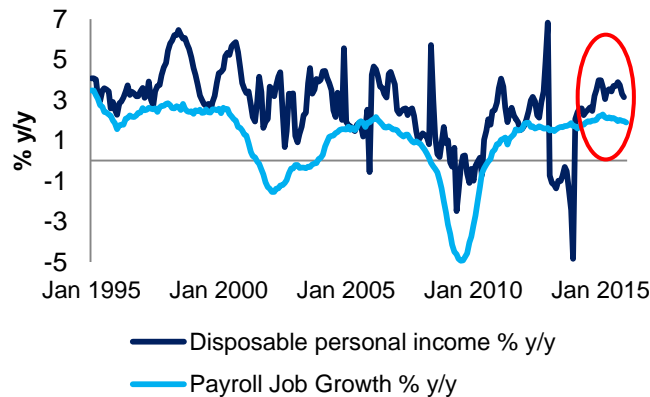
No matter how you slice it, the US is mired in an *Incomplete Expansion*

- Services production is fine; Goods production in recession
  - Global trade fails US corporations
- US economy stable; Rest of world - lackluster
  - Weak Exports and ineffective policy inhabit both Asia and Europe
- The first ever non-home sales expansion
- Household resources deficient to sustain economy alone

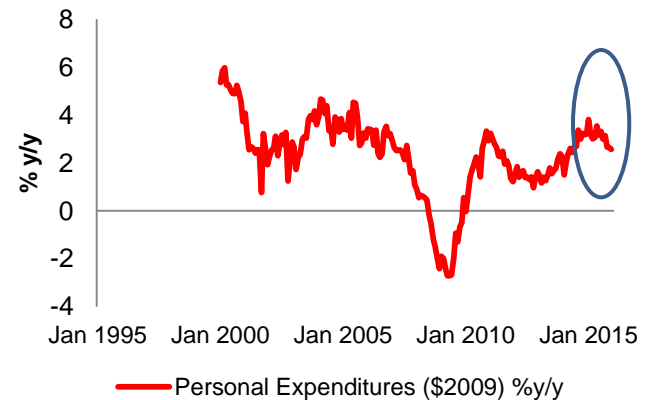
# An Economy on the Edge - part 2

- The Fed raised rates but banks did not rush to lend
  - Fed posts first rate rise, then takes a volatility pause
  - Rates have not moved despite December Fed action
- Inflation
  - Deflation still a problem - and its not all oil
  - Weak global and consumer growth builds excess inventory which pushes prices down
- Jobs and incomes grew, but spending retrenched

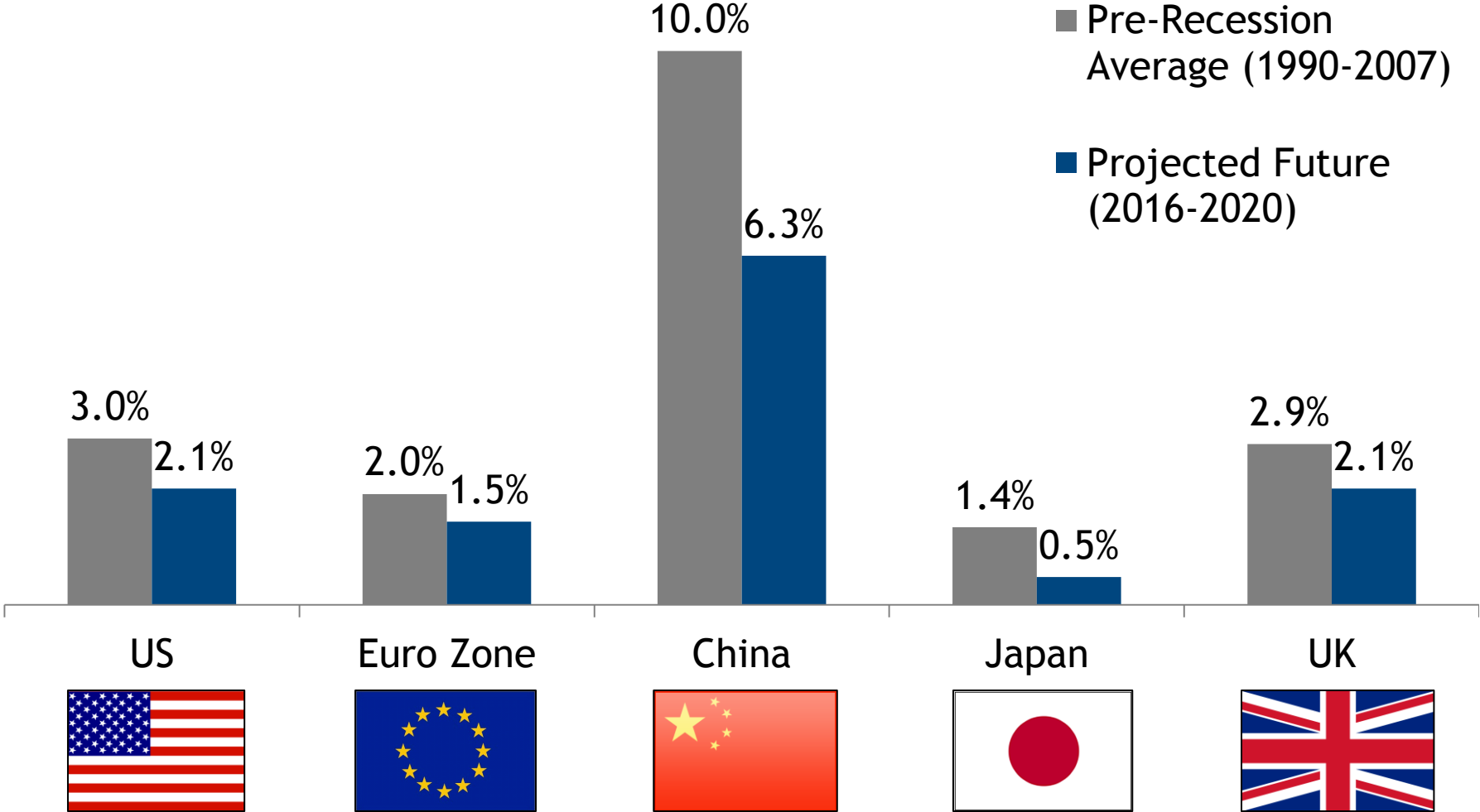
### Jobs and Real Incomes Finally Rising ...



### ... But Households Reluctant to Spend



# GDP: Growth Estimates - Lower for Longer

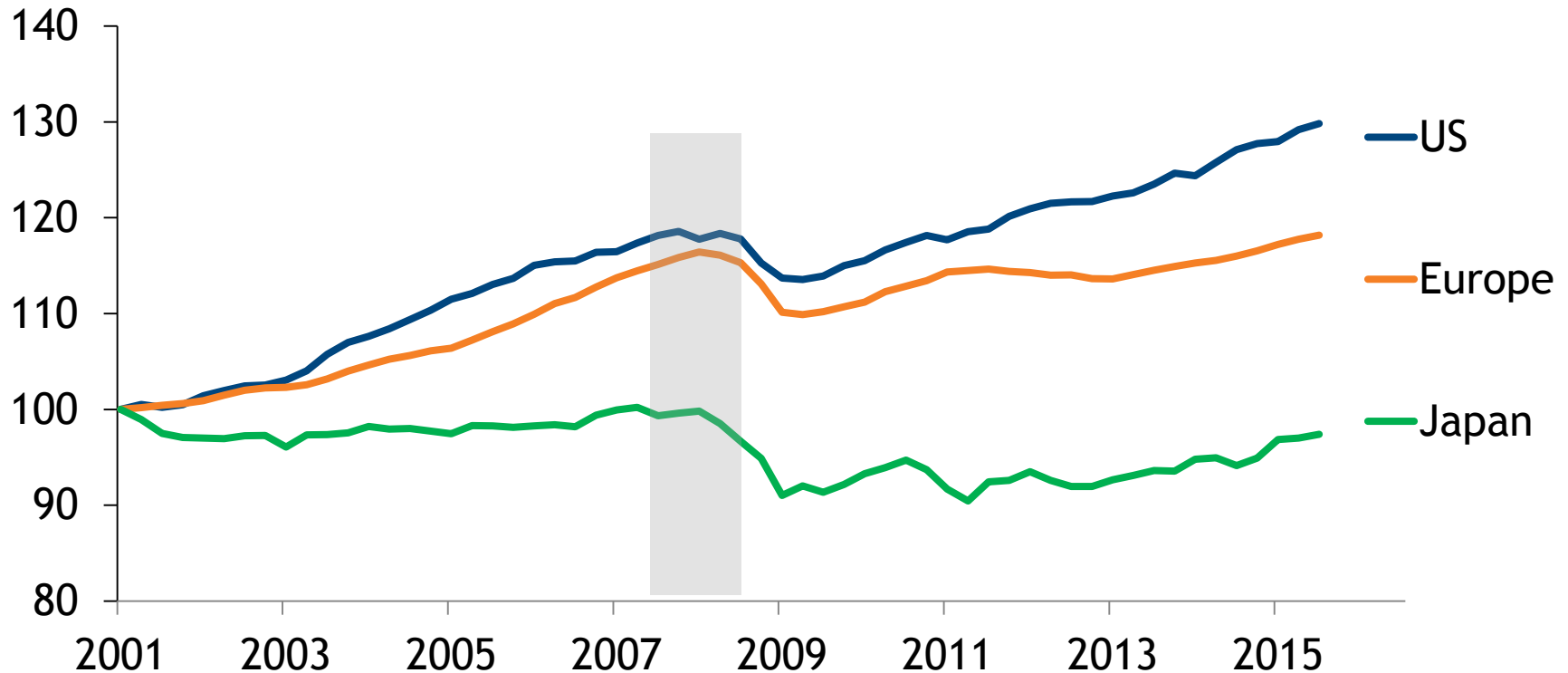


Data Source: International Monetary Fund, Organisation for Economic Co-operation and Development, United Nations, Bureau of Economic Analysis

# GDP: US Shines Bright in Low Growth World

## Trading Strength for Length

### Economic Growth Indexed to 100 at Tech Bust



# Corporate Profits: Rethinking Overseas Production

- Corporate profits decline is out of sync with domestic fundamentals
  - Corporate profits declining on revenue contraction
  - 2015: first y/y S&P 500 profit decline since 2009
  - Revenues have declined 3.5%
- Last four quarters, corporate profits contracted three times
  - Declines averaged: -1.26%
    - Domestic profits: -0.9%
    - US profits from the rest of the world: -2.7%
- The weakest non-recession profit period in the past 15 years

# Exports

## Trade is Good - Sometimes

- Who took my corporate profits?
  - US overproduced to serve global customers... who did not buy
  - Excess went into inventory
- China can't manage domestic consumption
- Euro Zone has no singular fiscal authority

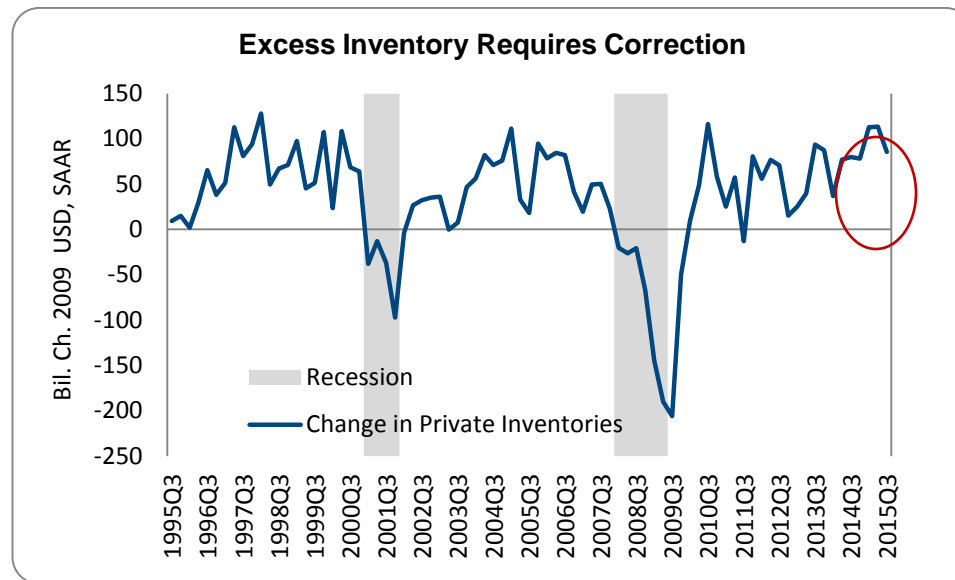
*US goods producers sag when global growth sags*



# Inventory: The Biggest Build in History

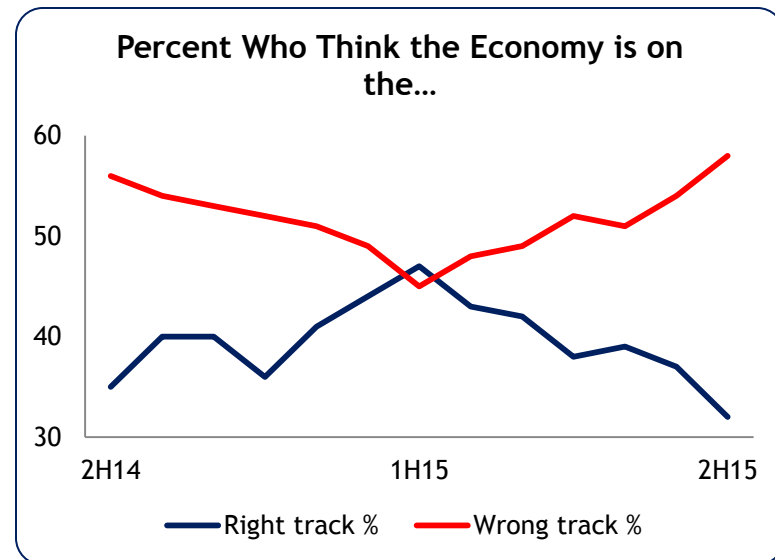
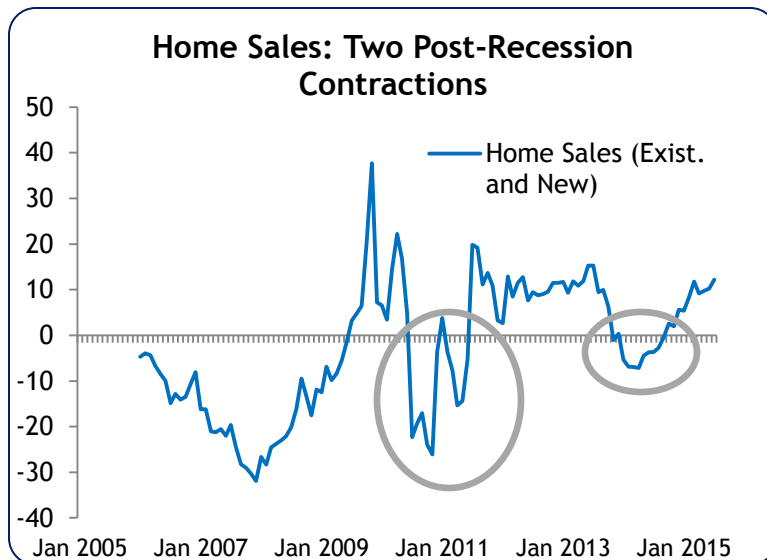
## (Where did Global Customers Go?)

- Largest concentrated inventory overhang EVER
  - Prior three quarters averaged over \$100 billion - 4Q15 slowed by 40%
  - Cost 0.5 percentage points to US GDP
- Business will correct inventory overhang... Just a matter of when and how
  - An orderly process will sustain expansion
  - A panic will start layoffs and increase risk of recession



# Did We Miss the Housing Recovery?

- In 2015, house prices set record highs in 18 states; Florida still not back to 2007 peak
- Normally, housing is among the cycle leaders; not this time
- Sales are weak. Typical home sales gain = 19%; Current home sales growth = 6.6%
  - Affordability is strong but mortgage availability is weak
  - And housing sentiment cautious: retirees and millennials remember '08-'09

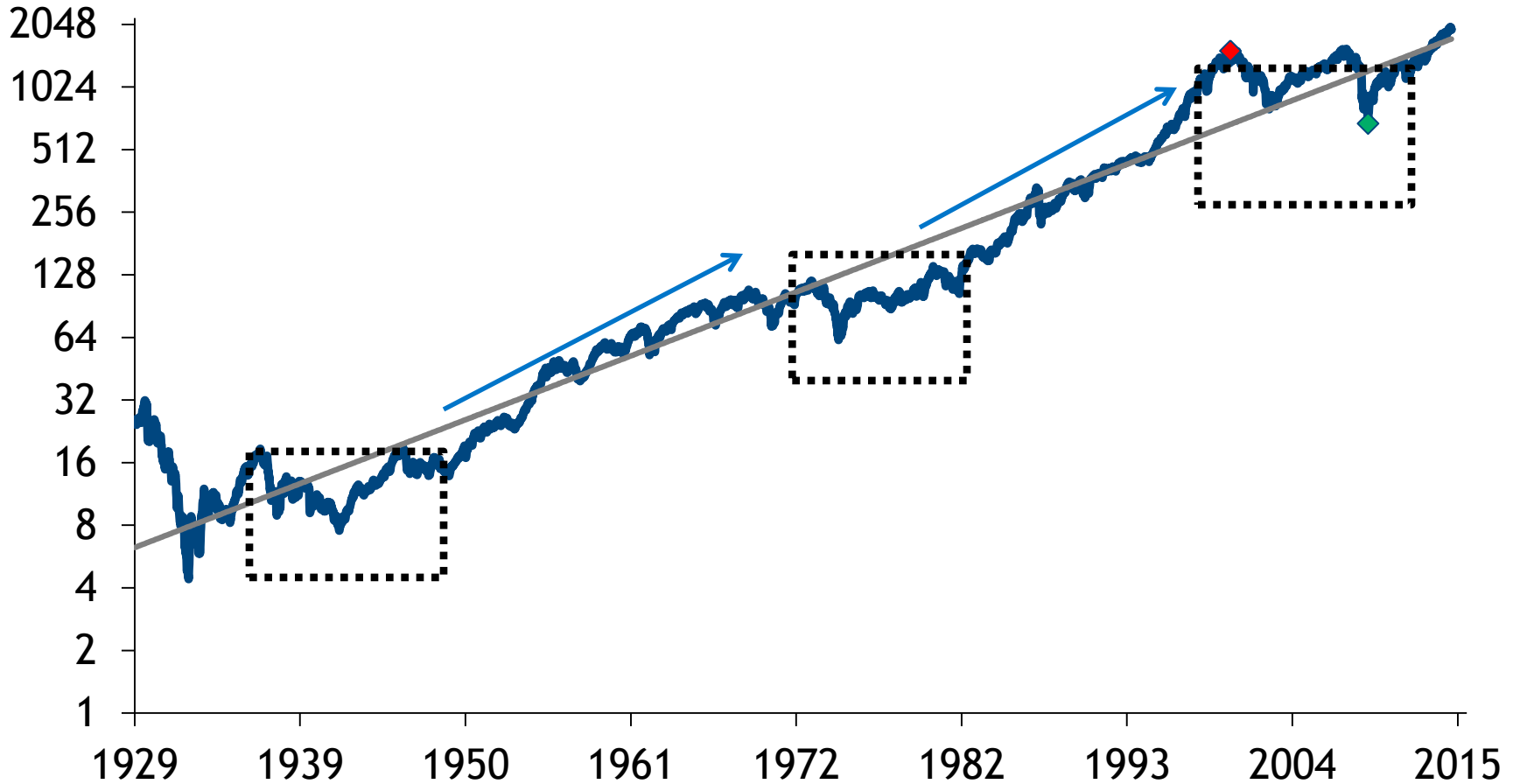


# Macro Conclusions

- US fundamentals are generally sound, if weak in the short-run
  - However, will China and Euro Zone improve?
- Recent volatility is disconcerting
  - US production fundamentals are solid, especially among services
  - But services' largest customers are goods producers
- Profit fundamentals remain weak
  - Global stagnation from bad fiscal and monetary policy reveals poor US corporate production decisions
  - US is the most self-reliant economy on the globe and the dominant energy producer

# Where Are We in the Stock Market Cycle?

## S&P 500 Index: 1929 – 2015



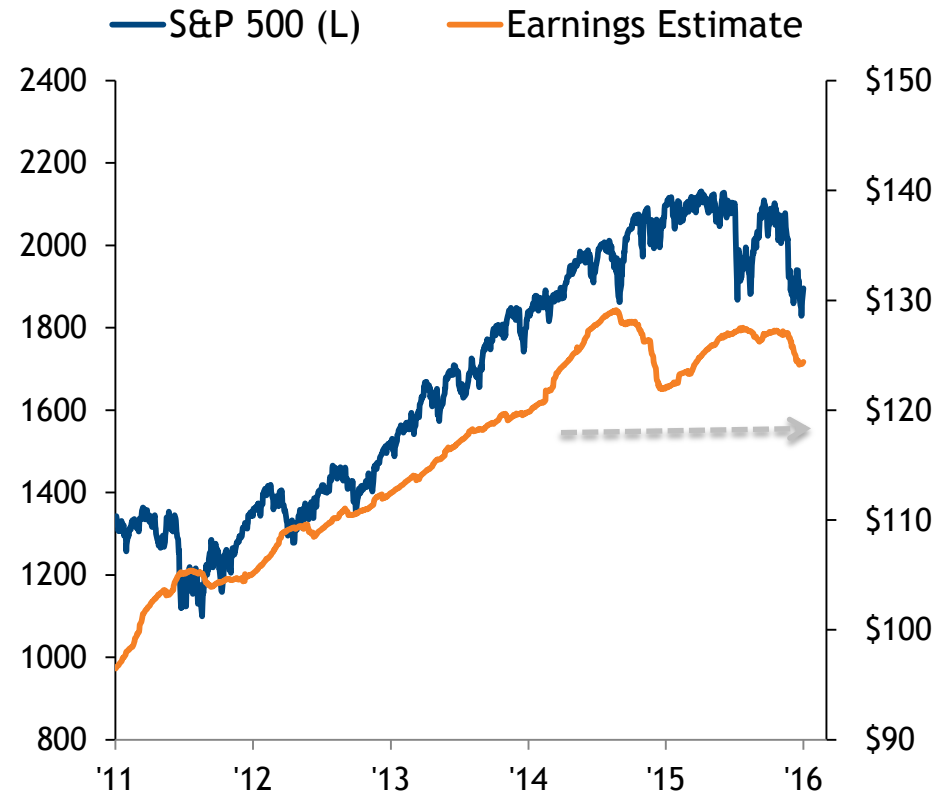
Data Source: Factset; through 2015

# Market Upside Likely Remains Capped Until...

We see:

- Stabilization in energy and the US dollar
- Fed and market alignment
- China “stabilization”
- Real ‘top-line’ growth

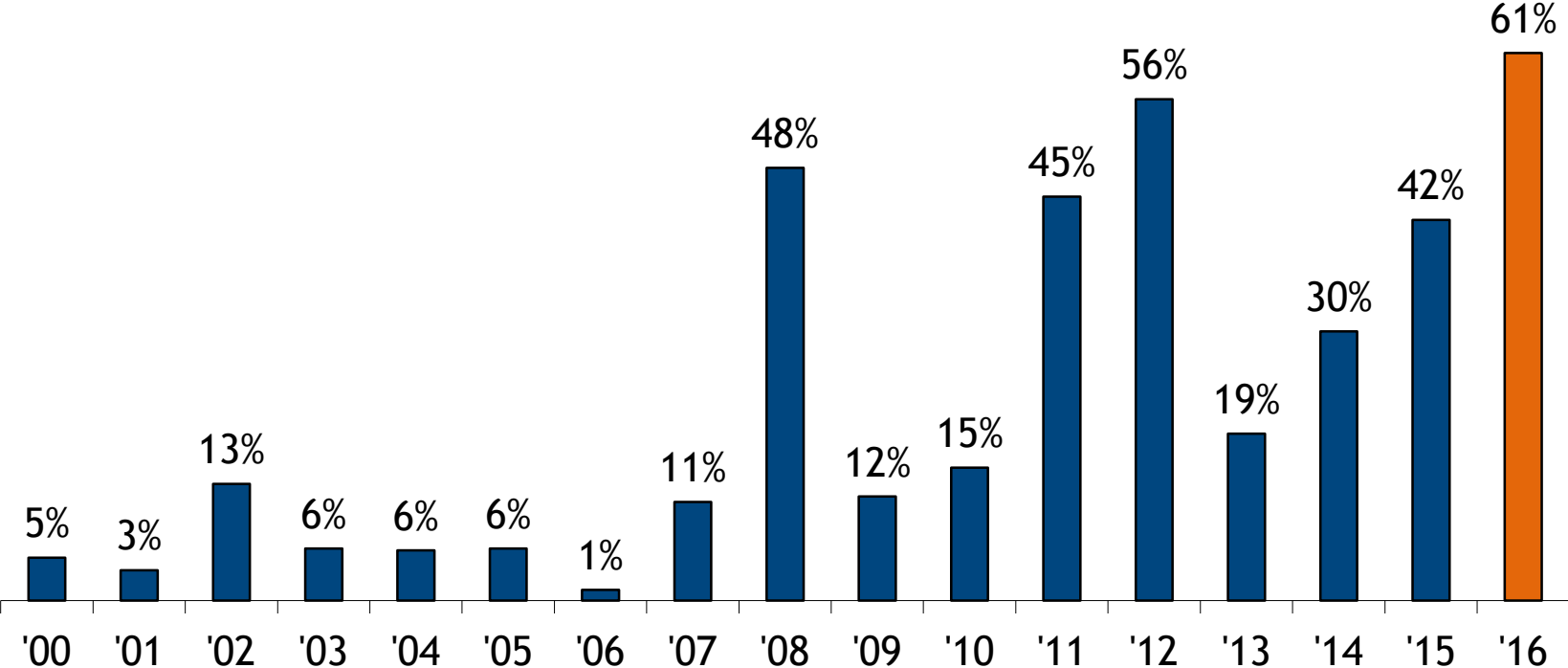
## S&P 500 vs. Earnings



Data Source: Factset

# Dividends: Get Paid to Wait

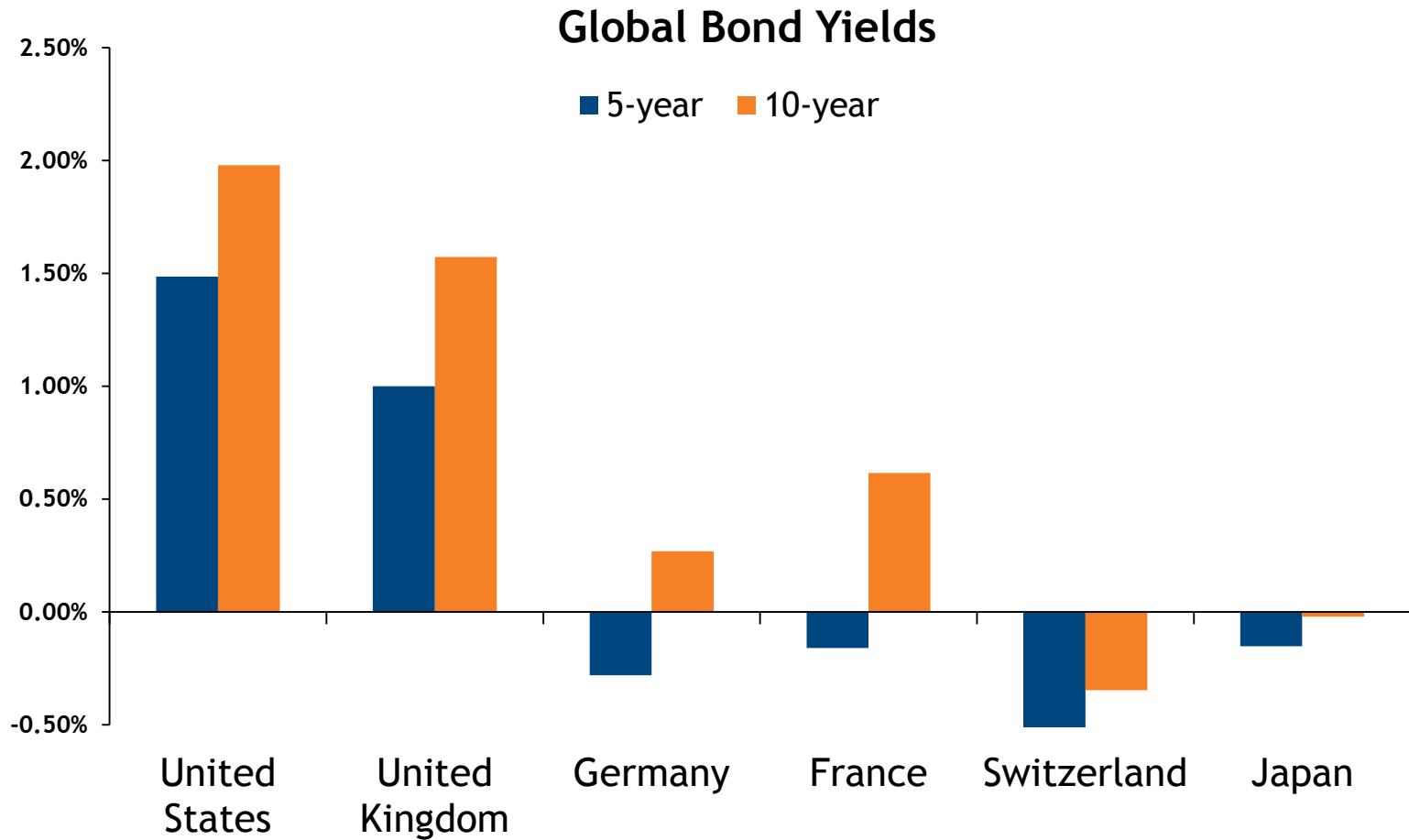
## Percent of S&P 500 Companies with Dividend Yields Greater than the 10 Year Treasury Yield



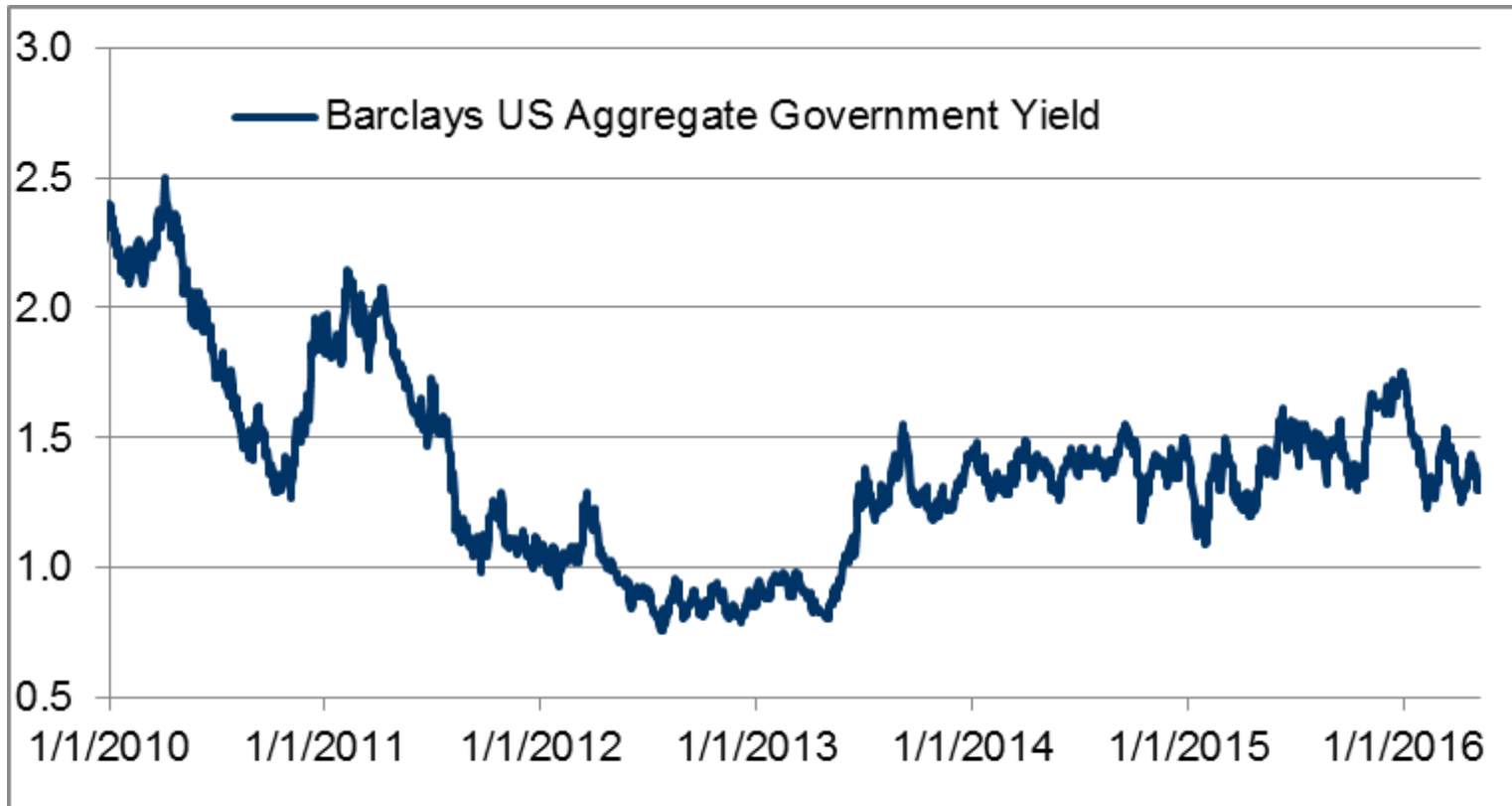
Data Source: Factset; through February 23, 2016



# Global Yields - Not Just Low, Some Are Negative



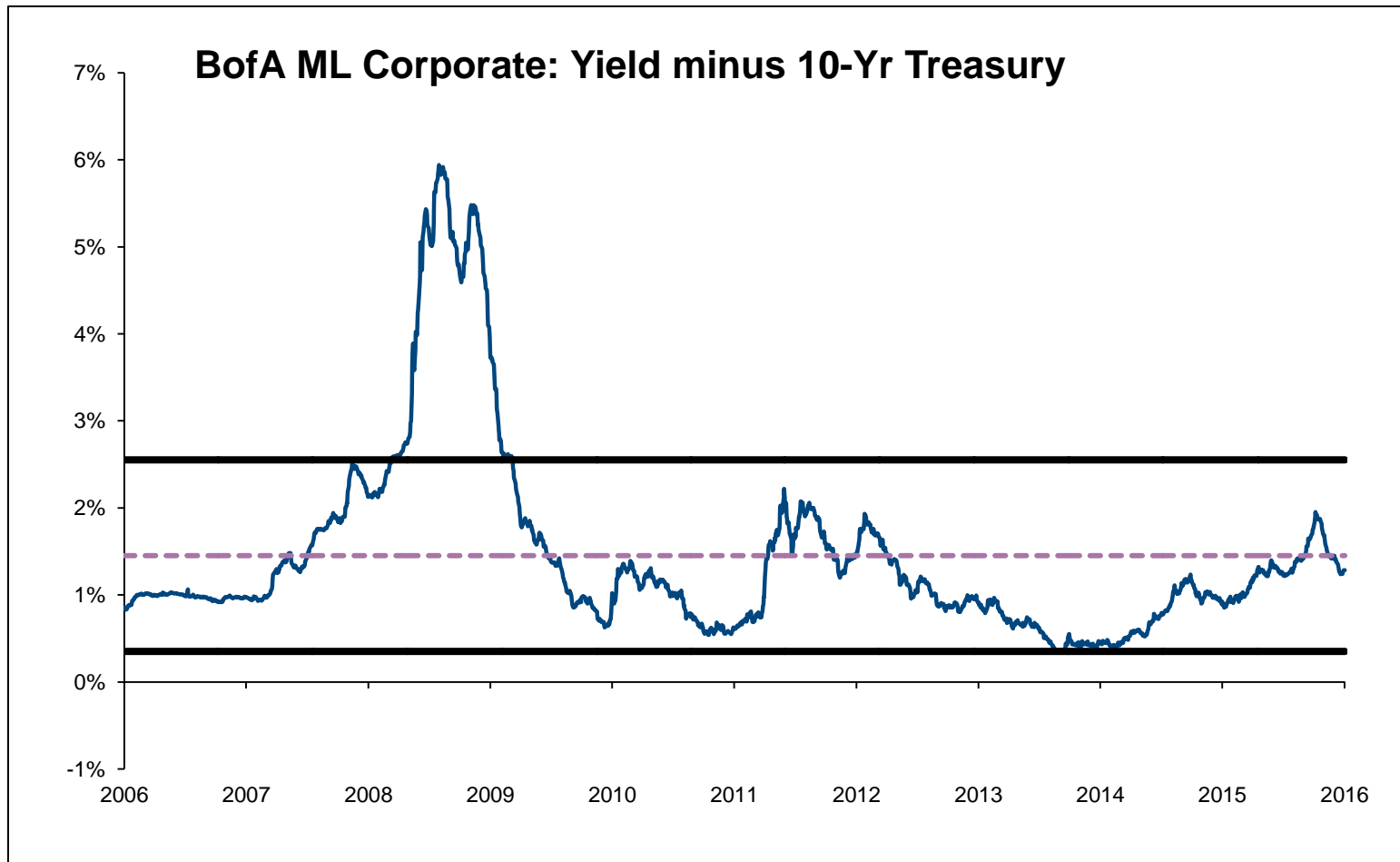
# Tight Trading Band Despite Anticipated Rate Increases



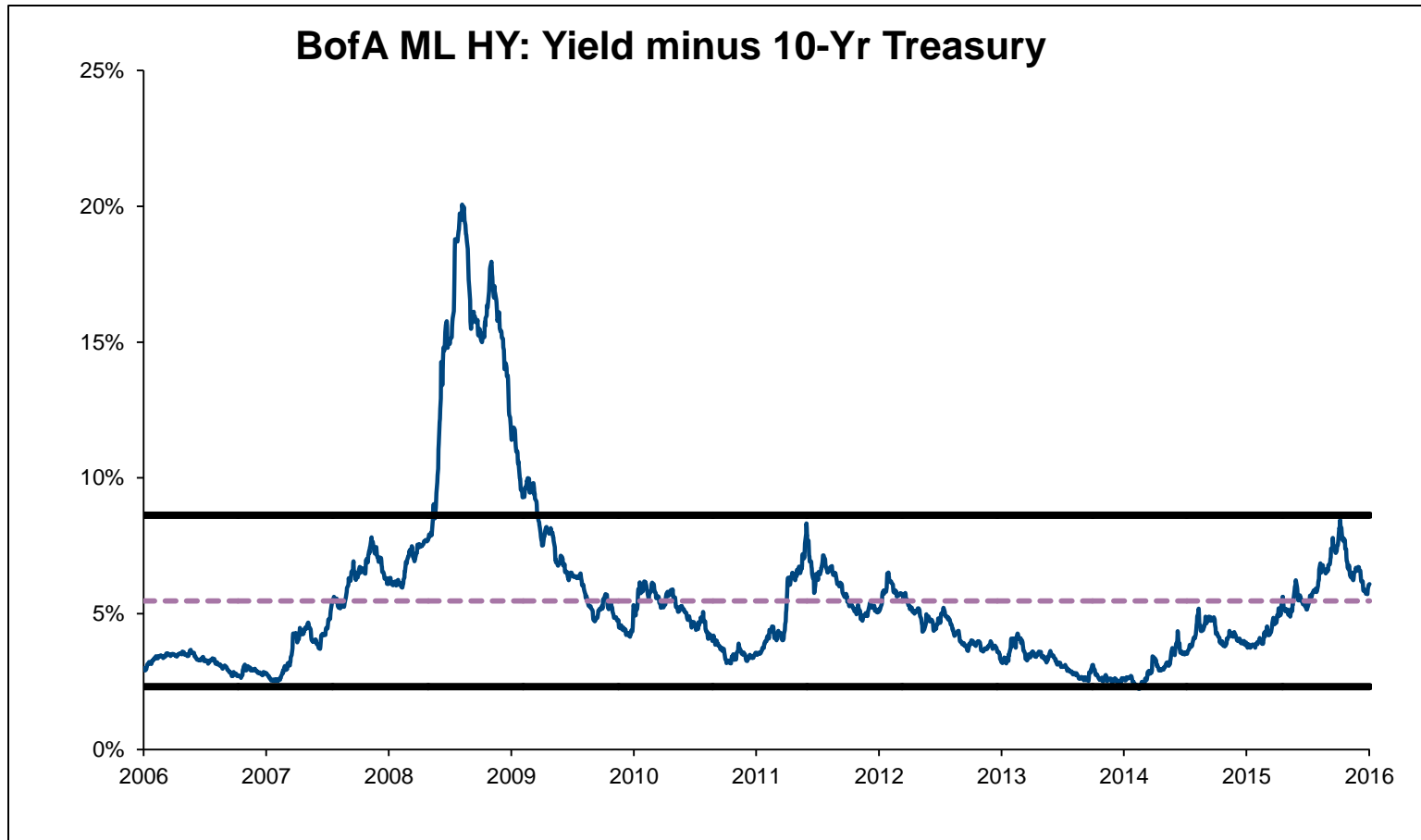
*Still a solid risk/reward tradeoff within fixed income*



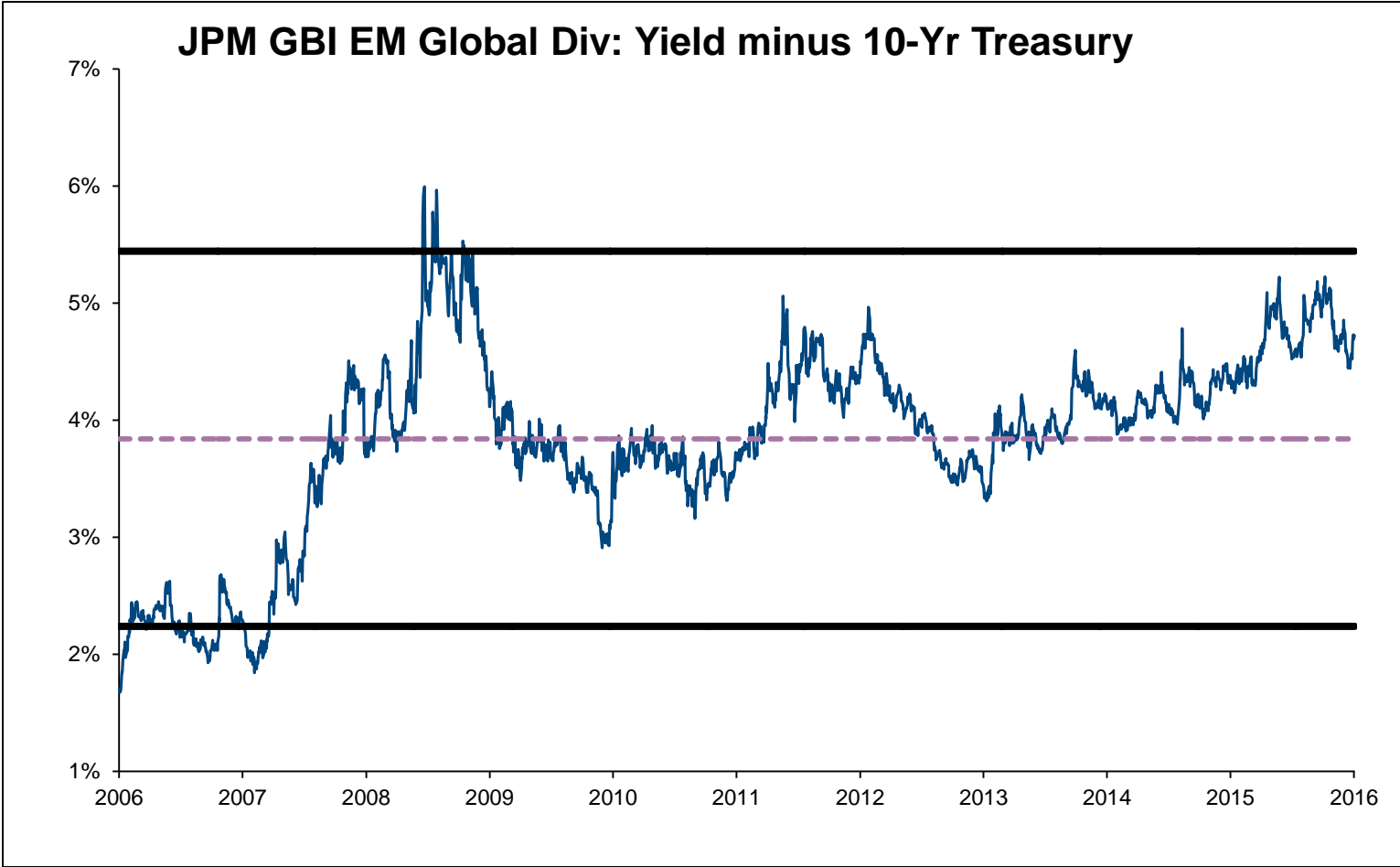
# Corporates: “Normal” Spread to 10 Year Treasury



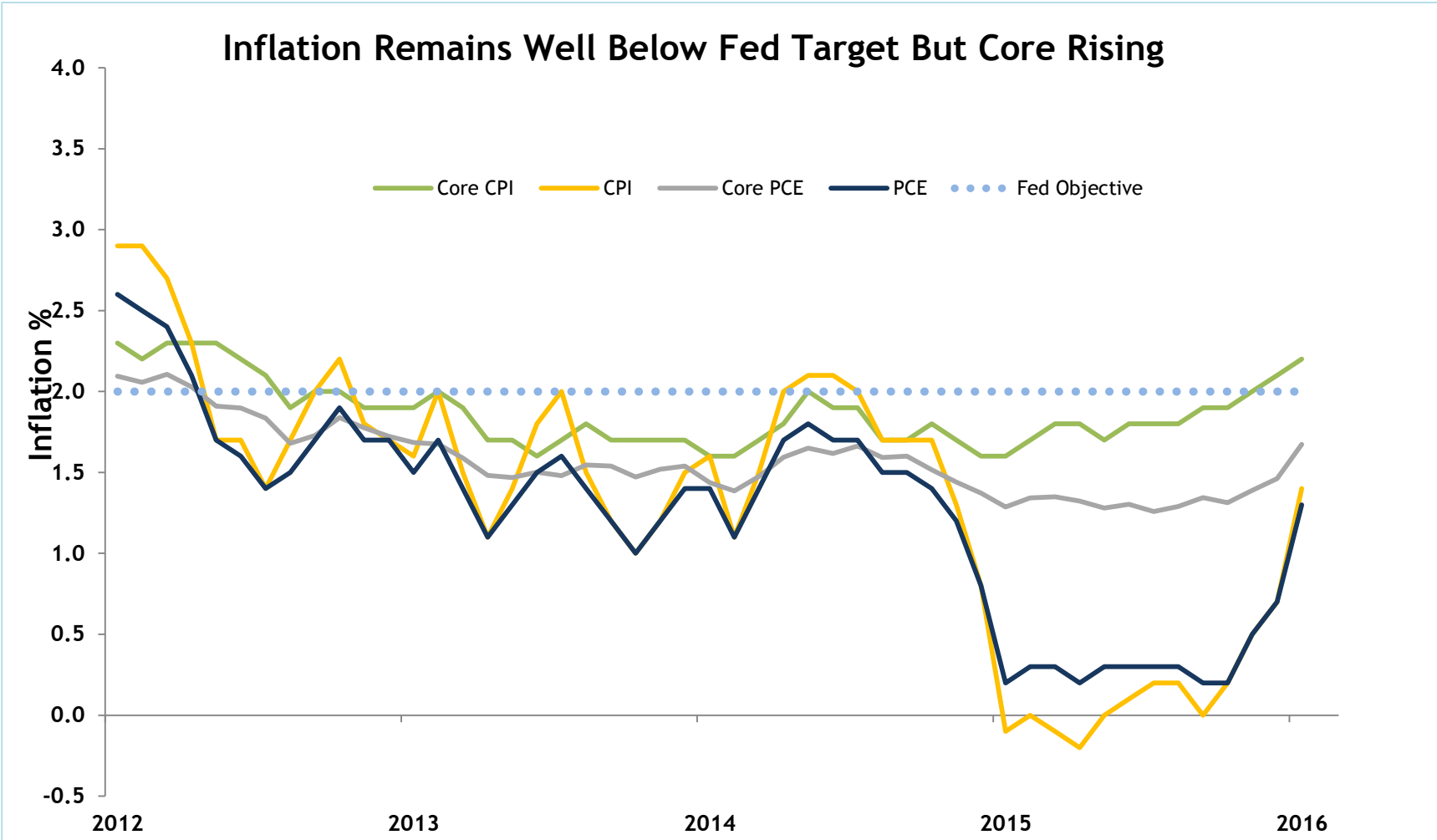
# High Yield: “Normal” Spread to 10 Year Treasury



# Emerging Markets: “Normal” Spread to 10 Year Treasury



# Inflation Below Fed's 2% Target - But Rising

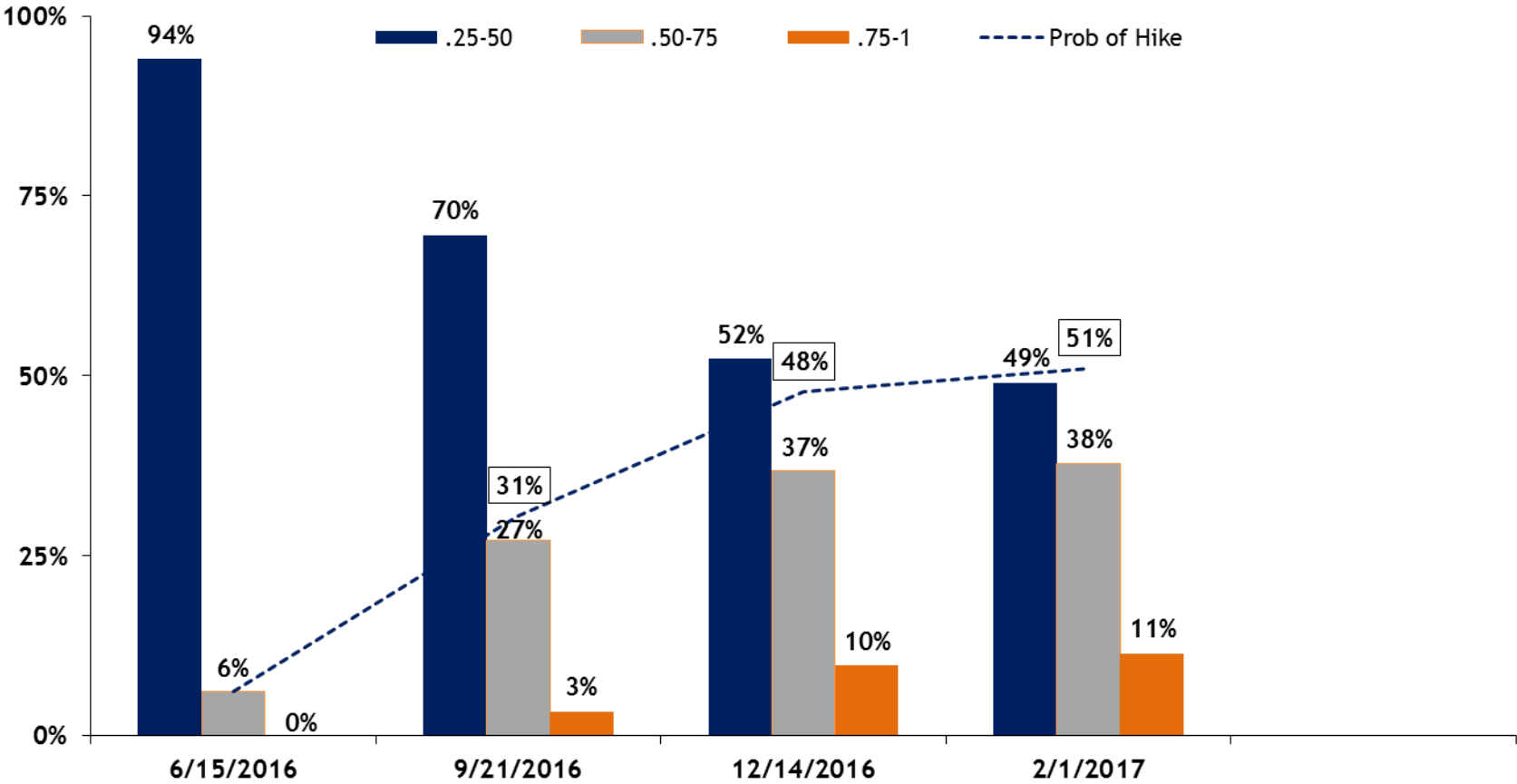


Data Source: Bloomberg



# Fed Rate Hike and Expected Policy Action in 2016

Fed Funds Implied Probability



Data Source: Bloomberg



# Pending Money Market Reform

- New money market rules will go into effect on October 14, 2016 and will have a significant impact on the structure of the funds
- New rules will require non-US Government or Treasury institutional funds to have a floating NAV
- Liquidity fees and/or redemption gates can be imposed on Prime and Municipal money market funds based on the liquidity of the fund
- Rules are intended to increase transparency while reducing systemic risk during times of market stress

# Impact on Money Market Funds

- Money market funds are used to protect from market volatility or manage liquidity needs - yield is a secondary concern
- Recommend clients think about how to actively manage liquidity needs - immediate versus strategic
- Focus on stable NAV funds for immediate cash needs
- Clients willing to tolerate a floating NAV or looking for enhanced yield have other options:
  - floating NAV money market funds, or
  - ultra-short fixed income funds

# Bottom Line Investment Implications:

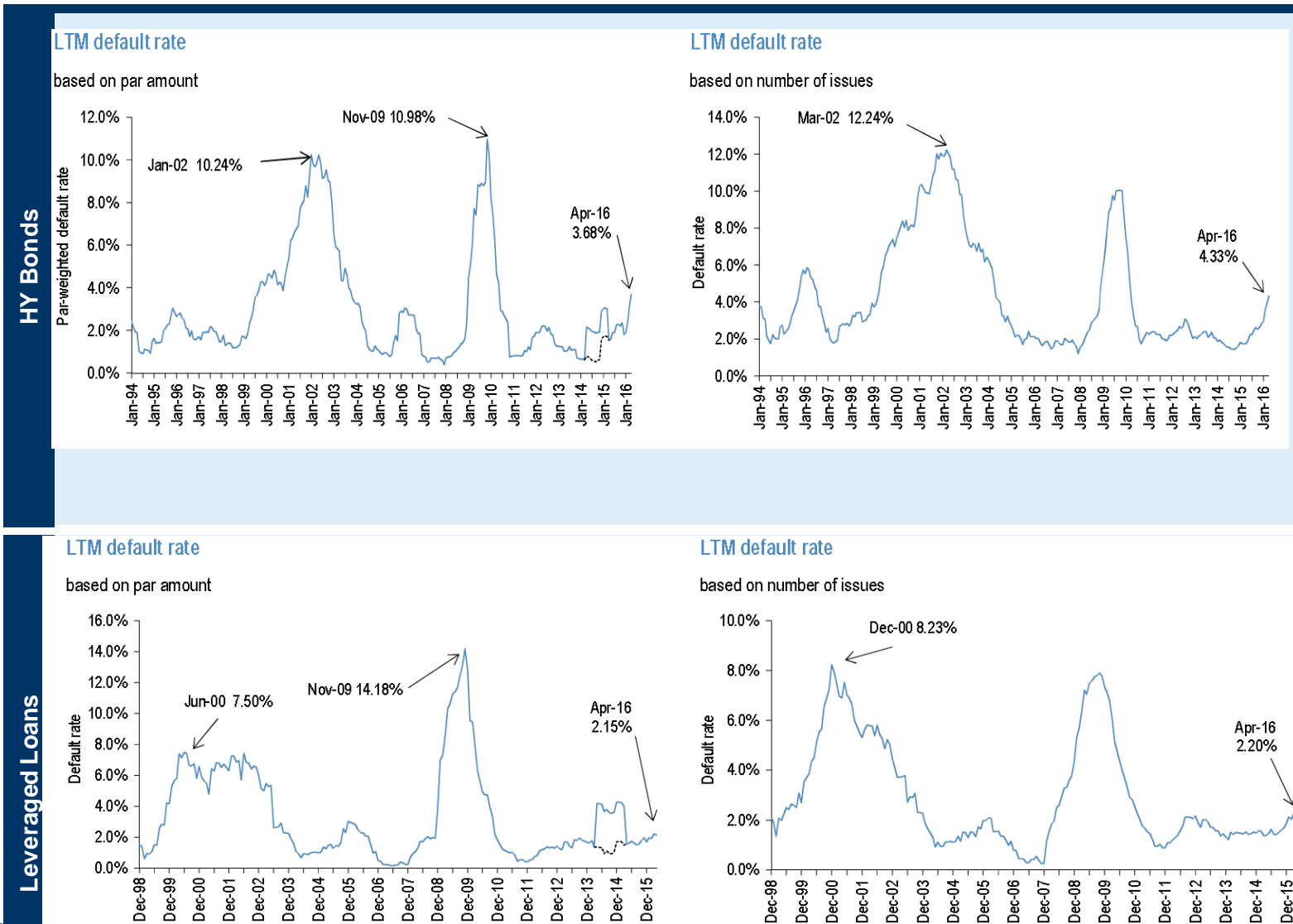
## Tug-of-war continues to frustrate both bulls and bears

- Stocks still modestly favorable to bonds
  - Emphasize: US large cap and dividends
- Fixed Income - Stay the course for income and diversification
- Reserves - Focus on stable NAV funds for operating cash



# Appendix

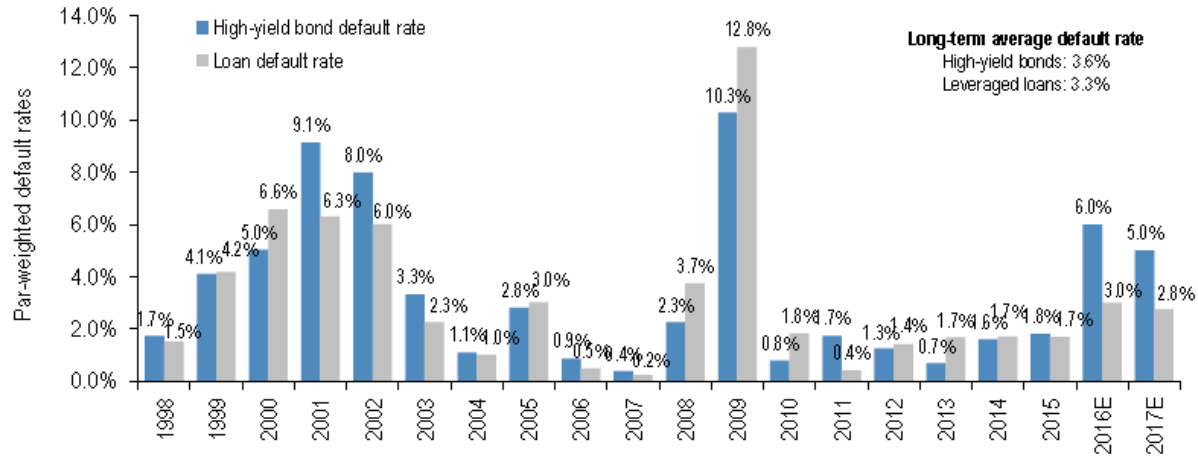
# Spread Products - Default Data



# Spread Products - JPM Forecast Defaults

Forecast Defaults

Figure 5: High yield bond and leveraged loan default rate forecast



HY Defaults

Figure 3: YTD default volume has nearly surpassed FY15 volume and already ranks as the seventh highest annual total on record

