1Q 2016 Market Insights
The Precipice of a New Era
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"Remember that history always repeats itself. Every great bubble in history has broken. There are no exceptions." - Jeremy Grantham[1]

I find it ironic that I sit here writing about the future, a great unknown, on the eve of the December 16th Federal Reserve meeting, where many expect the Fed to move rates from zero for the first time since the financial crisis. The irony being, if ever there was a moment when we don't quite know what to expect, it is now. The problem has very little to do with the 0.25% hike in the Federal Funds rate and its linear impact on the real economy. Hypothetically, the Fed could hike tomorrow, indicate that this will be one rate hike and done, and I would venture that few would notice the impact. Near term, conditions of risk assets would likely improve, while long-term rates might actually rise as a result of the guidance.

The greater concern, whether felt immediately or gradually, is the exponential impact of the change in interest rates (or for that matter, sequential change in rates). In fact, the question isn't if the impact is exponential; it hasn't happened yet and we are already feeling it. It is without a doubt exponential, carrying with it implications for equity, credit, currency, and commodity valuations.

At the heart of the issue isn't the rate hike itself; it's the adoption of divergent monetary policy from the rest of the globe. When you alter the differential level of real interest rates, it sets off a chain reaction that ripples across the globe. We are living it now. Any investor that owns non-US dollar assets, be it international stocks, emerging markets stocks and bonds, or commodities, have felt the pinch of this chain reaction. Don't own any of these? How about energy stocks? If so, you're feeling the pinch too. No energy stocks, how about stocks in general? If so, you are feeling the divergent monetary pinch. I can go on and on….no stocks, how about high yield bonds? You are certainly feeling this pinch. How you might ask? This quarter's Market Insights will address many of these points, including a popular media topic recently regarding the impact of rate hikes on equity valuations and market performance. In addition, we will speak to the US equity market's dirty little secret and some uncommon opportunities that have presented themselves as a result of this environment.

Note: As an aside, the Fed raised rates by an as expected 0.25%. The market responded to the accompanying language, which was especially dovish, with little reaction beyond what had occurred leading up to the meeting.

Focused on the Hole in the Doughnut

The impact of rising rates on stocks is one of the more recently discussed topics. There are two versions of this, which are only partially related. First, what is the impact of interest rates on stock returns? Second, what do interest rate hikes mean for valuation multiples and correspondingly fair value? While some would have you believe that stocks perform positively in the face of rising rates, since rising rates are a "sign of a strong economy", this statement is

[1] Jeremy Grantham is a British investor and co-founder and chief investment strategist of Grantham Mayo van Otterloo (GMO), a Boston-based asset management firm. GMO is one of the largest managers of such funds in the world, having more than US $118 billion in assets under management as of March 2015. Grantham is regarded as a highly knowledgeable investor in various stock, bond, and commodity markets, and is particularly noted for his prediction of various bubbles. He has been a vocal critic of various governmental responses to the Global Financial Crisis. Grantham started one of the world's first index funds in the early 1970s. In 2011 he was included in the 50 Most Influential ranking of Bloomberg Markets magazine.

misleading at best. In most publications, the key is “during the cycle.” What is often omitted from the analysis is the aftermath. Stocks can continue to advance in the short-run despite higher rates, but the impact is neither positive nor is it exactly direct. The impact to stocks comes through collateral channels like earnings and profits, which take time to reflect the increased cost of borrowing.

Let me state the question somewhat differently for illustrative purposes. Do stocks perform best over the next decade when beginning from high-interest rate or low-interest rate environments? If stocks respond well to interest rate hikes, which is more likely to occur: A rise in interest rates from a low-rate environment or a high-rate environment? A low one of course. The answer can be found in Chart 1. Beginning interest rate environments that are the highest have typically lead to the best forthcoming real stock returns at 12% annually over the next decade. The pattern is rather linear, declining to a low of 1.32% in quintile 4 until you get to the bottom quintile of rates, which experience real returns of 8% on average. The out-of-character nature of quintile 5 is likely skewed by the persistence of low rates and strong stock returns that have occurred over the past few years.

The second argument pertaining to PE multiples can be seen in Chart 2. It also fails to confirm that rising rates are good for stocks in terms of causing or justifying a higher valuation multiple. In fact, the data seems to suggest that as rates get higher, the valuation multiple declines with a significant crossover occurring at and beyond 6% in nominal rates. The good news for stock investors, if there is any here, is that the relationship between valuation and interest rates at levels below 6% appears to be quite random. Both high and low valuation multiples can be observed below 6% rates, whereas rates above that level are more consistent with low PE multiples.

Chart 1

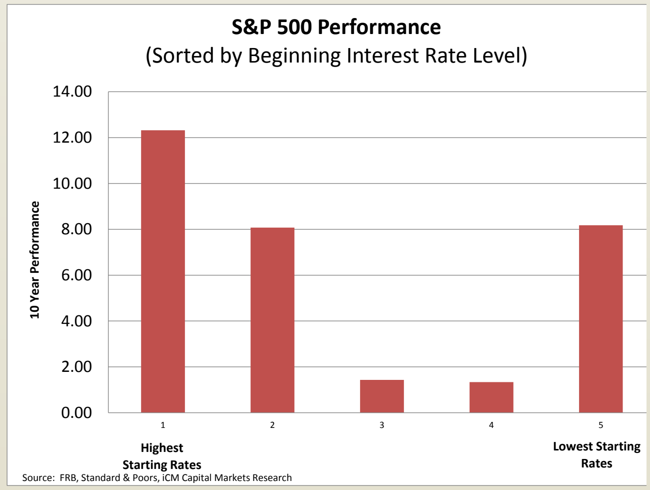


Chart 1 shows the relationship between the beginning yield on the US 10-Year Treasury bond and the return on the S&P 500 over the coming 10 years. Since 1953, high beginning interest rates not low have led to consistently better equity returns.

Chart 2

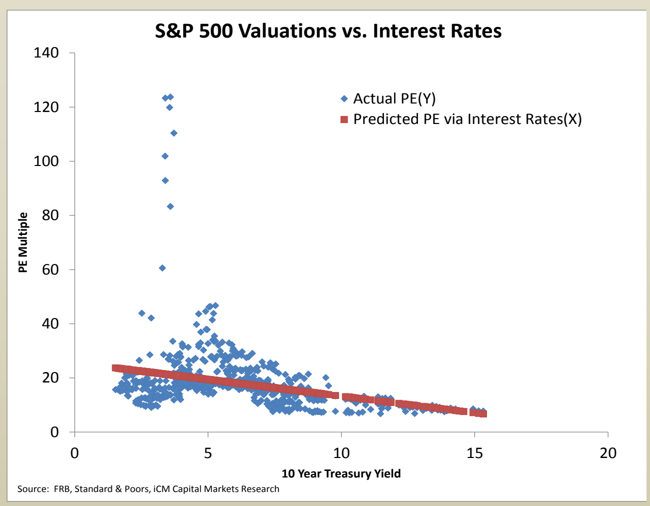


Chart 2 details the relationship between interest rates and PE multiples. The red line is the predicted value of PE multiple given a level of interest rates. From this analysis we can see that high interest rates tend to cause lower PE multiples and vice versa. That said, the relationship is rather weak especially at low rates. The crossover tends to occur at approximately 6%.

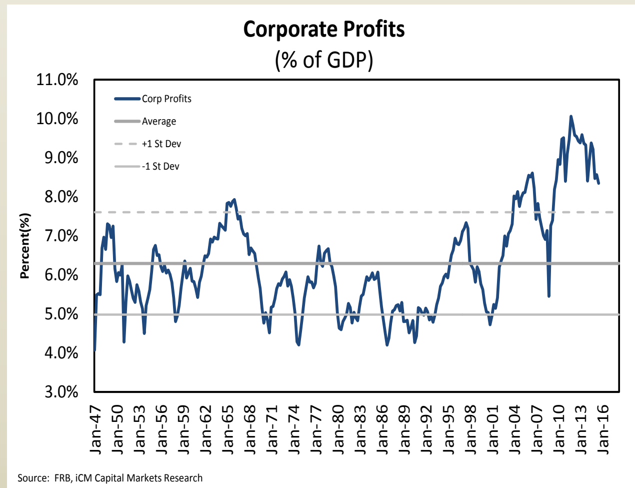
Trivia Question

If given the choice between option A and option B for the next 10 years (not the past 10 years) which would you prefer? Option A has grown earnings by a cumulative 13% since mid-year 2006, while the price is 62% more expensive than where it started. By contrast, option B has grown earnings by 50%, while the price has increased by 40% (summary in the table below). Hopefully, most would choose B since earnings have grown faster than the price gains and earnings are what ultimately create sustainable returns.

Trivia Answer

The asset with weak earnings growth that is 62% more expensive than 2006 levels, option A, is the S&P 500. The dirty little secret for US equities is that the impact we are feeling from prospective rate hikes is already affecting both profits and correspondingly earnings. Few will tell you that S&P 500 earnings per share(eps) peaked at $105 per share in September 2014, and are on pace to finish 2015 at $95. Want to know a really dirty secret? Since the beginning of 2015, the S&P 500 performance has been essentially flat. It began 2015 at 2058 and ending at 2053, but when accounting for the dividend, the total return is approximately 2% through year end. Yet, with no price action, valuations have not only moved up, but moved up substantially from 17x earnings in September 2014 to 22x earnings as I write this article. The answer to this riddle lies in the overstated nature of corporate profits as seen in Chart 3, as well as the aforementioned decline in earnings that correspond to the profit recession. Sadly, there are greater headwinds to come as it relates to profits and earnings, since both remain well above normal trend line levels.

Chart 3

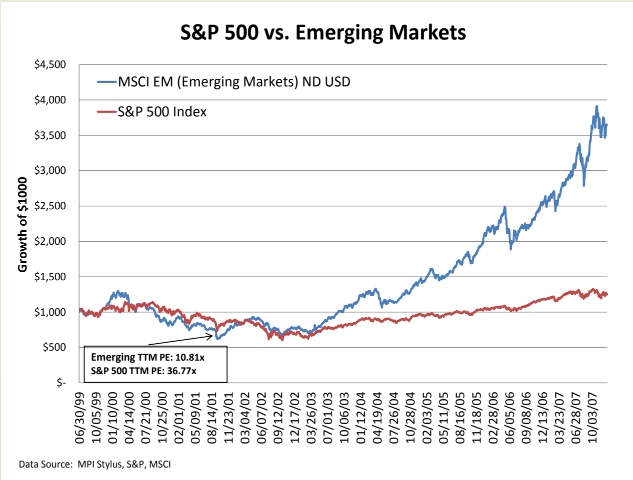


Given the historically high and mean reverting nature of corporate profits, the current drop and subsequent fall in S&P 500 earnings was expected. This has caused valuations to climb from 17x earnings to 22x earnings without the price moving up!

	10 Year Trailing Earnings Growth	10 Year Trailing Price Appreciation
Option A	13%	62%
Option B	50%	40%

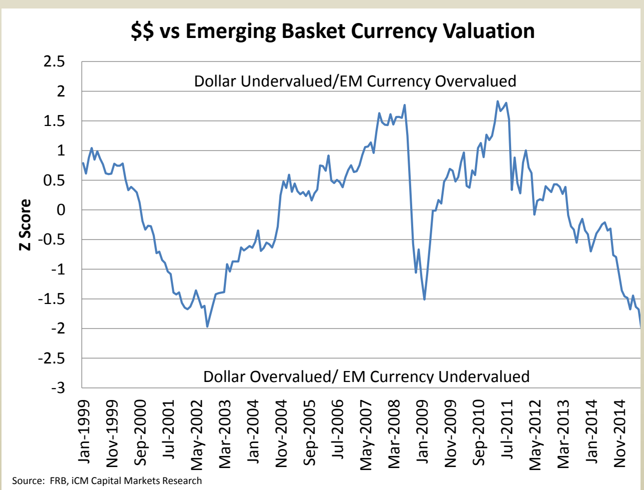
The other asset, option B, is none other than emerging markets equities. Over the past 12-18 months, the investment performance of emerging markets equities has been weak. How is it that we can continue to say we find the asset attractive when thus far, the inexpensive valuation has not resulted in gains? After all, there are many qualitative factors that must be considered. To that we would respond that the market is tremendously efficient at pricing in those pessimistic qualitative factors. Empirically, valuations at extreme levels of over or under valuation explain 84%(r-squared) of the out or underperformance of emerging markets when compared to the US over the next 5 years, leaving only 16% attributable to all other factors combined. What this tells us is that if you want to understand what should be the better performing asset over the coming 5 years, inexpensive valuations alone explain the vast majority (84%) of the outcome. So what went wrong? Actually, nothing. Unfortunately valuations serve as a wonderful guide to long-term performance and a lousy guide to short-term results. We've seen this in many instances across asset classes, but most recently with emerging markets during and after the internet bubble. As seen in Chart 4, emerging markets equities fell in value from 1999 – 2001 before rising in a spectacular fashion through 2007. Now notice the other asset in that same chart, the S&P 500. The S&P also fell in value, but did not recover nearly as well. Why? Valuations. Emerging markets traded at 10x earnings, while the US traded at 36x earnings. Today, we have similar, but not identical circumstances. The US trades at 26x normalized earnings, while emerging markets trade at 12x normalized earnings. What is different, other than a wider valuation gap, is that in 2001 emerging earnings were so depressed that the rebound in earnings paced the price gains for the next 6 years. This allowed the asset class to perform at a high level while never becoming expensive. Essentially, we are seeing the complete opposite today with the S&P 500. That is, a small 13% gain in earnings against a 62% price gain has resulted in the S&P 500 becoming expensive. The difference this time is that emerging market's earnings are not quite as depressed as 2001. On that basis, the opportunity within emerging markets should be good, but not quite as good as 2001, except for one factor. For that, I give you chart 5. Emerging markets currencies have also declined relative to the dollar. When the currency has reached 1 standard deviation undervalued relative to the dollar, the average return on the currency alone has been 4% per year. Today, the emerging markets basket of currencies is nearly 2.5 standard deviations undervalued. Statistically this equates to a 0.06% probability or about a 1 in 161 outcome of this occurring or becoming worse. In essence, the likelihood of this improving from here over the next several years is very high. It took all of these factors, each individually

Chart 4



So why are emerging markets struggling? We've actually seen this before. In 1999-2001 emerging markets fell before outperforming by a three-to-one margin over the next six years.

Chart 5



A falling basket of emerging markets currencies has contributed to the near term underperformance of the asset class. The silver lining to this fall is that when that basket has reached between 1-2 standard deviations below fair value, the average return on the currency alone is 4% annually. This is in addition to the asset class return.

unlikely, working against emerging to cause the poor trailing near term results, but also create a remarkable opportunity going forward.

The past few months have been frustrating for individual and institutional investors alike. Domestic equity and credit markets, as well as non-dollar denominated assets like emerging markets and commodities, have all been negatively impacted by the strong dollar. Our research would suggest that this is greatly overdone. At the same time, US equities have escalated in price and have seen earnings and profits erode. In the presence of pain, it is natural to want to move away from it. In their annual investor study, Dalbar indicates that the average return on the US market over the past 30 years was 11.1%, while the average stock fund investor return was just 3.7%. The difference is attributable to behavior. The key is discipline and not falling victim to driving out of the rear view mirror. As such, we have and continue to believe that we are ahead of this curve and properly positioned for the journey that lies ahead. We believe that risk matters, trees do not grow to the sun, and that certain long-standing investment practices like fundamental valuations matter most. Thank you for your trust and confidence.

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