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Market Update

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Solid Loan Growth and Credit Quality

The markets can take bad and good news in stride, but they don't like uncertainty. That is just what we faced in January as the S&P 500 plunged to its worst 10-day calendar-year start in our brief U.S. stock market history—only 3 generations separate us from World War II.

Geopolitical and macroeconomic concerns dominated investor worry, as global equity markets fixated on battered oil prices and China's slowing economy. Even so, the U.S. economy remains on pretty solid footing with housing starts hitting new highs, firm consumer spending numbers, and solid employment gains. We are watching the manufacturing numbers closely—a weak spot—as well as some deterioration in corporate balance sheets, but overall the economy continues to expand at a modest pace of about 2 to 2.5%. In fact, most of the bank earnings' calls and transcripts we have read are showing very solid loan growth and credit quality. Some highlights are noted below from our friends at BCA Research:

Davis, US Bank CEO: *"Generating core loan growth of 16% for the company… growth in commercial real estate of 17%, C&I loans were up 11%."*

Lake, JP Morgan CFO: *"I would just point out that credit card, commercial bank, middle-market, large corporate credit is as good as it's ever been. So obviously it's going to get a little bit worse."*

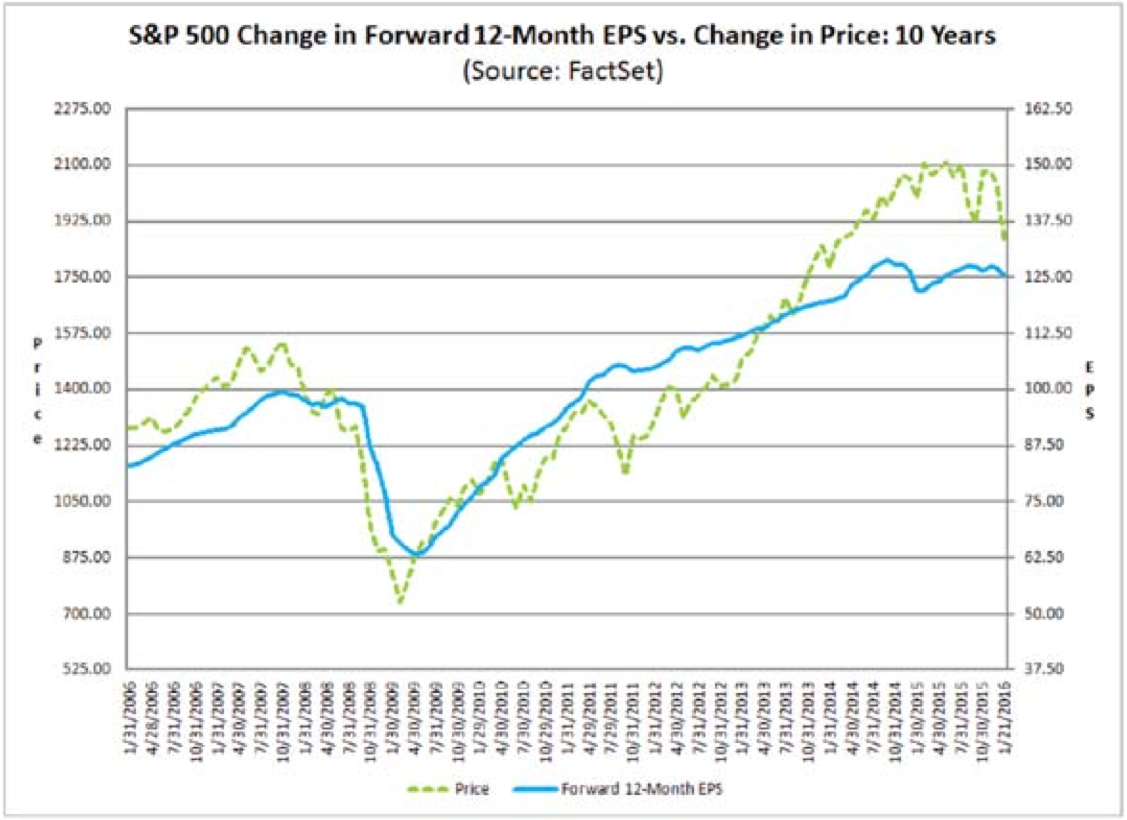
Shrewsberry, Wells Fargo CFO: *"We're focused very closely on watching the economies around the energy belt areas in the United States…. But it really has not shown up yet."*

Donofrio, Bank of America CFO: *"Total loans in our oil and gas portfolio were down 6% from a year ago and are now less than 2% of total loans outstanding."*

Embedded in our economy and somewhat of a canary in the coal mine when things begin to turn, these banks are reporting very solid loan growth and credit quality. Granted, credit quality is at an absolute peak, with charge-offs at such a low rate that we will see a natural increase in back-to-normal loss rates—as pointed out by Lake above. But for now, the banks are not indicating any cracks in the economy that would show up as a result of global slowdown concerns we have been hearing since the beginning of this year. As far as the impact of oil prices on energy loans, the large banks are not overly exposed; and in fact can charge off most of their energy loans and still have capital levels that existed before the 2008 crisis. No bad news there.

Stock Market & Earnings

Since we are right in the heart of earnings season, we thought it made sense to get back to the fundamentals and provide an update on the profits outlook for 2016. We have shown the chart below numerous times, noting that stock prices—the green line—had gotten ahead of earnings. And that we were likely due for a correction or swoon in the market that would bring price back in line with expected earnings. This is what we see in this chart, where the lines are beginning to converge, showing that the market is more reasonably priced than it had been at the start of last year. We are now looking at an estimated forward earnings for the S&P 500 of $125/share, which puts the market index around 13.9 times 2016 expected earnings—not nosebleed levels by any means. We know that fourth quarter 2015 will show negative earnings and that is already baked into stock prices, unless there is a surprise to the upside or downside.



The China Market Effect

On a global basis, we believe that market volatility over China's slowing GDP growth and the International Monetary Fund's (IMF) ratcheting back of global growth expectations does not have the makings of a 2008-like crisis. Instead, this is more of an adjustment in global markets to better align them with slower earnings growth—much like the chart above.

In a free market economy, long-term market returns are basically an overlay of economic growth, as companies participate in the growth that passes through to their bottom lines from consumption and capital investment. Global investors, however, appear more fixated on the movements of China's stock exchange than the impact on global earnings as China's economy slows. Yet the Shanghai composite and China GDP have taken very divergent paths over this stock exchange's relatively brief history, as shown below.

Economist.com

The reason for this divergence may lie in the fact that while China is arguably the world's largest economy, its tradeable stock market volume is only about one-third of GDP, compared to 100% in most developed markets. Some of this is due to Chinese government holdings in a large number of non-tradeable company shares, which adds to the transfer of risk to individual shareholders who comprise over 80% of the market. For now at least, we believe the Chinese stock market provides little information to global investors about what is really happening in their economy.

Much of the market volatility we experienced to date has been centered on the slowing Chinese economy and its impact on global growth. To put it in perspective, China's economy is roughly $11 trillion in GDP, and moving from a 10% growth rate to 7% would translate into a dollar hit of approximately $300 billion, or about the entire GDP of Denmark. Most of this slowdown has been felt by commodity-based emerging market countries like Brazil and South Africa. For us here at home, the U.S. economic and financial exposure to China is rather limited.

China accounts for only 7% of U.S. exports, and American multinational companies only pull about 2% of their net income from China. Sure, a number of U.S. companies like General Motors and Apple are much more embedded in the Chinese economy. Directionally, as China moves to a more consumer-driven economy, these companies should stand to benefit longer term. We are more concerned about any further devaluation in the Yuan and the possibility of China exporting more deflation to our shores. However, after finally being granted Special Drawing Rights (SDR) status for the Yuan by the IMF, we think it unlikely that China will jeopardize their membership in this elite club by taking their currency on a deliberate roller coaster ride.

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As we have mentioned in the past, equity investors are paid to face a lot of uncertainty, and in a perfect world with all good news, we would be left to collect our dividends and have no expectation of appreciating share prices or losses. Today, there is much uncertainty and the wall of worry is very high, building a very attractive equity risk premium for investors that can stick to their plans. Markets grappling with uncertainty tend to overshoot on the upside and downside, which is what we believe is now occurring. At the same time, we don't want to be complacent about some uncertainties that could become real problems to the U.S. and global economies.

With 2016 growth expected at only 2-2.5%, the U.S. economy is by no means insulated from an adverse shock, and we remain concerned that a wrong move by the Federal Reserve could throw the economy into recession. We do not see this is as the likely scenario, and we think the Central Bank will be especially careful with the possibility of further deflation as noted above.

With Ford just announcing positive earnings in Europe, the Eurozone economies continue to look better than they did a year ago. Longer term, however, we see significant problems with Italian bank non-performing loans which currently stand at an astonishing 17% of Italy's GDP. Mario Draghi and the European Central Bank (ECB) have made a commitment to continue buying the sovereign bonds of Italy and other Eurozone countries, which will kick the can down the road for some time. At present, the government is looking at bundling the bad loans and selling them (securitization), which may be a viable solution if there are willing buyers. Eventually, the problem will have to be addressed, and it will be bigger than the Greek crisis if there is a bad policy response.

For now, we will keep our eye on the fundamentals, and avoid making knee-jerk reactions to the noise and confusion that many in the media are paid to create. Although there is uncertainty, no real bad news exists for corporate earnings beyond the energy patch and related industrials. Yield spreads have widened, making corporate notes and select high yield sectors attractive, and small cap stocks are now off over 20% from their highs—this provides an opportunity in a number of sectors.

IRA Update—Path Act of 2015

In December 2015, Congress reinstated a number of "tax extenders." Under this bill, qualified charitable distributions (QCD) directly from IRAs to charities have been made permanent. Taxpayers who are over age 70½ can make a contribution directly to a charity from their IRA, with the charitable distribution not being taxed as income. In addition, the charitable distribution counts toward the taxpayer's Required Minimum Distribution.

As you evaluate your 2016 investment goals, we welcome an opportunity to meet with you to review any changes in your time horizons and address any concerns you might have during these volatile times. Please call us or email us if you have any questions or wish to explore additional investment or tax-planning strategies.

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