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Market Update

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In this month's edition, we're offering a brief update on the bond market and the state of the global economy. Negative interest rates, a market that appears to have detached from all the rules including smart money that was once in the bond market now giving us mixed information about valuations, changing investor behavior along the yield curve, and insecure relationships among asset classes are all contributing to roil the economic waters.

In previous letters, we described how bond prices move with interest rates. We have laid out a brief refresher of how this works to help better understand what is occurring in the market. The red squares on the chart below indicate countries with negative—yes, negative—interest rates.

Bond math. Bond prices move inversely with interest rates. A good example would be a bank that makes a mortgage to you today at 5%, and then six months later rates decline and the bank lends at 3% and holds the loans on its books. The bank decides to sell its loans to the market. What should be obvious is that the 5% mortgage can be sold for more than the 3% mortgage, its price having increased due to the decline in interest rates. That is the premise of bond math.

For roughly 35 years, we have seen interest rates decline as bond investors have enjoyed great appreciation on their fixed-income assets. This is called a bull market in bonds. We believe the bull market is now ending and that bond investors will be in for a painful period over the next decade as rates rise and prices decline. Valuation can tell us of the severity of a bear market, but it tells us nothing of the timing, so we really don't know exactly when the bull will end. We do believe it will be within the next two years, and it will be a fairly severe reset of bond price and interest rates.

From a global perspective, over 50 countries now have negative interest rates, as shown in the graph below. How can this happen, and how can an investor still profit from these negative rates? There are two reasons that this occurs: first, if investors believe that price deflation will occur, they will buy bonds even at negative rates because as rates go negative, their bonds will still appreciate in the market.

Country	1yr	2yr	3yr	4yr	5yr	6yr	7yr	8yr	9yr	10yr	15yr	20yr	30yr
Switzerland	-1.233	-1.231	-1.24	-1.164	-1.109	-1.044	-0.964	-0.845	-0.755	-0.704	-0.472	-0.35	-0.195
Japan	-0.363	-0.356	-0.369	-0.369	-0.364	-0.386	-0.392	-0.372	-0.339	-0.281	-0.138	0.047	0.094
Germany	-0.662	-0.702	-0.725	-0.69	-0.618	-0.587	-0.507	-0.429	-0.294	-0.169	-0.102	0.105	0.38
Netherlands		-0.633	-0.623	-0.627	-0.495	-0.47	-0.376	-0.243	-0.102	0.018	0.219	0.281	0.48
Finland	-0.661	-0.636	-0.633	-0.545	-0.502	-0.384	-0.304	-0.177	-0.085	0.083	0.313		0.51
Austria	-0.643	-0.605	-0.589	-0.554	-0.472	-0.426	-0.4	-0.348	-0.055	0.106	0.053	0.551	0.795
Belgium	-0.595	-0.634	-0.598	-0.572	-0.502	-0.402	-0.301	-0.141	0.026	0.166	0.485	0.557	0.995
France	-0.588	-0.607	-0.572	-0.516	-0.422	-0.373	-0.277	-0.168	-0.015	0.119	0.433	0.678	0.871
Sweden	-0.506	-0.643		-0.471	-0.301		-0.194	-0.055		0.145		1.034	
Denmark		-0.648			-0.44			-0.244		0.008			0.428
Ireland		-0.423	-0.347	-0.309		-0.17	0.013	0.195	0.355	0.429	0.695		1.172
Italy	-0.201	-0.073	0.004	0.091	0.289	0.473	0.662	0.861	1.032	1.199	1.487	1.873	2.2
Spain	-0.204	-0.125	-0.057	0.06	0.23	0.305	0.514	0.861	0.989	1.152	1.498	1.86	2.192
Portugal	0.058	0.652	1.173	1.575	1.844		2.339	2.822	2.89	3.079	3.445	3.728	3.933
United Kingdom	0.18	0.143	0.234	0.298	0.352	0.469	0.559	0.665	0.671	0.756	1.292	1.456	1.603
United States	0.4884	0.653	0.759	0.921	1.023		1.265			1.432	1.539	1.688	2.148

Source: Fidelity Investments

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Second, European central banks are trying to encourage lending and discourage banks from buying more bonds in the market. This is an experiment, and right now even the smartest central bankers in the world have no idea how it will play out.

Bad information. Neil Irwin of *The New York Times* noted recently that "the bond market right now is like a speedometer that is miscalibrated and is therefore unreliable." Irwin is referring to the relationships between assets mentioned above. For example, investors were usually able to glean telling information in the bond market about interest rate spreads and relative values among assets both here at home and globally. That has all changed.

Italy is a good example: with a current debt/GDP of 133%, and a very troubled banking system, Italian government bonds should be trading at a much higher risk premium to U.S. Treasuries. That is not the case with the 10-year U.S. T-note yielding roughly 1.50% and the 10-year Italian government note yielding 1.20%. There are many examples like this across continental Europe, where valuation relationships have broken down as governments continue to buy bonds to prop up the economy. In the past, the bond market was considered the "smart money." Not so today. Perhaps the information we receive today is like the feedback a golfer gets on a very windy day at the driving range. It is simply becoming very difficult to assess value based on yield and price relationships across different fixed-income asset classes.

Valuation. Over history, the key valuation metric for bond investors has been the real return of the asset. This is the key to valuing any asset. For bonds today, inflation remains very low, with the Federal Reserve trying hard to move inflation to a 2% level and having a difficult time. Even so, if we take the nominal interest rate—which is the coupon on the bond—taking the 10-year Treasury note at 1.50% and subtracting inflation of roughly 1%, we get a real return of .5%. Let us put this in perspective. In the past, real value in the bond market emerged only when the real return moved above the 3% level. This would indicate that bonds are very expensive today, and the only thing holding this crazy valuation in place is a Central Bank continuing to add stimulus to a weak economy. Our response is to begin to build more liquidity in shorter term bonds and to continue to ladder our portfolios to be positioned to make changes in response to rising interest rates.

Economy & Earnings

Economic cycles do not always unfold as expected. Traditional cycles are characterized by the consumer coming out of the gate and buying, followed by capital investment in corporate America picking up the slack as the consumer wanes, and then finally followed by government spending to keep the expansion alive, especially in an election cycle. Bloated inventories were typical of the excesses that ended historical expansions. But things are different now. The latest weak expansion has not experienced this progression. Capital spending has failed to kick in. The consumer is relatively strong, and government monetary stimulus continues to prop up an economy waiting for corporate spending to contribute to the expansion. Where does this weak capital spending impact U.S. companies?

On Emerson Electric's fiscal Q3 earnings call, they made very clear the impact of weak government spending on their business lines. We heard CEO David Farr refer to the weak GDP numbers and absent business spending as creating a "*very challenging environment*" for Emerson Electric, which just posted disappointing earnings and top line revenue numbers. He went on to say that they are facing "*challenging demand conditions in key service markets*." And when asked about providing 2017 guidance, Mr. Farr said "*No, thank you. I will not talk about 2017*." Granted, the company is going through a restructuring of a number of units and has just sold off a major business line, so it would be very difficult to offer good guidance. But this

response is indicative of the uncertainty facing many industrial companies as they grapple with this weak capital spending.

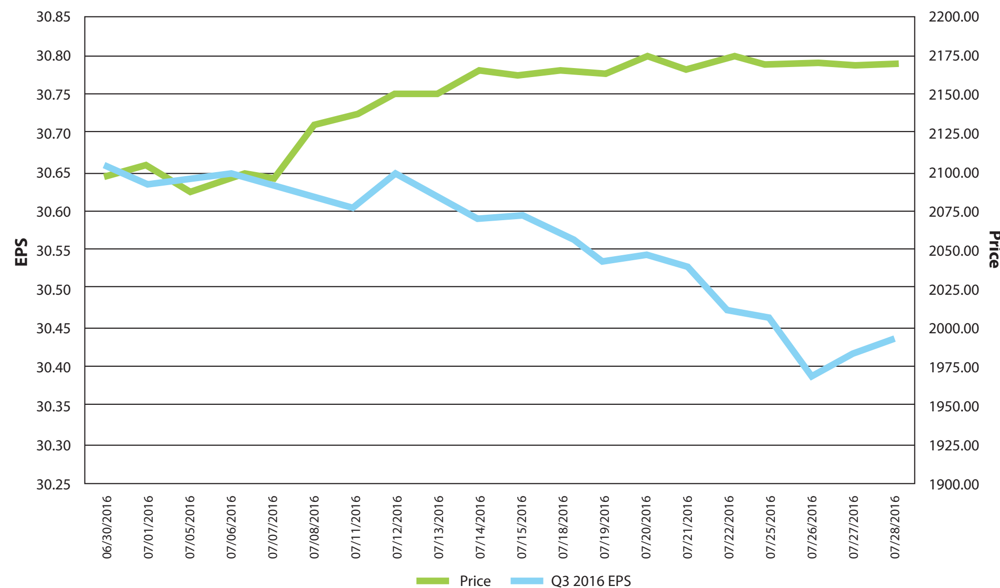
We are reviewing all of our industrial positions and have already made some changes in response to this market feedback.

Earnings

With 63% of S&P companies reporting earnings to date for Q2 2016, 71% have reported earnings above the mean estimate and 57% have reported sales above the mean estimate. We mentioned in our Q2 newsletter that the market was expecting an earnings decline of -5.5% for Q2 2016. As of today, the blended earnings decline is -3.8%, negative yes, but less than the market expected.

As has happened ahead of prior corrections over the past two years (see chart below), price—the S&P 500 Index level yellow line—has gotten well ahead of actual earnings per share (the blue line). We would not be surprised to see a market pullback on the order of 10% or more as the market takes a breather and awaits more visibility on year-end and 2017 earnings. Analysts are expecting double-digit earnings growth as we enter the first quarter of 2017. Given the comments on companies like Emerson Electric's inability to provide any guidance, the market will remain skeptical of these forecasts. So at 17X earnings, we believe the S&P 500 is overvalued by about 200 points.

S&P 500 Change in Q3 2016 EPS vs. Change in Price



Source: FactSet Research

For our client portfolios, we continue to focus on investing in companies that have strong, sustainable cash flow and a credo of sharing profits with investors. Even so, it is a difficult environment for many of the higher-yielding dividend payers. It is not a dart thrower's market. Many firms that pursue a strategy of sharing profits with investors are finding themselves in a difficult business environment. Emerson Electric now has to figure out how to replace a significant piece of its cash flow after jettisoning a key business line. We continue to monitor closely any exposure we have to companies operating in this challenging environment.

Finally, from an asset allocation perspective, we are beginning to see more value in certain emerging markets. Valuations remain depressed versus developed markets, and our approach at present is to lean toward emerging market strategies that are heavier invested in health care and consumer staples, versus the broader EM funds that are more weighted to financials and more cyclical companies. Our objective here is to gain exposure but with less volatility than the typical emerging market index fund.

Looking ahead, we will no doubt see more volatility as we head into the November election and markets look for more visibility on 2017 earnings forecasts, not to mention a Federal Reserve that may raise rates in September or October in response to strong employment and consumer numbers. These adjustments in the market are frequent and, unfortunately, an expected response to an ever-changing wall of worry. We invite you to call us or to stop in to review your portfolio and talk about any changes in your life situation that might dictate adjustments in your portfolio.

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