The Ten Themes of 1Q 2016

For the record books, the first quarter of 2016 ended with U.S. stocks, as measured by the S&P 500 index, posting a gain of +0.77%. However, stocks went on quite a roller coaster ride to eke out that slight gain. In fact, at one point it was one of the ugliest starts to a New Year for stocks ever! In January, the S&P 500 index declined -5.07% and in February the index fell another -0.41%. In our opinion, stocks struggled early in the year because corporate earnings expectations were being re-set to reflect much weaker than anticipated 2016 growth.

If you recall from our prior commentaries, the vast majority of U.S. multinational companies that make up the S&P 500 also reported declining year-over-year sales in every quarter in 2015. Some of the reasons for their disappointing sales results stemmed from weak economic growth outside of the U.S. and a strong dollar, which makes the cost of U.S. goods and services more expensive to foreign consumers.

So if sales were so bad what caused the S&P 500 to rally +6.60% in March and +12.61% from February 11, 2016 to the end of the quarter? For starters, stocks were beginning to price in a recession and the way the data was coming in, we were getting closer to one. However, as has been the case ever since the financial crisis of 2008, whenever the economic data weakens, the one constant has been global central bankers stepping in and providing support by pumping liquidity into the economy.

So on cue, Mario Draghi, head of the European Central Bank announced plans in early March to inject more liquidity into the European economy and essentially dish out free money to “targeted” banks beginning in June. Additionally, our own central bank chief, Janet Yellen, decided to keep interest rates “lower for longer” to accommodate growth. These actions by the ECB and the U.S. Fed helped pave the way for the relief rally in stocks.

Based on the loose central bank policies, our internal research now forecasts improving economic trends during the 2Q 2016 period. Because of this we adopted a more neutral position on stocks in early March. Quite simply, we do not want to fight multiple central banks who will do “whatever it takes” to re-inflate growth. We are also aware there are still problems and issues with the global economy. For this reason, it is hard to be overly optimistic at this point as well. In the meantime, **here are the ten themes** that we believe **impacted financial markets the most during the first three months of 2016.**

1. Volatility
2. Weak growth
3. Central Bank support
4. NIRP
5. Chinese slow down
6. Volatile commodity prices
7. Emerging Market outperformance
8. Low expectations
9. U.S. still looks good
10. Global stock market performance

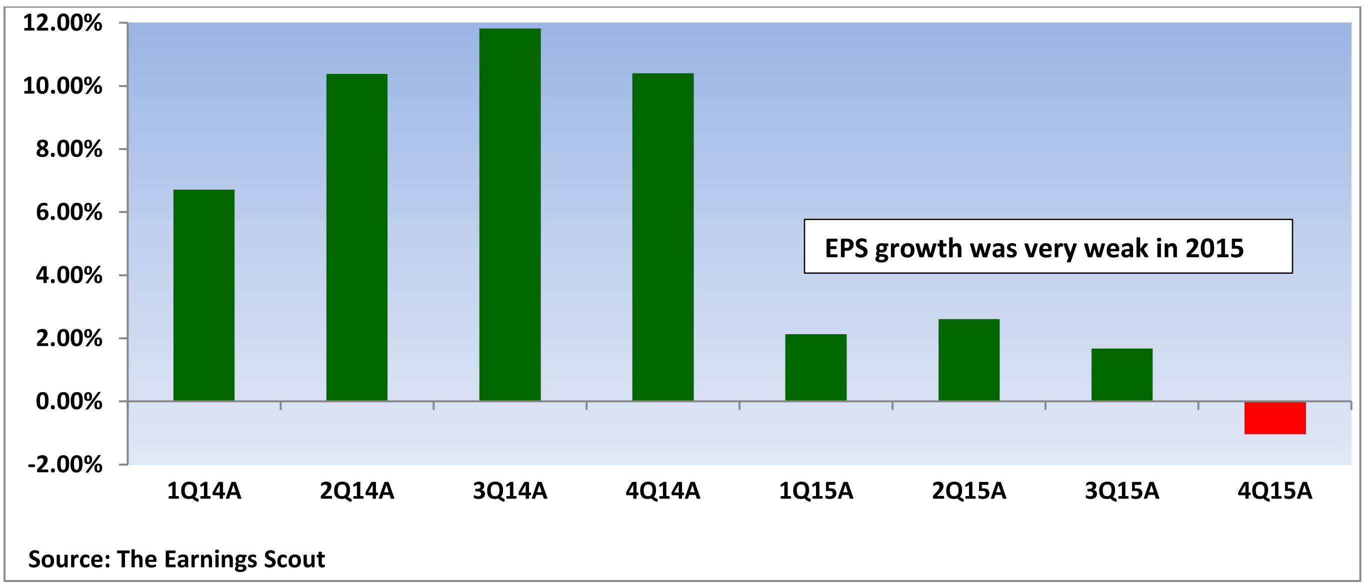
Volatility

We cannot stress enough how volatile global financial markets were in the first three months of the year. To put it in perspective, the Dow Jones Industrial Average's high during the 1Q 2016 period was 17,716 on March 30, 2016. Its low point was on February 11, 2016 at 15,660. This represents a 2,056 point swing on the Dow, and for the entire quarter, the index only gained 260 points! Yet, investors had to endure this massive point swing to get that meager gain. The volatility and falling stock prices justified our decision to underweight stocks early in the year.

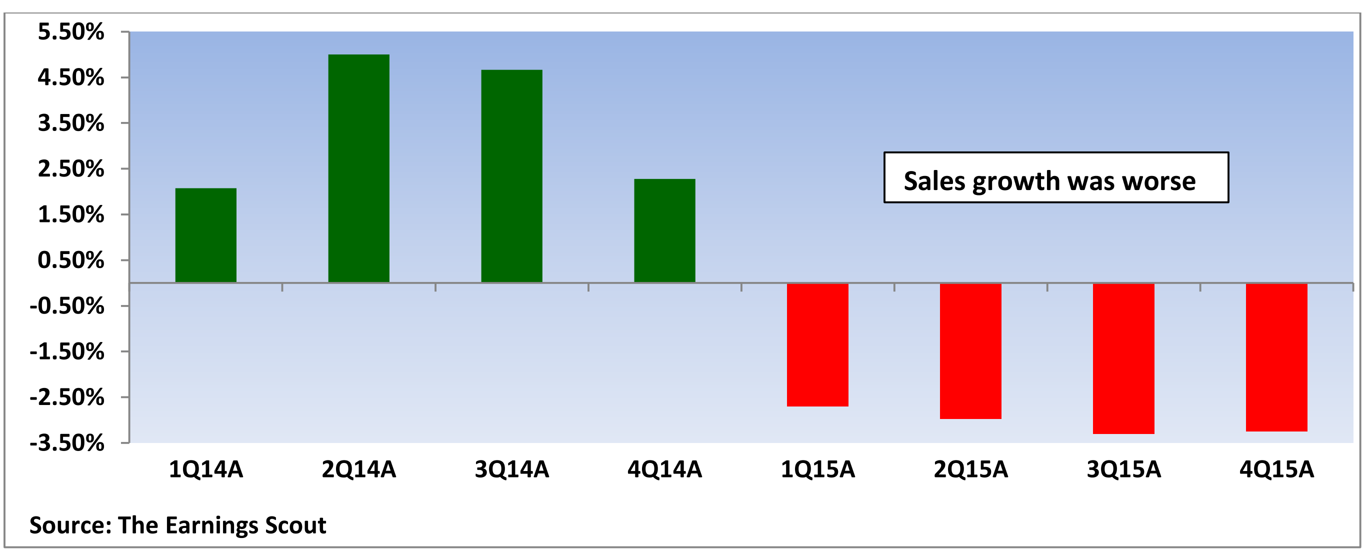
Weak growth

During the 1Q 2016, companies reported their 4Q 2015 results. How did the results look? Well, in 2015 earnings growth was weak and sales growth was even weaker. Until major corporations begin to increase their sales, it will be hard for global stocks to sustain a rally. Of course, central banks are doing their part to make sure business activity picks back up.

Quarterly S&P 500 EPS growth the last two years



Quarterly S&P 500 Sales growth the last two years



Central Bank support

As we have stated, over the past eight years there have been times when macroeconomic and corporate earnings expectations has deteriorated. Normally, the weakening economic data signals the initial stages of a recession. However, the last eight years have not been normal because every time the data turns south, central banks step in and provide support. They have done so by adopting ZIRP (Zero Interest Rate Policy) and providing massive amounts of stimulus into the economy under programs such as QE (Quantitative Easing). In other words, the central banks have done everything in their power to prevent a recession from occurring over the last eight years.

In 2015 and in early 2016, economic conditions began to weaken and the chances of a looming recession were rising. However in early March, Mario Draghi, the head of the European Central Bank, announced plans to cut interest rates further into negative territory, increase its QE bond buying program and begin to provide essentially free funds to targeted financial institutions across Europe in June. In addition, the U.S. Fed, which was expected to raise short-term interest rates four times this year, refrained from hiking rates during the 1Q 2016. This “lower for longer” strategy with regards to interest rate policy keeps U.S. monetary policy accommodative and is a big reason why global stock prices rallied in March.

NIRP

NIRP (Negative Interest Rate Policy) has been adopted by the European Central Bank and the Bank of Japan. In theory, negative interest rates should cause borrowers to want to borrow more at cheaper rates and savers to spend more – both of which would boost economic growth. In reality, information collected by The Earnings Scout shows NIRP is hurting bank profitability and is even causing savers to save more as they need to offset their decreased income. In other words, NIRP is not working to boost economic activity and is backfiring on central bankers.

Chinese slow down

One of the major reasons U.S. and European multinational companies are struggling to generate sales growth is because of the weakening Chinese economy. While China’s economy is expected to grow +6% in 2016, according to Chinese government officials on economic growth, and the U.S. will be lucky to generate 2% growth, financial markets do not care about absolute levels of growth. Instead, it is all about the direction of that growth and China’s economy is cooling off from +10% growth in prior years.

Mass over-investment and demographics are largely to blame for the decelerating economic trends in China. Furthermore, now that the country has become the second largest economy on the planet, its economic pain is felt across the world. This is why our central bank must consider what is going on in China when its sets monetary policy in the U.S.

Volatile commodity prices

As anyone who has been tracking the CRD Index would note, the price of commodities such as crude oil, aluminum, copper, coffee, corn, cotton, gold, live cattle, hogs, natural gas, nickle, orange juice, silver, soybeans, sugar, unleaded gas and wheat have been in a free fall over the past five years. During the 1Q 2016, that free fall continued through mid-February, then it stopped as expectations grew that global central banks would once again come to the rescue. The rapid rise in the value of the U.S. dollar has also been a reason why commodites have struggled over the last five years. However, in 2016, the Fed’s lower for longer interest rate strategy has weakened the dollar and allowed commodity prices to surge in March. Additionally, beaten down stocks in the Materials and Energy sector got quite a bounce towards the end of the 1Q 2016 period as well.

Emerging Market outperformance

The U.S. stock market was volatile but still ended up posting a gain of +0.77%. However, stocks in Emerging Market countries shocked almost everyone by posting a gain of +6.40% for the quarter after beginning the year worse off than the U.S. too. The same reasons (i.e. central bank policy and a weakening U.S. dollar) that caused commodity prices to bounce back in the 1Q 2016 period are pretty much the exact same reasons why Emerging Markets outperformed in the first three months of the year. The outperformance of Emerging Markets surprised even us.

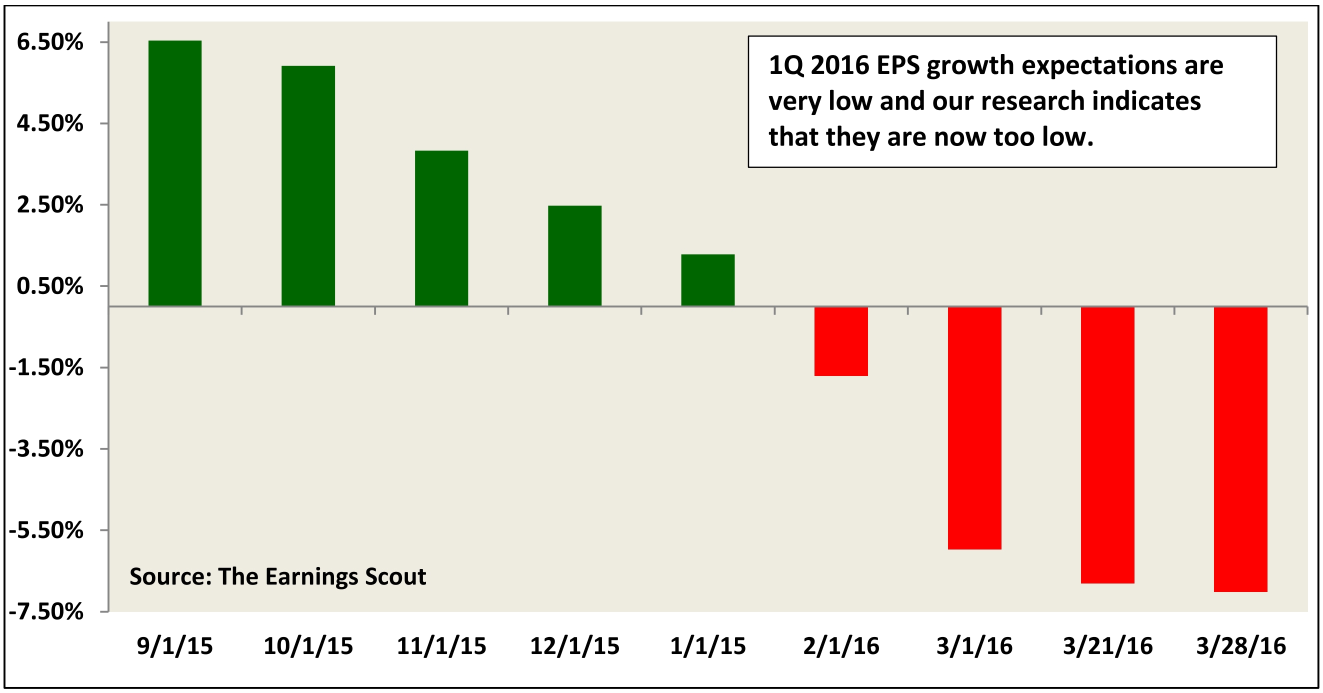
Asset Class	2015 Return	1Q 2016 Return
S&P 500	-0.73%	0.77%
MSCI Emerging Markets Index	-18.07%	6.40%
MSCI Developed International Index	-3.48%	-2.66%

Source: Bloomberg

Low expectations

Heading into 2016, corporate earnings and sales expectations were low. During the 1Q 2016, those expectations went even lower. This caused many to believe we would be heading into a recession. We believe that would have been the case until the central banks stepped in and provided their continued support. Now that 1Q 2016 earnings expectations have been set to their worst expected level since the financial crisis of 2008, this sets the stage for many companies to exceed estimates this earnings season at a rate higher than normal.

How have 1Q 2016 S&P 500 EPS growth expectations changed?



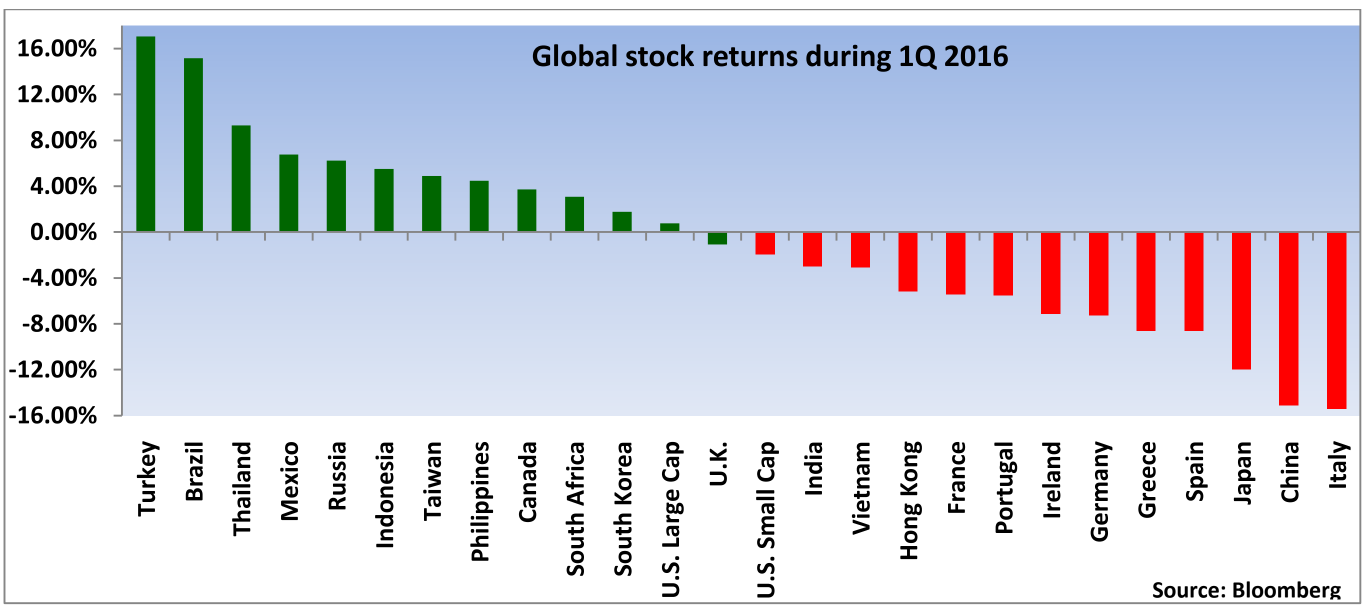
U.S. still looks good


The majority of U.S. companies, especially ones in the Energy sector, are expected to have awful earnings results in the 1Q 2016. However, most of the reasons for the weak earnings stem from deteriorating global economic growth. Given that foreign central banks are dealing with that weakness with more accommodation, our models indicate Wall Street analysts are now too pessimistic and this sets the stage for a greater than normal number of companies exceeding Wall Street forecasts in the weeks ahead.

Global stock market performance during 1Q 2016

Country	Stock Index	2015 Return	January	February	March	1Q 2016 Return
Turkey	BIST 30	-17.64%	2.99%	3.56%	9.76%	17.07%
Brazil	Ibovespa	-13.31%	-6.79%	5.91%	16.67%	15.17%
Thailand	SET Index	-14.00%	1.01%	2.41%	5.65%	9.29%
Mexico	Bolsa IPC	-0.39%	1.52%	0.19%	4.96%	6.76%
Russia	MICEX	26.12%	1.34%	3.10%	1.68%	6.23%
Indonesia	JSE Composite	-12.13%	0.48%	3.38%	1.56%	5.49%
Taiwan	TSE	-10.41%	-3.09%	4.09%	3.97%	4.88%
Philippines	PSEi	-3.85%	-3.80%	-0.25%	8.86%	4.46%
Canada	TSX Composite	-11.09%	-1.44%	0.30%	4.93%	3.72%
South Africa	FTSE/JSE All Share	1.85%	-3.06%	0.56%	5.74%	3.07%
South Korea	KOSPI	2.39%	-2.51%	0.24%	4.13%	1.76%
U.S. Large Cap	S&P 500	-0.73%	-5.07%	-0.41%	6.60%	0.77%
U.K.	FTSE	-4.93%	-2.54%	0.22%	1.28%	-1.08%
U.S. Small Cap	Russell 2000 Index	-5.71%	-8.85%	-0.14%	7.75%	-1.92%
India	SENSEX	-5.03%	-4.77%	-7.51%	10.17%	-2.97%
Vietnam	Ho Chi Minh	6.12%	-5.83%	2.59%	0.33%	-3.08%
Hong Kong	Hang Seng	-7.16%	-10.18%	-2.90%	8.71%	-5.19%
France	CAC	8.53%	-4.75%	-1.44%	0.72%	-5.43%
Portugal	PSI	10.71%	-4.66%	-5.89%	5.31%	-5.51%
Ireland	ISE	30.00%	-6.60%	0.01%	-0.55%	-7.11%
Germany	DAX	9.56%	-8.80%	-3.09%	4.95%	-7.24%
Greece	ASE	-23.58%	-12.44%	-6.53%	11.69%	-8.59%
Spain	IBEX	-7.15%	-7.63%	-4.02%	3.09%	-8.60%
Japan	Nikkei 225	9.07%	-7.96%	-8.51%	4.57%	-11.95%
China	Shanghai Composite	9.41%	-22.65%	-1.81%	11.75%	-15.12%
Italy	MIB	12.66%	-12.89%	-5.54%	2.80%	-15.41%

Source: Bloomberg



Conclusion

As we embark on the 2Q of 2016, our overall view on financial markets has changed given the central bank policy actions taken during the first three months of the year. We are no longer bearish on stocks as we were in 2015 and to begin the New Year. We now believe investors should deploy some of the cash they have set aside to move back to their normal strategic allocations to stocks.

We made the decision to upgrade our view on stocks to neutral because our research has determined that the worst of the negative earnings estimate revisions for corporate America, in terms of magnitude downward, are now over. That said, we remain cautious on stocks and do not want investors to over-allocate to weights greater than your individual portfolio allocation strategy recommends because we know central bank stimulus initiatives are NOT a long-term solution. Instead, central bankers are “buying more time” with their policies. As such, they likely thwarted a recession from occurring in 2016. However, until we see top-line sales of major corporations improve, we cannot be overly bullish on stocks at this point.

While we take great pride in our measurement and understanding of all the economic and earnings data, it is impossible for us to know every major market factor in advance. Because of this we continue to apply our fundamental beliefs that risk and return are related, markets are efficient over time, profitability matters and diversification is key. These fundamental beliefs continue to be the core of our short term and long term investment approach.

We hope you found this information useful, and encourage you to approach us with any questions you may have. We look forward to our next conversation.

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