The Ten Themes of 4Q 2015

Global stock markets rallied during the 4Q 2015 period. However, almost all of those gains occurred in October as stocks struggled in November and December. The S&P 500 index, which is a proxy for the results of large U.S. corporations, gained +6.45% during the last three months of 2015. Unfortunately, this was not enough to record a gain as the index finished the year down -0.73%. Stocks of smaller U.S. companies, as measured by the Russell 2000 index, fared even worse in 2015, declining -5.71%.

We were not surprised by the solid stock returns during the 4Q 2015 period as we wrote in our "Ten Themes of 3Q 2015" that stocks had become less risky and there were more values in the market at the end of September 2015. Further, we were also not surprised that for the calendar year both large and small cap U.S. stocks declined in value as we repeatedly warned of deteriorating corporate earnings expectations. As such, the subpar returns on stocks in 2015 fell in line with our modestly negative expectations.

As we embark on another year in the market, we are maintaining our cautious view. Given the Federal Reserve's plan to raise short-term interest rates, our research indicates there is an increased chance the global economic growth slowdown intensifies. At the very least, we believe sluggish growth should persist in 2016.

Therefore, we still believe playing defense will be the best offense until we can begin to measure improving business activity via a pick-up in corporate revenue trends. In the meantime, here are the ten themes we believe impacted financial markets the most from October 1, 2015 to December 31, 2015:

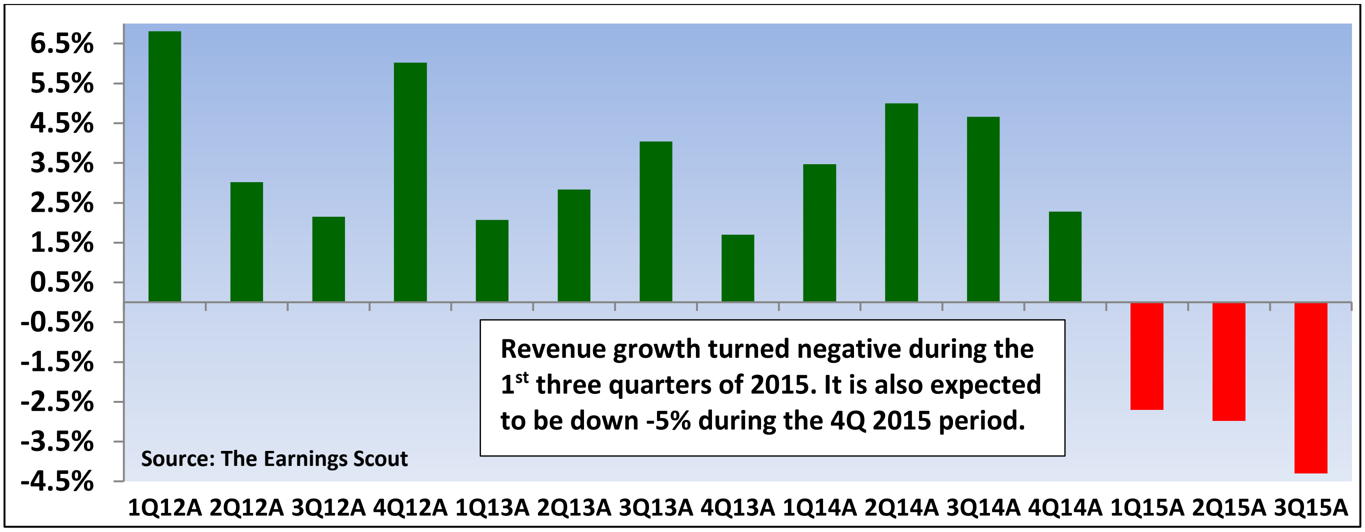
The ten themes of 4Q 2015

1. Better earnings, but weak sales
2. Financial engineering
3. European Central Bank
4. Solid employment
5. Federal Reserve Bank (Fed)
6. Chinese stock rally
7. Lower oil prices
8. Global terror
9. Presidential debates
10. International stock market performance

Better earnings, but weak sales

In the first & second quarter 2015 earnings seasons, a majority of companies exceeded their distressed earnings expectations, but failed to top their sales estimates. Third quarter 2015 earnings season was no different with 69% of companies in the S&P 500 exceeding their earnings estimates, but only 44% topping their 3Q 2015 sales estimates. This statistic on sales has many market bears claiming that earnings per share data is coming in better than anticipated only because companies are engaging in manipulative financial engineering. We wish we could refute the naysayers; however, we cannot.

S&P 500 Sales Growth since 2012



Financially Engineered Earnings

Market bears have questioned the sustainability of recent earnings trends due to companies engaging in financial engineering. By that, they mean companies have been borrowing at low interest rates (thanks to the Fed) to buy back their shares. This provides an immediate boost to earnings per share (EPS) because corporate profits are allocated amongst fewer shares. In addition, some companies are using excess cash to buy other companies as a way to grow through acquisition and not organically. We agree that the bears have a valid argument when it comes to financial engineering through share buy backs, M&A activity and other metrics and reiterate our view that it will remain difficult for stocks to sustain a rally without companies seeing their top-line sales improve.

European Central Bank

Leading up to the European Central Bank's (ECB) December 3, 2015 monetary policy decision, global financial markets were anticipating Mario Draghi, the head of the ECB, to deliver investors a fabulous gift in the form of increased stimulus. The hopes of more cowbell from the ECB helped global stocks rise early in the 4Q 2015 period, especially in Europe. In Germany, the country's benchmark stock index, the DAX, gained +12.32% in October and +4.90% in November. When the time finally came, Mario Draghi did deliver more stimulus, but it was less than investors were hoping for and their reaction afterwards was akin to a child getting a gift and unwrapping it only to reveal a new pair socks. Ultimately, the German DAX declined -5.62% in December.

ECB President, Mario Draghi

Solid Employment

On November 6, 2015, the U.S. Department of Labor reported that 268K jobs were added to the economy in October when the market was only expecting 168K. This blowout jobs number sealed the deal for the U.S. Federal Reserve Bank to embark on its plan to raise interest rates to more normal levels.

While the quality of the types of jobs added and how the Labor Department accounts for the long-term unemployed into its unemployment rate statistics are debatable, we would agree that the overall jobs picture has improved since the financial crisis of 2008. However, the improvement in employment has been gradual and appears to remain fragile as well.

Federal Reserve Bank (Fed)

Last month, Nick Raich (an esteemed member of SIA's investment committee) met with the Financial Stability Team and several other economists and analysts at the Federal Reserve Bank in Cleveland. The Financial Stability team at the Cleveland Fed is responsible for measuring and analyzing the fiscal health of all banks in the country. This team then presents to members of the Federal Reserve Open Market Committee (FOMC), headed by chair Janet Yellen. In this meeting, Nick presented his macroeconomic outlook and analysis on corporate revenue and earnings expectation trends highlighting how they have weakened over the past year. He concluded that banks would be net beneficiaries of an interest rate hike, but expressed concern over how well other parts of the economy, as well as international economies, would be able to handle higher U.S. interest rates.

The blowout October jobs report in November is what paved the way for the Fed to hike rates for the first time in nine years on December 16, 2015. Normally, the Fed begins raising interest rates when the economy is improving. This time the Fed is tightening policy as corporate revenue and earnings estimate trends are weakening. Therefore, the Fed will need to be careful in 2016. The good news from Nick's meeting in Cleveland is that many at the Fed are keenly aware of their need to be cautious as it brings U.S. interest rates back up to more normal levels.

Chinese Stock Rally

Chinese stocks, as measured by the Shanghai composite index rose 9.41% in 2015. However, the ride to get this return was a wild one. From the beginning of last year until June 12, 2015, Chinese stocks, rose +59.72%. When they first began to rally, there was justification for the run-up based on improving economic expectations and depressed prices. However, valuations on many Chinese stocks became stretched and soon were no longer reflective of economic reality. The bubble burst and they fell -43.34% from June 12, 2015 to August 26, 2015. Given that China is now the #2 economy in the world, its pain has spread across the world, and rightfully so, as many countries do business with and in China. We watch the development(s) in the Chinese economy so closely because they do ultimately impact the profitability of major U.S. & European corporations.

It was the best of times. It was the worst of times for Chinese stock investors in 2015

Lower oil prices

Crude oil prices have been almost impossible to predict. For example, in the middle of 2014 when WTI crude oil was $107 a barrel, many on Wall Street were forecasting increased geopolitical risks would spike prices to over $125. Instead, prices plummeted all the way down to $45 by March 2015. Then prices began to stabilize rising up to $60 a barrel in the 2Q 2015. This brought the oil bulls back out and many re-upped their forecasts to at least the $70 range. Then, as global growth slowed and supplies remained high, oil prices plummeted again. The most recent move downward has been swift and sharp and will have major implications for overall corporate profits and capital spending plans in 2016 for the Energy sector. In our opinion, it is fair to correlate the rise and fall of oil prices over the past decade with the rise and fall of Chinese economic growth expectations.

West Texas Intermediate (WTI) Crude Oil Prices in 2015

Global terrorism

During the last three months of the year, there was an increased amount of terror with the most horrific of events unfolding in Paris on November 13, 2015. Fighting against the militant group, ISIS, has proven difficult since the group is fractured with misguided sympathizers across the globe. Financial markets proved to be very resilient after the Paris attacks though. This was the best fight investors could make against terrorists showing they would not sell stocks in fear. Regardless, the threat of a major terrorist act occurring and adversely impacting economic activity is very real and has been a risk factor for markets ever since 9/11.

Presidential debates

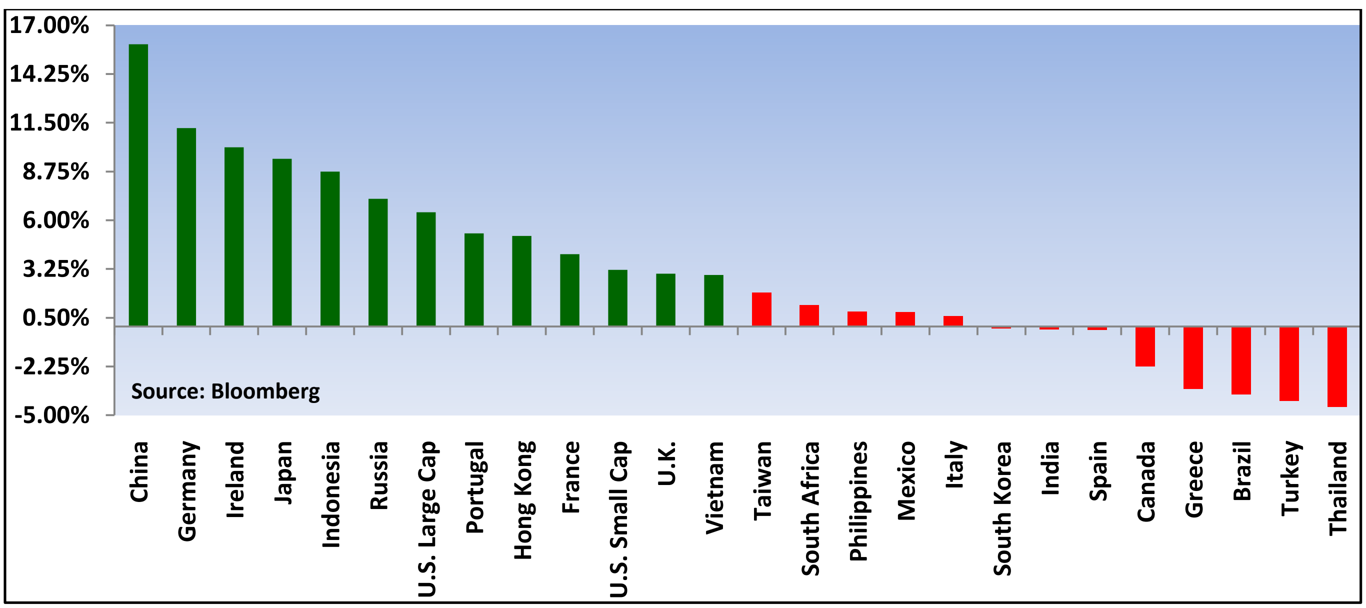
Admittedly, the Democratic and Republican debates did not really impact global financial markets in 2015. However, as markets begin to “price in” a winner and what his or her policies will be, we will likely see a shift in industries that benefit or languish under that leadership. We expect that only a select few industries will be impacted as the majority of industries will chug along, or slow, regardless of who is President.

Global Stock Market Performance during 4Q 2015

Stock Market	4Q 2015 Return	October	November	December	2014 Return	2015 Return
China	15.93%	10.80%	1.86%	2.72%	52.87%	9.41%
Germany	11.21%	12.32%	4.90%	-5.62%	2.65%	9.56%
Ireland	10.12%	4.23%	6.38%	-0.68%	15.09%	30.00%
Japan	9.46%	9.75%	3.48%	-3.61%	7.12%	9.07%
Indonesia	8.74%	5.48%	-0.20%	3.30%	22.29%	-12.13%
Russia	7.21%	4.17%	3.48%	-0.55%	-7.10%	26.12%
U.S. Large Cap	6.45%	8.30%	0.05%	-1.75%	11.39%	-0.73%
Portugal	5.27%	8.35%	-2.16%	-0.70%	-26.83%	10.71%
Hong Kong	5.12%	8.60%	-2.84%	-0.37%	1.28%	-7.16%
France	4.08%	9.93%	1.22%	-6.47%	-0.54%	8.53%
U.S. Small Cap	3.20%	5.56%	3.12%	-5.19%	3.53%	-5.71%
U.K.	2.98%	4.94%	-0.08%	-1.79%	-2.71%	-4.93%
Vietnam	2.91%	7.95%	-5.63%	1.02%	8.12%	6.12%
Taiwan	1.92%	4.56%	-2.73%	0.21%	8.08%	-10.41%
South Africa	1.21%	7.40%	-4.06%	-1.77%	7.60%	1.85%
Philippines	0.84%	3.49%	-2.90%	0.36%	22.76%	-3.85%
Mexico	0.81%	4.48%	-2.52%	-1.02%	0.98%	-0.39%
Italy	0.58%	5.39%	1.23%	-5.72%	0.23%	12.66%
South Korea	-0.08%	3.40%	-1.85%	-1.54%	-4.76%	2.39%
India	-0.14%	2.03%	-2.02%	-0.11%	29.89%	-5.03%
Spain	-0.16%	8.38%	0.25%	-8.11%	3.66%	-7.15%
Canada	-2.23%	1.67%	-0.44%	-3.41%	7.42%	-11.09%
Greece	-3.49%	7.19%	-9.47%	-0.55%	-28.94%	-23.58%
Brazil	-3.79%	1.80%	-1.63%	-3.92%	-2.91%	-13.31%
Turkey	-4.17%	7.65%	-6.13%	-5.17%	28.75%	-17.64%
Thailand	-4.52%	3.41%	-2.53%	-5.27%	15.32%	-14.00%

Source: Bloomberg

Global Stock Market Performance during 4Q 2015



Conclusion

As we begin the New Year, our overall view on financial markets remains relatively unchanged. While we are pleased to see stock prices become much more reflective of their true underlying earnings power, we remain cautious given weak top-line sales figures reported by major corporations. In other words, it is great that corporate earnings have held up well versus expectations, but a large part of that is coming from financial engineering (i.e. cost cutting, share buy backs and some creative pro forma adjustments.) Until top-line sales rebound, markets should continue to struggle to sustain a rally. By that we mean most institutional investors will need to see proof businesses are actually growing as opposed to just being manipulated.

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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