April 2016

First Quarter 2016 Investment Commentary

It was a tale of two halves in the first quarter of the year for global financial markets. Stock markets plunged early on, falling 10% to 15% or more, but then sharply reversed, staging a furious rally into quarter-end. Emerging-markets stocks led the charge, gaining 5.9% for the quarter. Larger-cap U.S. stocks also finished in the black, up 1.3%, though domestic small-cap stocks trailed, down 1.5%. Developed international stocks also failed to keep pace in the rally, ending with a 1.9% loss for the quarter. And while the 10-year Treasury yield rose around 15 basis points from its mid-quarter low, it was still 49 bps below where it started the year. As such, core bonds have gained 3.1% year to date.

March Benchmark Returns (Preliminary)

Large Cap Benchmarks	Mar	1Q	YTD
Vanguard 500 Index	6.8%	1.3%	1.3%
iShares Russell 1000	7.0%	1.2%	1.2%
iShares Russell 1000 Growth	6.7%	0.7%	0.7%
iShares Russell 1000 Value	7.3%	1.6%	1.6%
Mid-Cap Benchmarks			
iShares Russell Mid-Cap	8.1%	2.2%	2.2%
iShares Russell Mid-Cap Growth	7.2%	0.6%	0.6%
iShares Russell Mid-Cap Value	9.2%	3.9%	3.9%
Small-Cap Benchmarks			
iShares Russell 2000	8.0%	-1.5%	-1.5%
iShares Russell 2000 Growth	7.6%	-4.6%	-4.6%
iShares Russell 2000 Value	8.3%	1.8%	1.8%
Other Benchmarks			
Vanguard FTSE Developed Markets ETF	7.2%	-1.9%	-1.9%
MSCI World ex USA Index	6.9%	-1.8%	-1.8%
Vanguard FTSE Europe ETF	7.0%	-2.2%	-2.2%
Vanguard FTSE Emerging Markets ETF	12.7%	5.9%	5.9%
Vanguard REIT Index	10.4%	6.2%	6.2%
Vanguard Total Bond Mkt Index	0.9%	3.1%	3.1%
BofA Merrill Lynch U.S. High Yield Cash Pay	4.4%	3.2%	3.2%
Vanguard Intermediate-Term Tax-Exempt	0.3%	1.6%	1.6%
S&P/LSTA Leveraged Loan Index	2.8%	1.5%	1.5%
Citigroup World Govt. Bond Index	2.7%	7.1%	7.1%

Broadly speaking, the stock market decline in the first half of the quarter was due to

- ongoing fears of a hard landing in the Chinese economy, possibly accompanied by a sharp and sudden devaluation of the renminbi;
- a continuing plunge in oil prices to under $30 per barrel (bbl), using the WTI benchmark, from $40 at the start of the year;
- some weaker-than-expected U.S. economic data and growing fears of a global recession, if not also a U.S. recession; and
- a contagious loss of market confidence (whatever little remained) in the ability of global central banks to stimulate real economic growth and increased concern that current monetary policies (e.g., negative interest rates in Japan and Europe) are now causing more harm than good.

On the last point, the Bank of Japan surprised markets by joining the negative interest rate policy (NIRP) club at the end of January. The BOJ pushed its policy rate down to negative 0.1%, joining the European Central Bank, which later lowered its rate to minus 0.4% in March. (Swiss, Swedish, and Danish central banks have policy rates ranging from negative 0.5% to negative 0.75%). But rather than having the

intended effect of weakening the yen, Japan's move had the opposite effect and helped trigger another leg down in global stocks and other risk assets.

Then, beginning on February 12, everything changed. Oil prices spiked higher. Stock markets started moving higher. The renminbi stabilized, then started appreciating a bit. High-yield bond prices started moving higher and credit spreads fell. Core bond prices fell and the 10-year Treasury yield moved higher. These broad market trends continued through March, as shown in the table below.

A Tale of Two Halves

Asset Class	1/1/16–2/11/16	2/12/16–3/31/16	YTD 2016
U.S. Stocks	-10.3%	+12.9%	+1.3%
Developed Int'l Stocks	-12.2%	+11.8%	-1.9%
European Stocks	-12.1%	+11.3%	-2.2%
Emerging-Markets Stocks	-10.9%	+18.8%	+5.9%
Core Bonds	+2.4%	+0.7%	+3.1%
High-Yield Bonds	-5.1%	+8.8%	+3.2%
Floating-Rate Loans	-1.4%	+3.0%	+1.5%
Managed Futures	+9.0%	-5.4%	+3.1%

Source: Morningstar. Data as of 3/31/2016.

As is often the case, there was no single obvious catalyst for the turnaround that began on February 12 other than speculation in the news that major oil producers might be ready to cooperate to cut oil output. At the same time, the head of the Federal Reserve Bank of New York dismissed the likelihood the Fed would need to adopt NIRP given the U.S. economy's strength and momentum. Then, over the following weekend, the head of the Chinese central bank stated it saw no basis for further yuan depreciation.

The rally continued in March, on the back of better economic news in the United States. Markets also reacted positively to dovish ECB and Fed actions during the month, as well as additional monetary and fiscal stimulus in China. On March 10, the European Central Bank (ECB) went deeper into negative rates, cutting its policy rate to negative 0.4%—its third rate cut since adopting NIRP in June 2014. The ECB also expanded quantitative easing bond purchases by €20 billion per month (to €80 billion) and will also now include investment-grade non-bank corporates in the program, boosting prices for such bonds. Finally, it initiated a new program of targeted long-term refinancing operations, where it will lend money at zero or negative interest rates to banks that increase their lending to the private sector. This should mitigate some of NIRP's negative effects on bank profits, the fear of which had been driving European bank stock prices sharply lower this year.

In the United States, the Federal Open Market Committee held its mid-March meeting and did not raise the federal funds rate, stating that "global economic and financial developments continue to pose risks." But it also highlighted solid U.S. economic fundamentals. The FOMC also lowered its projection of the number of rate hikes for the rest of the year (from four to two) and longer term, communicating both a slower pace and a lower trajectory of rate hikes than what it had projected in December. This was broadly consistent with the market's views (e.g., as reflected in Treasury futures markets), which had already discounted a high likelihood of just one or two hikes this year.

Financial markets responded positively to the Fed announcement, with stocks and oil/commodities continuing to rally and the dollar falling. After peaking in late January, the dollar (whose prior rise was likely driven in part by anticipated higher U.S. rates) ended the quarter down more than 4% for the year.

Looking ahead, however, with consumer price inflation and market inflation expectations rising, stock and credit markets and oil prices rebounding, and the dollar no longer appreciating, the Fed may soon turn more hawkish again. (In fact, just a few days after the March announcement, several Fed governors suggested the Fed could raise rates at the April meeting.) This could trigger market reactions that reverse these recent reflationary trends.

More generally, we'd note that global monetary policy is moving deeper into uncharted, historically unprecedented territory, bringing with it unknown and unintended consequences. This continues to be a key uncertainty and risk as we construct and manage investment portfolios for a range of potential outcomes. How and when will the current extreme monetary policies be "normalized" and how will they impact the global economy and financial markets? No one knows.

Our investment outlook—both in terms of potential return drivers and risks—has not materially changed over the past quarter. But in the context of the market's recent gyrations, we'd like to highlight reasons for optimism that the recent relative performance trends *may* be sustained for a while, to the benefit of our portfolios. In short, the post-financial-crisis period has been dominated by a few very strong market trends. It is important to view these for what we believe they are—cycles that will eventually turn and may be in the process of turning. Our next section discusses the concept of cycles as well as several very specific cycles we've experienced in recent years.

Cycles of Investor Behavior

We often talk about cycles when discussing our investment philosophy and tactical asset allocation approach. This is because financial market and economic history is a series of multiyear cycles—albeit in the case of most stock markets and economies it is cycles within a very-long-term (secular) growth trend. These cycles, we believe, are driven by natural human group or herd behavior. And since we don't think *human* behavior is going to evolve much over the next few decades, we expect *markets* will also continue to behave cyclically.

The existence of market cycles creates significant risks for investors who ignore them (i.e., the "this time is different" syndrome) and great opportunities for disciplined long-term investors. But while this time is *rarely* different when it comes to investing, neither do history and cycles repeat *exactly* in terms of timing, duration, or magnitude.

Howard Marks, co-founder of the hugely successful investment firm Oaktree Capital and the author of many insightful investment memos over the past 25 years, often emphasizes the importance of understanding cycles. He uses the metaphor of a pendulum to describe market behavior, as summarized in the following excerpt from his 2011 book, *The Most Important Thing*.

> Investment markets follow a pendulum-like swing:
>
> - between euphoria and depression [greed and fear],
> - between celebrating positive events and obsessing over negatives, and thus
> - between overpriced and underpriced.

> This oscillation is one of the most dependable features of the investment world.

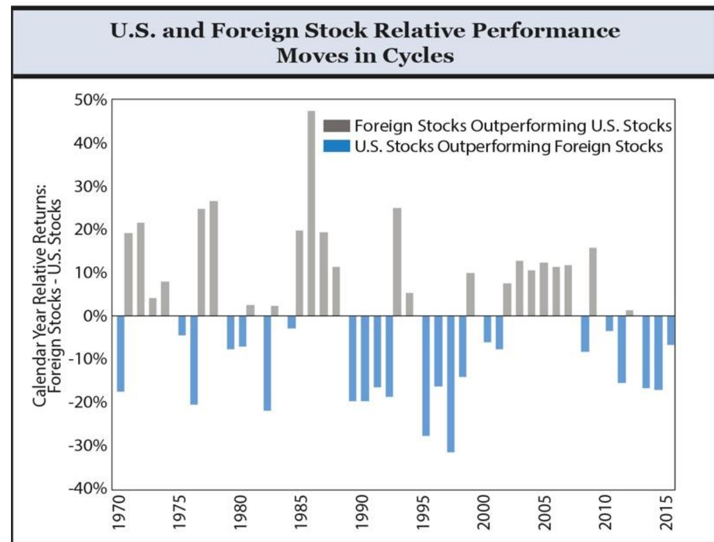
Marks notes that the oscillation of the investor pendulum is similar to the up-and-down fluctuation of economic and market cycles in that while the occurrence of the pendulum-like pattern is extremely dependable in most markets, one never knows exactly how far the pendulum will swing, how long it will stay at one extreme or another, or what might cause it to reverse.

It is impossible to consistently and accurately predict exactly when a cycle will turn or when the pendulum will start to swing back the other way or how far it will go at the extremes. But with our longer-term analytical framework and forward-looking assessments that are informed by and grounded in market history, we can position our portfolios to benefit from the cyclic swings of the pendulum. This requires having a long-term perspective and the discipline to stick to your process and consistently execute it over time, *especially* when the cycle and pendulum are swinging to extremes.

Market Cycles and Portfolio Positioning

In recent years, our portfolios have been positioned for a turn in some market cycles that haven't yet changed course, namely our tactical underweight to U.S. stocks versus foreign stocks, and our exposure to value or cyclical stocks (i.e., businesses that are more sensitive to the broader economic cycle). While this has negatively impacted our short-term performance, we remain confident the current market cycle *will* turn. The charts below show the relative performance cycles for both of these markets.

U.S. Versus Foreign Stocks—Our portfolios are positioned with the view that over our five-year tactical investment horizon, U.S. stocks are likely to deliver underwhelming returns (low single digit), while developed international and emerging-markets stocks are poised to produce much higher returns. This has been a headwind to our portfolio performance as the current cycle of U.S. stock outperformance versus foreign stocks now ranks as the longest relative performance streak for U.S. stocks since the inception of the international stock index in 1970.



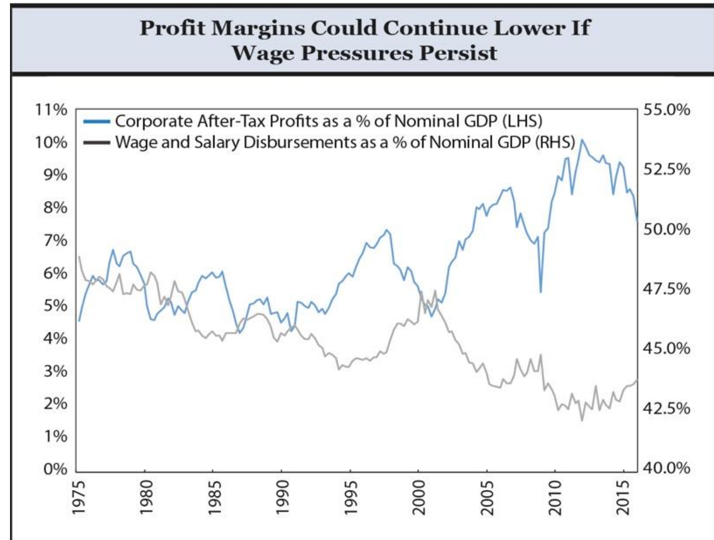
Source: Morningstar. Data as of 2/29/2016. Foreign stock returns tracked using the MSCI World ex USA Index from 1970 to 1987 and the MSCI ACWI ex USA Index from 1988 onward.

Here are just a few points that illustrate why we believe this cycle will eventually turn in our favor:

U.S. profit margins (and earnings growth) have been coming down, as we expected. But margins are still high relative to history and are likely to continue lower if and as wage pressures continue to build as the labor market tightens. Higher interest rates (and therefore higher corporate borrowing costs) would also be a negative for margins. *Current* corporate profit margins have been negatively correlated with *future* earnings growth. That is, historically high profit margins are associated with low five-year forward

earnings growth and vice versa. If topline revenue growth remains subpar and profit margins decline, earnings growth will remain under pressure.

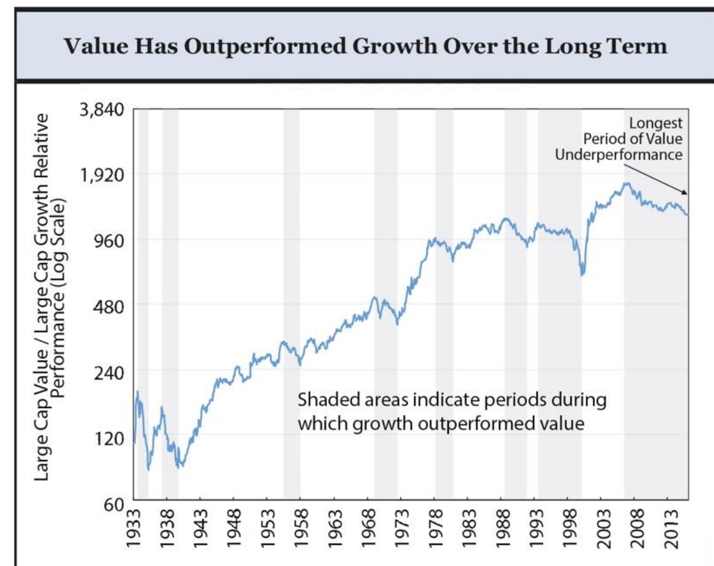
Meanwhile, on the valuation side, we see little room for market-multiple expansion in the United States. The 12-month trailing price-to-earnings ratio for the S&P 500 is 24x, and the 12-month forward P/E ratio is 18x (using analysts' consensus forward earnings estimates). These are both historically high levels. Our base case scenario assumes the P/E multiple contracts over time, bringing it in line with longer-term historical averages. Putting it all together, it means poor expected returns for U.S. stocks.



Source: Bureau of Economic Analysis. Data as of 12/31/2015.

In contrast, developed international and emerging markets are almost a mirror image of the U.S market, with below-normal earnings and the potential for faster earnings growth from current levels. We also expect valuation multiples to expand somewhat from current levels as earnings improve. On this point, one additional supporting factor is that foreign markets have already suffered a steep decline, as if the markets expect a global recession even though it isn't at all clear we are in such a recession or about to fall into one—although that's one reasonable near-term scenario. In other words, at the low in February foreign stocks had discounted a lot of negative news, setting them up for a potential rebound if actual events turned out to be no worse (let alone better) than expected, which seems to be what we've seen over the past month.

Value (Low Multiple) Versus Expensive (High-Multiple) Stocks—In another unusually long market cycle, this has been the longest run of underperformance for value stocks *on record going back to 1930*, at nearly 10 years (outlasting the six-and-a-half years of the Internet/tech stock bubble). The flipside has been that on the other end of the style spectrum, expensive growth and momentum stocks have had unusually strong returns.



Source: Morningstar and Kenneth French. Data as of 2/29/2016. Data prior to 1979 is from Kenneth French's database. Value is defined as high book-to-market ratios and growth as low book-to-market ratios. From 1979 onward we use the Russell 1000 Value Index and the Russell 1000 Growth Index.

The chart above also shows that over the long term a value investment approach has meaningfully outperformed a strategy of buying expensive (high-multiple) stocks. But *there are cycles.* Value investing has had several periods of significant underperformance. The inability of most investors to stick with a value approach during such cyclical reversals is likely what enables the "value premium" to persist over the long term. And the short-term performance-chasing tendencies of most investors pushes the pendulum still further.

So both of these cycles have been headwinds to investors like us who are valuation-driven and look at things on a longer-term "normalized" basis (i.e., based on reasonable estimates of earnings and valuations through an entire cycle as opposed to overweighting a single point in time that may reflect unsustainably high or low earnings). As such, we have been underweight (expensive) U.S. stocks and have found (cheaper) foreign stock markets more attractive in terms of their expected returns relative to risk. In addition, many, though not all, of our active fund managers have a long-term value approach as well and have lagged the broad market benchmarks at least in part due to the factors highlighted above.

Consequently, the reversal in the markets starting in February *may* mark a change from a cyclical headwind to a tailwind for our tactical positioning, as well as for many of our active equity managers. From the February 11 low, the MSCI ACWI ex USA Index is up 13.2% beating the S&P 500 by 21 basis points. Emerging-markets stocks have rebounded 17.7% (and are up 21.9% from their January low). The MSCI ACWI ex USA Value Index has jumped 14.5%, beating the MSCI ACWI ex USA Growth Index by more than two-and-a-half percentage points. European and emerging-markets stock indexes also have larger exposure to cyclical and traditional value sectors (such as financials, materials, and industrials) than the S&P 500. (Compounding both of these effects, our deep value, actively managed emerging-markets fund is up a whopping 30% from its January low, after suffering a huge drawdown over the previous year and half.) Our flexible and absolute-return-oriented fixed-income positions have also performed nicely since the market lows, gaining anywhere from 2% to 7%, while the core bond index returned less than 1%.

Will Recent Market Trends Sustain?

We have started to see references by several market strategists and investors to the potential for a so-called reflation cycle to kick in. James Paulsen, chief investment strategist at Wells Capital Management, recently laid out a scenario in which the recent market reversals may be the beginning of some new cyclical trends.

In a nutshell, Paulsen argues that if oil prices have bottomed and the current rebound to around $40 per bbl (or higher) is sustained, it may have significant repercussions on a wide range of financial markets. Because the U.S. dollar has been inversely correlated with oil prices for the past 15 years, higher oil prices imply a weaker dollar (or at least minimal further appreciation). This would represent a major change from the strong-dollar trend of the past two years.

In addition, Paulsen hypothesizes that with the U.S. economy near full employment, wages and inflation are likely to continue to rise (barring a recession), thereby pressuring corporate profit margins, earnings growth, and U.S. stock valuations. (We've been highlighting this risk to U.S. earnings growth expectations for a while now too.) This should also lead to higher inflation expectations and higher U.S.

interest rates. Rising rates would not be good news for core bond prices, but would likely be positive for our non-core fixed-income funds.

This reflation scenario also suggests many of the most popular investment themes of the post-financial-crisis U.S. bull market—such as defensive and growth stocks outperforming cyclical value stocks, and U.S. stocks beating foreign stocks—could be reversed during the balance of this recovery.

To be clear, this isn't a prediction of what will happen over the near term, but we think it is one plausible scenario among many that could play out. And while we use a short-term (12-month) time frame to run "reasonable worst case" stress-test scenarios as we manage our portfolios against various downside risks, it is nice to sometimes look at a "reasonable best case" and acknowledge the shorter-term "upside risks" to our portfolios as well.

Concluding Comments

Markets are cyclical, and for the past several years our portfolios have been facing some meaningful cyclical performance headwinds given our tactical asset class positioning and, more broadly, our long-term, active, valuation-driven investment approach. As discussed above, the sharp reversal in the markets beginning in the middle of the first quarter may indicate the market pendulum is starting to swing in our favor.

Even if the recent positive market trends turn out to be short term or reverse course, we remain confident that our disciplined investment process and risk-management process, consistently executed over time, will pay off over the completion of this *full* cycle, and through future cycles as well.

It is impossible to consistently time short-term market moves, trends, and reversals. As always, patience, discipline, and fortitude remain key to achieving one's long-term investment goals, and to avoid getting swept away by the pendulum's unceasing swings.

Wiggin Financial Services (4/1/16)