Investment Manager Meetings Recap

Strategic Income Group Current Views (Q1 2016)						
		Bearish	Slightly Bearish	Neutral	Slightly Bullish	Bullish
Capital Market Outlook					X	
		Underweight	Slightly Underweight	Neutral	Slightly Overweight	Overweight
Equities	U.S. Large Cap				X	
	U.S. Mid Cap			X		
	U.S. Small Cap			X		
	International				X	
	Emerging Markets	X				
Fixed Income	U.S. Government			X		
	U.S. Investment Grade Corporate			X		
	U.S. High Yield				X	
	International			X		
Alternatives					X	
Cash				X		
Please Note: These are 12-18 month views from the published date of the applicable commentary.						

2016 brings with it another leap year and another presidential election cycle. Sometimes I wonder if they chose a leap year so they would have an extra day to campaign and make the news. This election cycle has brought with it a dramatic increase in interest, news stories, and media hype. We have candidates on both sides that actually have something in common: they are all telling us what is wrong with our country, economy, and foreign policy . . . not what is right.

This, of course, is music to the news media’s ears as they know that fear sells more advertising and gets more eyes glued to the news than greed. The news media plays along and tells us all about China, oil, and the rise in the dollar. This creates uncertainty which then creates volatility, which then creates uncertainty followed by more volatility. It seems to be an endless cycle. In fact, we have been violently flat in the markets over the last 24 months.

The questions that most investors are asking us or themselves include:

- “Is this another 2008?”
- “Should we be preparing for another global recession?”
- “Should we be concerned with all of the negative news we are seeing?”

Those are great and very tough questions. I don’t know how anyone can avoid the negative whirlwind of news, especially this election year. Our investment committee just

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finished our first quarter investment manager meetings with some interesting findings. Let’s first discuss the “news du jour.”

China

China is continuing a long transition from an emerging economy to a developed economy. This is expected to continue for the next 5-10 years. Here are some interesting facts you might not hear in the media about China:

- Less than 1% of the U.S. gross domestic product (GDP) is made up of exports to China.
- China added more to the world GDP last year growing at 6.9% than they did in 2005 when they were growing at almost 12%.
- Consumer-driven economies are more stable than government-driven economies. China will be more stable at 4-6% than they were at 10%+.

In short, we do not believe China will be a huge hindrance of global growth. They are still considered an emerging market economy and we believe that the emerging market equities could still struggle for the next several years during this transition period. We got out of our pure emerging market equities exposure in 2015.

Oil

Oil hit $146.73 in July of 2008. For years when oil was trading above $100 per barrel many would argue how that was economically unstable and was bad for the economy. Now we have an oversupply of oil and it hit $27.53 in January. Of course, many of the media argue how low oil is bad for the economy and is unstable. Which is it? The reality is that low oil is good for the consumer and since the consumer makes up 60% of our economy it is good for the economy as well. The market, however, does not like uncertainty and the huge drop in oil provided a lot of uncertainty. We are now seeing a bottoming process around $30 in oil.

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Here are some interesting tidbits you might not hear on the news about oil. Every penny that gas is cheaper at the pump adds $1.1 billion back to the consumer on an annual basis. The free cash that has been generated to consumers from lower oil has now totaled $170 billion and counting. To compare this amount, the 2008 government stimulus package was only $118 billion. We believe the U.S. consumer is strong and increasing in strength.

The Dollar

Oh, the forgotten dollar. While it has gotten some news, the media has just not done it justice. The dollar is the real culprit.

Performance (%)	YTD	1 Year	3 Years
U.S. / Euro	2.8	11.4	21.4
U.S. / Japan	0.4	0.4	38.8
U.S. / China	1.9	4.4	4.0

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The strength in the dollar since 2014 has been the largest detractor of returns to the market more so than oil and China. Since 2014 the dollar’s 25% rise is the 3rd largest advance in history. The dollar is currently about 20% above its long-term average.

We are now starting to see stabilization in the dollar which should also create more stabilization in U.S. corporate earnings.

Interesting Facts

- In 2015 the S&P 500 was up 1.3% (including dividends) and if you take out just four stocks referred to as "the FANG" (Facebook, Amazon, Netflix, and Google) the total return would have been (4.8%).
- Free cash that has been generated to consumers from low oil is $170 billion (and counting). The 2008 government stimulus package was $118 billion.
- Every penny that gas is cheaper at the pump is $1.1 billion back to the consumer on an annual basis.
- Many in the investment world consider Warren Buffet to be the world’s greatest investor. However, they usually fail to mention that during his downturns he can lose as much if not more than the average investor . . . he just is better at removing the emotions of investing. Last year (2015) he was down 11% underperforming the market by over 12%.
- U.S. employers hired a net +151,000 new workers (new hires less voluntary and involuntary terminations) in January 2016, the 64th consecutive month of gains in the number of workers. The last month when "terminations" exceeded "hires" was September 2010 (source: Department of Labor).
- How many holdings are in the S&P 500? Answer: 506.

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Majority Investment Manager Consensus Points

- We are closer to a recession; however, many still are looking at 2017-18 and beyond giving a probability of 25% or less for 2016.
- Most managers believe we are moving from mid-cycle to late-cycle of a bull market. They pointed out that this cycle could still last three to five years.
- There was a general consensus of 2.0-2.5% GDP for 2016.
- Now that the European Central Bank (ECB) has added additional clarity to their quantitative easing (QE) at $60 billion per month with the stabilization of the dollar, most managers are favoring International equities over domestic equities.
- High quality larger-cap companies that increase their dividends over time are the preferred area in late-cycle bull markets. They tend to outperform with lower volatility.
- Most of the managers are still expecting domestic equities to generate mid-single digit returns. For international equities, high-single digit returns are expected with continued volatility and swings of 10%+.
- The selloff in high yield is creating an attractive opportunity over the next few years.

Final Thoughts

This is the first quarter that we have broken down our investment committee’s views for the overall capital market as well as different areas of investment (see chart on front page). We hope that you will find this of value to see quickly where we stand. As you can see, we are slightly bullish from this point over the next 12-18 months. It is important to realize that we are expecting mid-single digits for returns in the coming years. We are in a short-term period of a market correction which also leads to the potential of higher than normal returns.

To help understand this better, consider that from 2010-2015 the S&P 500 dividend rate was 2.1%. Earnings per share was 4.8% totaling 6.9%. Fundamentally, the return of the S&P 500 should have been 6.9% annualized during these years. Due to the injection of money into the economy from the U.S. Federal Reserve, which acted like a steroid, the return of the S&P 500 was actually 14.4% causing an expansion in the multiples. It pushed U.S. stocks from being undervalued at the time to slightly overvalued at the beginning of 2016. Since the beginning of this year we have had a selloff pushing equities back to where they are undervalued.

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If we look at the fundamentals right now this is not another 2008. The fundamentals of the economy are suggesting that equities should generate mid-single digit returns. The fundamentals are fine, the companies and consumer are strong, and the million dollar question is will the fundamentals win out this year or the uncertainty which leads to volatility which leads to more uncertainty?

Our belief is that you can never predict the short-term moves of the market. They can become extremely irrational over short time periods. However, if you give them time, the markets will always move back and follow the longer-term fundamentals. This will cause times where investments are cheap and times when they are expensive. There has never been a rolling five-year period from 1950-2015 that a balanced portfolio (50% equity/50% fixed income) lost money (Barclays Capital).

We remain confident that our fundamental and consistent approach to investing at Strategic Income Group works over time for our clients.

While times of volatility leads to uncertainty for most investors, we feel it is important for our investors to remain vigilant in their financial plan.

What Are Investment Manager Meetings?

At Strategic Income Group, we believe in reviewing detailed investment research. Every 90 days we set aside a week during which around 7 to 10 investment managers give us recommendations on our current portfolios as well as share their firms' current views on the market and economy. This recap is our commentary on the most recent meetings.

Questions?

If you have any questions whatsoever regarding our investment manager meetings or any of the notes, give us a phone call or stop by our office:

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