



The Benedict-McLoughlin Report 2015 Mid-Year Update

By Christopher Benedict, CFA

- Global financial markets are mixed so far this year as policy begins to diverge regionally
- The U.S. Federal Reserve remains in focus as they appear to be ready to begin raising short-term interest rates, albeit in a deliberate fashion
- Greece and China are causing a mid-year correction in risk assets, however, economic and earnings growth should bring global markets higher by year-end

THE BENEDICT-MCLOUGHLIN GROUP

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Global financial markets are mixed through mid-year as relative liquidity shifts around the globe. Developed markets with Quantitative Easing (QE) programs still on full throttle like Japan and Europe are up while the U.S. (as measured by the S&P 500), where QE has already peaked, is basically flat for the year. Emerging market equities were also mixed with the emerging market index up very modestly while local shares in China, for example, have advanced sharply (although they are in the midst of a significant correction). Importantly, now six years removed from the Financial Crisis of 2008/2009, it is once again a “stock picker’s market” with individual stocks and sectors reacting according to specific fundamentals (i.e. correlations have decreased) as opposed to the “risk-on/risk-off” environment that dominated in the years just following the Crisis. Of course, we may see a bit of an echo of that “risk-on/risk-off” mentality as we move through the next phase of the Greek saga but, I would not expect the higher correlations to last that long.

On the fixed income side, interest rates have been rising as investor focus has turned from “if” to “how soon” the U.S. Federal Reserve will begin raising the federal funds rate. The yield on the 10-Year U.S. Treasury Note, for example, has gone from a low of 1.64% on 1/30/15 to 2.38% as of 7/2/15. Similar moves have occurred in Japan and Europe, despite their QE programs being in full

force. An improving economic picture in the U.S. has driven sentiment as the economy continues to create jobs, albeit at a below average pace for this stage of the cycle. Importantly, while the unemployment rate has recently dropped to 5.3%, it has done so with the help of people leaving the workforce as opposed to strong job growth.¹ So, while investors are fairly certain that the Fed will begin increasing interest rates this year, it may be the pace of any future hiking cycle that will drive overall interest rates. Certain factors do make a case that the pace could be very slow such as low inflation, geopolitical unrest as well as the fear that the dollar becomes too strong, which would weaken U.S. exports.

Overall, the world remains in a unique period in regards to extremely expansionary monetary policy. The ultimate outcome is not exactly clear but, in my opinion, it will be a multi-year and likely choppy exit from these policies for global economies and financial markets. For investors, I believe this will translate into below-average medium-term investment returns across asset classes (i.e., over the next 5 – 10 years) although, perhaps ironically, investment returns may still do OK over the next couple of years as central bankers are expected to keep the spigots relatively open for the foreseeable future. In other words, we may be pulling some of those medium-term returns forward.

Time to Pay the Piper?

After several years of bailouts, it appears that the Greek drama has finally turned into a tragedy. The July 5th Referendum resulted in a “No” vote which is somewhat surprising in that the Greek people have indicated support for remaining in the European Union (EU) and common currency (Euro). On the other hand, it is not that surprising as the Greeks did elect their current Prime Minister in January on an anti-austerity platform. In my opinion, the “No” vs. a “Yes” vote is not the real issue for Greece...the real issue is that they have accumulated more debt than their economic growth prospects could ever pay back. Furthermore, membership in the European Union/common currency calls for a harmonization of policies (and, really, attitudes) among member countries. So, if Greece were to stay with the common currency then one would think that both sides would need to bend...the Greeks would need to implement much needed internal reforms while the EU would have to consider giving Greece debt relief. If no common ground can be found then, the other two scenarios (of equal probability at this point, in my opinion) are continuing to “kick the can” down the road or just ripping the band aid off (i.e., Greece defaults on its debt and goes back to using the Drachma). We should have an idea on which path will be taken before month’s end.

The stark reality is that Greece is a symptom of a larger problem...the world is now more indebted than even before the Financial Crisis as low interest rates and over-extended budgets have, arguably, led to too much leverage. Closer to home, Puerto Rico is another economy that has issued more debt than their economy could ever re-pay. With a population of only 3.6 million (and declining), they are the third largest issuer of municipal bonds (\$73 billion) behind only California and New York, states with populations of approximately 40 and 20 million, respectively.² The U.S. Congress is just beginning to think about how they will deal with what will most likely be some sort of debt re-structuring. This over-promising was what led to the city of Detroit’s bankruptcy and the same issue lingers for some other municipalities in the U.S. as well as other countries in Europe (i.e., Italy, Portugal and Spain).

However, the “elephant in the room” remains Japan with its total debt load of over \$10 trillion which translates to 230% of its Gross Domestic Product (GDP).³ The equivalent ratio for Greece is 175% and, while the size and diversity of the two economies are not comparable, they do have another similarity besides their oversized debt loads...a decreasing population. In my opinion, Japan’s debt load is too large and it is only a matter of time before investors focus on it. Their current QE program is a decent start as it helps weaken their currency which spurs on inflation and economic activity, both of which help indebted countries. Japan is an export economy and the recent weakness in the Yen has markedly improved their global competitiveness as their good and services become relatively cheaper on the global market. I expect the Yen to continue to weaken over time but, too much weakness may hurt the export business of its Asian neighbors, China included. Of course, this dynamic bears watching in the quarters and years ahead.

Too much debt is obviously a negative influence once the optimal level is exceeded because the issue of the servicing and re-payment can cause a crisis, as we saw during 2008/2009 and now with Greece. But, there is also another issue; ever-increasing levels of debt essentially pulls economic growth forward from future years and the implications for global growth going forward are significant. To be sure, borrowing can be beneficial and, indeed, optimal for an entity if those proceeds are used for productivity enhancing investments such as infrastructure, etc. However, chronic increases in debt that simply cover ongoing operational budget issues and/or potentially over-promised pension obligations tend to be the increases that become problematic. These are the ones we have seen in Greece and in Puerto Rico...and there are others out there as well.

Risks to the economy: A renewed credit crisis spurred by sovereign debt concerns (beyond Greece) in Europe (or the U.S. or Japan) may reduce global economic activity and investor confidence; Large, chronic budget deficits (including unfunded entitlement program liabilities) may eventually cause higher interest rates. A sharp appreciation of the U.S. dollar would likely put pressure on export-focused businesses including

manufacturing which could hurt job growth in the U.S.; Terrorism.

The Stock Market

Despite the short-term correction, the path of least resistance is still likely to the upside for global equities, particularly in markets where QE remains in full force. Developed markets outside of the U.S. like European and Japan have been relative laggards on both the economic growth and stock market performance fronts since the Great Recession...and the relative valuation gap has widened (see graph on p.6). As discussed above, the Greek issue has clearly been a market issue, however, it is not much of an economic issue as it makes up approximately 2% of EU GDP. Furthermore, EU officials have spent years “ring-fencing” the European banking system for any potential Greek exit from the Euro. The European Central Bank (ECB) is about where the Fed was around 3 years ago, policy-wise (i.e., very accommodative). Economic growth is picking up and earnings are following. The same can generally be said about Japan. I expect this trend to continue for several quarters, thus providing a confluence of positive earnings catalysts with a still discounted valuation opportunity...this tends to be a pretty good combination for positive investment returns. On the emerging market (EM) front, the picture is not as clear. The discounted valuation opportunity is there, however, the economic and earnings momentum has not arrived yet, so, a little more patience may be required. The correction in China is not helping...interesting fact of the month: Mainland China’s 90 million stock traders now exceed its 87.8 million Communist Party members.⁴ The communists may take the lead again before this is over. Nevertheless, I suggest selectively adding to EM, particularly in the consumer focused sectors.

Despite, the overall valuation premium, there still are a number of attractive areas in the U.S. The housing industry continues to drive the U.S. recovery as evidenced by the ongoing climb in housing starts (see graph on p.6). This continued increase has helped homebuilders as the many of years of under-investing in housing needs to be remedied...and I believe this will last a couple more years. Also, financial institutions trading at below-book valuations also look attractive as

investors still treat them like tarnished goods from the Financial Crisis. Their balance sheets are much improved and they only need things to go modestly right in order to outperform. Finally, consumer discretionary sector should continue to benefit from both an improving job market as well as declining energy costs. Consumer spending looks to be moving in a positive direction for the foreseeable future.

Risks: Geopolitical events may cause highly volatile stock prices; A significant up-tick in inflation which could result from too much economic stimulus would likely compress valuations; Conversely, the U.S. Federal Reserve may feel obligated to raise interest rates sooner than otherwise would be expected to quell inflation which may hurt the economic recovery. The pendulum of government regulation in the U.S. may swing too far the other way (i.e., potentially too restrictive) which could dampen free enterprise and economic growth. Terrorism.

The Bond Market

Developed market interest rates have risen from historical lows so far in 2015 but, remain low overall. And, while global rates may have already seen their cycle lows last year, they may not increase rapidly from here. Inflation is the biggest enemy of fixed income investors but, it remains fairly tame due to two important factors: Little wage growth and falling commodities prices, particularly energy. While the labor market has improved a great deal since the Great Recession, wage growth has been subdued due in part to the “shadow” labor supply alluded to above. The price of oil has collapsed due mostly to supply issues which appear to have some staying power although, eventually, this cyclical industry will come back into balance but, it may not be until next year. The rising U.S. dollar is also helping keep inflation low.

Despite the potential that medium and long-term rates stay lower for longer, we remain underweight longer maturities as well as high grade bonds in general...there is simply not enough return for the interest rate risk. We remain overweight shorter-term high yield bonds as well as “non-vanilla” income producing assets such as infrastructure-focused Master Limited Partnerships

(MLPs), direct lending entities, international bonds and select dividend paying equities. We are also particularly interested in closed-end bond mutual funds that are trading at large discounts to net asset value (NAV). In some cases, investors are able to buy a portfolio that is professionally managed at \$0.85 - \$.90 on the dollar, which provides a nice margin of safety, in my opinion. Overall, we feel more comfortable taking credit risk than interest rate risk in a global economy that continues to make forward progress.

Risks: The Federal Reserve may be either too conservative or too aggressive as it manages monetary policy, which may cause interest rate volatility; Rising budget deficits and/or entitlement obligations may cause a rise in bond supply, which may cause a drop in bond prices (higher yields).

Tactical Allocation Strategy for My Model Portfolios (as of 6/30/15)

Equities	Equal	Fixed Income	-1	Alternative Investments	+1
U.S.	-1	Treasuries	-2		
Int'l/Em. Mkts	+1	Inv. Grade Corporate	+1		
Growth	Equal	High Yield	+1		
Value	Equal	REITS	-2		
Large Cap	+2	Floating Rates	+2		
Small/Mid Cap	-2				

Legend	
+2	20% Overweight
+1	10% Overweight
Equal	Equal Weight
-1	10% Underweight
-2	20% Underweight

Overweights: Absolute/Total Return Strategies, Large Cap Multinational Equities (U.S. and Europe), Consumer focused China/Emerging Market Equities, Sustainably High Dividend Yield Equities, Corporate/High-Yield Fixed Income, Floating Rate Loans/Bonds.

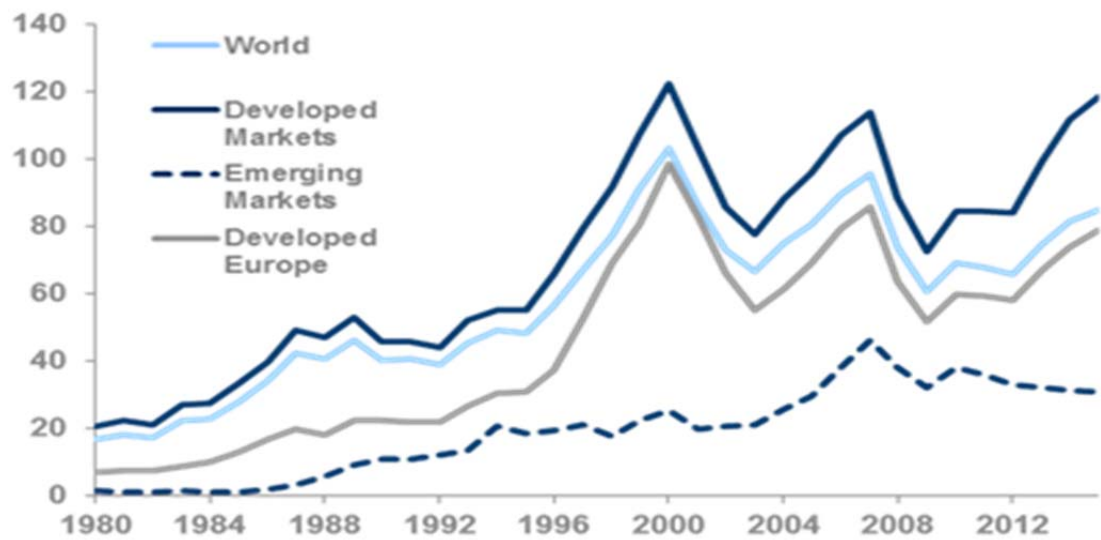
Changes from the 2015 Investment Outlook: None

Underweights: Long-term Fixed Income, U.S. Treasury Securities, Small Cap Equities, Developed Market Consumer Equities, REITs.

Changes from the 2015 Investment Outlook: None

GRAPHS OF INTEREST

Market Cap to GDP (2015)



Source: Morgan Stanley, Equities – Market Observations 4/23/15

U.S. Housing Starts in 000's (1960 - 2015)



Source: Bloomberg

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1. Unemployment Rate Decline Could Have Yellen's Fed Scrapping Projections, Bloomberg News, 7/2/15.
 2. Despair and Anger as Puerto Ricans Cope With Debt Crisis, The New York Times, 7/3/15.
 3. www.tradingeconomics.com and www.nationaldebtclocks.org, 7/8/15.
 4. China's Stock Market Boom Has World Bank Worried, Bloomberg News, 7/3/15.

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S&P 500 Index is an unmanaged, market value-weighted index of 500 stocks generally representative of the broad stock market. An investment cannot be made directly in a market index.

International investing may not be suitable for every investor and is subject to additional risks, including currency fluctuations, political factors, withholding, lack of liquidity, the absence of adequate financial information, and exchange control restrictions impacting foreign issuers. These risks may be magnified in emerging markets.

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