



## The Benedict-McLoughlin Report 2016 Mid-Year Update

By Christopher Benedict, CFA

- Global risk assets have regained their footing as commodity prices appear to have bottomed
- Regardless of the outcome of the U.S. elections, there appears to be agreement on both sides of the aisle that fiscal stimulus would be beneficial
- Despite pockets of anti-globalization rhetoric and actions, increasing global free trade is beneficial on the whole in regards to both economic growth and political stability

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Global markets remain impressively resilient through mid-year, getting past the collapse in energy prices as well as the surprise vote by the U.K. to leave the European Union (Brexit), among other things. Investors went from pricing in the next recession in February to buying at record highs in August (at least in the U.S.). In fact, as of mid-August, global equities have rallied approximately 19% from the February low and are now modestly positive year-to-date.<sup>1</sup> The magnitude of this rise combined with some upcoming potential volatility-inducing events suggests some short-term caution may be warranted. I do not believe this is the end of the bull-run but, I would not be surprised to see a correction before year-end or, at the very least, a “pause that refreshes”.

On the interest rate front, central banks around the world continue to do their best to suppress interest rates in an effort to support economic growth and financial markets...and, just when you think that they may have run out of bullets, the Bank of England recently lowered interest rates in an attempt to counter any fallout from the surprise Brexit vote. This aggressive monetary policy is working although there is some debate as to both the degree of

the overall effectiveness as well as the marginal benefit of even more aggressive measures (such as negative interest rates). Some economists are now recommending that fiscal stimulus should be increased to augment the monetary stimulus. This argument has merit if the money is invested wisely into projects that provide a solid return on investment and increase productivity. I imagine there are a number of such projects available, particularly those that upgrade our transportation infrastructure...and funding these investments via government debt has never been cheaper.

Looking forward, the job market continues to improve and is signaling that not only is a recession not imminent but, it likely is not even on the horizon just yet. Some economists argue that the length of this recovery already makes us due for the next economic slowdown but, a similar argument can be made that this recovery should last longer simply because the average annual growth has been relatively slow. This “lower but, longer” recovery view looks promising if we do in fact get the aforementioned fiscal stimulus...any up-tick from other parts of the world would also help.

## Brexit, Schmexit?

The surprise vote by the U.K. to leave the European Union (E.U.) stunned financial markets in late June but, only temporarily. The bear argument includes the risk that the exit of the U.K. is the first domino to fall and that other countries will follow suit, eventually leading to the breakup of the E.U. The more “constructive” view is that this event is really just a negative for the U.K. economy...an economy that has become and will continue to be a smaller portion of the global economy. Furthermore, Brexit is not really an “event” but, a process that will play out over multiple years...so, while the results were sudden, even the quickest path of execution is a relatively gradual one. Nevertheless, there really are not any positive economic benefits that will result from Brexit and, in fact, it is this author’s opinion that they should do what they can to reverse the decision or dilute it as much as possible, although, the probability of any reversal may be slim.

So, yes, the U.K. did effectively shoot itself in the foot by voting to leave the E.U., in my opinion. The world is getting “smaller” and more integrated on many levels. Even if the world’s largest economy, the U.S., decided to pull out of trade blocs and agreements, it would be a significant negative for the U.S. as well as the rest of the world, given how important the U.S. is. The U.K. is around 1/7 the size of the U.S. economy, so, the effect on the rest of the world will be minor, however, the negative effects for the U.K. will be real.<sup>2</sup> As part of the E.U., the U.K. has enjoyed numerous trade and commerce benefits as a direct result of trade agreements executed for the E.U. as a whole. Given that the E.U. is the second largest economy in the world when taken as a whole, it carries a strong negotiating position when dealing with other countries as compared to a single country such as the U.K. Furthermore, the U.K. will likely have to renegotiate a substantial amount of new bilateral agreements with other countries around the world as well as with the E.U. So, just the inefficiency of this is likely going to be an economic drag for the U.K. And, I would expect most of the new agreements to be slightly less favorable for the U.K.

Of course, the benefits of free trade go beyond just the efficiency benefits of executing trade agreements and

both theory and empirical evidence bears this out. The theory of comparative advantage describes how countries are better off producing (and exporting) those products or services that they can produce at a lower marginal cost. In a very simplistic example, if Country A has relatively large amounts of arid land and Country B has a relatively large skilled work force, then Country A should focus on growing wheat, for example, and Country B should focus on producing, say, cars. These countries would then trade and benefit from lower cost goods. Multiply that by numerous countries and a multitude of goods and services and the benefits increase. Of course, Country B could tax imports of wheat which might benefit a few wheat growers in Country B but, hurt the overall well-being of both countries’ population. Now, Brexit does not mean the U.K. is retreating from free trade but, I doubt the overall amount of taxes/tariffs decreases as they renegotiate countless numbers of agreements. Good luck with that.

**Risks to the economy:** A renewed credit crisis spurred by sovereign debt concerns 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

Global equities continue to be paced by the U.S. with the S&P 500 recently moving into record territory. The U.S. market is by far the best developed equity market so far in 2016 with both Europe and Japan actually in negative territory through mid-August (Japan is up slightly in U.S. \$ terms).<sup>3</sup> Emerging market (EM) equities have begun to show some positive signs...this should be monitored as the relative valuation for EM is attractive but, there have been some “false starts” in recent years. Overall, while I am constructive over the next 6 - 12 months, we may be due for some corrective action in the short-term as the Fed may continue to raise rates in either September or December and we also have important U.S. elections in November that may cause some volatility.

Although the S&P 500 is not cheap (as of 8/19/16, it trades at a price to earnings (P/E) ratio of 16.5 times the consensus earnings for 2017), there are still a number of areas that look attractive.<sup>4</sup> Maybe the most compelling stocks are the large multi-national financial institutions that trade at cheap valuations and, in some cases, below book value (see graph on p.6). And, if interest rates do move up a bit as the labor market tightens, then earnings should improve in the financial sector...potentially providing the needed catalyst for outperformance. Additionally, given the continued improvement in the jobs outlook, certain areas in the consumer discretionary sector should benefit. Airlines, automobiles and homebuilders offer compelling opportunities, in my opinion. Airlines and automobiles are classic consumer cyclical with histories of boom and bust, so, investors rarely reward these industries with high P/E multiples. This is playing out currently with most companies in both industries trading at mid-to-high single digit multiples. So, therein lies the potential opportunity. Investors appear to be pricing in the next down-cycle but, the cash flow return dynamic for many of these companies is very strong and there is a case to be made that certain of these companies are being managed in such a way that may enable them to achieve higher than usual profitability during the next trough. In the meantime, investors are being rewarded with cash returns via dividends and stock buybacks and have a potential kicker that this expansion lasts a bit longer than currently expected. Homebuilders are also attractively valued at below market-multiple P/E ratios. Structurally, the U.S. is still building too few homes to satisfy the pace of household formation and interest rates will likely remain relatively subdued for a while, albeit potentially a bit higher from current levels. Finally, a wild card might be an increase in infrastructure spending. This would likely benefit a number of construction, engineering and materials companies.

There are a number of international opportunities as well. Japanese equities offer an attractive tactical entry point as I expect the Yen to depreciate vs. the U.S. dollar which should help their export-focused economy. Of course, to maximize returns in this scenario, U.S. dollar investors should gain equity exposure but, hedge out the currency exposure. European equities are generally cheaper than the U.S. and offer higher dividend yields. Overall, I estimate that Europe is around two years behind in

regards to their monetary policy and economic recovery. Of course, Brexit reminds us that risks do remain in regards to the strength of the E.U. and any further breakdown of the Union would be a negative...investors will certainly be monitoring how Brexit unfolds.

Potentially, the area with the most promise in the medium and long-term is emerging markets. If equity performance is a function of profit growth which, in turn, is a function of economic growth, then EM equities would be expected to do relatively well over the medium and long-term. Disposable income and personal consumption is rising in many emerging markets. There is an interesting dynamic of rising income as well as consumption making up a relatively small portion of total EM economies vis a vis developed economies. China is a particularly compelling example. Consumption only comprises approximately 40% of China's economy as compared to around 70% in the U.S. (See graph on p.6). Even if China only closes the gap halfway, the money flows are extremely large and should benefit the companies and investors that focus on this trend.

**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 faster 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

Value in global bond markets is as scarce as ever. Sovereign debt around the world continues to trade at historically low yields and even negative in certain cases. Investment grade corporate and municipal bonds are really no better. High yield bonds started off 2016 with attractive yields, largely due to the collapse in energy prices. Energy related bonds were hit very hard and this effectively took the whole high yield market down with it in a "baby with the bathwater" type of way...fast forward to August and that process has almost fully reversed, even the energy bonds.

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Overall, we continue to maintain a relatively shorter duration fixed income allocation as the path of least resistance for interest rates is likely higher over the foreseeable future. It appears that the Federal Reserve is ready to move away from what has been effectively “emergency” monetary policy and will likely methodically raise short-term rates over the next year or so. And, if we

do actually see some of the aforementioned increase in fiscal policy, we would then see an increase in bond issuance (i.e., supply goes up) to finance it. All else equal, higher supply will translate into lower bonds prices (higher yields). It is time to be a little more picky in the income portion of the portfolio.

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## Tactical Allocation Strategy for My Model Portfolios (as of 6/30/16)

Equities	Equal	Fixed Income	-1	Alternative Investments	+1
U.S.	-1	Treasuries	-2		
Int'l/EM	+1	Inv. Grade Corporate	+1		
Growth	Equal	High Yield	+1		
Value	Equal	REITS	-2		
Large Cap	+2	Floating Rate	+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, Short-term Corporate/High-Yield Fixed Income, Floating Rate Loans/Bonds.

*Changes from the 2016 Investment Outlook:* None

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

*Changes from the 2016 Investment Outlook:* None

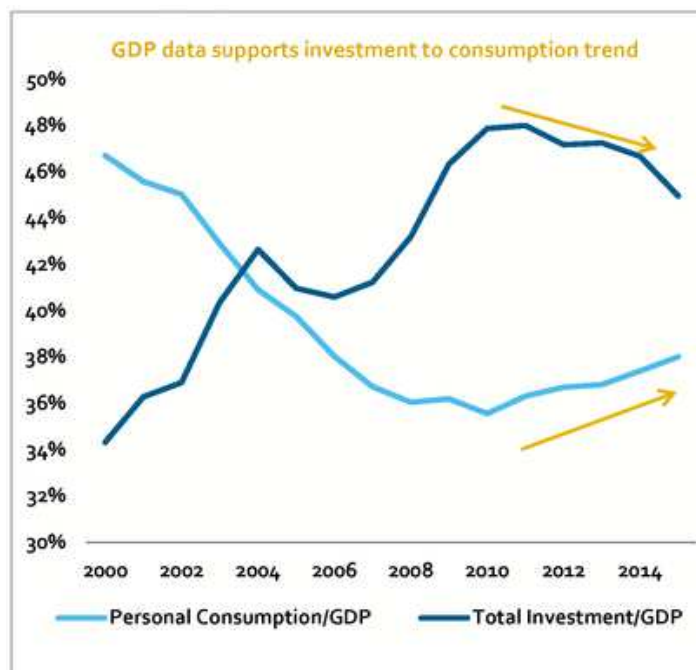
## GRAPHS OF INTEREST

### Banks Are Trading At Historically Low Valuations (as of 3/31/16)



Source: Morgan Stanley, Chart Book – August 2016

### China Personal Consumption and Investment as a % of GDP (12/31/15)



Source: Morgan Stanley, Chart Book – August 2016

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1. Bloomberg Markets, 8/17/16.
  2. International Monetary Fund, [www.imf.org](http://www.imf.org), 8/30/16.
  3. Bloomberg Markets, 8/17/16.
  4. Barron's, "Beware the Bear", 9/5/16.

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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.

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Date of first use: 9/15/16