Strategy Quarterly

Fourth Quarter 2015

Executive Summary

❑ The S&P 500 Index declined over 6% in the third quarter of 2015, as investors focused on continued uncertainty over Federal Reserve policy, slowing global growth, ongoing weakness in commodities and extended market valuations.

❑ Despite higher volatility and a significant market drawdown, we believe that this is not the beginning of a bear market, as the current economic and corporate earnings backdrops are supportive of a stabilization of the equity market. In addition, the shape of the yield curve does not suggest a recession is imminent.

❑ Historically, bear markets have been associated with economic recessions caused almost always by a progressive increase in rates implemented by the Fed in an attempt to contain rising inflation driven by the ebullient phase of the business cycle. However, today's backdrop - characterized by tepid economic growth and subdued inflation – does not necessitate a restrictive monetary policy yet, in our view.

❑ Extremely low interest rates provide liquidity and low-cost financing to businesses, stimulate economic growth, and support asset prices and valuation. However, "zero" interest rates deprive the Fed of the most important tool of monetary policy should the economy require further stimulation. The inability to intervene in case of an economic contraction may relegate the Fed to being merely a "spectator" on the sidelines.

❑ From a bottom-up standpoint, a maturing earnings cycle, historically high profit margins, and wage pressures from employment gains, may restrain corporate earnings growth and limit further stock price gains in the absence of robust top-line growth.

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Market Volatility

Over the last seven years equity investors have been handsomely rewarded. Despite numerous potential and disparate risks (i.e., European currency crisis, U.S. government shutdown, U.S. possibility of default, flash crash, Fed tapering, end of QE, etc.), equity markets have advanced by over 200% since the 2009 bottom in the aftermath of the financial crisis. And although along the way the market has paused a few times and even fallen for short periods, its advance has been quite steady and one of the longest in history.

More recently, stock market volatility has begun to increase after several years of calm. Geopolitical conflicts, global economic weakness, plunge of commodities prices, and the age of this business cycle are but a few reasons investors are nervous today.

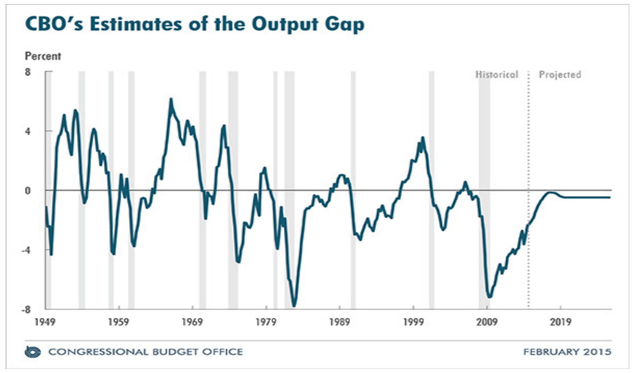
The recent market drop has unnerved investors and prompted them to question the sustainability of current valuations and equity prices. Some people are increasingly asking the question: Is this the beginning of a bear market?

Volatility and corrections of this magnitude are not uncommon within a bull market – particularly after a prolonged and significant price appreciation period like the one we have experienced since the bottom of 2009. When you look back historically over several decades, you will see that bear markets have been most of the time associated with economic recessions. In fact, during bear markets the average maximum drawdown was around 40%. Importantly, such recessions were almost invariably the result of a progressive increase in rates implemented by the Fed in order to contain rising inflation driven by the ebullient phase of the business cycle.

Thus the relevant question is: Are current market and economic conditions conducive to an economic recession and therefore a bear market?

An analysis of the business cycle is enlightening. Although we have been in a positive growth trend for over 6 years, the economic damage inflicted by the 2008 financial crisis and the subsequent deleveraging have made the recovery one of the most sluggish ever when compared to other recoveries over the last century. In fact, even as of today some economists continue to estimate a negative output gap! (Output gap = the difference between actual and potential GDP growth.) This means that, when compared to past cycles, the current cycle has yet to really enter the late stage of the expansion phase. This stage is characterized by robust economic growth, *positive* output gap, low unemployment and rising inflation. This is also the phase where the monetary authorities start to intervene in an attempt to control economic overheating and potential rampant inflation. Historically, the Fed has enacted a number of rate increases which have led to a slowdown in economic activities and eventually planted the seeds for the next recession.

Chart 1. U.S. Output Gap



Source: CBO

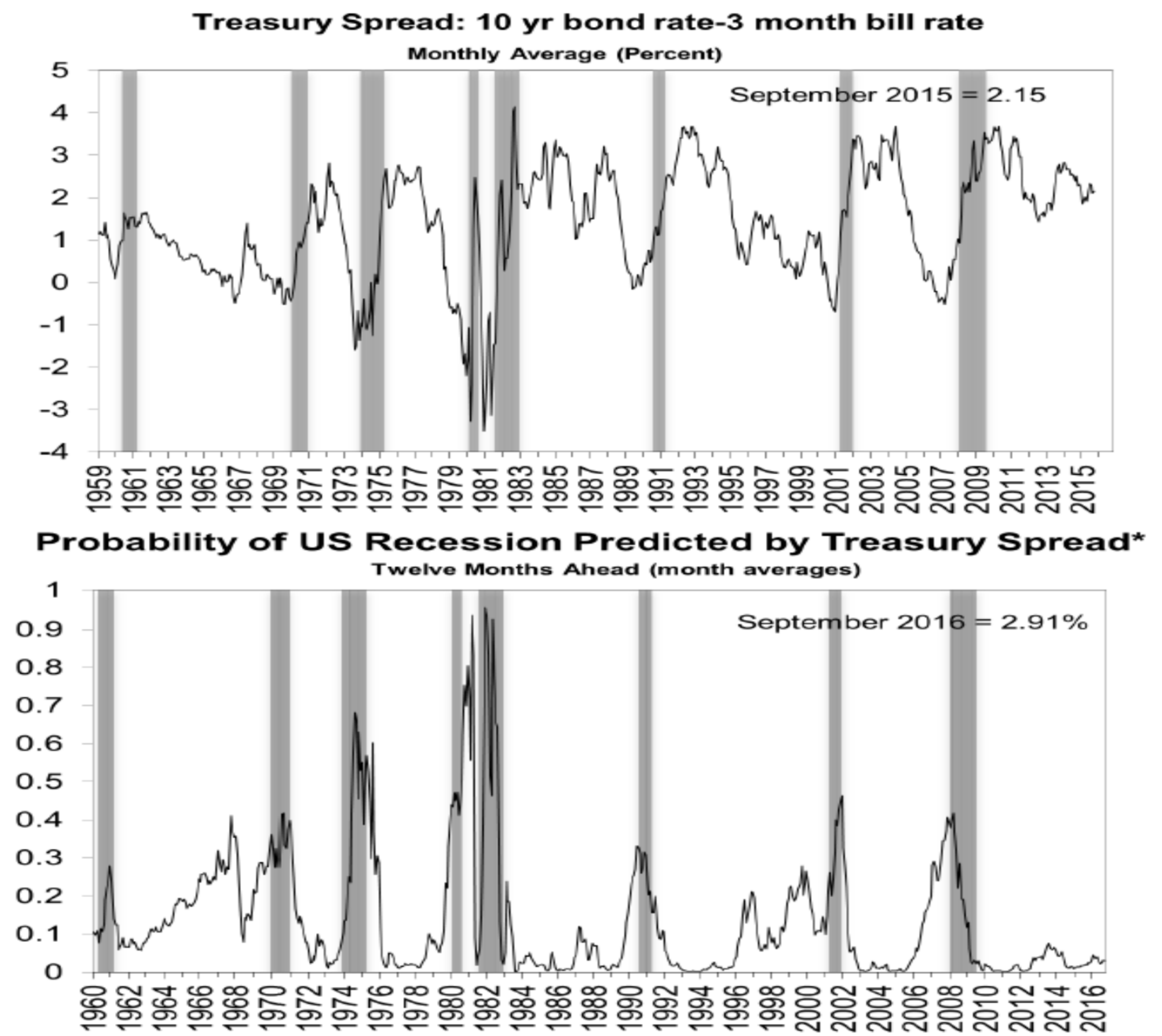
All of these conditions seem to be absent or at least too mild to prompt the Fed to aggressively raise rates. Recent news of higher productivity and lower unit labor costs together with continued global deflationary forces only strengthen a bias against higher rates. And even in the case of an increase in rates before the end of the year, the starting point is so low (basically 0%) that at the end of the day the first hike may just turn out to be a non-event. In summary, current economic conditions and business cycle evolution do not resemble the backdrop typically associated with recessions and bear markets.

Of course, exogenous events such as financial crises or geopolitical episodes, could still cause an economic recession and market turmoil through spillover effects and a crisis of confidence.

Probability of Recession: What's The Bond Market Message?

One of the most accurate predictors of economic activity is the well-known spread between the 10-year treasury rate and the 3-month bill rate. The charts below plot the yield spread over the last sixty years and the probability of recession associated with each spread level.

Chart 2. Treasury Spread and Probability of Recession



Source: New York Federal Reserve

The steepness of the yield curve is an excellent indicator of a possible future recession for several reasons. Current monetary policy has a significant influence on the yield curve spread and hence on real activity over the next several quarters. A rise in the short rate tends to flatten the yield curve as well as to slow real growth in the near term. In addition, expectations of future inflation and real interest rates contained in the yield curve spread also play an important role in the prediction of economic activity.

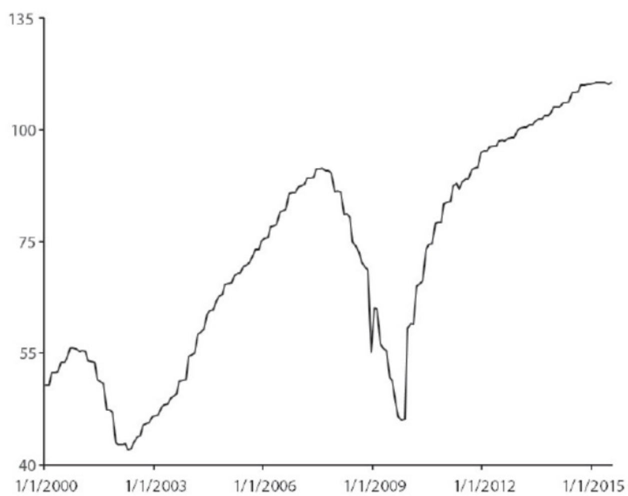
As the charts show, since 1960, a negative spread (meaning short rates greater than long rates) have predicted a recession with a lead of 6-12 months, on average. More recently with the yield spread at 2.29%, the probability of recession (chart in lower panel) is estimated at only 2.91%.

Corporate Earnings and Equity Valuation

The earnings recovery that started in 2009 is showing signs of aging. In the aftermath of the financial crisis, earnings rebounded sharply from depressed levels driven by revenue growth and operating leverage. More recently, persistent economic slack has kept the economy from intensifying inflation pressures and has allowed companies to increase and maintain historically high profit margins.

However, share buybacks – which have supported EPS and therefore stock prices – are showing signs of slowdown. S&P Dow Jones Indexes recently reported that S&P 500 Q2 2015 stock buybacks, or share repurchases, decreased 8.7% to $131.6 billion, down from the $144.9 billion posted in Q1 2015. S&P also noted that total shareholder returns, through regular cash dividends as well as buybacks, decreased by 4.9% to $226.0 billion from $237.7 billion in Q1 2015, but was still 11.4% higher

Chart 3. Aggregate Earnings Per Share – S&P 500



Source: Wells, S&P

Chart 4. Dividends and Buybacks – S&P 500

	DIVIDENDS & BUYBACKS $ BILLION	BUYBACK YIELD	DIVIDEND & BUYBACK YIELD
Q22015	**$226.01**	**3.04%**	**5.07%**
Q12015	$237.69	2.94%	4.92%
Q42014	$225.43	3.03%	4.95%
Q32014	$234.22	3.14%	5.10%
Q22014	$202.82	3.06%	4.98%
Q12014	$241.24	3.20%	5.14%
Q42013	$214.40	2.88%	4.77%
Q32013	$207.42	2.98%	5.03%
Q22013	$194.72	2.94%	5.02%
Q12013	$170.82	2.97%	5.02%
Q42012	$178.98	3.13%	5.33%
Q32012	$173.20	3.01%	5.08%
Q22012	$179.05	3.27%	5.35%
Q12012	$148.37	3.14%	5.09%

Source: S&P Dow Jones

However, as capacity utilization increases and unemployment declines to the important 5% level, companies may soon start to confront cost-push pressure and profit margin erosion.

Thus, even under a decent revenue growth scenario, corporate earnings growth may be much less strong than in the past few years.

It is hard to see how stock prices can keep going up with this backdrop of peak margins, full valuation multiples, potentially rising inflation and higher interest rates.

According to S&P, companies continue to use buybacks to boost their earnings per share at a time when EPS growth has become the center of attention for investors. The current share count status is that for each of the past six quarters, over 20% of the index membership used share count reduction to significantly increase EPS by at least 4% in their year-over-year comparisons.

than the $202.8 billion reported in Q2 2014. For the trailing 12-month period, companies returned $923.34 billion in buybacks and dividends to investors, up from $900.2 billion in Q1, and setting a new 12-month record.

Cash reserves bulked up during the second quarter as S&P 500 (ex-financials) available cash and equivalents increased to $1.32 trillion, from the first quarter's $1.23 trillion, and was just a tick under the record $1.33 trillion set at the end of 2014.

Higher levels of shareholder return are now part of the market expectation, with many investors anticipating continued high payouts. Although companies currently have the resources and low-cost access to funds to continue this trend, once interest rates increase, buybacks may be significantly reduced given that they are more discretionary and dividend cutbacks are typically seen as a last resort action.

Do I Need a Living Will?

By Scott Button, Trust Officer, Cypress Trust Company, Palm Beach office

The Terri Schiavo Story

March 31, 2015 marked the 10th anniversary of the death of Terri Schiavo. Those of us who lived in Florida during that time remember the story very vividly, but for those who didn't, let me share her story.

In 1990, at the age of 26, Terri Schiavo went into cardiac arrest and suffered irreversible brain damage, leaving her comatose. After several months without improvement, she was diagnosed as being in a persistent vegetative state. A feeding tube was installed to nourish her. In 1998, her husband petitioned the court to have the feeding tube removed, claiming that he and Terri had discussed end-of-life care and that she would not want her life prolonged in such a manner. Terri's parents were in total disagreement; they claimed their daughter was a fighter who would choose life over death. A long court battle ensued, and in 2001 the court ruled in favor of Terri's husband. The feeding tube was removed. Terri's parents appealed to the court and 7 days later it was put back in. Finally, in 2005, it was taken out permanently, but only after an ugly legal battle in which 14 appeals were filed and 5 suits were filed in Federal Court. On March 31, 2005, Terri Schiavo died.

The case was highly publicized for years on local and national news media. One would expect that laws would have changed as a result, but in actuality, they have not. For the purpose of this article, the main takeaway from this story was that Terri Schiavo did not have a Living Will.

What Is a Living Will?

A Living Will - also referred to as an Advance Directive - is a legal document which declares your wishes for your own end-of-life care; for example, if you were ever to be diagnosed to be in a terminal condition, comatose, or in a persistent vegetative state where you required life support to survive. Place your family into the Schiavo scenario, and imagine the stress and emotional anguish they would suffer. While Terri's husband won the legal battle, there were no real winners in that case. A Living Will would have communicated clearly to all parties exactly what her wishes were.

Most states have an Advance Directive form, which is in two main parts. Part One names a Health Care Power of Attorney (or Health Care Surrogate). This is someone who is charged with making medical decisions on your behalf if you are unable to do so (for example, in the event of incapacity). This document is especially important if you are single or without family support nearby.

Part Two is the Living Will. The Living Will is drafted to include whether or not you want to refuse treatment and nutrients for terminal, and/or end-stage, and/or vegetative state conditions. Part Two also includes a section on Post-Mortem decisions, such as organ donation for transplantation, research, therapy or education, and whether you would like to donate your body to science. You can also prearrange to have an organ or organs (also tissues or eyes) donated to a specific individual (if there was such a need).

Do yourself and your family a favor and be sure to have these documents executed as part of your estate plan. Your attorney can assist you with obtaining and executing them. If you would like to see an example, most states have them available online. We advise our clients to post these executed documents on their refrigerator door - as this is the first place paramedics will look – and not tucked away in a box or a drawer. A little bit of planning ahead can often save a great deal of time and money later on, and provide you with peace of mind.

Fixed Income

Bonds have also been responsive to the Fed's decision regarding the direction of interest rates, as well as to global economic data. Bond returns have been negative when the focus was on rate hikes and potentially restrictive monetary policy. Conversely, they have been positive when the focus was on global economic weakness. The Fed funds futures suggest the market is pricing in only a low probability of a rate hike. Although "rate hike" is grabbing the headline, we believe that its effect on fixed income markets should be limited over the intermediate to long term.

Strong deflationary forces should keep inflation at bay for a while. The strong U.S. dollar in conjunction with weak commodities prices and still limited wage pressures are all working together to reduce inflation expectations. Thus, given subdued inflation and global weakness, we expect the Fed to take a very gradual approach to rate increases that should not disrupt the bond market.

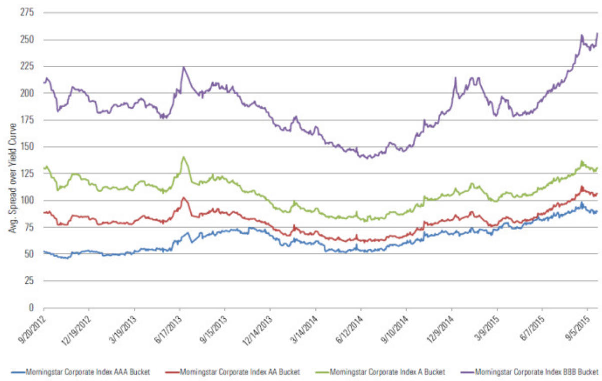
With the Fed funds rate near zero since the financial crisis in 2007 any changes in Fed policy should mainly affect the short end of the curve while longer bonds could remain near today's low yields.

In fact, the "front" of the yield curve is driven by current expectations for Federal Reserve policy. The consensus is that the Fed will begin to raise rates before the end of 2015 or in the first part of 2016. When this much anticipated event does in fact occur, it could create volatility and ultimately raise yields for bond prices with maturities of three months to five years.

Bonds in the intermediate part of the curve—(maturities from 5-10 years)—could see slightly higher rates as the economy improves on declining unemployment, consumer credit growth and eventual upward pressure on wages. Since this part of the curve is more sensitive to the outlook for economic growth, we should expect somewhat higher rates at this stage of the business cycle.

However, longer-term yields may remain restrained on foreign and institutional investors' demand such as pension funds. The resultant effect of this differential behavior will likely be a flattening of the yield curve.

Chart 5. Morningstar Corporate Index Spreads



Source: Morningstar

Credit Markets

The slump in commodities prices on softening global economic growth, especially in China, has reduced demand for industrial raw materials. In fact, the price of copper (which has one of the highest historical correlations to economic growth) has fallen to its lowest level since mid-2009. As these commodity prices have fallen, the average credit spread in the basic materials sector of the Morningstar Corporate Bond Index has risen to +250 basis points over Treasuries. The impact of weakening commodity prices has had an outsized effect on the high-yield market. However, compared to the previous two credit cycles, the current default cycle is still looking benign. The chart below shows that the current cycle is characterized by lower leverage, greater liquidity, strong debt coverage and low debt growth. These metrics suggest that we have not yet entered the dangerous mature phase of the cycle, and that unless a strong acceleration takes place in the upcoming quarters, U.S. companies probably won't enter it for the time being either.

Chart 6. Credit Cycles Comparison

Source: Amundi Research

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