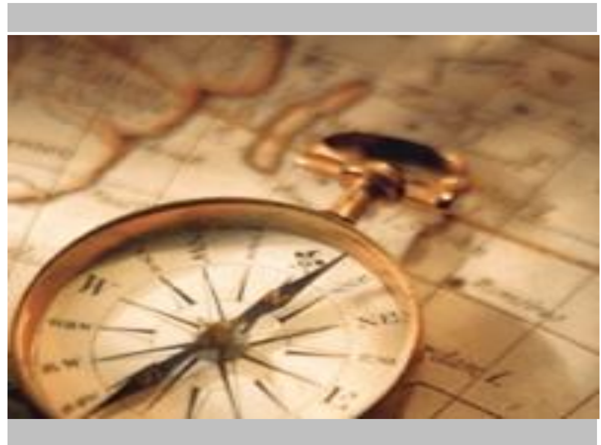
Strategy Quarterly

Second Quarter 2016



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Executive Summary

❑ Fear of recession on deterioration of some economic indicators related to global trends such as manufacturing, exports and oil investment still persists. However we don't see a recession near as the U.S. households are in good shape and continue to support the economic expansion through solid consumption.

❑ The two main drivers of household spending – wealth and income – show strong positive trends with personal wealth at historical high and real disposable income growing healthily. Similarly, the housing sector continues its steady recovery.

❑ A number of positive trends could support the recent advance in equity markets. As commodity prices bottom and wage gains strengthen, fears of a global deflationary spiral dissipate. Second, economic momentum has significantly improved across most regions and could result in a globally synchronized rebound. Finally, some positive corporate earnings surprises may be likely in the second half of the year given currently depressed expectations.

❑ Although the Federal Reserve has been shifting towards a more overall hawkish tone, global economic weakness and financial development concerns should limit the speed of rate increases.

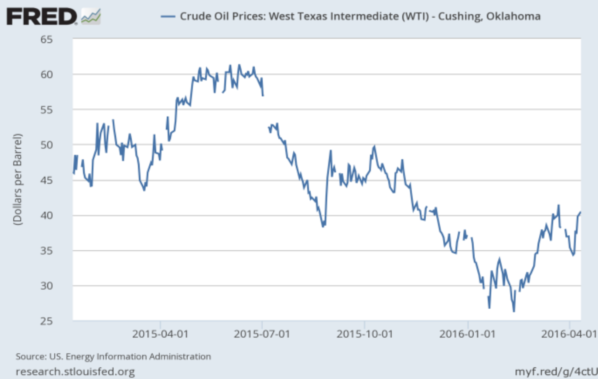
❑ Several economic gauges seem to indicate that we are still in the mid-cycle stage of the business cycle. Typically, during this phase corporate margins flatten but earnings growth is still positive supported by robust consumer spending, ample credit availability and a still accommodative monetary policy.

Economic Backdrop

In preceding editions of this report we highlighted the risks of a potential deflationary spiral stemming from a combination of declining commodity prices and dollar strengthening. Additional worries were weak global economic growth, over-extended monetary policies and weak corporate earnings growth. While not completely off the table, these concerns appear to have diminished based on a number of positive trend reversals.

First, oil price rebounded nicely after a sharp multi-month decline that brought it down below the

Chart 1. WTI Spot Price



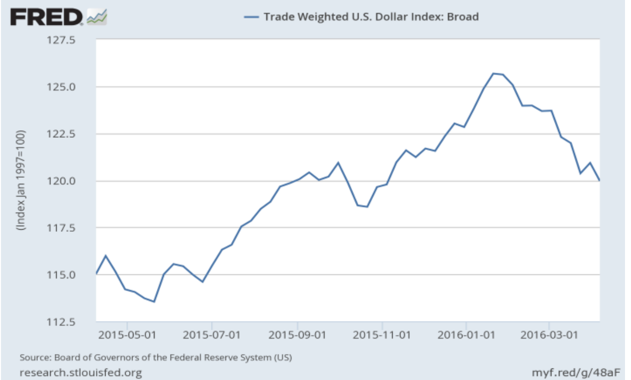
Source: Federal Reserve

level reached during the 2008 financial crisis (Chart 1). More importantly, the raw industrial commodity prices have been increasing steadily since the November bottom, representing a positive signal as industrial commodity prices are particularly sensitive to economic activity (Chart 2). Finally, the damage to U.S. exports and U.S. multinationals' earnings may start to abate as the US Dollar has recently softened after a strong rally that started in the summer of 2014 (Chart 3).

Chart 2. CRB Raw Industrial Commodity Price Index

Source: www.barchart.com

Chart 3. US Dollar Index



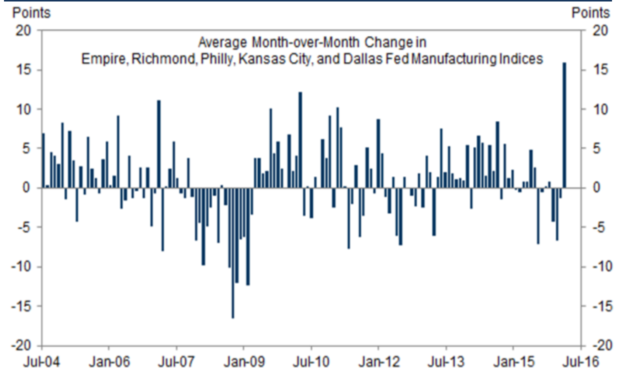
Source: Federal Reserve

Regional manufacturing surveys seem to indicate that these three headwinds have started to dissipate. Chart 4 shows that the average monthly change of a compiled index of the main regional surveys on the state of factories in the Philadelphia, New York, Richmond, Kansas City, and Dallas Fed districts has soared in March, representing the largest one-month jump on record, according to Goldman Sachs.

This data give some reasons to believe that economic momentum may continue in the next couple of quarters, as survey measures of activity are less volatile and subject to revision that hard data such as core durables and retail sales.

Despite such strong data reading, we still believe that U.S. manufacturing is potentially vulnerable to global economic weakness, strong U.S. Dollar and possibly to renewed pressure on oil and commodity prices.

Chart 4. Regional Fed Manufacturing Indexes

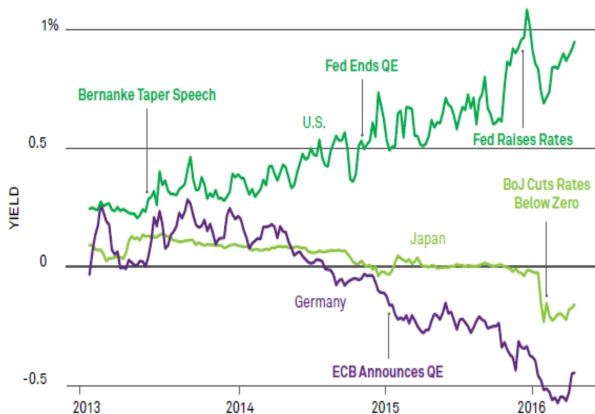


Source: Goldman Sachs

Monetary Policy and Financial Conditions

A major market theme over the last couple of years has been global monetary policy divergence: anticipation of a Fed lift-off contrasted with easing measures from the ECB and Bank of Japan. This conflicting monetary policy is evident in the divergent patterns of the U.S. and German two-year government bonds (Chart 5). While the German bond yields have been declining, the U.S. bond yield has been moving steadily upwards.

Chart 5. Two-Year Government Bond Yields



Source: BlackRock

Such a divergent monetary policy has been mainly the result of a non-synchronized global business cycle in the aftermath of the financial crisis. In fact, while the U.S. economy has continued to recover – albeit sluggishly – the Eurozone has been mired between a lackluster recovery and outright recession. These different economic environments have required distinct monetary policies.

However, going forward we should see a much less pronounced divergence and perhaps even a convergence of policies as the Eurozone's growth gains momentum and the U.S. recovery solidifies.

A by-product of divergent bond yields has been the strengthening of the green buck, which has been equivalent to a tightening of global financial conditions through weak commodity prices, deflation and erosion of U.S. multinationals' corporate earnings.

At this point we would anticipate a resumption of dollar appreciation only when expectations of Fed rate hikes pick up again.

Based on Janet Yellen's most recent communication of February 2016, we don't expect aggressive tightening over the short term. According to the Fed Chairman, *"…financial conditions in the U.S. have recently become less supportive of growth, with declines in broad measures of equity prices, higher borrowing rates for riskier borrowers, and a further appreciation of the dollar… Foreign economic developments, in particular, pose risks to U.S. economic growth. Most notably, although recent economic indicators*

Chart 6. Financial Conditions index

Source: Federal Reserve

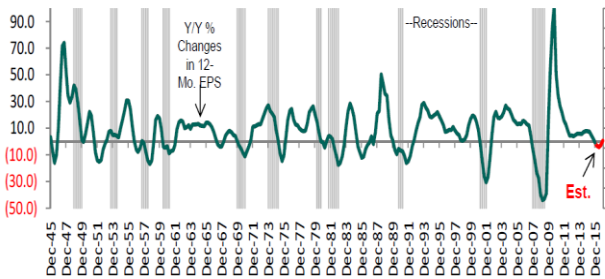
do not suggest a sharp slowdown in Chinese growth, declines in the foreign exchange value of the Renminbi have intensified uncertainty about China's exchange rate policy and the prospects for its economy. This uncertainty led to increased volatility in global financial markets and, against the background of persistent weakness abroad, exacerbated concerns about the outlook for global growth. These growth concerns, along with strong supply conditions and high inventories, contributed to the recent fall in the prices of oil and other commodities. In turn, low commodity prices could trigger financial stresses in commodity-exporting economies, particularly in vulnerable emerging market economies, and for commodity-producing firms in many countries. Should any of these downside risks materialize, foreign activity and demand for U.S. exports could weaken and financial market conditions could tighten further."

Despite the Fed's apprehensive tone, we note that financial conditions are still benign as the Chicago Fed National Financial Conditions Index shows (Chart 6).

Corporate Earnings

Weakness in global economic growth, deflationary trends and lower commodity prices have impacted ongoing profitability and earnings growth of U.S. companies. In the past, negative trailing EPS growth has been associated to recessions and bear markets (Chart 7).

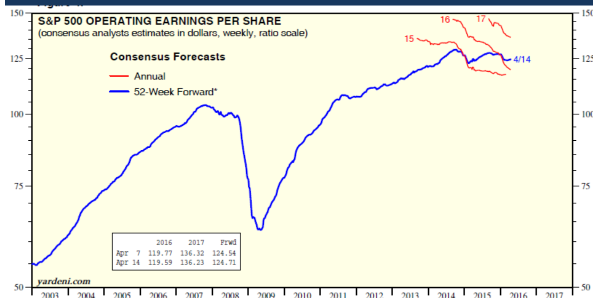
Chart 7. Rolling S&P 500 EPS Y/Y % Change



Source: S&P Capital IQ

Analysts estimates of future growth have incorporated the negative impact of those macro trends. Chart 8 shows the steady downward revision trend of 2016 forecasted earnings per share since January of this year. We actually believe that such negative expectations are already reflected in market prices and that they may have actually set a low bar for positive earnings surprises.

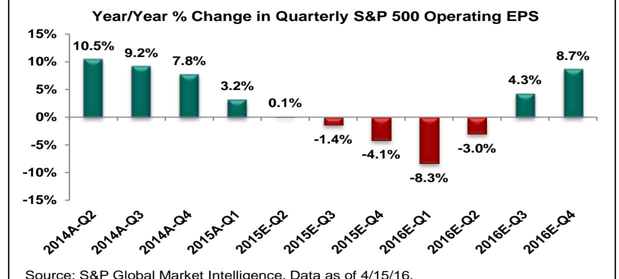
Chart 8. S&P 500 2016 EPS Consensus Estimate



Source: Yardeni Research

In fact, as commodity prices rebound, deflation fears subside and the global recovery gains strength, we may well see a resurgence of corporate earnings in the second half of 2016. Importantly, this EPS recession is the result of one sector: Energy, which saw a 60% decline in EPS in 2015 and is projected to record an additional tumble of 70% this year, based on aggregate EPS estimates for the S&P 500. Excluding energy, S&P 500 EPS would have been up by 6.8% in 2015, and could rise 3.1% in 2016. In addition, estimates point to the current quarter, as the trough in EPS with its 8.3% decline. Estimates for the remainder of the year are seen rising sequentially until hitting

Chart 9. Y/Y % Change in Quarterly S&P 500 EPS

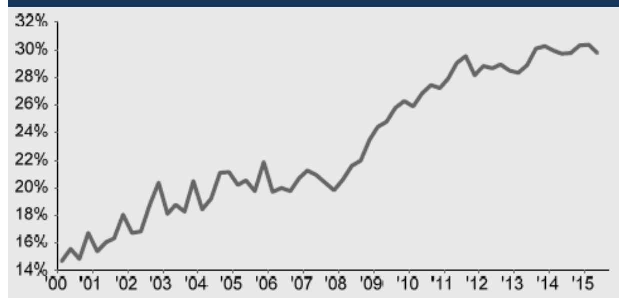


Source: S&P Capital IQ

an 8.7% year-over-year gain in the fourth quarter (Chart 9).

Partly offsetting the positive trends underpinning possibly positive earning surprises, are potentially rising input inflation which could cause profit margins to shrink and earnings growth to decelerate. Particularly, strong employment gains at this stage of the cycle may spur accelerating wage inflation with negative effect on corporations' margins.

Chart 10. Cash as Percentage of Current Assets



Source: JP Morgan

Nonetheless, we believe we are still in a benign phase of the earnings cycle supported by strong consumer spending and good liquidity.

Last but not least important, strong cash flow generation has fortified corporate profitability and resulted in cash-rich balance sheets and lower levels of debt (Chart 10).

Estate Executor Problems? Agent to the Rescue!

By Jack Kuhn, CFP , Cypress Trust Company, Naples

According to the Wall Street Journal, the traits people consider for selecting an Executor are, in order; Trustworthiness, Financial Skills and Knowledge, Objectivity and Fairness, Organizational Skills, Health or Longevity, Emotional State, Time Availability and Mental Health. So while being selected to serve can at first seem like an honor, it quickly becomes a blizzard of paperwork, deadlines, legal liability and all the family issues and personalities that even the most dedicated family member would often rather avoid dealing with under normal circumstances. All this while trying to get your duties completed correctly in order to avoid being sued by the beneficiaries in the emotional aftermath of a loved one passing away.

Those that have served often cite the incredible time commitment as the most difficult part of the job. Additional challenges included having access to and knowledge about records and information. Estates are seldom neatly organized. Also, having sufficient legal and financial knowledge to actually perform the duties including; performing the probate process, securing tangible assets, paying off debts, determining the value of all assets, managing the investments, covering the final bills, filing tax returns and settling disagreements among beneficiaries often lead the Executor (male) or Executrix (female) to seek out a professional Personal Representative for help. Often the decedent may not have kept current with their attorney who drafted their original documents or may have over time drifted away from their CPA. If you find yourself in this situation, or not wanting to leave your loved ones in this situation, the good news is that Cypress Trust Company has the expertise to serve as Personal Representative or as the Agent for the Personal Representative (Executor/Executrix).

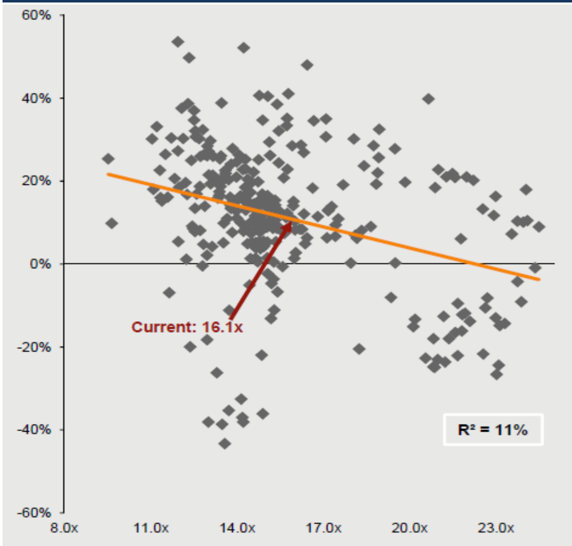
The demands and responsibilities for an individual acting as a Personal Representative can be overwhelming and burdensome. Under the Florida Statutes, a Personal Representative can hire an Agent to provide guidance and relief. By hiring an Agent, the Personal Representative is not relinquishing their role and still controls the settlement process. Institutions with trust powers, such as Cypress Trust Company, routinely settle estates and have the structure and systems in place to provide this support. Cypress Trust Company recognizes the benefits of the Agent role to Personal Representatives and over the years has provided this service to a number of individuals.

If you haven't reviewed your estate planning documents lately or think the person you named as Personal Representative might need some assistance if they choose to serve, reach out to your local Cypress Trust Company Officer. Our conversations are always confidential, never at cost to you and not binding or obligating you in any way. We're here to help your Personal Representative avoid the probate pitfalls and costly mistakes that the well intentioned but inexperienced individual encounter while settling estates.

Valuation

From a valuation standpoint, the market is not cheap on a price-to-earnings ratio basis. However, as Chart 11 shows, valuation ratios are very weak predictors of short-term future returns.

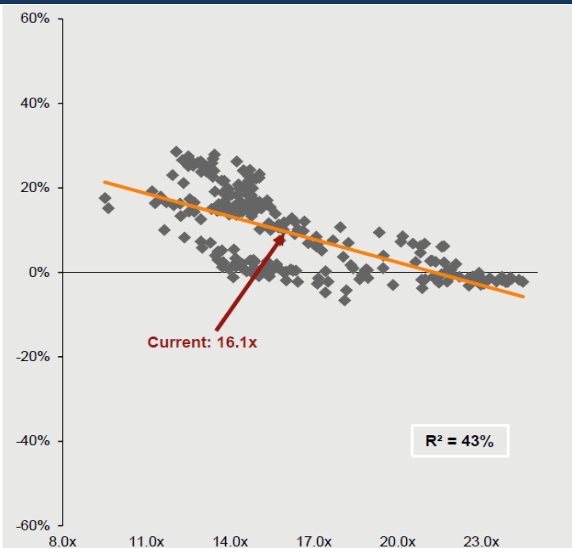
Chart 11. Forward P/E and Subsequent 1-yr Returns – S&P 500



Source: JP Morgan

Conversely, chart 12 shows that when the forecast horizon is expanded to 5 years, current forward P/E multiples have a quite robust relationship with future returns: the higher the P/E the lower the future 5-year annualized return.

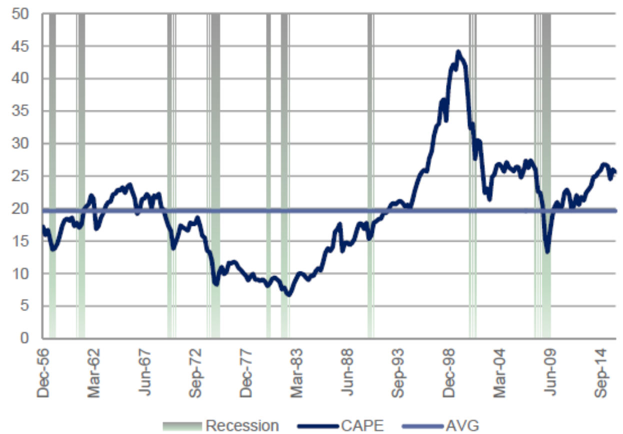
Chart 12. Forward P/E and Subsequent 5-yr Annualized Returns – S&P 500



Source: JP Morgan

Based on this relationship and the current market forward P/E ratio we would estimate high single-digit forward returns. Contrarywise, the cyclically-adjusted P/E ratio (CAPE) indicates stocks are no longer cheap (Chart 13).

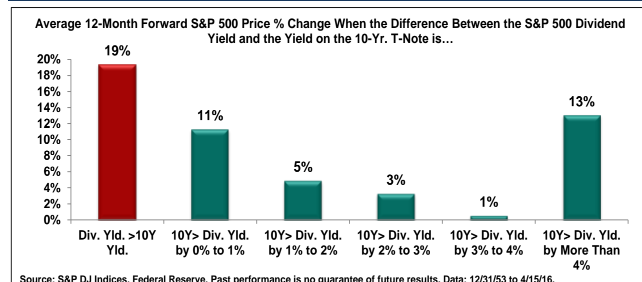
Chart 13. S&P 500 Cyclically-Adjusted P/E Ratio (CAPE)



Source: Legg Mason

An alternative valuation method with good track record is to compare the dividend yield on stocks as measured by the S&P 500 with the yield offered by bonds as measured by the 10-year treasury bond yield. Since 1953, whenever the yield on the S&P 500 was higher than the 10-year yield, the S&P 500 rose an average of 19% in the following 12-month period, and posted a positive return more than 80% of the time. In addition, whenever the 10-year yield was higher than the dividend yield on the S&P 500 by less than one percentage point, the market rose an average 11% in 12 months, and recorded a price gain 80% of the time (Chart 14). The current dividend yield of 2.2% vs. 1.7% for the bond yield, seems to augur well for equity investors.

Chart 14. Dividend Yield, Bond Yield and Future Returns



Source: S&P Capital IQ

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