Strategy Quarterly

Third Quarter 2016

Executive Summary

❑ Brexit and its impact on markets dominated the second quarter of 2016. The U.K. vote to leave the European Union caused political and economic uncertainty, a rise in market volatility and a further drop in global bond yields on expectations of even easier monetary policy.

❑ While the political repercussions of Brexit may slow down the recovery and increase downside risks to the global economy, we still maintain a constructive view of the U.S. economy and stock market on mid-digit earnings growth supported by resilient consumer spending, improving labor markets and low interest rates.

❑ A number of positive trends support expectations of continued growth. Consumer spending is projected to pick up, the housing sector remains a bright spot and the labor market continues to improve on lower unemployment and higher wage gains.

❑ The current divergence between VIX and high yield bond spreads is likely attributable to the increasing use of equity buybacks and other types of shareholder compensation to boost stock prices.

❑ Since the 2009 market bottom, non-cyclical or defensive sectors have significantly out-performed cyclical, more economic-sensitive sectors. This strong performance has coincided with massive investors' money flows into so-called "low volatility" and "high dividend" mutual funds and ETFs. Their recent price appreciation has pushed the valuation of these stocks well above the historical average and potentially rendered these funds risker than their labels imply.

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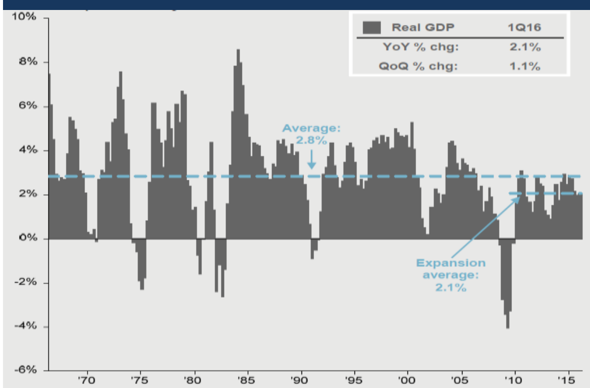
Economic Backdrop

The global economy was seriously damaged by the financial crisis of 2008-2009. Seven years later, the U.S. economy has slowly recovered and continues to expand. While the future pace of growth is likely to be constrained by global political turbulence and economic uncertainty, we still maintain a constructive view of the U.S. economy and equity markets. We expect below-historical average economic growth of 2.0-2.5% and earnings per share growth in the 5-6% range on decent revenue growth and continued share buybacks.

Chart 1. Real GDP Year-Over-Year Growth



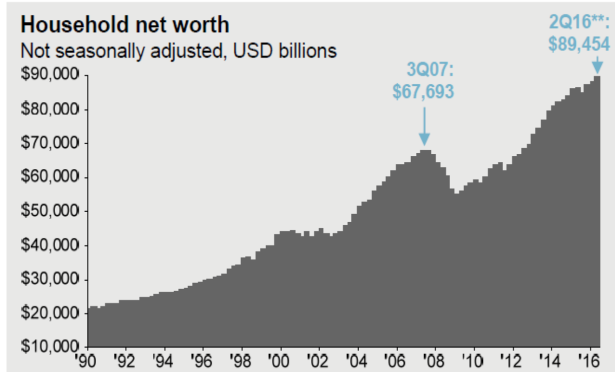
Source: JP Morgan

We believe the cyclical recovery still has room to run driven by the housing sector where prices should be supported by low inventory, better affordability and a strong labor market. Importantly, household net worth (Chart 3) has reached new record highs at the same time as debt service ratios have fallen to 35-year lows. This combination of higher wealth and lower debt has significantly strengthened households' finances which bodes well for consumer spending.

Chart 2. Household Debt Service Ratio

Source: JP Morgan

Chart 3. Household Net Worth

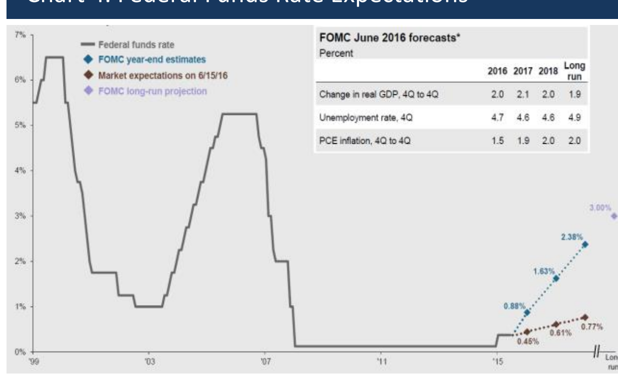


Source: BEA, JP Morgan

According to J.P. Morgan, from the mid-1950s to the mid-2000's, U.S. annual real GDP growth averaged 3.4%, with 1.7% of this coming from growth in the number of workers, and 1.7% coming from growth in the output per worker. Over the past decade, GDP growth has fallen to just 1.5% as retiring baby boomers have hampered labor supply and a lack of capital spending has hurt productivity. These trends are likely to continue in the decade ahead, limiting GDP growth to less than 2%.

On the positive side, interest rates are still at historical lows and expectations of Fed tightening have been once again ratcheted down on concerns of Brexit's consequences on global economic growth and financial markets stability (see Chart 4). Even in the case of a surprise rate hike, given the low absolute level of current rates, history shows that equities should be able to stand a gradual rate increase at this stage of the business cycle. Fixed income securities would likely suffer more from a tightening cycle.

Chart 4. Federal Funds Rate Expectations



Source: Federal Reserve, JP Morgan

After seven years of economic expansion and stock market gains, some investors are concerned about the potential for an economic recession and an accompanying bear market. We don't see the conditions in place for such a scenario as most of the indicators we follow still display positive signals. First, the EPS trough is behind us. According to S&P, projected Q2 2016 S&P 500 EPS are expected to be down by 5.3% on a year-over-year basis. This projected decline represents the first time since 2009 that the S&P 500 recorded year-over-year EPS

Chart 5. EPS Forecasts

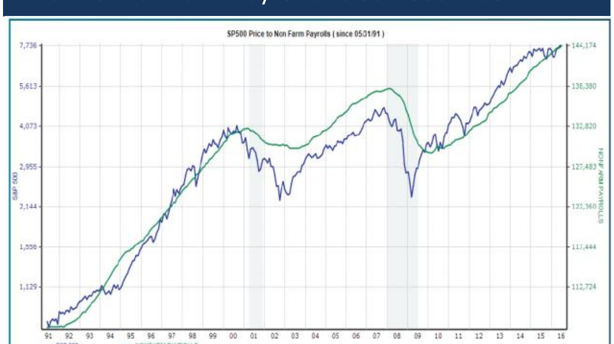
	2016 EPS % Changes				
S&P 500 Sector	Q1A	Q2E	Q3E	Q4E	Year
Consumer Discretionary	21.3	9.4	10.3	11.0	12.6
Consumer Staples	0.8	(3.1)	5.3	9.4	3.1
Energy	(106.6)	(80.6)	(54.3)	1.7	(70.5)
Financials	(15.4)	(8.5)	5.1	13.0	(2.1)
Health Care	8.0	3.0	6.7	9.0	6.6
Industrials	(3.3)	6.9	1.0	2.9	2.0
Information Technology	(4.0)	(5.3)	1.8	3.4	(0.7)
Materials	(11.4)	(7.8)	15.5	24.5	2.7
Telecom. Services	9.1	(2.7)	(1.8)	2.4	1.6
Utilities	(2.5)	3.0	5.1	13.2	4.1
S&P 500	(6.8)	(5.3)	2.0	7.9	(0.5)

Source: S&P Capital IQ

declines in four successive quarters. Despite the more than 5% expected shortfall, Q1's 6.8% drop projected for the aggregate EPS estimates represents the trough quarter through the end of 2017 (see Chart 5).

Second, historically when U.S. nonfarm payrolls grew, the U.S. stock market has risen (see Chart 6). As the labor market continues to improve, this trend should support the market through higher consumer confidence and spending and therefore higher corporate profits.

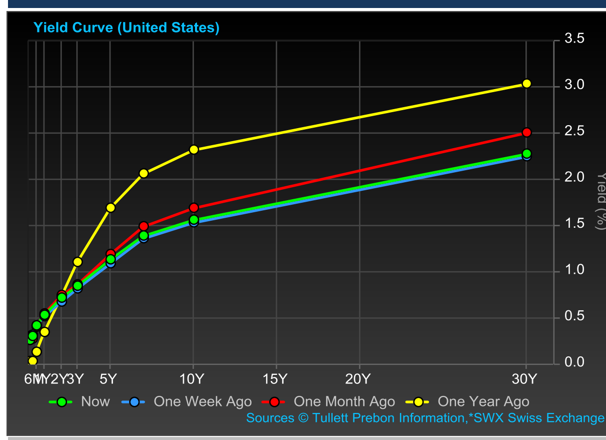
Chart 6. Non Farm Payroll and S&P 500 Index



Source: Zach Research

Third, as we have written in the past editions of this report, we are not yet seeing an inverted yield curve. Although there has been a flattening of the curve more recently driven by a flight-to-quality in the aftermath of Brexit, the spread is still positive at about 1.5% at the time of this writing (see Chart 7). Such a spread is typical of this advanced phase of the business expansion and is well above those negative spreads that have historically preceded recessions.

Chart 7. U.S. Yield Curve



Source: Factset

Fourth, due to the recent bond yield compression the dividend yield of stocks is now relatively attractive versus the long bond yield (see Chart 8).

One factor that could limit further advances of the market is valuation. With the S&P 500 trading at about 17X, further stock gains will have to be driven by continued earnings growth rather than valuation expansion.

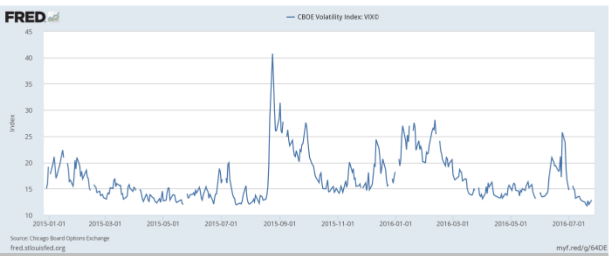
Chart 8. Dividend Yield to 10-Year Treasury Yield

Source: Zach Research

Shareholders Gain at Creditors' Expense

Chart 9 and Chart 10 are commonly employed as measures of risk. The VIX, often referred to as the *fear index* or the *fear gauge*, represents one measure of the market's expectation of stock market volatility over the next 30-day period. It is constructed using the implied volatilities of a wide range of S&P 500 index options.

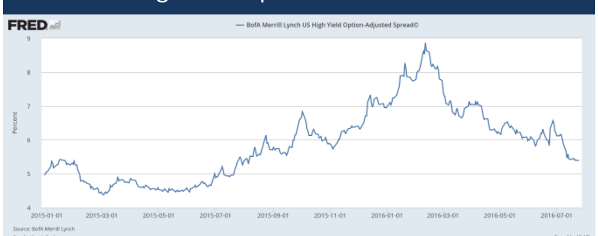
Chart 9. VIX CBOE Volatility Index



Source: St. Louis FED

The high yield spread is the percentage difference in current yields of various classes of low quality bonds compared against treasury bonds. Both indicators tend to spike during periods of increased perceived market risk caused by either exogenous events (like Brexit) or by deterioration of the economy or corporate earnings.

Chart 10. High Yield Spreads

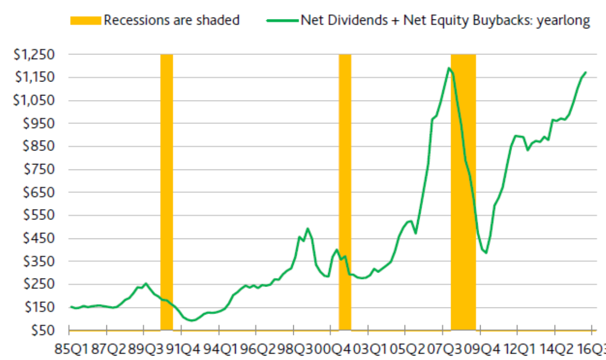


Source: St. Louis FED

Moody's in a recent report noticed that since mid 2015, while the bond spreads have been higher than their historical average and therefore signaled increasing risk, the VIX has been hitting new lows. The credit agency attributes this divergence to the growing use of share buybacks and dividends to boost equity prices. Chart 11 shows that shareholder compensation – the sum of dividends and share buybacks – has been growing steadily since the 2009 market bottom and has reached about $1.2 trillion as of March 2016. This massive return of cash to equity shareholders explains why the VIX has not been overall trending lower.

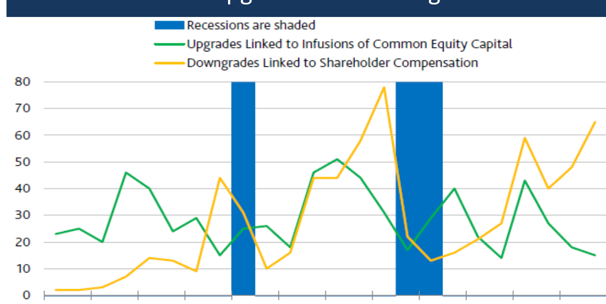
On the contrary, large cash distributions in the form of buybacks and dividends may often reduce financial flexibility and result in downgrades of credit quality which in turn is reflected in wider bond spreads. While there is always "tension" between credit holders and shareholders, it is important to be aware of which stage of the business cycle we are in. Typically, cash distributions are higher in the mature phase of the cyclical recovery when corporate earnings slow down. As the economic upturn decelerates, managements try to prop earnings per share and stock prices by reducing the shares outstanding through buybacks. Credit analysts don't fall for it as they are focused on the company's creditworthiness (Chart 12).

Chart 11. Shareholder Compensation



Source: Moody's

Chart 12. Credit Upgrades and Downgrades



Source: Moody's

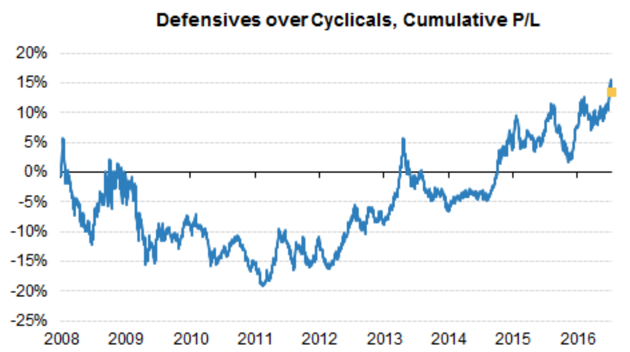
Investors need to be mindful of the potential negative consequences of stepped-up cash distributions – particularly buybacks – on the company's credit quality. Ultimately, while share buybacks may have positive short-term effects on company's stocks prices, in the long-term a deterioration of credit quality can have deleterious effects on the operating performance and even the very survival of the company.

"A Defensive Stocks Bubble?"

A puzzling aspect of the stock market advance during the recent economic recovery has been the significant out-performance of non-cyclical, defensive stocks over economic-sensitive, cyclical stocks (see Chart 13).

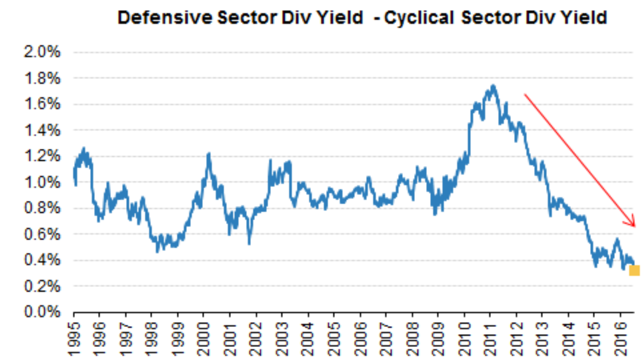
Such strong out-performance has driven defensive stocks' valuations well above historical averages and has reduced their relative dividend yield advantage (See Chart 15).

Chart 13. Return of Defensive vs. Cyclical Stocks



Source: Morgan Stanley

Chart 15. Relative Dividend Yield Defensives vs. Cyclicals

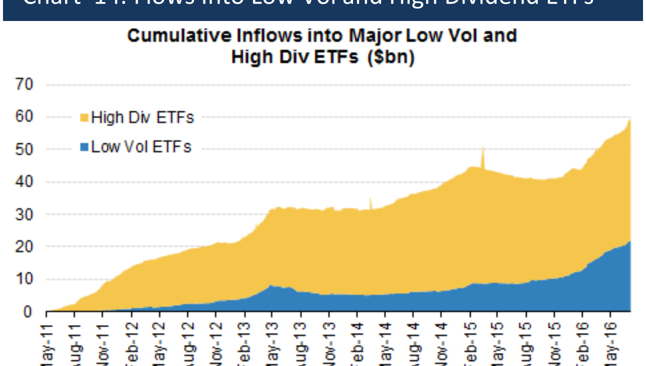


Source: Morgan Stanley

According to Morgan Stanley, since 2011, non-cyclical stocks have out-performed cyclical stocks by 43% on a cumulative return basis. This seems counterintuitive, as one would expect cyclical stocks to outperform defensive stocks during an economic expansion. Perhaps investors, unconvinced of the strength of the cyclical recovery, have chosen to participate in the bull market by investing in more defensive, dividend-rich, less volatile sectors such as utilities and consumer staples. This behavior has been strongly encouraged by the proliferation and marketing of "low volatility" and "high dividend" funds and ETFs. These products have seen massive inflows over the last five years and today have become an actual sub-asset class of the equity space (see Chart 14).

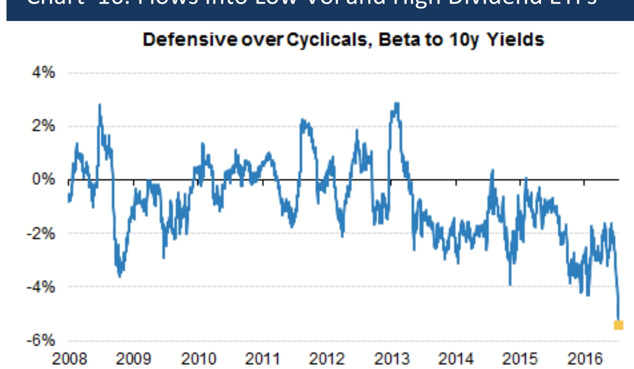
This higher market valuation makes defensive stocks relatively less attractive as it reduces their future potential appreciation and it may even partly negate that defensive behavior that attracted investors to them in the first place. Besides high valuations, defensive sectors and stocks with high dividend yields are vulnerable to increases in interest rates. In fact, historically, during periods of increasing rates, high dividend yield and defensive stocks in general have underperformed cyclical stocks. Chart 16 shows that the sensitivity of defensive stocks' returns to changes in the 10-year bond yield has increased in the last few years and has recently reached a 15 year extreme. This suggests that any slight adverse move in yields may create a rush for the exit.

Chart 14. Flows Into Low Vol and High Dividend ETFs



Source: Morgan Stanley

Chart 16. Flows Into Low Vol and High Dividend ETFs



Source: Morgan Stanley

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