**Voting with Their Feet**

### Table I: Global Equity Market Returns -%

<table>
<thead>
<tr>
<th></th>
<th>Jan. 2016</th>
<th>YTD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Russell 1000</td>
<td>(5.38)</td>
<td>(5.38)</td>
</tr>
<tr>
<td>Russell 2000</td>
<td>(8.79)</td>
<td>(8.79)</td>
</tr>
<tr>
<td>MSCI – EAFE</td>
<td>(7.27)</td>
<td>(7.27)</td>
</tr>
<tr>
<td>MSCI – Emerging</td>
<td>(6.52)</td>
<td>(6.52)</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>(4.96)</td>
<td>(4.96)</td>
</tr>
</tbody>
</table>

Source: Russell, MSCI and Standard & Poor’s

After a volatile year end in 2015 for equities, the New Year has not been any kinder to global stock markets. Globally equity markets fell 5 to 9% despite best efforts by central banks to keep air in the stock balloon. Economic weakness on fears of the global economies will slide back into recession. Plummeting oil prices is also weighing heavily on equities.

**Economy**

As commodities crater, particularly oil, countries across the globe are feeling the pressure of an economy that is heading towards another recession. Oil is flooding the markets and prices are plummeting which has created growing chaos and unrest. Add in the terror attacks and the recipe for another financial crisis is starting to take shape. The Emerging Markets, which thrived on the global demand for commodities of all types, is now suffering the consequences of falling demand. In 2015, the Emerging Market has seen a net outflow of capital of $735 million; this is the first outflow since 1988. This credit crunch is weakening global economies.

The two economies that serve as the bell weather of things to come are the U.S. and China. China has seen a dramatic slowdown in growth while the government has closed its stock market as the government was buying shares to stave off a downward spiral. In the U.S. several indicators raw numbers suggest the numbers are more a mathematical exercise than an indication of the state of the economy.

 Refugees from the Middle East remain an unsettling situation for many parts of Europe. Refugees being accepted in Germany, Sweden, Turkey and Norway among others are putting strain on an economy already under duress. In addition, concerns over terrorists slipping through a weak screening process is growing as unrest and violence is starting to escalate.

In the U.S. the presidential candidates are working overtime in their bids to be the next White House resident. The leaders so far are a socialist with a penchant for exorbitant tax rates and handing out other people’s money like candy at Halloween and casino owning salesmen who has no filter in his public discourse. So far there is little concern of this outcome but it is providing a blue print of what the future may hold.

In the meantime, the unemployment rate in January fell to 4.9%, a level typically associated with full employment. Yet, the labor participation rate and people in the labor force (See Chart I, below) show a much different picture. Additionally, after 7 plus years of being technically out of a recession, we still have record number of folks on Food Stamps. The administration keeps pointing to the number of jobs created each month but fails to acknowledge that these are minimum wage jobs. In January of the 151,000 non-farm jobs created 70% were minimum wage jobs. GDP estimates are being revised downward.
Another indicator that is foretelling global economic weakness is the Baltic Dry Index. In Chart II. The Baltic Dry Index is hitting new lows. This index is a gauge of raw materials moving across 23 different shipping routes. Raw materials like metals, coals, iron ore, and grains among others are experiencing weak demand across the globe.

The central banks have painted themselves into a real tight corner. Most countries followed the failed model of raising spending, raising taxes with the central banks flooding the system with liquidity. As the future is less certain, investors have opted for risk-free options. Central banks, like the Bank of Japan, in their efforts to drive investors into riskier assets have introduced negative interest rate bonds. Investors have flocked to these even knowing that at maturity they will receive less money than they invested.
Additionally, on Jan. 29 the BOJ announced that it would start charging private sector lenders a penalty of 0.1 percent to hold onto their excess cash, or reserves. All is being done in an effort to stimulate the economy. As we turn to the Federal Reserve in the U.S. they for reasons only understood by them raised rates in December with the promise to raise rates four times in 2016. Now given the recent data Federal Reserve Chair Janet Yellen went “oops”. Now Yellen and the other federal governors are feverishly backfilling to try and find a path whereby they can save face while just months later reverse rates and future policy. Investors have helped make that decision as the U.S. 10 year has fallen around 55 basis points since the Fed raised rates (Chart III.)

Chart III. U.S. Treasury 10 Year Note

If the weakness in the economy wasn’t sufficient, President Obama has decided to propose a $15/bbl tax on oil. Now it doesn’t take a Nobel Prize winning economist to determine who will actually be paying that tax. The tax increase will be passed on to the middle and low-income folks who already are struggling. It is this tone deafness with regard to spending, taxes and regulation that has allowed a Trump and Sanders to run successful presidential campaigns. We remain concerned that the U.S. will join other countries in sliding back into another recession in 2016.

Investments

The collapse of oil prices is having a marked effect on equity markets. There has been over the past few months a 0.88 correlation between oil prices and stock movement. The oil producers all have self-interest in pushing as much oil to the market at a favorable price. Unfortunately, that favorable price may fall to the $20.00/bbl level.
Currently company earnings being reported are coming in light and we are seeing revisions in 2016 estimates for Q1 (Chart IV.). Only 3 sectors remain for positive earnings growth. Not good news for equity holders facing high valuations and high earnings expectations. If we continue to see a weak economic environment these revisions may still prove to be optimistic. Valuations in the U.S. as seen in Chart V. based on PEG ratios are at levels not seen in the past 30 years.

Chart IV.

Q1 2016: Growth

![Chart IV](image)

Chart V.

S&P 500 PEG Ratio Per Expectations

![Chart V](image)
Strategy

The Central banks have failed to deliver stable economic growth as they instead focused on inflating risk assets. Investors are beginning to vote with their feet and some sense of panic is beginning to take shape. Current allocations have been lowered in equity and sovereign debt exposure (Negative interest rates). Spreads in high yield markets are beginning to expand. We would hesitate increasing exposure to high yield just yet as the damage in the oil patch may not be over. Banks have more capital than 2008 however negative interest rates will affect its lending business and Dodd-Frank regulations have hamstrung offsetting moves for banks. Consequently banks will be under pressure especially as the economies get weaker.

Precious metals have been the bright light for many investors. Gold is the investment that loves to be hated. It has been accused of being illiquid, difficult to store, doesn’t pay a dividend and has no value. In times of duress, uncertainly and political unrest, gold like other “hard” assets have served investors well. The backdrop of terror, refugee flight, civil unrest caused by high unemployment and food shortages hitting much of Europe, the Middle East and even the U.S. has forced investors to look for hard assets whether they be gold, farmland, timber or other real estate.

We still estimate a downturn of 35% although it may not be a straight line down. Investors need to take care to protect capital as the next 8-12 months unfold.
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