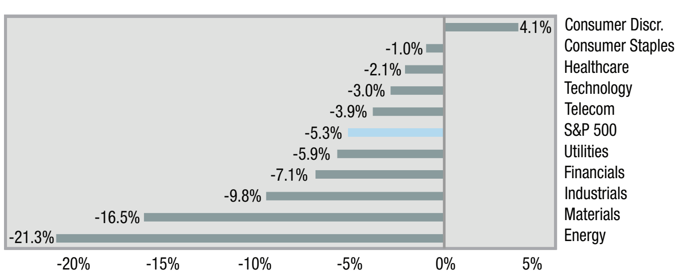
COMMENTARY 2015 Q3

Inverness
Counsel

During the quarter, equity markets experienced the first significant correction since 2011. After a swift 12% decline, the S&P 500 rebounded, ending the period down 6.4%. Recent growth in the U.S. economy has surprised to the upside. Global growth and markets, specifically China, were the source of concern. The Federal Reserve delayed its first interest rate increase, citing concerns that international and financial developments could hurt the U.S. economy. The expectation is that rates will be increased later this year. For now, the markets are wrestling with uncertainty surrounding the Fed and global growth, and healing from this correction will likely take a while. We expect volatility to remain elevated for the remainder of the year, and we have liquidated or reduced a number of investments that we have less confidence in. For now, we view this correction as an opportunity to add to our most compelling names, although we are watching for signs of deteriorating fundamentals.

The S&P 500 Index declined 6.4% on a total return basis for the quarter and is down 5.3% for 2015. The Consumer Discretionary sector was relatively strong this quarter and is the only sector with positive performance for the year. The economically sensitive sectors—Energy, Materials, and Industrials—led the way down this quarter and have been the weakest performers for the year.

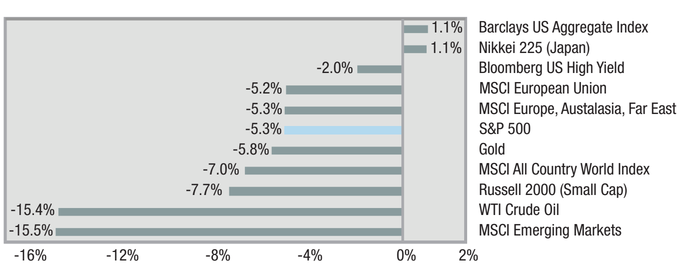
Figure 1: 2015 Performance by Sector



Source: Bloomberg. Data as of 09/30/2015.

From a global perspective, most markets declined more than the S&P 500 during the quarter. Europe, Japan, and most emerging markets saw declines in excess of 10%. The Japanese Nikkei is the only major market with a positive return for the year. In the U.S., oil continued to decline.

Figure 2: 2015 Performance by Category



Source: Bloomberg. Data as of 09/30/2015. All returns in U.S. dollars.

Growth Expected to Continue

The U.S. economy, as defined by Gross Domestic Product (GDP), continues to grow. We saw a substantial upward revision to the originally reported second-quarter GDP growth numbers from 2.3% to 3.9%. The revisions were positive across the board, but stronger consumption growth and higher residential and nonresidential spending drove a large part of this positive surprise. GDP growth is expected to average 2.5% for the second half of the year and 2.7% for 2016.

After languishing for most of 2014, housing is seeing strength in all three major segments—sales, improvements, and new construction. New home sales in August were above consensus expectations and rose to an eight-year high. Yet they still look depressed compared to long-term averages. The NAHB homebuilder confidence level is at a 10-year high. For most Americans, their house represents their biggest asset. Higher prices should help consumer confidence and spending.

In addition, the consumer should benefit from cheaper gasoline and higher income. Core consumer price inflation is holding steady just below 2%, while wage growth is averaging 2.4%. Unemployment at 5.1% is getting close to full employment, and further improvement is expected next year. Hotel and lodging companies have been reporting positive revenue per room trends. Recent Federal Reserve data shows an acceleration in total consumer loans in July and August, on top of a robust mid-single-digit growth rate for the first half of the year.

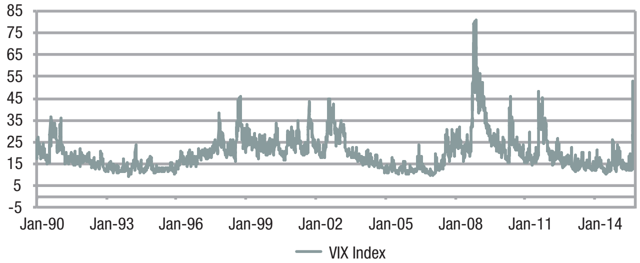
In general, the consumer and service parts of the economy seem healthy. The industrial segment of the economy has been weak this year. Capital spending has been below expectations, primarily due to lower oil prices, but the stronger dollar has also impacted exports. The ISM Manufacturing Index, which monitors employment, production inventories, new orders, and supply deliveries, remains above 50, signaling growth. At the same time, the index stands at 50.2, which is the lowest level we have seen in a couple of years. With economic growth expected to continue, this index should improve.

More Speed Bumps Ahead

From its all-time high on May 21, 2015, to its recent low on August 24, the S&P 500 declined 12%. Over the last 30 years, the S&P 500 has had a 14% correction once a year on average. Volatility is a part of investing in equities, and corrections are helpful in restoring some discipline in the markets. The magnitude of the current correction is in line with historical averages, but the swiftness of the correction was extreme. The S&P 500 retreated 10% in just three days.

On August 24, the Dow Jones Industrial Average shed over 1,000 points in early trading, the worst drop for stocks since October 2008. The VIX, a measure of market volatility and, to some degree, fear, reached an intraday high of 53, a level not seen since 2011. During the darkest days in 2008, the VIX reached 80, and it recently registered as low as 13 (see Figure 3).

Figure 3: CBOE Volatility Index (VIX), 1990–2015



Typically, the process of healing from a significant correction takes a little while. Unfortunately, positive resolutions to the sources of this recent volatility (China and the Federal Reserve) are still unclear.

In response to the 2008 financial crisis, China quadrupled its debt and funded massive infrastructure and construction projects to drive growth. At this point, supply exceeds demand. China has tried to shift its economy, to one more focused on the service sector and domestic consumption, and this shift has slowed annual GDP growth below the historical average of 7%. In June, the Shanghai Composite Index was up almost 150% over 12 months as ownership in equities expanded to an estimated 9% of Chinese households—almost 200 million people. The market then corrected by 36% in two months. The government intervened to prop up the stock market and then orchestrated a surprise devaluation of its currency in August. These actions have been seen as red flags that the Chinese government is worried their economic slowdown could be worse than originally feared. Investors are looking for signs of stabilization and future growth.

Prior to the recent correction in the global equity markets, the market was expecting the Federal Reserve to make its first increase in the federal funds rate to 0.25% at its September meeting. Instead, the Fed left rates unchanged due to "heightened uncertainties abroad," a move that seems to expand their mandate to include global economic concerns. Thirteen of the 17 officials on the Federal Open Market Committee still expect to raise rates this year. Their next meetings are in October and December. Market-based odds of a rate hike by December are 58%, so we may have this uncertainty with us for a few more months. The implication is that the Fed will move away from zero if global trends stabilize.

What Are the Markets Telling Us?

This is a question the Investment Committee has been asking a lot these days. As we have highlighted in previous commentaries, this is one of the longest economic expansions in American history, and the current bull market is now the third longest since 1929. Similar to 1998, U.S. spending indicators are looking strong, but the rest of the world is weak and vulnerable to the effects of a Federal Reserve interest rate increase.

The bearish list is growing. The MSCI All Country World Index is now at a two-year low. The commodity-exporting countries' economies are all on the ropes. Brazil's economy, the seventh largest in the world, has fallen into a deep recession, joining Russia. Canada's economy has also slipped into an official recession, and Australia is dealing with its first recession in a very long time. Many other countries in Latin America, Africa, and Asia depended on China's economy for growth as China became the largest importer of commodity products in the world.

Domestic high-yield (i.e. junk) bond markets are also flashing warning signals. Investors have priced in a higher default rate during the next 12 months. The last time junk-bond investors priced in this level of defaults was 2011. Many challenged oil and gas companies were able to deal with lower commodity prices for a while, but negative cash flow and high debt levels are now becoming a major problem. Banks are cutting back their loans to these industries, and we think this trend will accelerate. Loan loss provisions will likely go higher as banks prepare for defaults, and this will act as a headwind to growth.

For quite some time, we have been saying that future stock prices would be driven by earnings growth and not valuation expansion, since multiples were at the higher end of historical ranges. For large multinational companies, currency translation due to a strong dollar has impacted earnings. For other companies, declining commodity prices and/or sluggish economic growth have resulted in weak or negative earnings growth this year. With little expected growth and higher valuations, the market was susceptible to a correction. It is possible that profits peaked in the fourth quarter of 2014, and a peak in profits tends to happen seven to nine quarters before a downturn in the markets.

On the positive side, inflation remains low, economic growth has been slow and steady, and interest rates are still very attractive for borrowers. People are employed and receiving raises, although there remains enough slack in the system that the level of these raises is well below historical peaks. Balance sheets, for corporate America and for private citizens, remain healthy. Although this economic recovery is getting old, it has not been a strong enough recovery to drive many imbalances in the economy.

Course of Action

For now, we view this correction as an opportunity to add to our most compelling names. We also believe that volatility will remain high for a while, and we have reduced exposure in some of the more volatile names with less reliable prospects.

Earnings growth has been concentrated in certain sectors: Technology, Consumer Discretionary, and Healthcare. As we emphasized last quarter, we have been closely examining valuation assumptions on a number of our better-performing names. We continue to find compelling opportunities in these three sectors, and the recent correction has addressed some of the valuation concerns.

We are finding it tougher to identify new opportunities in the more economically sensitive sectors, such as Industrials, Materials, and Energy. Our emphasis in these areas has been on higher-quality, domestically focused names with strong balance sheets.

845 Third Avenue
New York, NY 10022

www.invernesscounsel.com

(212) 207-2122

Inverness
Counsel