PCM

PEAK CAPITAL MANAGEMENT

# SIC 2016 Insights

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John Mauldin hosted the 2016 Strategic Investment Conference last week in Dallas in what many called one of the greatest gatherings of financial minds ever assembled. For four days, one luminary after another took the stage and presented to a sold out crowd of investment industry leaders, portfolio managers, and sophisticated investors. Many in attendance had traveled from Asia, Europe, Australia and South America to hear first hand what the presenters thought investors should be focused on in today's environment and how they were positioning portfolios. It was extremely enlightening to be a part of the gathering.

**"The problem with human beings is that they buy what they wish they had and sell what they are going to need."**

Given Mauldin's bearish tilt in his widely read Thoughts From The Frontlines, many expected the presenters to be predominately "cup half empty." However, several highly respected economists or analysts suggested that now is not the time to be bearish. Here are just a few of the highlights:

- Dr. Lacy Hunt, Hoisington Investment Management: Lacy began his presentation noting the declining efficacy of Fed policy, continuing his theme of pushing on a string. He noted that just a few years ago the U.S. government borrowed and spent $1.72 to generate $1 of GDP. He showed data that suggests the government now must use $3.50 of debt to generate $1 of GDP. Massive debt levels around the world have created structural, not cyclical, growth challenges and he sees bond yields falling significantly from current levels.

- Mark Yusko, Morgan Creek Capital Management: Mark repeatedly referred to GMO's 7-year forecast that shows U.S. stocks likely to generate negative average annual returns making domestic stocks unattractive and even suggested we are entering a period that will mirror the 2000-2002 collapse in the equity markets. Mark may have provided the best quote when he said, "The problem with human beings is that they buy what they wish they had and sell what they are going to need."

- David Zervos, Jeffries: David walks onto the stage wearing a baseball hat with the message "I love QE" lauding the Fed's efforts. He believes the Fed needs to do even more in order to create growth because increasing growth rates of the economy is the only way to exit the structural problems we face. Zervos pointed out that we are 6 years into recovery from the last recession and yet the standard of living for the average person is 4% lower than it was in 2009.

- Niall Ferguson, Harvard Professor: Niall was clearly the most bullish and optimistic of the crowd and suggested that the global economy had already experienced an inflection point and the long-term rebound is underway.

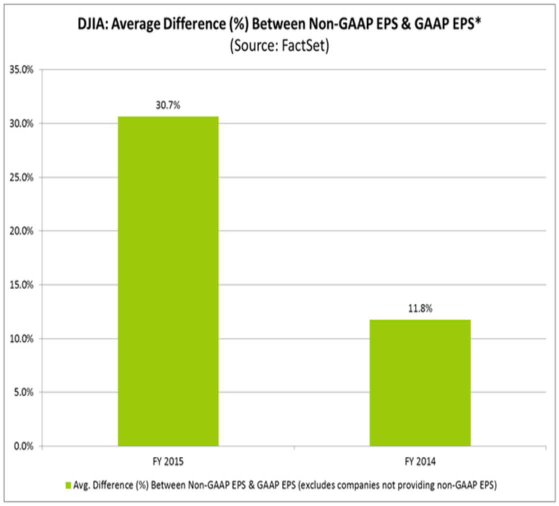
Jim Grant, revered expert on interest rates and the fixed income market, believes the Fed will not hike anytime soon and gave reasons why he is a gold bull today. Richard Fisher, with extensive experience in China, highlighted the problem the Chinese face as they continue rapid production increases with no focus on profitability. Anatole Kaletsky of Gavekal made one of the more controversial statements given so much focus on the massive debt levels around the world when he suggested government debt sitting on the balance sheet of the central bank should not be considered debt. The range of opinion covered the bull/bear spectrum and provided a lot of data to consider.

It was an honor to have been asked by John Mauldin to present on the topic of "Portfolio Construction in a Decade of Disruption." Stephen Cucchiaro, Jason Hsu and myself provided insight into how to manage risk and capture gains in the midst of unprecedented uncertainty. I made the case that volatility is going to remain at elevated levels as a result of: (1) the end of the debt supercycle; (2) continued central bank activism; and (3) very high valuations.

It is challenging to hear so many of the smartest financial minds in the world present such differing outlooks all with compelling data to support their view. I argued that portfolio management in today's environment needed to move beyond trying to figure out which scenario becomes reality, rather, and construct portfolios that are internally adaptable to whatever the future holds. The only way to accomplish this without a crystal ball (all of us wish we had) is to create and follow a disciplined, rules-based approach to risk management. Our asset allocation decisions based on risk budgeting provide the framework for reducing exposure to equities when risk is elevated and increasing exposure as risk wanes.

The greatest takeaway from the Strategic Investment Conference was simply that there is no way to confidently predict what the future holds. Yusko suggested going to 100% cash with equity allocations and Fisher answered "fetal" when questioned on his investment positioning. In a near zero interest rate environment that means you are guaranteed annual losses after the impact of inflation. The ability to dynamically allocate portfolios while controlling the level of volatility should continue to provide results most investors are searching for.

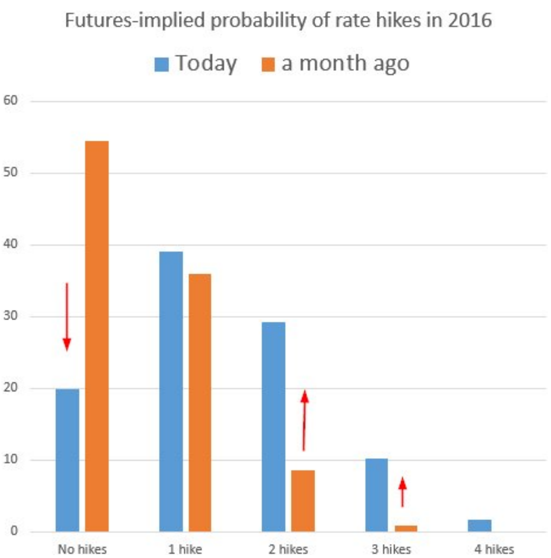
## Mind the GAAP




If you have taken public transportation in London, you recognize the phrase “mind the gap” as the incessant reminder to keep a safe distance in the underground rail known as the Tube. We have repeatedly been warning that investors should also be “minding the GAAP” or the difference between GAAP (generally accepted accounting principles) and Operating Earnings. Companies desperate to please investors, not to mention the bonus’ of leaders, are using non-GAAP Operating Earnings to report increasingly inflated earnings per share. The GAAP/non-GAAP spread nearly tripled from 2014 to 2015 as companies struggling in a challenging economic environment use more aggressive accounting measures.

- Earnings per share (EPS) for the Dow Jones fell by 12.3% in 2015 using GAAP standards while non-GAAP results were reported as a drop of only 4.8% in EPS.
- Merck and GE both reported EPS that were 100% higher than their GAAP results and Apache reported Operating Earnings of +$7/share versus GAAP earnings of -$11/share.
- The Price-to-Earnings (P/E) ratio today using Operating Earnings is 16 but on a GAAP basis the P/E ratio skyrockets to bubble territory of 26.

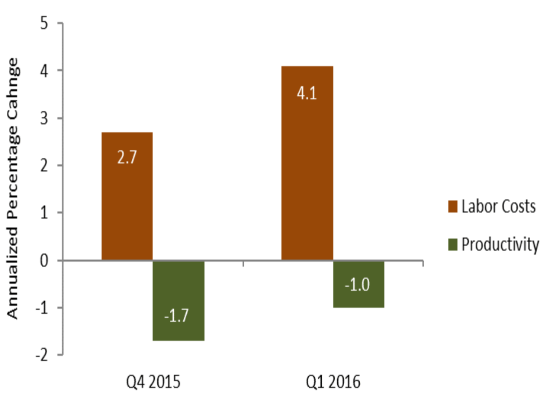
## Turning Hawkish




Janet Yellen and the Federal Reserve pivoted, signaling the potential for an increase in rates in June. Participants in the committee's April 26-27 meeting said they wanted to see signs that economic growth was picking up in the second quarter and that employment and inflation were firming, the minutes showed. "Then it likely would be appropriate for the committee to increase the target range for the federal funds rate in June," according to the minutes. The data points that the Fed is tracking seem to show stability in the economy. "Most pointed to the steady improvement in the labor market as an indicator that the underlying pace of economic activity had likely not deteriorated," according to the minutes.

- Prices for futures contracts on the Fed's benchmark overnight lending rate implied that investors saw an increased probability of a rate hike next month, according to CME Group and the chart below.
- Data since the end of April has pointed to a pickup in consumer spending and manufacturing output, bolstering the view that economic growth was accelerating after stalling in the first quarter. (Reuters)
- Challenges to a rate hike include a possible “Brexit” from the European Union or by continued currency devaluation in the Chinese Yuan.

## Going Into Labor

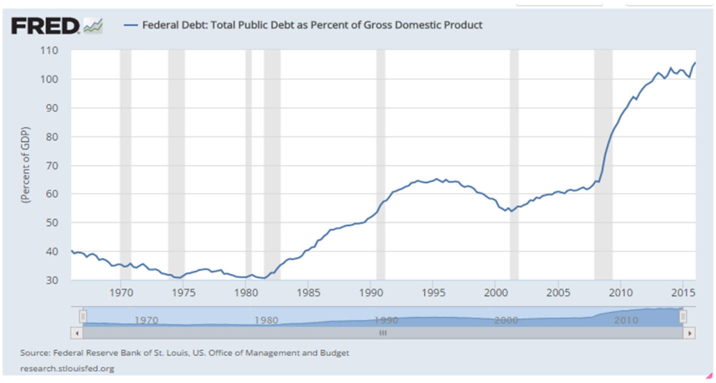



According to the Labor Department, unit labor costs rose in the first quarter at a faster pace in more than a year, while productivity continues to decline. A combination of rising labor costs and declining productivity is a somewhat disturbing trend. The path to rising living standards and overall economic prosperity (GDP) is linked to improvements in productivity. When productivity is rising, businesses can raise wages without having to raise the cost of its goods and services. However, with unit labor costs going up and productivity going down, the growth outlook for GDP could come under pressure. In addition, fiscal schemes to support minimum wages could add additional costs for businesses.

- Labor costs rose at a rate of 4.1 percent in the first quarter of 2016, which was the fastest increase since a 5.7 percent increase in the fourth quarter of 2014.
- Productivity declined at an annual rate of 1 percent in the first quarter of 2016, following a 1.7 percent decline in the fourth quarter of 2015.
- Recent legislation to support minimum wages will likely have unintended consequences as businesses will be faced with addition unit labor costs against a backdrop of a weak economy.

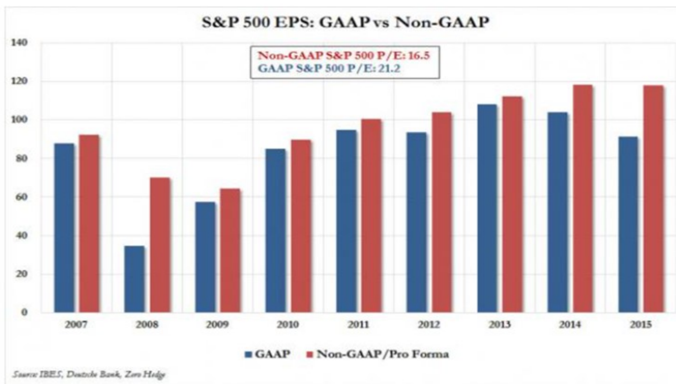
## Macro View – A Slave and His Master

Debt as a percent of GDP is a data point that is closely tracked among economists and financial analysts. It serves as a barometer for the health of a nation's economy. The chart below from the St. Louis Fed shows that the national debt has made a precipitous ascent coming out of 2008, now consistently hovering over 100% of GDP. As was noted in the PCM Report's coverage of the 2016 SIC, Dr. Lacy Hunt noted that just a few years ago the U.S. government borrowed and spent $1.72 to generate $1 of GDP while the government now must use $3.50 of debt to generate $1 of GDP. Despite many differing views among experts at the SIC, there was consensus that the most likely solution is to "inflate away" the debt, normalizing the debt to GDP ratio.




## Taking Stock – Behind the Earnings Curtain

Earnings continue to show weakness, especially as analysts examine how companies calculate earnings. S&P companies that follow GAAP standards in declaring earnings were reflected in an S&P earnings per share of $85.50 while non-GAAP, as reported earnings for the S&P were reflected in an EPS of $100 (Bloomberg). The chart below demonstrates the difference. The red bar represents the GAAP reported earnings while the blue bar represents the Non GAAP reported earnings. The difference between the two is clear, particularly for 2015 where the Non GAAP average EPS was just below $4 per share while the GAAP EPS was well below $3 per share. The chart also indicates that the average price-to-earnings ratio is higher than it may appear. This is viewed as an area of concern and a red flag for equity markets.




## Fixed Income – Opportunity or Trap?

Lacy Hunt of Hoisington has been the most successful fixed income manager of the last decade because he has ignored the panicked calls that rates were headed higher. Based on macroeconomic research, largely the massive levels of global debt, Hunt has remained resolute that yields have further to fall. Falling yields can generate significant profits for bond investors and a comparison of yields on 10-year government bonds suggests Mr. Hunt may be proven correct. An investor buying a 10-year Japanese bond earns 0% and in Germany a paltry .18% per annum. The U.S. yield on 10-year bonds is 1.85%, more than 10X the German bund. In a world of negative interest rates, betting on long-term yields in the U.S. to fall may be a far safer assumption than many believe.


## Technical – Bumping Against Resistance

Studying the patterns that formed during previous market tops can be helpful in evaluating what the technical picture is telling us. S&P closed last Friday fractionally below the 2100 level. Since hitting its all-time high in May 2015 at 2130, we have seen the market retreat at 2110 and 2102. If the market retreats from the 2100 it will be telling. Other technical indicators like margin debt suggest a new high is unlikely. Margin levels typically peak around market tops, and leverage for stocks is now 15% lower than the level of April 2015. What has many technicians concerned would be the continuation of the patter of higher highs, and lower lows. If repeated, the next correction would take the S&P below the 2009 low of 660 on the S&P 500.

# Equity Factors and the Market Cycle

**Clint Pekrul, CFA**

Factor based investing has grabbed the attention of many investors over the past several years. Much academic research has delved into the efficacy of tilting portfolios based on certain characteristics, such as company size, fundamental valuation, quality of earnings and balance sheets, volatility of share price and momentum trends.

Intuitively, it makes sense to us to segment the broader equity universe (as measured by the S&P 500) based on factors, or characteristics that are unique to a sub-set of companies. As we flow through the business cycle, we would expect companies with certain traits to behave differently. This view has been shared by investors for some time.

We evaluated the returns of five U.S. equity factors – value, size, quality, momentum, and volatility – over the entire sample and business cycle dates, as well as the risk-adjusted returns for each factor and betas to the broader market (as measured by the S&P 500). We wanted to capture how each factor behaved in general based on the phases of the market cycle, and which factors delivered outsized returns versus the broader market (if any).

The indexes used were the S&P 500 Low Volatility Index, S&P 500 High Quality Index, S&P 500 Enhanced Value Index, S&P 600 Small Cap Index and the S&P 500 Momentum Index. Table 1 below illustrates the findings:

| Table 1 | Recession March 2001 – November 2001 | | | | Expansion December 2001 – December 2007 | | | | Recession January 2008 – June 2009 | | | | Expansion July 2009 – December 2015 (Current) | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Metric | Return | Risk | Sharpe | Beta | Return | Risk | Sharpe | Beta | Return | Risk | Sharpe | Beta | Return | Risk | Sharpe | Beta |
| US Value | 1.3 | 1.3 | 0.9 | 0.9 | 11.7 | 17.3 | 0.7 | 1.0 | -25.2 | 57.0 | -0.44 | 1.3 | 16.6 | 19.1 | 0.9 | 1.1 |
| US Momentum | 1.7 | 1.4 | 1.2 | 0.9 | 11.3 | 18.3 | 0.6 | 1.0 | -15.1 | 44.5 | -0.34 | 1.0 | 16.9 | 20.1 | 0.8 | 1.2 |
| US Quality | -13.1 | 1.2 | -10.7 | 0.7 | 10.7 | 15.9 | 0.7 | 0.9 | -23.0 | 34.9 | -0.66 | 0.8 | 16.6 | 17.1 | 1.0 | 1.0 |
| US Size | 3.0 | 1.1 | 2.6 | 0.8 | 11.5 | 15.1 | 0.8 | 0.9 | -16.4 | 36.9 | -45.4 | 0.9 | 17.5 | 15.0 | 1.2 | 0.9 |
| US Volatility | 0.8 | 0.8 | 0.9 | 0.5 | 10.3 | 12.5 | 0.8 | 0.7 | -12.9 | 27.7 | -46.7 | 0.7 | 15.6 | 12.2 | 1.3 | 0.7 |
| S&P 500 | -4.8 | 1.4 | -3.5 | 1.0 | 7.0 | 16.2 | 0.4 | 1.0 | -21.2 | 39.3 | -53.9 | 1.0 | 15.9 | 16.2 | 1.0 | 1.0 |

Source: S&P, Peak Capital Management. Periods over one year are annualized.

The business cycle is commonly measured by the National Bureau of Economic Research (NBER). In general, economic expansions begin off the heels of a contraction, so equity valuations are generally low and growth forecasts are encouraging. As the economy expands, equity valuations begin to rise (i.e. equity prices generally trend higher) and volatility is normalized. Then, as the expansion reaches its final stages, equities are perceived to be "overvalued" and volatility tends to rise (i.e. investors get nervous). In the contraction phase, valuations contract to more normal levels as investors shun the risk of stocks in favor of less volatile assets, such as bonds. Then the economic cycles starts over again.

We looked at data going back over the previous two cycles, beginning in March 2001 through the end of 2015 (today). This period included the cycle from March 2001 (peak) through November 2001 (trough), the subsequent expansion through December 2007 (peak) and the trough of June 2009, and then the subsequent expansion through the end of 2015.

While the analysis above is very cursory, the moral of the story is that there is no single factor for all stages of the business cycle. For every stage listed in Table 1, there is a factor(s) that deliver superior returns (absolute or risk-adjusted) than the broader market. For example, drawdowns can be mitigated in contractions (e.g. 2008) by tilting to certain factors such as momentum and low volatility, while above average returns can be achieved in expansions by tilting to size and value.

The ultimate question is how to tilt the factors. In our portfolios we apply a risk budget to each factor and adjust the capital allocation as market conditions change. In general, periods of high volatility are associated with low or negative returns (and vice versa). With a risk budget, we don't attempt to predict the performance of the factors, but position our capital in those exposures that are likely to deliver market-like or above market returns, and underweight those factors that are likely to underperform.

## Q: Will the Brexit decision impact my portfolio?

The June 23rd referendum to determine if the UK remains a part of the single market EU (European Union) or votes to leave can be seen as the kick off event to a year of political fireworks. While it looked like Brexit was likely to succeed just one month ago, the polls now show the “remain” camp trending slightly higher as Prime Minister David Cameron and other leaders have emphatically made their case not to exit the EU.

The decision will impact Britain far more than the rest of the world and I see no negative spillover effects for global markets regardless of the outcome. Britain would regain much of the lost sovereignty from heavy-handed EU regulation and benefit from saving more than 10 billion pounds sterling in net EU funding. The potential risks of Brexit include reduced foreign investment in Britain and facing tariffs on exports that non-EU countries must deal with.

Politicians are well known for painting “end of the world” scenarios, but that will not be the case regardless of how the vote turns out. After some chest thumping and a brief war of words, I am confident that British and EU leaders would agree on trade agreements with very little disruption. As a result, I would not expect either a “leave” or “remain” decision to impact investment portfolios.

Not much in my opinion. I think this decision by Britain will impact them a lot more than it impacts us. Plus, I think this event (whether it happens or not) has been mostly priced into the market. The larger story here is the continued economic mess that is the EU, but it won’t be the end of the world or the collapse of the EU.

The longer-term question is whether Britain is the first domino to fall. They can exit without major disruption because they never adopted the euro currency. If this were a scenario where, say Germany, said they were going to exit the EU, it would be much more disruptive from a currency point of view. I think Britain simply wants to expunge itself from the bureaucratic oversight from the EU politicians.

The G7 leaders warn against a “serious threat” to global growth if the UK exits. But I think failed monetary policies (and perhaps a failed monetary union fundamentally) pose much greater risks than a UK exit and any disruptions to global trade that it might cause.

With the political season just heating up, we are sure to hear plenty of rhetoric around the issue of a Brexit, but when it comes to substance, I don’t foresee a major disruption.

## Q: Where is the next bull market?

Financial entertainer Jim Cramer ends each of his broadcasts with the words, “There is always a bull market somewhere” and I tend to agree with that sentiment. At the SIC, several presenters claimed the next bull market will be China. I am not as convinced that will be case and remain concerned about the political and economic leadership of the world’s 2nd largest economy.

Bull markets are born out of low valuations. The challenge is to find markets with compelling valuations that are experiencing a change in fundamentals or sentiment that can propel prices higher. Many expect emerging markets to be the next bull market but I am not certain emerging markets can deliver on either the fundamental or sentiment factors necessary for a prolonged advance in prices.

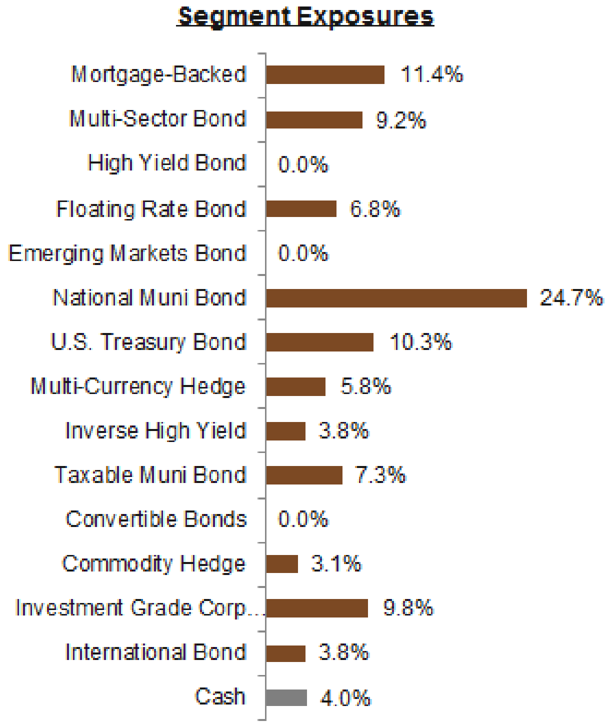
There are two markets primed for advances that could result in years of double-digit gains. First is energy. We are getting very close to equilibrium between supply and demand, which would stabilize oil prices. OPEC still represents a lot of uncertainty and shale producers will try to flood the markets again with prices above $50. It is likely the bull market in energy may be 6 to 12 months away but should provide extraordinary gains for the winners. Gold appears poised to enter into a long-term bull market along with other precious metals. In a world where negative interest rates may persist, gold is not penalized for having no yield. To be long gold can be viewed as being short central bankers, a concept that is attractive to many investors.

Good question. It might seem a bit crazy, but if all the talk of zero (or even negative) interest rates and non-conventional monetary policy prove to be true, then long-duration U.S. Treasuries might be a source of meaningful returns over the intermediate term. There’s simply nowhere else for investors to go who are searching for yield from a sovereign entity. If equities begin to falter and investors get nervous, then they very well could move to Treasuries and push yields even lower.

I wouldn’t necessarily call this a “bull market” per se, but a 100bps reduction in yield (from current levels) on long dated bonds is roughly a 50% price appreciation. That’s nice on the way down, but when yields reverse and go up, it will be very painful, so timing is critical.

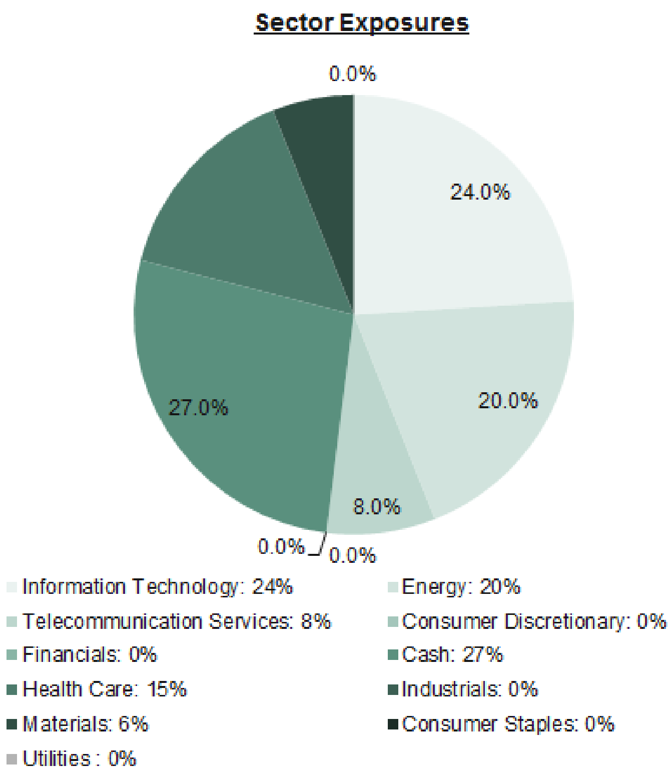
Gold could also see a run. At the recent SIC conference, Jim Grant (Interest Rate Observer) suggested that gold is “the reciprocal of bad monetary policy”. I agree. As central bankers continue to tinker with fiat currencies around the world (with unintended consequences), gold could be increasingly seen as a safe haven asset. This could push prices higher. But as with any commodity, gold has no intrinsic value and the forces of supply and demand can lead to volatile price swings.

# Fixed Income




- The theme of long durations and high credit quality continue in the portfolio as we view credit risk a greater threat to fixed income portfolios.
- We expect the Fed to raise rates in June or July but believe it will only impact the short end of the yield curve.
- Inflation is ticking higher in the U.S. and is likely to result in a higher allocation to inflation-protected securities.
- The spread between 10-year German Bunds and 10-year U.S. Treasuries suggests significant upside for Treasuries.

# Equity




- Energy companies with strong balance sheets are rallying as oil hits $50/barrel.
- Nearly 65% of companies reported higher EPS than estimates in Q1 but less than 50% reported in-line revenues as uncertainty remains high.
- Healthcare stocks are showing signs of market leadership as valuations in the sector are compelling.
- We expect M&A activity in Information Technology to rise in the 2nd half of 2016 creating opportunity.

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