PCM

Peak Capital Management

# False Sense of Security

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One of the most dangerous places we can find ourselves is having a false sense of security where we fail to understand the peril we are facing. It is difficult, if not impossible, to forge solutions to challenges if we do not understand the magnitude of the problem. Investors may soon realize they have placed too much trust in the Fed to solve global financial imbalances and the markets may soon reflect that. In the infamous words of Brody, "You're going to need a bigger boat."

We had a financial crisis in 2008 and understandably did not know what to do. Big banks would not lend to other big banks because no one knew where counter party risk was and who the next Lehman would be. The Fed stepped in, quite boldly, to create a backstop by flooding the financial system with liquidity. Their actions abated a domino effect of potential defaults but after six years of 0% short-term interest rates the question now turns to "at what cost"?

> ***"Misallocation of capital is at staggering levels, there are massive levels of overcapacity, and businesses that should have gone away remain and consume resources that would be better allocated elsewhere. "***

After watching from the sidelines, wanting to make sure the Fed's policy of QE did not create any great white sharks, the ECB and BOJ entered the QE game. To date, about $11 trillion of money has been created by central banks. The result? In the U.S. we have averaged 2.1% GDP growth since the end of the recession in 2009; the weakest recovery post-WWII. Misallocation of capital is at staggering levels, there are massive levels of overcapacity, and businesses that should have gone away remain and consume resources that would be better allocated elsewhere. Under this backdrop, we pose the following questions to Fed Chair Yellen (along with our concerns for asking the questions):

*Why keep U.S. policy at hyper-accommodative levels at a point when the economy is in a self-sustaining expansion?*

The most obvious answer is that the Fed is focused on data points that suggest the economy is not expanding as we are led to believe. While the "official" unemployment number has fallen from over 10% to near 5%, much of the gains are more a matter of how employment is tracked today. If we counted the unemployed using the same metrics as 25 years ago, including all discouraged workers, we would have an unemployment rate around 23%.

*What is the endgame for ZIRP (zero interest rate policy)?*

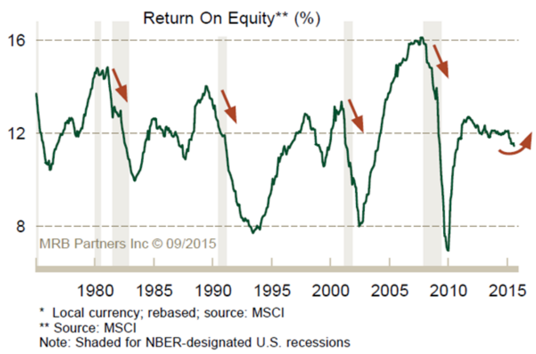
Reinhart and Rogoff's research shows in a compelling manner that high debt levels are deflationary and create significant headwinds to growth. Manipulating rates at low levels has encouraged an explosion of over $60 trillion in new debt since 2009 globally. Debt has been used to pay dividends to shareholders and buy back their own stock; financial engineering is favored over business expansion. When policy is "normalized", there will be many questions about whether governments can afford to service their debt. Governments may be forced to monetize their debt which might ultimately lead to the run away levels of inflation many fear.

*What should we be fearing?*

Despite the most colossal, coordinated effort of the Fed, ECB, and BOJ, deflation continues to reign over inflation. China is exporting deflation. Global currency devaluation is deflationary. The outlook suggests that interest rates are unlikely to normalize until debt levels are truly at unsustainable levels.

The legacy of the Bernanke-Yellen Fed is unlikely to reflect heroic efforts to save the economy but more likely a lesson on arrogance and believing central planning can repeal the business cycle. They have facilitated a global debt-to-GDP ratio of 286% with government debt increasing nearly 100% since 2009. They expect to be hailed when they should probably be tarred and feathered. Zero percent interest rates are the problem, not the solution, that we believe will be obvious 20 years from now.

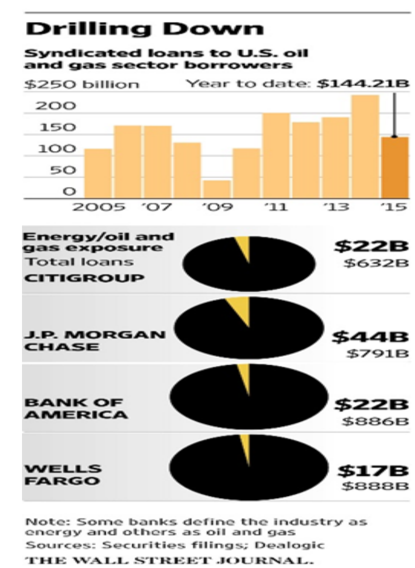
## An Ominous Signal




Return on Equity is an important measure of how efficient a company uses its shareholder equity to generate profit. It is measured by calculating how many dollars of profit a company makes with each dollar of equity on their balance sheet. When ROE falls, as it is doing right now, it suggests profit margins are contracting or companies are not growing revenues. What is most concerning about the current trend is that stock buybacks and debt issuance are near all-time highs, both metrics that typically would help firms increase their ROE.

- Corporate debt issuance has exceeded $1T YTD, an increase of 14% over the same period in 2014 with investment grade 22% higher and high yield 16% lower.
- More than $275B in stock buybacks occurred through Q2 of 2015, an increase of around 4% over the prior 12-month period, lowering total equity that should put upward pressure on ROE measure.
- Slower than expected domestic consumer spending and a strong U.S. dollar have proved to be headwinds for corporate profitability.

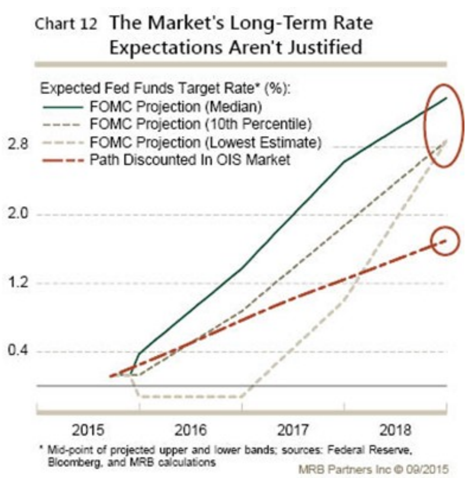
## Coming Up Dry




The drop in oil prices has had a significant impact on the lending to oil and gas companies. April and September are pivotal months as banks typically determine the assets that drilling companies use as collateral for loans. Post crisis regulation has made it even more difficult for banks to lend to oil and gas companies whose balance sheets are low on cash and assets. Exploration and production companies find their backs against the wall as they rely on credit lines to sustain their business despite the fall in prices. Regulators, on the other hand, question whether a company's reserves or assets serve as needed collateral while oil hovers around $40 to $45/barrel.

- Loans to U.S. oil and gas companies has dropped from nearly $250B in 2014 to just over $144B in 2015.
- The Office of the Comptroller of the Currency (OCC) regulates the national-bank units that make many of the energy loans. The OCC stated in a June report that the "significant decline in oil prices in 2014 could put pressure on loan portfolios" going forward.
- A recent Citigroup report stated that banks will reduce lending to energy companies by as much as 15%.

## Connecting the Dots

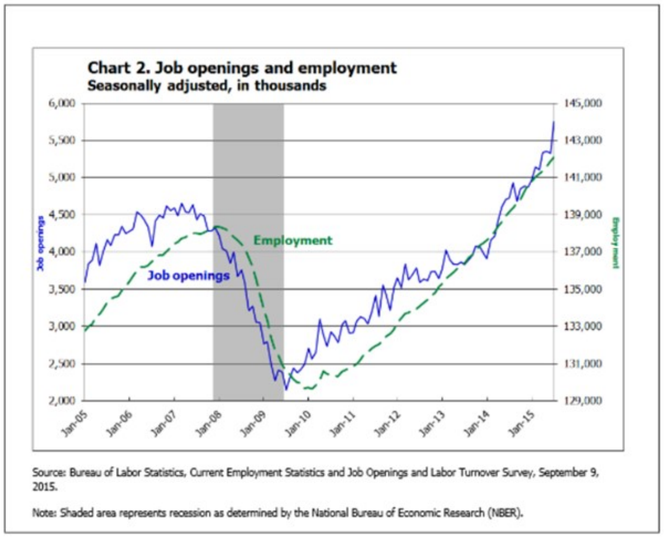



The Federal Reserve held rates steady in September citing concerns over increased global headwinds and wanting to be more "confident" that the economy is on solid ground. In her post-meeting press conference, Chairperson Janet Yellen conveyed a dovish tone that left markets guessing as to when the first rate hike will occur. But in a speech she gave later in the month she suggested that the first move will likely occur later this year. The lack of clarity and continued uncertainty helped weaken markets and heightened volatility in late September. In the economic forecasts released at their September meeting, the pace of interest rate hikes implicated by the FOMC's median forecast suggests a steeper path of increases than indicated by the futures market (see chart). Who's right?

- Inflation remains below the Fed's target and the FOMC has admitted that inflation expectations are well anchored. Meanwhile, the economy is near "full employment" but other factors such as the participation rate and wages suggest a weaker environment.
- Either way, the path to higher rates is likely to be gradual, only 3.4% by the end of 2018, which averages out to a 13 basis points (bps) increase per meeting. The market seems to think 1.8% or so by 2018, which suggests an average increase of 7 bps per meeting.
- Our best guess puts it somewhere in between, but the Fed needs to get started already.

## Macro View– Jobs Strength and Weakness

The Bureau of Labor Statistics (BLS) published the Job Openings and Labor Turnover Survey (JOLTs) in September. The survey is suggesting wage inflation may be imminent. This could force the Fed's hand in raising rates prior to the end of the year. The chart from the BLS shows the number of job openings declining to a low in July of 2009, one month following the end of the recession. Employment continued to decline, reaching its lowest point in February 2010. Job openings have since trended upwards, now surpassing the prerecession peak in March 2007.

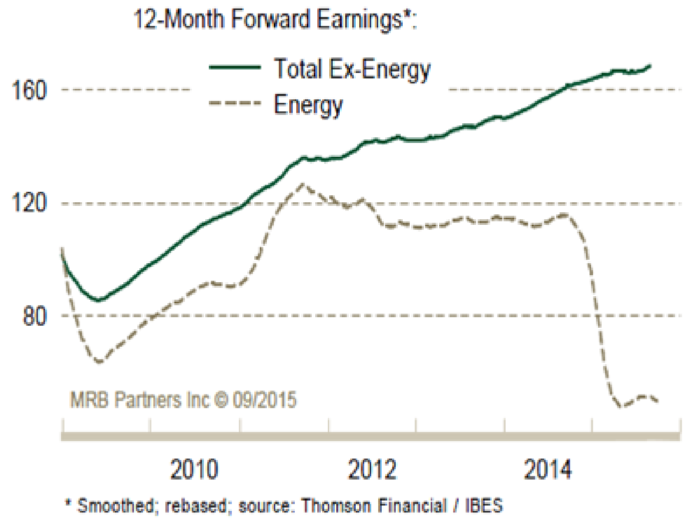



Source: Bureau of Labor Statistics, Current Employment Statistics and Job Openings and Labor Turnover Survey, September 9, 2015.

Note: Shaded area represents recession as determined by the National Bureau of Economic Research (NBER).

## Taking Stock– Continued Dislocation

Energy was the largest contributor to the decline in revenue for the S&P 500. Energy is also projected to report the largest year over year decrease in sales for the 3rd quarter. If the energy sector is excluded from the S&P 500, the estimated revenue growth rate for the S&P 500 would go from -3.3% to 2.4%. The chart from MRB Partners below shows health in 12 month forward earnings ex-energy, continuing to trend upward. The chart also depicts the dramatic collapse in 12 month forward earnings for the energy sector.




* Smoothed; rebased; source: Thomson Financial / IBES

## Fixed Income– Widening Spreads

The challenges facing the high yield bond market, with significant exposure to smaller energy companies, have been well documented. Liquidity is drying up and many of these firms will be forced to seek bankruptcy protection. What is surprising, however, is that spreads on investment grade (Baa) bonds over treasuries are at the widest level since 2009. We view this as the bond market warning that the broad economy is slowing and the potential for a recession is elevated. We anticipate the flight to safety trend to continue, especially if the message from bond traders proves to be accurate.


## Technical– Falling off a Cliff

The most compelling technical indicator that we watch is the Advance/Decline line on the stocks traded on the NYSE. This data is the most short-term direction the market is headed. The clear pattern that has developed over the last 5 months is of lower highs and lower lows. We also track the long-term trend for the A/D Line and it is currently below its 200-day moving average. The breakdown in this technical indicator is not isolated. It confirms what multiple other technical signals are telling us, and that is portfolio managers should focus on risk management.

# False Sense of Security

Brett Lapierre, CFA, *Director of Research*

**Low Beta Investing**

With financial markets having entered into a period of heightened volatility, investors may be positioning their portfolios more defensively these days. But how does an investor accomplish this? Do they overweight less cyclical sectors like health care and consumer staples and underweight economically sensitive sectors like industrials and consumer discretionary? Or, do they hold more cash and pursue various hedging strategies? What about owning higher quality stocks? These are all viable strategies in our view. But perhaps Investors should consider low-beta investing as a viable option.

One simple way to pursue a more defensive Investment strategy while remaining fully invested is to favor low beta stocks, which are stocks that generally have lower volatility than the overall market. As most investment professionals know, beta is a measure of relative volatility. The higher the beta, the greater the risk a portfolio or stock has relative to say the S&P 500 Index. Low beta portfolios, those with a beta less than 1, tend to be less volatile than the market. Portfolios exhibiting high betas, or a beta greater than 1, would be more volatile than the market. The goal of low beta investing is to own low beta stocks in an attempt to lessen the overall risk of the portfolio. The downside to low beta investing is that investors may be giving up some potential upside in exchange for that lower volatility. But is this necessarily the case?

**Performance and Risk Analysis**

| | | 1Y | 3Y | 5Y | 10Y | 15Y | 20Y |
|---|---|---|---|---|---|---|---|
| S&P 500 Low Volatility | | | | | | | |
| | Total Returns | 14.8% | 14.0% | 15.8% | 9.1% | 10.1% | 10.7% |
| | Volatility | 8.2% | 9.0% | 8.7% | 10.7% | 10.5% | 11.4% |
| | Sharpe Ratio | 1.72 | 1.50 | 1.73 | 0.75 | 0.82 | 0.73 |
| S&P 500 | | | | | | | |
| | Total Returns | 11.2% | 17.6% | 16.2% | 7.7% | 4.6% | 8.8% |
| | Volatility | 9.1% | 8.6% | 11.7% | 14.7% | 15.0% | 15.2% |
| | Sharpe Ratio | 1.21 | 1.94 | 1.34 | 0.50 | 0.27 | 0.47 |

**Drawdown (DD) Analysis**

| S&P 500 Low Volatility | | | | S&P 500 | | | |
|---|---|---|---|---|---|---|---|
| DD(%) | Peak | Valley | Recovery | DD(%) | Peak | Valley | Recovery |
| 35.36 | May-07 | Feb-09 | Dec-10 | 50.95 | Oct-07 | Feb-09 | Mar-12 |
| 22.91 | Jun-99 | Feb-00 | Oct-00 | 44.73 | Aug-00 | Sep-02 | Oct-06 |

*As of 7/31/2015. Source: Standard & Poor's, Corinthian Investment Research.*

Standard and Poor's launched its low volatility index in April of 2011 and has provided some data showing how their methodology would have performed as far back as 1991. The results are somewhat compelling in our view. The table below compares some key performance statistics for the S&P 500 and the S&P 500 Low Volatility indices.

Favoring low volatility stocks outperformed the S&P 500 by roughly 200 basis points during the 20-year period ending July 31, 2015. In fact, the low volatility version of the S&P 500 Index outperformed in all but the three and five year periods. The 5-year period's underperformance of roughly 40 basis points is overshadowed in our view by the lower volatility and superior Sharpe Ratio. To us, this suggests better risk-adjusted results. The 3-year period is disappointing across the board in our view.

The underperformance during this time period was accompanied with higher volatility than the S&P 500, suggesting that low volatility investing is not always a superior strategy. However, it is interesting to note that the underperformance during the last three years came during a stretch of abnormally low volatility for U.S. equity markets. So maybe we should over look this time period given the domination it has add across all other periods.

Taking this analysis further and looking at some the largest drawdowns over the 25-year period, one can see the benefits of low beta investing. First off, the peak to trough, or valley, during the "Great Recession" was much less, at 35% for the low volatility index relative to the nearly 51% drop for the S&P 500. Second, the time it took the low volatility index to recover from its lows was much less, roughly 22 months, Feb. 2009 to Dec 2010. The S&P 500 took 37 months, Feb. 2009 to Mar. 2012, to recover. The decline at the turn of the century showed similar results with the low volatility index having half the drawdown and a much shorter recovery period. These represent compelling statistics in our view. After all, the name of the game is to generate as much return as you can with as little volatility as you can.

Whether or not the outperformance of a low-beta portfolio can persist into the future remains to be seen and investors pursuing such an approach should understand this. But we think it warrants much attention. In fact, it has already garnered much attention in academic circles. There is a lot of research on the subject of low-beta investing. Some researchers have empirically identified that a portfolio of low beta stocks tends to outperform the market when accounting for risk. Some have gone as far as to say that the persistence of the low beta phenomena makes it a worthwhile strategy to pursue regardless of the market cycle. Others have indicated it is simply another version of value investing, which is a market anomaly that has been shown to outperform over the long term.

Regardless of where one stands on the subject of low beta investing, it does appear to us to have a great deal of merit and is worth serious consideration. While low-beta investing may make a lot of sense in challenging investment environments such as the one we are experiencing today, it appears to us to be a worthwhile pursuit across all market cycles.

# Did You Know?



## Q: Is it time to take a bite into Apple?

Yes, absolutely!

I have often referred to AAPL as a victim of their own success ever since they were included into the Dow Jones Industrial Average. Even though AAPL continues to produce impressive growth of both revenues and earnings, they are treated as if they were a value stock in today's market.

In their latest quarterly earnings report, they posted a 32% jump in revenues and 45% earnings growth. Apple also generated more than $60 billion in free cash flow during their first 3 quarters of the fiscal year (a rise of more than 50% from the prior year). My view of AAPL is that China represents more of an opportunity than a risk as they remain the only "status brand" in the smartphone and wearable space.

Trading at single-digit price to earnings when adjusted for the cash on their balance sheet, they are probably the most compelling valuation of any company on the S&P I follow.

I recently upgraded my 2-year old iPhone 5 to last year's iPhone 6 Plus while my wife chose the I Phone 6 – the Plus was too big for her. We are both amazed at the improvements made in just over two years and how the technology continues to progress. There is no doubt in my mind that Apple is leading the way, something that I like in a company. These devices just get better and better. Wireless carriers have changed the payment plans around the phones and customers are paying full price now in most cases. No more subsidies really. While paying full price for the phones may slow the upgrade cycle some, wireless carriers are setting up payment options that allow the customer to spread the payments over 20-30 months at $18 to $35 increments; and no interest. This may help alleviate some of the potential slowing of sales as a result. The new iPad Pro device is also quite impressive. My concern would be that it cannibalizes some of the MacBook sales as it may be powerful enough to replace a laptop.

Looking at Apple as an investment, there is a lot to like in my view. High and relatively stable margins, high returns on capital, strong balance sheet and a relatively low valuation (13.3x trailing 12-month earnings vs 17.8x for the S&P 500) make Apple an attractive stock in my mind. The company's stock has underperformed the market during the recent downturn however, falling roughly 13% versus the S&P 500's 10% decline. I would expect Apple's stock to return as an equity market leader given I see Apple as a very high quality company. And I'd rather own high quality names in this market. I'm a fan of their products and of their stock, so I'd take a bite.

## Q: Will the U.S. dollar rise or fall?

The greenback took a small step backwards when the Fed decided it would delay raising interest rates in their latest meeting, but I do not believe it impact the long-term trend that has been in place for a couple of years now. There are many factors driving these expectations:

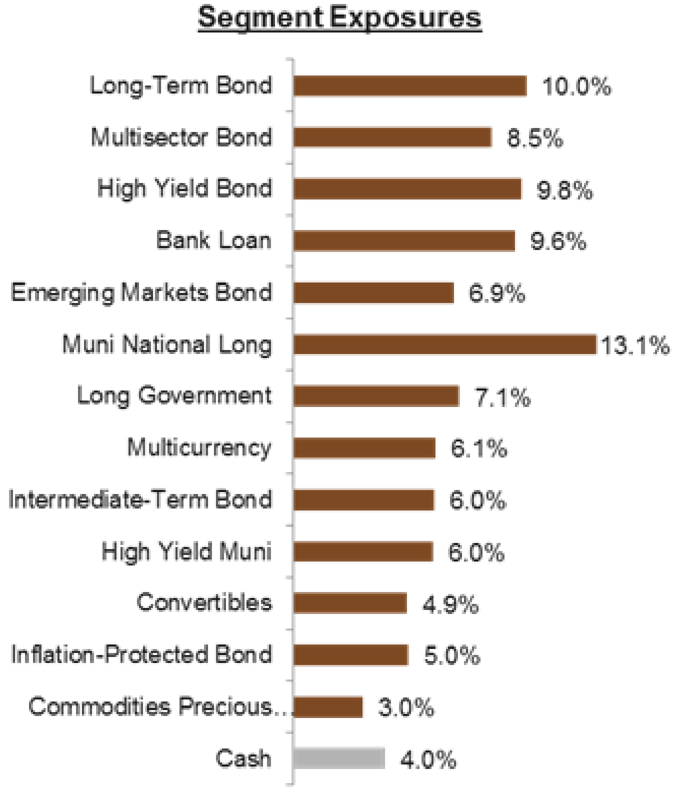
- USD remains the only viable global reserve currency and that will not change soon.
- When the Fed does hike rates it will be the only major central bank to be tightening.
- Technical indicators suggest the dollar has more upside.

We expect the Fed to raise rates in December unless there is a rapid drop in U.S. economic activity. Once the Fed begins the normalization process, sovereign debt yields will be far more attractive in the U.S. than other developed countries that should result in a large inflow of capital into the U.S.

The risk to the dollar, which has increased significantly in the last 3 months, is that the economic expansion in the U.S. stalls and the Fed is forced to announce another round of quantitative easing. The rest of the world is involved in QE but the direction of markets, whether stocks or currencies, are more driven by expectations than anything else and more QE in the U.S. is not currently priced in.

I think the concern and anxiousness over the U.S. economy and the timing of the Fed's first interest rate hike are slightly over blown. In my view, the pattern of modest and uneven growth that has prevailed since the "Great Recession" has a few more years to play out. Yes I acknowledge the rising headwinds with China's slowdown and the impact this is having across emerging markets and the rest of globe. Yes I have some concerns over China's debt levels and ability to sustain 7-plus percent economic growth. And I've heard a lot of commentary on how the current U.S. recovery is getting long in the tooth and that the probability of a downturn is rising. But we are still in unique times. The shallow path of the U.S. recovery coming out of the 2008-2009 downturn suggests to me that it could last longer than typical business recoveries. Couple this with the Fed's patience and what I see as a very gradual normalization of interest rates and I think this recovery has the potential to last a few more years. With the rest of the world's central banks pursuing various forms of stimulus and the Fed poised to raise interest rates, I think the U.S. dollar is likely to continue its rally. The key risk in my view is that the Fed has to reverse course or that it takes an even slower pace than the market expects, which seems unlikely. Europe's continued woes and China trying to solve its own challenges represents a positive backdrop for the U.S. dollar as well in my view. I may be a little too optimistic or have misplaced confidence in the Fed, after all, they may have missed a golden opportunity to lift rates in September. Nevertheless, I think the dollar continues higher.

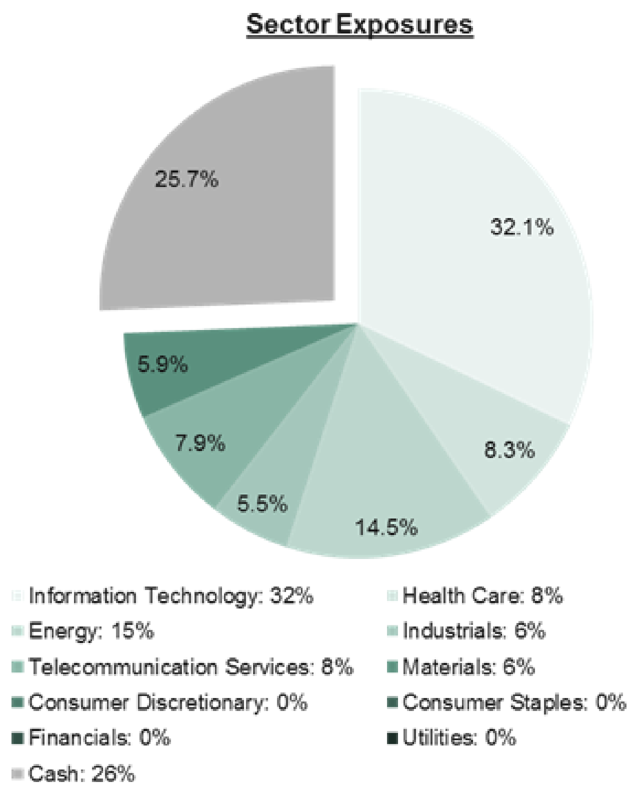
## Fixed Income




*As of 08/31/2015*

- Individual equity performance remains mixed with earnings for sectors outside energy demonstrating a level of stability while earnings among energy names struggle significantly.
- Exposure to convertible bonds has been reduced.
- As volatility among risk assets persists, we expect to see a flight to quality, creating an overweight of holdings with higher credit quality.
- Emerging market debt was dramatically reduced with anticipation of the Fed meeting in September

## Equity




*As of 08/31/2015*

- As the Fed maintains a zero interest rate policy (ZIRP), risk assets continue to appreciate.
- We continue to overweight and look for opportunities in technology and healthcare.
- As volatility and uncertainty persists, cash is being raised among equities.
- The yield for equity holdings fell from 2.46% to 2.25% as a result of higher cash positions.

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