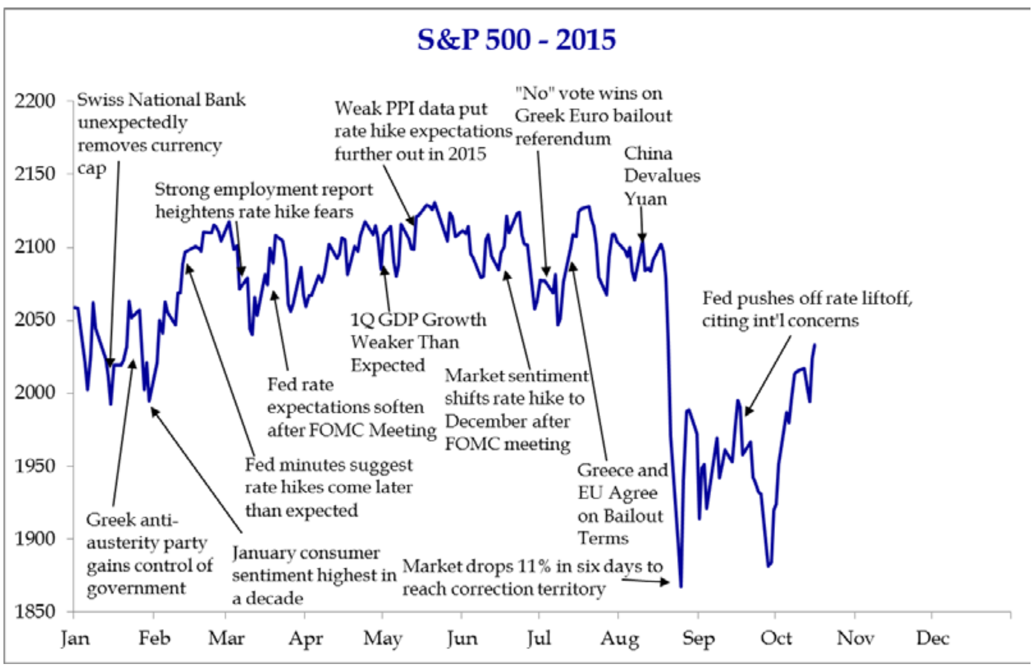
Market Turbulence Reflects the Global Shifting of Economic Trends

The U.S. and global equity markets swooned sharply negative in the third quarter of the year (Table I). This was the first substantial correction the equity markets experienced since the spring of 2012. Underscoring the heavy third quarter selling, the market recovered over half the decline in the quarter during the first two weeks of October. As we enter the third quarter earnings season in the latter half of October and early November, the direction of the market may well hinge on Corporate America's expectations and tone of business in the intermediate future. Additionally, part of the impetus to the market correction was the anticipated comments coming out of the Federal Reserve about its outlook on interest rates.

Table I



Source: Strategas

After years of the Federal Reserve making an effort to be clear in its intentions, Janet Yellen, the new Federal Reserve Chief, muddied the waters in September. Rather than raise the federal funds rate from the approximate historical low point of 0.13%, the Fed opted to wait citing low inflation and concerns over global economic weakness as contributing reasons. While we were not surprised that the Fed decided to hold rates stable, we did not expect her to indicate that concern over global economic issues were weighed in making that decision. This suggests that the Fed is now taking into account global economic issues and not just U.S. economic trends. There is some precedent for this in the past. During periods of very excessive economic and stock market stress, the Fed and their equivalent foreign institutions, worked together to generate liquidity for the world financial markets. However, this is the first time the Fed cited factors influencing their decision when no global-coordinated efforts to create more liquidity were needed. Additionally, Ms. Yellen came back to the public markets the following week and suggested the Fed may still raise interest rates before the end of the year! This was viewed as a bit like flip flopping on the outlook for interest rates. Worse, it was also confusing.

Needless to say, the U.S. and global markets dislike lack of clarity. Indeed, the global markets began to discount a potential deteriorating economic environment. Hence, a global correction in equity prices quickly ensued.

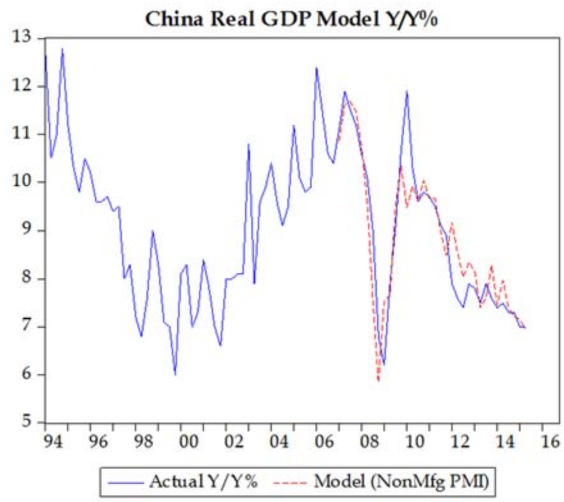
Our position on interest rates is somewhat different than the Fed's view. Under normal economic periods of low inflation, 2% GDP growth and full employment, the fed funds rate would be considerably higher than 0.13%. By keeping this rate at current levels, it underscores the position of the Fed and global equivalents that interest rates are likely to stay disproportionally low for a considerable time. It also suggests a low global growth outlook.

Our principle concern rests with the excessively low interest rate environment that has pushed money away from less risky assets such as investment grade bonds and into more risky assets such as equities and high yield debt. Quantitative easing and uniquely low interest rates may ultimately create liquidity bubbles in a number of investments. By prolonging a return to normal interest rates, the Fed continues to create an environment where investment funds seek riskier alternatives to more traditional (and less risky) diversified investment assets.

If the 2% inflation target of the Fed is to be considered in this equation, then we will need to see significant real wage increases in the near future. That prospect seems unlikely. Global economic growth continues to be cut by most forecasters to about 3% in 2016 from a peak forecast of 3.5% in previous months. While Europe continues to hold up well, emerging market growth and U.S. growth appear to be slower than forecast.

China and the Emerging Markets

Table II



China Real GDP Y/Y%= -26.7 +0.6 Nonmanufacturing PMI Est. 2007-2015 R^2 = 82%*
Source: Strategas

As we pointed out in our last quarterly review, China is more likely to be the pivotal issue in global growth, more so than Greece and the European Union. To put China in perspective, the country is shifting its economic profile from an export-driven infrastructure buildout mode to a consumer-consumption orientation. This means that further emphasis will likely be placed on job growth and wage increases, reduced pollution of air and water resources and improved working conditions. At the same time, infrastructure, plant and office construction may be slow versus the last ten years. This shift is having a direct impact on commodity prices (as China slows consumption and importation of various commodities) and is also slowing its GDP growth as it transitions to a consumer economy. Concurrent with this shift, the government has enacted an anti-corruption campaign aimed at illegal payoffs and money laundering activities. These campaigns have reached to very senior officials in the government and underscores how serious the Chinese government is taking this effort. Clearly, this has also slowed economic trends in China as local officials focus on redeploying government money at a slower (and more productive) pace. We underscore that this shift to a consumer-driven economy is a major step in the right direction for China. While GDP growth is likely to be less robust as this transition continues, it is likely to put China in a stronger economic position in the future. Indeed, wage growth has reached a point where some manufacturing jobs have shifted to other (emerging market) countries.

We dwell on this analysis because we believe that once China stabilizes and develops a slower, but more sustainable growth, global commodity prices are likely to improve. This in turn should set the stage for a recovery in emerging markets in the next one to two years.

<u>Global Oil and Master Limited Partnerships – Has Anyone Blinked Yet?</u>

Oil prices have been depressed in the last eighteen months due in large part, we believe, to Saudi Arabia's desire to regain, or at least stabilize, its share of the world oil market. With the success of fracking in the U.S., our domestic oil and natural gas production has risen sharply in recent years. This has reduced our dependence on OPEC oil, particularly from Saudi Arabia. By most estimates, we may have cut our consumption of OPEC oil by as much as 2.5 million barrels a day. By continuing to produce a large output of oil, the Saudi's have created an oversupply situation in the global oil market. Concurrent with a sharp reduction in exploration, as oil prices collapse, it has also forced the marginally profitable wells to close. Importantly, Russia and Venezuela, two big oil producers, continue to pump at near record levels since their economies are directly tied to oil as their principal export. Some experts believe supply/demand may move to equilibrium by mid-2016.

This turmoil in oil prices has led to a full scale collapse in oil stocks and virtually all Master Limited Partnerships. The MLPs have been impacted by the current collapse in oil more negatively than in the 2008-09 period when oil fell to $35 a barrel (versus $47 currently) and access to capital markets was severely restricted. There are a number of reasons for this. First, the oil price correction in 2008-09 was much sharper than the current pullback. This time, supply continues to exceed demand and may not reverse until sometime in 2016. Secondly, investor demand for MLPs has been surprisingly strong in recent years as the Fed embarked on an extended period of quantitative easing, which pushed up bond prices to what many consider bubble territory. Thus, money that would normally be in bonds has found its way into high yield equities such as MLPs. We also believe that MLPs may have attracted a different investment group than the average MLP investor historically. Institutional investment managers have grown significantly in this space. Since MLPs are still a small asset class, liquidity issues are magnified during peak periods of stress.

Table III

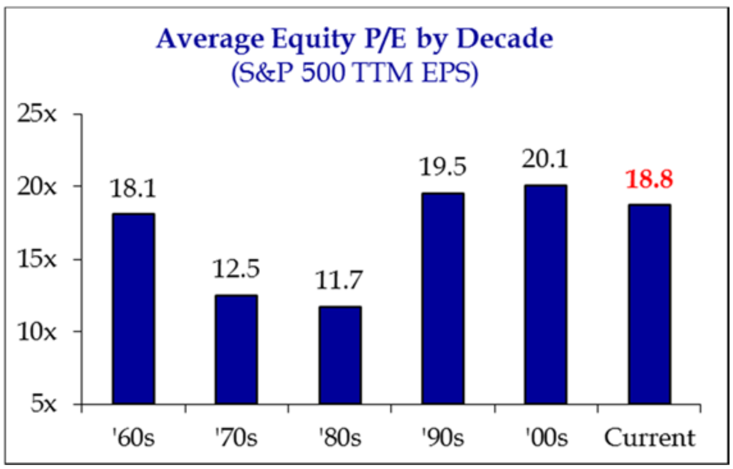
Source: Credit Suisse on 10/9/15, Company Filings, Thomson Reuters

Lastly, unlike 2008-09, interest rates are likely to rise in the next 10 years versus the almost steady decline since 2008. However, we believe the market has overly punished this group and has created an attractive opportunity for current investment in this asset class. As Table III indicates, MLPs have reached a uniquely high level of attractiveness relative to historical trends. We remain positive on our investments in this space. Our position in mid-stream (very limited commodity exposure) MLPs gives us confidence that their expected dividend distributions may likely rise over the next few years. Finally, our MLP portfolio is heavily dependent on transporting natural gas. Our direct exposure to oil is limited.

2016 and Beyond

Four factors are likely to weigh on the U.S. equity market over the interim term. First, interest rates are likely to rise. This will mark a reversal in an almost 30-year decline in interest rates in the U.S. ***Importantly, we expect a very gradual rise in rates in the next few years.*** Secondly, stock market volatility is likely to be with us for a while. The absence of quantitative easing takes away the perceived safety net that ultimately asset values will rise. Thirdly, corporate profit growth is likely to be single digits in the next few years concurrent with a peaking in profit margins.

Table IV



Source: Strategas

Finally, U.S. and global GDP may be slower than “normal” until inflation begins to move toward 2% based on improving economic activity. These factors should be enough to keep P/E ratios in a relatively narrow band of 15-19 times projected earnings in the foreseeable future. Overall, we expect single digit equity returns in the intermediate term. As Table IV demonstrates, the equity market is fairly priced in the near term. We believe the market is currently selling at 16.5 times projected profits in 2016. Barring a surprise recession, the market is likely to grind modestly higher next year.

On the other hand, a number of factors are also adding to a potentially more positive trend. Europe continues to show slow, but steady growth in most countries. Japan is also beginning to show moderate improvement, and it may finally emerge from its 10 plus years of deflation. China is also likely to grow moderately in 2016. The government is well aware of the need to avoid unrest in the population and sustaining growth-oriented programs should be in evidence. Finally, we expect many companies in our portfolios to continue to generate good earnings growth concurrent with rising cash flow and dividends. In fact, should the U.S. dollar decline against the Euro next year, it could act as a tailwind to multinational earnings. Overall, we expect a positive year in 2016.

Kings Point Adds New Professionals

We are pleased to announce two new additions to our staff.

Recently **Jordan Lentz** joined our administrative staff as an Associate Financial Advisor. Prior to joining KPCM, she was a Registered Sales Assistant in the Fixed Income division of Raymond James. While living four years in China, Jordan worked for Reign Private Wealth Management, specializing in business development and investor relations. She also worked at Elite Investment Group, providing financial services, as well as insurance coverage, to fellow expatriates. Proficient in Mandarin, Jordan graduated cum laude from the University of Florida.

We are also pleased with the addition of **Steve Martin** to our Investment Research staff. Steve joins us as a Senior Research Analyst and will be a member of our Investment Committee. Steve began his Wall Street career at Smith Barney in 1982 where he and Jack Salzman worked together on a number of transactions for consumer products companies. From 1985 to 1990, he was employed at Merrill Lynch where he was a founding member of the firm's Merchant Banking Group. During his tenure as an investment/merchant banker, Steve continued to specialize in transactions, both as agent and principal, in the retail and consumer products fields. Steve also served on the Board of Directors for a number of private companies in which Merrill Lynch had equity investments, including Pathmark and Del Monte. In 1996, Steve founded Slater Equity Partners, a Long/Short hedge fund focused on the domestic retail/consumer sector. Steve served as the firm's Chief Investment Officer from 1996 – 2010, managing $350 million of assets. Steve graduated from the Wharton School at the University of Pennsylvania in December 1978 (B.S. in Economics), where he majored in accounting and finance. After graduating, he was employed as an accountant and received his CPA in 1981.

We are excited to add these two outstanding individuals.

Our investment strategy remains focused on strong, uniquely positioned companies that generate excess free cash flow. As always, if you have any questions regarding the portfolio, please call at your earliest convenience.

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