A Global Central Bank's "Put" Policy

Every quarter we analyze the domestic and economic "tea leaves" to properly gauge how the equity and bond markets may act in the next few months. Like most, we are generally on target and tend to get the overall direction correct. This is not to suggest we currently have a unique insight to the global economic landscape. Rather, we tend to fall back on the assumption that global and U.S. interest rates are likely to remain lower for even longer. In fact, all three major central banks reinforced policies during the quarter to keep a lid on interest rates:

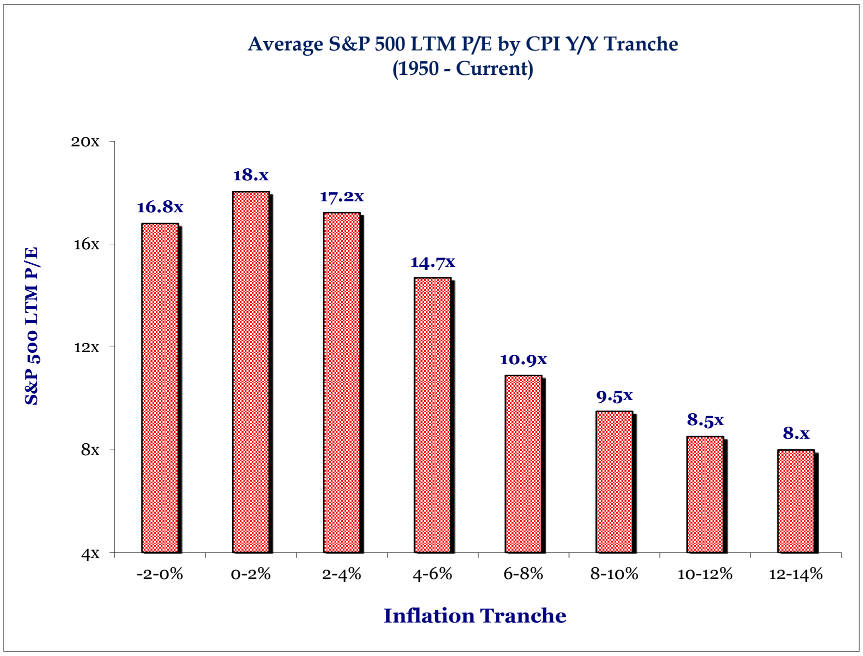
- In 2014, Mario Draghi stated that the ECB would do "whatever it takes" to provide support for the EU. In the wake of BREXIT, now with the UK's probable invocation of Article 50 in March 2017 and the upcoming Italian December vote whether to remain in the EU, it is highly unlikely that any rate increase will occur throughout Europe. In fact, the ECB is now considering the purchase of European equities given the lack of available debt.
- The current head of the Bank of Japan (Kuroda), as recently as last month, announced a policy to cap the 10-year JGB (Japanese Government Bond) at 0% until inflation exceeded 2% per year. Since this target has not been achieved in a long time, it does not appear any rate increase is on the horizon.
- Lastly, while the FOMC has continued its accommodative stance through much of 2016, the committee is expected to raise the Fed Funds rate by 25 basis points (0.25%) in December. The last increase occurred in December 2015, and the move was supposed to signal further increases as the path for rates was higher. Unfortunately, the last twelve months of economic data, market turmoil, international events and flat earnings have held the Committee in check. As such, any single rate increase in the coming months will be limited and generally have a muted impact.

These supportive central bank policies are clouding economic trends globally and, as such, are making it more difficult to determine whether things are truly getting better. While ignoring sluggish GDP growth, many economists believe trends are improving as indicated in job growth and wage increases. Job creation is running at 175,000 or more monthly, and the economy is nearing a state of full employment. Wages are finally moving upward after a long period of stability. If this trend continues, it is possible that inflation could gradually move higher toward 2.0% in the intermediate term. Corporate productivity also seems to be rising modestly as well, however further data is needed to determine if these changes will actually warrant a rate hike.

Unless we see a geopolitical reason or a negative economic trend develop, the benign interest rate environment will continue to support equity valuations. Perhaps the more critical variable in valuation is the expectation for corporate earnings growth in 2017. Arguably, corporate profit margins probably peaked in 2015–16. Thus, we suspect that the bottom-up consensus estimates of $125-$135 a share for the S&P 500 next year may prove too optimistic. Our base case (17x P/E at

$125 a share) puts the ***overall market flat with current valuations***. (See chart 1.) Thus, with the U.S. equity markets already at fair value, we expect stock selection (vs. passive indexing) will be critical over the coming year.

Chart I



Source: Strategas

Election Expectations

We agree with most observers that the current political environment is ugly. However, one conclusion is self-evident. The composition and orientation of the new Congress should be far different than is currently the case. Thus, we believe that there is a silver lining regardless of which presidential candidate wins. The new president is likely to finally break the long-term logjam of legislative inaction in 2017 forward. Both political parties are well aware of the unhappiness with our current political process. We expect the new Congress will likely address some of our pressing issues by finding some compromise between both political parties. To that end, we expect to see new legislation that addresses issues relating to healthcare and financial reform, as well as defense spending. Furthermore, we believe that each party may also consider more infrastructure spending as a new policy tool to help stimulate GDP growth in future years.

Current Portfolio Structure

In this environment, our equity focus continues to be on specific companies with the capability to generate earnings growth of 8–15% in 2017. More importantly, we continue to maintain a disciplined attitude toward seeking equities at reasonable valuations. In the volatile market we are currently facing, it is just as important to know when to wait. Active investing is often coupled with properly timed inaction.

As we have mentioned in past quarterly reviews, we find equities in business services and defense industries attractive. Both are characterized by high free cash flow, strong balance sheets and high returns on invested capital. As previously mentioned, we still expect a significant acceleration in defense spending in the next few years as the U.S. government brings defense budgets back to pre-sequestration levels.

Finally, we are finding good opportunities in certain healthcare areas. Valuations are currently depressed due to concerns over drug pricing and rising healthcare costs. We believe these issues are transitory and will be resolved by mid-2017.

For investors seeking more yield, the outlook for long term bonds continues to be unattractive. We have found selected, short-term, high yield alternatives, as well as strong dividend growth equities to supplement bond portfolio income. With our expectation of a continued low interest rate environment, these equities should continue to generate modest to moderate total returns over the next 12–18 months.

As mentioned earlier, central bank policies continue to dominate market activity, and any perceived benefits have diminished. While we are hopeful that a light bulb will go off in our leaders' minds toward fiscal policy reform, we remain skeptical at this time. However, should this occur, our stance would become more constructive over time.

<u>Upgrades</u>

We recently upgraded our corporate website and invite our clients to review our new look. We have tried to make it more informative and easy to use. Our website address remains the same.

Please contact our offices with any questions.

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