Verity Asset Management

Commentary

March 31, 2016

When we last wrote, in late January, markets were in a full-blown panic – the price of oil was plummeting, pessimism regarding the Chinese economy and the prospect of Fed rate hikes was high, and talk of a U.S. economic recession was widespread.

There were and are legitimate causes for concern, but the scope of the market reaction at that time seemed more about emotion than information.

By mid-February, the price of oil was stabilizing, China had not dramatically devalued the yuan or fallen off an economic cliff, the Fed seemed to be considering rate increases with caution, and the U.S. economy appeared to be modestly picking up its pace again. Equity markets began rebounding; the panic had begun to subside.

By quarter end, much of the lost ground had been recovered.

The question now: Where are the earnings? We are facing a fourth consecutive quarter of decline in corporate earnings. Fortunately, that decline began from record highs, but a positive change in trend is essential. Markets can rise in the short term for all kinds of reasons, but higher prices on a sustained basis depend upon growth in earnings.

Markets have recovered on the recognition that things were perhaps not as dire as they had suddenly seemed as the year began, but valuations in most sectors are stretched - and notably so in what are considered "safe" sectors such as consumer staples and utilities. We find ourselves in sort of a "where do we go from here" situation.

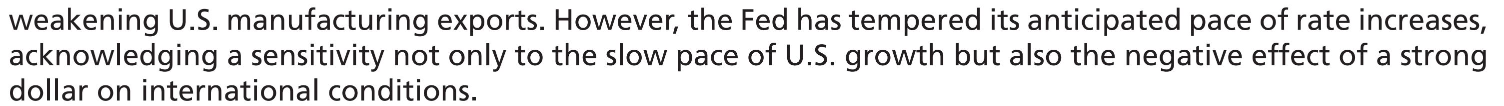
Since the most notable drains on U.S. economic growth over much of the past year and beyond have been the result of plummeting energy prices and a strengthening dollar, let's begin there …

Oil

Oil prices, as we all know, have fallen in the face of significant oversupply as a consequence of the hugely successful application of horizontal drilling and related technologies. However, we now appear to be back on a path toward a supply/demand equilibrium. World production in 2015 was 96.4 million barrels per day. With the caveat that specific figures in this arena are notoriously unreliable, some estimates place the current rate of oversupply at 700,000 barrels per day, with demand currently growing at a monthly rate of 100,000 barrels per day. Iran is meaningfully ramping up production following the lifting of economic sanctions, while U.S. supply is now declining in response to the deep reduction in prices. There are innumerable other variables, but world demand could reasonably equal supply in roughly 7 to 10 months. Though prices can be expected to remain low relative to prior expectations, oil could before long recover sufficiently to permit a positive turn for energy industry earnings on a year over year basis.

The Dollar

With the Federal Reserve embarking on a path of raising rates and the world's other major central banks easing, the general expectation heading into 2016 was for the dollar to continue to strengthen, further



weakening U.S. manufacturing exports. However, the Fed has tempered its anticipated pace of rate increases, acknowledging a sensitivity not only to the slow pace of U.S. growth but also the negative effect of a strong dollar on international conditions.

In addition, following the G-20 meeting of the world's major central bankers and finance ministers in Shanghai in late February, it seemed that the central banks of the U.S., Europe, China, and Japan had at least informally adopted a policy of cooperation in an effort to avoid serious currency dislocations. Prior to this meeting, there were growing fears of such dislocations, with complex but deeply disruptive effects on international markets in ways that could prove profoundly negative for all. It is questionable how long this "accord" can last, if in fact it exists, and – more significantly - about the ultimate ability of central banks to control the currency situation regardless of their best efforts. However, the major economic powers seem intent on avoiding outright currency conflict – for now – and this has appeared to help calm markets.

In this environment, the dollar has at least temporarily backed off its surge higher. Though it is too early to draw conclusions, manufacturing has in recent weeks shown some positive signs of a meaningful turn from the significant decline of the past year and beyond. And even a stabilizing of manufacturing would remove a significant headwind to U.S. economic growth.

The Rest of the Economy

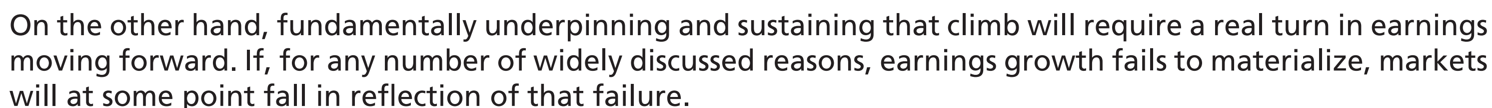
On the whole, the economy has ***appeared*** to be firming somewhat after a very weak close to 2015. But growth remains at best very slow with a frustrating mix of negatives for nearly every positive - encouraging steps forward mixed with deflating steps back again. Ultimately, there is little clear momentum forward or backward, despite the many "confident" opinions on both sides of the issue.

In perhaps the most consistently positive trend, the labor market has continued to relentlessly improve, and the consumer, despite legitimate frustrations, is in much better shape than a few years back. There has been steady growth in employment and income, consumer credit conditions are favorable, the debt service ratio is near record lows, energy prices are low, consumer confidence has remained relatively strong, and housing prices continue to appreciate solidly – all of which are supportive of a strong consumer spending outlook.

As seems too often the case, much depends on the American consumer – and in another one of those offsetting negatives, the broad economic effect of the improving labor market is being undermined to some degree by low productivity growth - but the American consumer remains a powerful force. Absent a renewed deterioration in energy and manufacturing, or something comparable, the U.S. consumer ***could*** help turn corporate earnings and give the market a fundamental reason to move to higher levels, but the jury is still out. So far, the consumer has been pushing incremental economic gains into savings rather than spending – not a bad thing in the long run, but not yet supportive of a solid near term boost to the economy.

Earnings

From a market perspective, if there's a perverse positive to the negative earnings outlook, it's that analysts have revised earnings estimates down so severely during 1st quarter that expectations may not be hard for a large majority of companies to beat. Positive surprises on earnings – including earnings which are simply less bad than expected - can be very strong market catalysts. In an environment of modest economic growth, a gradually strengthening American consumer, and with energy and manufacturing stabilizing, a wave of positive earnings surprises could provide a path to higher markets in the near term.



On the other hand, fundamentally underpinning and sustaining that climb will require a real turn in earnings moving forward. If, for any number of widely discussed reasons, earnings growth fails to materialize, markets will at some point fall in reflection of that failure.

In short, what all of this means is that there is both (a) a viable path to higher equity markets in the short term, and (b) a viable path to a return to the kind of earnings growth which could fundamentally support higher market prices. But neither path is without significant risks and formidable headwinds.

This analysis has intentionally focused primarily on U.S. issues. The international economy, though weak, appears to be plugging along. But the lack of meaningful growth across the globe is concerning, and there are plenty of other factors which could undermine – at least for a time - whatever constructive moves the slow-moving U.S. and international economies are struggling to make. A British exit from the European Union; a banking crisis in China, Spain, Italy; further escalation of the political and economic turmoil in Brazil; expanding political chaos in the U.S.; more concentrated terrorist activity in the West – there's always a list of risks, and the current list could go on perhaps longer than the norm.

And unfortunately, in a world where central bankers have become primary players, a market analysis such as the above can be undone very quickly by an unexpected move emanating from any of the world's major central banks.

As we have addressed in various ways over an extended period of years, current economic and market outlook reflect events playing out in the shadow of a nearly incomprehensible volume of debt worldwide, which since the financial crisis has only continued to expand. Debt of such magnitude, wherever located and however managed, presents a very serious and ever present risk, with the potential to materially change current conditions at any time. Portfolio positioning should consider not just current market outlook, but appropriate levels of risk given an investor's personal circumstances.

This material contains forward looking statements; there is no guarantee these outcomes will be achieved. All investing involves risk of loss, and there is no guarantee that strategies which may have been successful in the past will be similarly successful in the future.