Verity
Asset Management

*Second Quarter 2016*

# *Waiting for Godot*

**Samuel Becket won the Nobel Prize in Literature in 1969. That was a banner year for the arts and sciences - the same year as Woodstock and Apollo 11.** The reason I know something about Beckett is because I am familiar with one of his plays: "Waiting for Godot." The plot revolves around two older guys who are both waiting in a park for a fellow named Godot (pronounced "ga-doh"). The two acquaintances meet some rather strange characters as they wait endlessly and in vain, because Godot never arrives. The play is about waiting.

**The popular theme on Wall Street lately has had a similar plot: investors wait in vain for the economy's next recession, which never seems to arrive.** Like the characters waiting for Godot, the real life participants keep convincing themselves the recession should be here soon.

**Investors did get plenty of reasons to expect a recession in January.** Analysts warned that falling energy prices could lead to massive junk bond defaults. There were negative stories about weakness in the global economy. Corporate earnings fell and, for the first time since 2009, the S&P 500 recorded a year-over-year earnings decline for the third straight quarter in a row. Both the S&P and the Dow dipped back into "correction" territory for the second time in six months, a rare pattern that has historically preceded bear markets.

**As it turned out, large cap stocks were just the final shoe to drop in what turned out to be the end of a bear market in small company stocks and in many cyclical company stocks.** Now that the correction and bear markets are behind us, the stock market uptrend looks healthier than it has in quite some time.

**While the correction was sharp, the rebound was even stronger.** One analyst commented that stock market breadth (a measure of the number of stocks participating in a market rally) recovered so quickly in March that it looked more like a new bull market than an aging one.[1]

**What seemed to turn stocks around were comments by Federal Reserve Chair Janet Yellen. She indicated that, due to global economic weakness, interest rates will not be raised as quickly as had been previously communicated.** The Fed's willingness to keep monetary policy loose in order to avoid a recession may be the best explanation for why a recession is unlikely. With interest rates so low, the Fed has few tools to aggressively stimulate the economy. So, keeping the country from slipping into a recession in the first place may be the Fed's primary goal. For this reason, a slow economy may actually be a good thing for investors because interest rates will remain low!

**Call me a skeptical bull, but the overall evidence looks fairly bullish to me.** I find the market somewhat overvalued and there are still questions about growth in Europe. However, U.S. monetary policies should remain quite friendly to the U.S. economy and financial markets.

**My sense is the market will return to the old highs then take a pause to see which way the wind is blowing.** Once the political conventions are behind us and the nominees are chosen, investors will make assessments about which of the candidates and policies are likely to prevail, and then adjust accordingly.

## Corrections and Bear Markets

***Peak-to-trough Market Performance***

*The correction in large capitalization U.S. stocks masked bear markets in small U.S. companies and in emerging markets.*

Large Cap Stocks
*S&P 500 ETF (SPY)*
**-15% correction in 9 months**

Small Cap Stocks
*Russell 2000 ETF (IWM)*
**-27% bear market in 8 months**

Emerging Market Stocks
*Emerging Markets ETF (VWO)*
**-42% bear market in 57 months**


*Source: stockcharts.com*

**It is Time to Invest in Emerging Markets Again**

**There are signs that the long slide in emerging markets may be at or near an end. Here are a few:**

1. Prices for commodities like oil, iron and soy have stopped falling and have actually risen a lot. Oil prices are up 54% since hitting a low on February 11. Iron and copper prices are up this year too. This is great news for emerging markets, many of which depend on commodities to drive growth.

2. Fears have eased about China's economic slowdown and how much value its currency, the yuan, will lose.
3. Interest rates aren't rising as expected. That eases the pressure on developing countries, some of which have to pay off their debt in higher value U.S. dollars or euros.
4. The U.S. dollar rallied a lot against several currencies in emerging markets last year. In fact, now some of those currencies are gaining value against the dollar in 2016.[2]

**Another key reason is value.** The -42% bear market in emerging markets left them quite undervalued compared to U.S. markets. Valuations of emerging markets are trading at steep discounts to the S&P 500.

One important measure of value, the price-to-earnings ratio or P/E, measures how many dollars an investor must pay for a dollar of earnings. The P/E for the S&P 500 is 18, while the P/E for the emerging markets is only 12.5. Cash flow multiples are even cheaper by comparison.

| | Emerging Markets ETF (VWO) | S&P 500 ETF (SPY) |
|---|---|---|
| Price/Prospective Earnings* | 12.5 | 18.0 |
| Price/Book* | 1.4 | 2.5 |
| Price/Sales* | 1.2 | 1.8 |
| Price/Cash Flow* | 3.9 | 9.8 |
| Dividend Yield %* | 3.4 | 2.4 |

Source: Morningstar.com

As of 04/22/2016

*Forward-looking based on historical data

**As the year progresses, I'll be watching how market leadership evolves.** I suspect it will continue to favor emerging markets internationally and large companies domestically. I will make portfolio adjustments accordingly.

Thank you for your ongoing business and confidence. Let me know whenever I can serve you.

**Malcolm M. Trevillian, CFA CMT**
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Notes:
[1] Ned David Research (ndr.com)
[2] Summary from money.cnn.com: "Emerging markets have rallied. Will it last? April 15, 2016.