Traub Capital Management Q4 2016 Outlook and Commentary

October 7, 2016

Introduction

So far, 2016 has been unfolding pretty close to what we envisioned in, as Coach Belichick would say, all three phases. In our case, the three phases are not offense, defense and special teams, but rather the domestic economy, the world economy, and the financial markets. We projected growth in the domestic US economy to be somewhat over 2.5%. Our forecast for domestic unemployment was for it to remain under 5%. Growth of both the Japanese and the European economies was forecasted to be low, with 6% economic growth in China. Our forecast for S&P500 earnings was up 7% from 2015: - $122 vs $114. We forecasted little to no change in the overall P/E ratio, indicating a 7% overall increase in the S&P 500 index. We were looking for oil to increase from the mid $30's to about $50 per barrel.

The year has unfolded remarkably close to our forecast. The consensus for S&P 500 earnings for the year 2016 is now $125. The consensus P/E ratio is now 16.2x vs 16.5X at the close of last year. The forecast Traub Capital made for the overall S&P 500 index for 2016 was for a fairly small, single digit, rise coupled with increased volatility compared with what we had seen in the past five or six years. So far, the S&P500 index is up more than 5% with a dividend income of almost 2% additional return. Volatility in the stock market has definitely exceeded that of recent years as we projected.

On the economic front, domestic growth looks like it should be just a bit over 2.5%, while both Europe and Japan will be positive, but considerably below that of the US. China looks to turn in economic growth numbers of 6.5%. Domestic unemployment has held at 4.9%, with labor force participation increasing from 62.6% to 62.8% and a net average monthly increase of 158,000 new non-farm labor jobs added throughout 2016. The price of West Texas Intermediate oil is now about $50/barrel, vs. $37 at the beginning of the year.

Economic Projections

Economic growth both in the US as well as in the rest of the world is anemic for a business expansion and will most likely remain so. We expect that the US Federal Reserve will increase the Fed funds rate in December by 0.25%. The abnormally low interest rates here in the States are exceeded by negative short term interest rates prevalent in Europe. We believe these very low interest rates are causing artificial distortions to our economy as well as to the economies of Europe. Normally, banks make money by borrowing short term funds and loaning them out with higher, longer term durations. They make money on the yield spread. Today, with very low interest rates across the board, banks are hard pressed to make money in the so-called "normal" way. At the same time, banks, particularly those banks in Europe, remain undercapitalized. It is hard for banks as a whole to raise capital if they are allowed such a small margin as indicated by the yield curve. Banks, particularly in Europe, need capital. Unfortunately, the yield curve supported by governmental policy will not afford an opportunity nor

incentive to lend. Insufficient earnings potential has led to “creative” solutions, which have worked to various degrees in various countries around the world.

The very low interest rates hurt banks, but they do help big companies that can borrow money at very low interest rates and that can float bonds at low rates as well. Small companies, however, face a different set of rules. Small companies are the largest creator of jobs in the domestic economy and their access to investment funds is often very limited. They have to borrow from banks and those banks do not have much incentive to lend or to take much risk.

It is not likely that all this distortion will unwind any time soon, so we continue to expect to see limited economic expansion here in the States and even less in Europe and Japan where interest rates are even lower.

We are, however, creating jobs. Domestically, about 150,000 jobs are being created each month, which closely matches the additions to the workforce, keeping unemployment at about a constant level. The jobs that are being created in general however are not high paid ones. The parts of the domestic economy that are expanding are healthcare and education. The highly paid parts of the healthcare and education industry, however are not exactly entry level positions. Teaching is not the most lucrative career, but after a few years, teachers earn a reasonably good salary. Doctors are well paid, but only after a lengthy period of education, internship and residency. Jobs with multi-year lead times are not going to respond to short term changes in economic conditions.

The highly paid manufacturing jobs that the domestic economy enjoyed for many, many years are gone. Some of these jobs are indeed victims of outsourcing to lower wages in foreign economies, but frankly, the overwhelming number have been simply destroyed, not outsourced to lower wage locations.

We have been destroying jobs in the domestic economy for well over 150 years. Just think of textile and shoe manufacturing that one hundred and fifty years ago employed a substantial part of the non-farm labor in this country. By 1850, improvements in textile processing equipment coupled with the efficiency of mechanized shoe making machinery and the McCormick reaper were displacing manufacturing and farm workers by the score. The balancing impact over that 150 year period was the rise of other manufacturing opportunities that absorbed the workers. The displacement process was not smooth nor was it painless, but the overall impact was a multifold increase in labor productivity and a vastly improved standard of living.

We are still increasing manufacturing output in this country. The difference is that it no longer requires significant labor input. Ford’s River Rouge manufacturing complex, for example, employed 120,000 people during WWII. Today, there are about 5,500 employees at the plant, yet Ford is building way more cars that it ever has in its history. The same story is true in the American railroad industry. In 1947, railroads in this country employed 1,560,000 and produced $8.7 billion in revenue. Today 235,000 railroad employees produce $77 billion in freight revenue. Revenue per employee went from $5,738 to $330,357 - far outplacing inflation which would account for an increase to only $48,000 in revenue today. The rest of the increase is in efficiency and that story is replaced throughout numerous other major industrial segments of the domestic economy.

You cannot say to Ford that it needs to hire 100,000 people just to have them hanging around. Just think what a car would cost with all that extra labor cost. The fact is that highly paid manufacturing jobs in this country are not coming back any more than the family farm of the 1900's, or the New England woolen mills or shoe factories, all of which were huge employers for many, many years.

Strong banks, with an economic incentive to lend money to small companies might make a difference in the quality of jobs being initiated. Unfortunately, we are not going to find out if that is the case due to the mega distortions in the banking and financial sectors throughout the world and much heavier regulatory burdens and costs. So we are going to be stuck with an economic expansion that is far from robust.

That said, the economy should plod along domestically as well as in the rest of the world well into next year. Europe and Japan will put up very small numbers; China will not have a "hard landing". Inflation will be moderate. Some increase in labor costs will occur as employees become harder to find. However, with the present balance in the domestic labor markets, labor inflation will be modest and no amount of financial incentive will convert a high school graduate immediately into a highly paid surgeon or software engineer.

All-in-all, we believe our projections for 2016 should all be within range. Look for small gains for the balance of the year in domestic equity markets. International equity markets have lagged their domestic counterparts for years and could see better returns.

It is not unusual for equity markets to have an extended pause in the midst of a substantial upturn. We are seeing signs of this behavior, which portends some further upside potential, but we cannot be sure just when. Earnings of the S&P 500 companies are expected to increase 13% in 2017, led by a very substantial 300+% increase in earnings from energy companies. Many energy companies will swing from losses to profits with the increased price of oil. Energy company earnings will no longer be the drag on the overall corporate averages that we have seen in the past two years. This forecast bodes well for the future. But because better earnings from energy companies are widely anticipated, we will not see any substantial increase in stock prices for energy companies. The expected earnings improvements in the energy sector are already priced in. Exxon, for example saw its profits drop by 75% since 2014, but its stock price is pretty much unchanged. The stock price for Exxon is not going to quadruple as it gets back to profit levels of 2014. Rather, the P/E ratio (currently at 34x for Exxon) will go down. The same is true for all energy companies and the result will be for the P/E ratio of the overall stock market to decline back towards its historical average as overall earnings improve faster than overall stock prices.

The impact of improving profits from the energy sector will couple with lower P/E ratios next year to give, what we believe, will be modest gains overall. Also volatility will not go away and we believe the potential for upside volatility is similar to that for the downside, so holding the investment course seems to be the best advice. We will make a more detailed set of projections for 2017 with the next quarter's economic review.

Revisiting 2014 Disaster Scenarios:

At the end of 2013, we took a look at seven possible economic disaster scenarios. We thought with now three years of perspective, it might be worthwhile to revisit those possibilities to see if any of those potential disasters might be unfolding.

At the time, Japan was teetering. Things have improved a bit since then. The country is headed in the right direction, but negative interest rates and cultural changes are much needed in the societal fabric. However, it is unlikely that diversity will increase within the culture thus stifling innovation. Certainly the age demographics will not change, which are trending considerably older. Nonetheless, even though Japan is in a tough spot, it does not appear to be facing an implosion and they seem to be muddling through.

Banking counterparty risk also seems to be abating. This risk was one of the chief culprits behind the great recession of 2009. Since the end of 2013, bank capital has rebounded, particularly here in the States. The European banking system remains severely undercapitalized and will continue to face difficulties. However, at Deutsche Bank and virtually every bank in Italy notwithstanding, there is some hope for improvement as the plight of the European banking system is in the spotlight. Perhaps it will get some much needed attention.

Pension default seems to be receding with continuing gains in equity investment values. If pension funds can actually realize a 7% return on their investment, they will actually be able to fund their obligations. A 7% return is an unlikely goal to reach, but it is feasible with very strong stock market returns and we continue to see progress on pension funding.

The balance sheets at the world's central banks continue to be questionable and this situation continues to warrant vigilant review. However, at the moment, it does not appear to be at a tipping point.

We wish we could write that the basic world order appears to be on the mend, but, in fact, world order is continuing a downward spiral without any real leadership. Examples are numerous, starting with Britain's exit from the European Union. No one knows just how this process is going to wind up. The European Union is facing other difficulties as Italy will be dealing with a vaguely similar referendum, probably in November. The structure of the EU is a single currency and a single set of bureaucratic regulations, but individual country fiscal policies. Unfortunately, this structure is fraught with underlying difficulties. It does not appear that more unity is in the cards and free immigration and worker movement adds to the strain. Because it appears that European leaders are not restoring order, the situation is not getting back on track.

Saudi Arabia and Iran are not reconciling their differences in spite of proclamations that OPEC is ready to limit oil production.

Russia is backed into a corner with the decline in the price of oil. Their only option seems to be "blame the foreigner". There is no agreement between world powers on Syria, and Russia has recently decided to abrogate its treaty with the US on plutonium disposal.

China and the US continue to be at odds over China's building of new islands in the South China Sea and outfitting those islands with military positions. No resolution appears to be in sight. These trends are disturbing and bear continued surveillance.

The US Dollar remains firmly in place as the world's reserve currency. In fact, the US dollar has increased in value over 20%since mid-2014 compared to the Euro. The strengthening relative to the Pound Sterling is a bit more over that period. Since June 2015, the dollar has strengthened about 25% compared to the Yen. It is good to see that the increasing value of the dollar has not triggered a retaliatory currency war with US officials taking steps to cut the value of the dollar. The US economy has stood up to the strain, which further solidifies the dollar as the world's reserve currency. Given the difficulties of the euro, it is not likely that the euro will become a threat to the dollar as the world's reserve currency any time soon.

Frankly, we were very displeased at the recent political antics surrounding the so called Saudi Arabia 9/11 bill. Congress, on both sides of the aisle displayed their penchant for political grandstanding by overriding President Obama's veto of this bill which challenges the concept of sovereign immunity and allows US citizens to sue the country of Saudi Arabia for its alleged role in the 9/11 attack. The repercussions from this override could be substantial, forcing Saudi Arabia to liquidate its US treasury holdings and its presence in the United States. It could also open the door for any citizen in any country to sue any sovereign entity for most any alleged transgression. The fall-out will be increased world isolationism, which will have negative economic consequences. We are following the impact of this override. While it has not challenged the US Dollar as the world's reserve currency, it could definitely impact world trade and promote national isolationism as noted in the paragraphs below.

World trade trends are disturbing. Growth of the combined world economies has slowed from 5.4% in 2010 to 3% last year and is headed for continued very slow growth. At the same time, growth in world trade has reversed. While trade had been increasing at a rate of 2.8% in 2014, trade growth has slowed to a forecasted 1.7% in 2016. Hanjin Corporation, a large container shipping company from Korea has declared bankruptcy amid the slowdown. The International Monetary Fund (IMF) has noted an increase in national protectionism and both US presidential candidates are sounding populist alarms.

It is easy to blame "foreigners stealing jobs" and it makes for good political headlines. There is no doubt that the world economy will continue to disrupt domestic economies. Those people who face the disruption will react bitterly. On the other side, people who get new jobs because of increased trade will not likely show similar gratitude. Boeing's forecast of $5.9 trillion in new aircraft demand globally over next twenty years, of which Boeing will garner a large share, gets very little press as does Mercedes Benz's new $500 million plant in South Carolina.

The preponderance of the S&P 500 companies derive a substantial percent of their sales and in aggregate about one-third of their profits from international operations. Curtailing world trade is not a real solution as much as politics would have you believe.

A potential Health Care crisis is a new item added to the possible disaster scenarios this year. Private exchanges supporting Obamacare are not making money and they are starting to opt out. Health care costs continue to increase and it is not very clear that the increasing costs are a net positive to the economic position of the domestic economy.

Conclusion:

On the economic front, equity markets in 2016 showed a bit of an increase and have continued their pause in what we believe will continue to be a bull market. At the same time, there remains plenty to worry about. Several disaster scenarios have diminished in probability, but there is a new one on the radar screen. None of the possible disasters is imminent and all likely have horizons longer than 3 years, which is about the horizon of the investment community. That said, investors are not approaching anything resembling euphoria. We believe the equity markets will continue to climb this wall of worry over the next few years but with some serious hiccups.

We look forward to continuing to monitor the overall economic picture and we thank you for your confidence and for your continued support. Please do not hesitate to give us a call should you have any questions.