Traub Capital Management: Q3 2016 Outlook and Commentary

Introduction

It's been another bumpy ride in the markets this quarter. From the headlines, you would have thought that England voluntarily decided to leave the planet while Europe was swallowed up by the big hole that was left behind. Come on. Measured by the MSCI World Index, global equity markets were up 1.0% for the quarter, following a loss of 0.4% in the first quarter. Not much of a change all together when looking at that statistic. The US stock indices have fared a bit better than that while international stock markets are actually down for the year. The forecast Traub Capital made for 2016 was for a fairly small, single digit, rise in the equity index coupled with increased volatility compared with what we have seen in the past five or six years. The day before the British vote, the S&P 500 index stood at 2113, five days later the S&P 500 index stood at 2107. (Of course, it was a little bumpy in the meantime, but still.) The equity market's measurement of volatility has spiked three times in the first half, but then settled down about back to where it started.

We at Traub Capital try to look at the economic environment as it develops and assess which events portend major changes in the economic landscape and which events are the noise surrounding those major developments.

In the case of Brexit, most of what we see so far is noise and any impact in the longer term economic picture will not develop for many quarters. For further detail on the Brexit issue see what we sent to our clients just after the vote at www.traubcapital.com under the "Education and Research" tab.

The important economic variables are: the state of the US economy, the state of the Chinese economy, the broad economic picture in Europe, and any significant changes in the value of the respective currencies. These significant economic impacts will translate into corporate earnings and then into equity valuations. The coming changes in economic growth, and related changes in inflation expectations will affect interest rates and ultimately the value of bonds (which then affects stocks as well).

Domestic Economic Picture - Base-Line Forecast

The US accounts for about 25% of the world GDP. The broad picture of the US economy is good, but not great. We are expecting the US economy to grow about 2.5% this year and our base-line forecast is for a similar amount of growth in 2017. Job growth for June was very strong and offset the disappointing May numbers. The jobs that were created for the most part, however, were not the "great" paying, high value type. Nonetheless, the US economy is approaching a state of "full employment" where the jobs growth is pretty well balanced by the growth in the labor force. This situation starts to put some economic power into the hands of employees and we will start to see some pick-up in wage inflation that we have not seen for many years. Wage inflation, coupled with moderate overall economic growth, will start to put pressure on corporate earnings and corporate earnings are one of the keys to equity valuations.

Continued job growth, however, does lead to more optimism and that is another of the major factors affecting equity values. We see a bit more optimism coupling with very limited increases in corporate earnings sort of balancing each other, leading to a flat overall equity market, albeit with some upside potential. The economic factors, however, do leave some potential for risks to the overall picture. We will describe these risks and probabilities for them further on in this review.

While we do not see a significant softening in the price of oil over the horizon, we do not expect the price to rise either. A continuation of oil in the $45 to $50 range will be a drag on earnings for energy companies compared to last year. Oil prices are up since January, but at the present level of $50, the price is still 40% less than the average for 2015. Earnings for companies in the energy sector will similarly be down compared to 2015.

Interest rates remain very low as well and the difference between very short term rates and rates for 10 year obligations is low compared to historical averages. The low spread means that bank loan margins are low and bank earnings growth will also be low. Low earnings from banks and low earnings from energy companies make up a fairly large chunk of the market and thus the projected overall sluggish earnings growth.

Domestic Economic Picture - Recession Possibility

Creeping up on the radar screen is the possibility of what we would see as a mild recession starting in 2017 and/or early in 2018. Mind-you, we do not see this scenario as the most probable, but the likelihood is increasing. There would be three driving forces which could set the economy on a downward trajectory. First, will be an increase in the US inflation, which could be triggered by the wage inflation mentioned above. Second will be a series of interest rate hikes by the Federal Reserve. In past recessions, the third or fourth rate hike by the Fed often shows to be a contributing factor. This is particularly true when we see what is known as an “inverted” yield curve, i.e. a situation where short term interest rates are higher than long-term ones. The Fed controls the short term rates, but there are driving forces detailed below which contribute to keeping a lid on longer term rates, setting up the possible inverted yield curve scenario. Third, will be an expansion in protectionism. “Protecting” trade, means that countries continue to put up trade barriers. Trade barriers were one of the main contributing factors in the Great Depression and unfortunately, when one country does so, other countries are inclined to do the same and it becomes a vicious cycle. We have seen more trade barriers instituted than removed in the past five years and are closely watching the situations with Britain and the EU and between the US and China to see if the situation is inclined to get worse.

European Union Economic Picture

The European Union accounts for about 23% of the world GDP. The majority of the S&P 500 companies derive substantial revenue and substantial profits from Europe. The economic picture in Europe is not strong. Economic growth should be about 1.5% in 2016 and not much more in 2017. Unemployment is much higher than here in the States and inflation is significantly less than 1%. Depending on which axe they have to grind, pundits have lots of villains to assign the blame from over-regulation, to lack of entrepreneurial spirit, refugees, etc. We are not a political entity, so we will leave the reasons up to the politicians.

Economically, Europe lags. European interest rates across the board are significantly lower than are their domestic counterparts and that interest rate differential has led to major capital movements from the euro to the US dollar, weakening the former and strengthening the latter. There is no reversal on the horizon for the interest rate differential and we expect further increases in the value of the dollar and further flows of capital to dollar denominated securities. These capital flows put a real cap on the 10-year Treasury bond yields in this country. Any higher interest rates leads to higher capital flows into the US, higher value of the dollar, weaker world currencies, more expensive US exports, and lower earnings for S&P 500 companies since a lot of those earnings are in world currencies other than the dollar. Most of these effects are generally considered as “bad” for the US economy/earnings and keep a lid on 10 year+ interest rates.

The effect of Brexit is unclear. We believe it will be a net negative for the economies of both Britain as well as for the EU. The extent of the impact will be determined in the political arena over the next several years, but it is a permanent shift. There will be swings up and down, but the damage will be done to both economies. We do not believe that Britain harbors any ill will towards Europe, but, to the extent that the EU wants to “punish” Britain for their behavior, the worse both parties will be for the effort.

The damage to the European economies is a possible risk to S&P 500 earnings since a significant portion of those earnings are made in the EU. Damage to the British economy is not particularly problematic for most US based companies, since domestic trade with Britain is actually quite small compared to the US economy. The European economic outlook is one that we will be watching closely as it relates to earnings of US-based companies.

Chinese Economic Picture

China accounts for about 15% of the world GDP. Growth in their GDP has “slowed down” to about 6.5%. Now, if the US were growing at 6.5%, it would be phenomenally good. The US economy is a bit bigger than is China’s so a 6.5% growth in the economy in China would be the same boost to the economy in actual dollar terms as 4% growth in the domestic economy. There are some concerns in China, namely the real estate sector, but there is no anticipated “hard landing” nor is there a negative growth recession in the economic picture for China and bringing the Chinese economy to a consumer driven economy, rather than an export driven one, is beginning to take shape. It is interesting to note that reports from China are now beginning to bemoan the “exporting of jobs to cheap labor countries like Vietnam” and headlines form Vietnam bemoaning “automation” for taking jobs. This litany sounds eerily familiar to scenarios that have played out here in the States, doesn’t it?

Salaries for knowledge workers in China are now approaching those for their counterparts here in the US, so China will no longer be able to rely on low cost labor to fuel its expansion and it is understandable that the rate of growth is slowing.

Stock market picture

Overall, we see the stock market to be appropriately valued, or slightly expensive, based at least on the overall S&P 500. We are looking for earnings to be about $115 per share this year, leaving a P/E ratio of 18.5. This ratio is a bit on the high side. We are watching earnings closely as, in our view, overall earnings growth of the S&P 500 companies will not grow much faster than the overall domestic economic growth of 2.5%. The big efficiency gains of reusing existing capacity and integrating new technology are behind us. Innovations from "The Internet of Things" (IoT) will have some positive impact, but nowhere near that of the internet itself or cloud-based computing. Advances in biotech and disease control will be wonderful for those in need, but will not add markedly to the efficiency of the production of goods and services.

As we look at the situation, however, we see some real divergences in various sectors and various stock groups. And we have positioned the portfolios to take advantage of what we see are the undervalued sectors and limit risk to the others.

Growth vs. Value

The first cut at different parts of the market is "Growth" vs. "Value". For the past nine years, "Growth" stocks have significantly outperformed "Value" stocks with only a couple of calendar years where "Value" inched above "Growth". We see that leadership changing and most certainly, the risk profile for the two parts is quite different. Going forward, while we see very small growth in the overall market valuation, we do see a bigger risk for sell off on growth stocks as opposed to those on the value side of the spectrum. This view is based on the fact that the previous nine years saw much stronger performance of growth stocks and thus has led to much higher valuations of growth stocks relative to value stocks. This year we have seen this finally reverse with value stocks doing better, and we expect this to continue to the benefit of our portfolios.

Apple Update

We were very glad to see that Apple has been approved to open retail stores in India. Although it has not yet received approval to sell used phones, and although we have no inside information on Indian regulatory agencies, we do believe that approval will be forthcoming. When it does, the combination of new stores, a big market in India (it is the second most populous country after China), and the ability to sell much less expensive, refurbished, phones there will bring some sales growth back into Apple. At the moment, with its balance sheet, its stock buyback program, a low P/E ratio, and its 2.4% dividend, it is a classic value stock. Yet we continue to believe it has a much more valuable customer base and much more growth capability than the market is recently building into the price (arguably its current multiple presume negative earnings growth going forward).

Conclusion:

That's it for the summer. More volatility in the markets as the issues raised above pop in and out of the news combined with an election getting closer and which few Americans are enthused about.

And if you need some summer vacation advice, go to England. The weather is great in the summer and the Pound Sterling is down over 25% from where it was a year ago compared with the dollar, so everything is 25% off before the music even starts.

Again, we thank you for your confidence and for your continued support and please do not hesitate to give us a call should you have any questions.