RIVERPOINT
CAPITAL MANAGEMENT | INVESTMENT ADVISORS

MARKET INSIGHTS

From RiverPoint Capital Management

Market Insights is a publication of RiverPoint Capital Management.

Like everything we do, it is designed to bring you talented resources and proactive advice with a single purpose in mind – to help our clients achieve financial security and peace of mind.

Learn more about what we do at www.riverpointcm.com.

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Complacency—Not on Our Watch!

History books tell us, and our own observations back up the fact, that stocks on balance have risen in value 3.5 years for every year of decline. Since 1925, over any rolling 12-month period of time, the stock market has generated a positive return 73 percent of the time (S&P earnings data herein from spindices.com). Over any rolling 5-year period of time, the stock market has generated a positive return 86 percent of the time. This we know. That said, this rather rosy data cannot be used to rationalize a buy and hold forever mentality. Tactical adjustments must be made and a more defensive posture embraced when signs of an extended bear market appear. After all, these periods of decline can last a year or more. We do not see such negative signals present; this is why we remain positive on the U.S. equity market and maintain the midpoint of targeted allocation to stocks in our client portfolios. It is the data, not complacency, which leads us to this conclusion. When the facts change, we will change our view.

Leading Causes of Extended Bear Markets

Historically, the stock market has fallen by 20 percent or more for an extended period of time due to:

- Extremely tight monetary policies: This isn't a .25 percent increase in rates. Think of the monetary policy being applied to short term interest rates in the early 1980's. Paul Volker, former Chairman of the Federal Reserve, raised interest rates by 2 percent in one action! That's a tight monetary policy action.
- High valuation levels: We're not referring to stocks selling at today's valuation levels (17x earnings) but rather to the valuation levels we saw in the 1999-2000 era when the S&P 500 was selling in excess of 25x earnings.
- Economic recession

So, where do we stand on these three historical drivers which have preceded prior significant bear markets? ***We don't believe the Fed is going to tighten monetary policy excessively or rapidly, nor do we currently believe the stock market is grossly overvalued. This leaves the possibility of a recession as the last item to address.***

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Recessionary Signals

Economic recessions are always of great concern because they can inflict significant pain on both the markets and economy, and on average last 12-18 months. Should we see an economic recession as likely we would want to reposition client portfolios to be more defensive. Temporary corrections not associated with recession, on the other hand, are much shallower and short term in nature. It is generally not advisable to reduce equity exposure during these mild and brief wiggles that are a normal course of bull market advances.

The possibility of a recession requires close monitoring. Though recession fears have significantly subsided after the January/February swoon, speculation about the potential onset of recession continues to be the talk of many market analysts. Looming economic recessions were the catalyst for stock market declines of more than 20 percent for multi-month periods in the early 1980s, in 2000-2001 and again in 2008-2009. ***While anticipating oncoming recessions is not an exact science, we can look at conditions prior to past recessions and compare those conditions to today's economic activities to give us an inside track on predicting if a recession is on the horizon or not. Cutting to the chase, we don't see the weight of evidence pointing to a recession occurring any time soon. We've been consistent with this message and this view enabled us to hold positions in a volatile first quarter in which all of the early S&P 500's losses were recouped in short order.***

What We Are Monitoring

In order to help us determine if and when a recession may be coming we have three different indicators we are watching very closely. Separately they have a good history of predicting an impending recession, but together they are an even better predictor.

Indicator	What We Are Looking For
Employment Data	Current job creation remains strong at over 200,000 jobs per month. If this were to slow materially and do so over the course of consecutive months this would raise concerns that the economy was slowing down.
Yield Curve – More specifically the difference between the 10-year treasury yield and the 2-year treasury yield.	Currently the 10-year treasury yield (1.8 percent) is around 1 percent higher than the 2-year treasury yield (0.8 percent). If this relationship inverts (the 2-year treasury yield becomes higher than the 10-year treasury yield) then we should be ready for a recession. This indicator has a 100 percent accuracy rating of predicting recession.
Manufacturing and Service Data	Both manufacturing and service data released by the Institute of Supply Chain Management (ISM) are currently in expansion territory. A sign of a pending recession would be preceded by both of these measures contracting...one alone is not enough.

If Not An Economic Recession, What About A Profits Recession?

Many analysts are now conceding that an economic recession is unlikely in 2016. Instead, they suggest that we may nevertheless experience a "profits recession" or a decline in earnings in 2016, citing the low 2 percent overall profit growth in the S&P 500 last year and declines in earnings in the first quarter of 2016. What is our take? We think earnings growth is likely to have bottomed in the first quarter. Since we don't expect an economic recession to ensue over the next 6-12 months, we suspect corporate earnings should rise. This is typically the case as GDP growth tends to drive corporate earnings.

Two major issues have impacted corporate earnings over the last year:

1. **Declining commodity prices (oil, for example) have decimated energy company earnings.**
2. **A strong dollar compared to foreign currencies has hurt multi-national companies.**

Let's analyze these two drags on reported earnings. Each appears to be softening which bodes well for acceleration in earnings in 2016's second half.

Falling Commodity (oil) Prices

As oil prices declined last year, oil company profits collapsed. The S&P 500 energy sector's reported operating earnings vanished. Earnings dropped by 132 percent in 2015 as compared to 2014. At the beginning of the year energy earnings were projected to decline 11 percent and continue to be a drag on S&P 500 earnings. Oil began the year trading for $37/barrel and declined to $26/barrel by the middle of February. This led many analysts to reduce earnings expectation even further for energy companies to minus 65 percent for the year. Oil prices currently are above $40/barrel, higher than where we began the year, yet earnings expectations remain extremely low. We believe the estimates have been decreased too far and should be higher than anticipated if oil prices stabilize around current levels. ***We suspect energy company operating earnings changes may cease being a major drag on S&P 500 earnings during the third quarter of this year.***

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Strong Dollar to Foreign Currencies

Almost half of the average S&P 500 company's sales come from overseas. Unless the currency conversion on those sales is effectively hedged, the company's reported sales are subjected to currency fluctuations. As an example, if a company sells $100 of goods in France, that transaction takes place utilizing the euro. Over that period of time, if the euro declines by 10 percent in value to the dollar, when the company "translates" that sale in dollars, it won't be reported as $100, but $90.

Over the last three years, the value of the dollar has been rising in relation to most foreign currencies. This trend appears to be changing. The dollar has declined relative to the euro and yen for the last six months. ***Therefore the negative impact the strong U.S. dollar has had on multi-national companies should begin to reverse course and be a positive contributor to earnings. For every 1 percent decline in the value of the U.S. dollar, S&P 500 earnings increase approximately $0.50. A weaker dollar could lead to higher S&P 500 earnings in 2016, and in turn higher stock prices.***

Collectively these two factors—oil price declines and dollar appreciation— reduced S&P 500 earnings growth by more than 10 percent in 2015. If these headwinds simply stabilize in 2016, we could see positive revisions to earnings per share and decent earnings growth in the back half of the year.

How We Are Investing Through All This Noise in 2016

We remain disciplined and committed to our process of investing in high quality stocks with consistent earnings growth, dividend payouts and growth of those dividend payouts. After a recovery of over 13 percent from the February 11, 2016 low in the market, we found it prudent to take some profits and trim some of the stocks which have had significant gains over the past few years and become larger positions in our client portfolios.

In the short term, we do expect volatility to continue. But, we believe a fact-based decision making process, that lies at the heart of our disciplined long term investing approach, will lead to success in achieving your goals and objectives. Please call your Wealth Advisory Team at RiverPoint with any questions you may have.

