Mixed Messages

Our 2015 outlook was the second consecutive to include the notion that markets would be weaker than the broader economy. Specifically, we said that “we continue to expect markets to be weak and volatile compared to the economy”¹ and this is largely what happened. If one checked the S&P 500’s price at the close of December 31, 2014 and not again until the close of 2015, it would appear that not much happened on the year. The S&P 500 had a -0.81% price return, alongside a 1.23% total return. The Dow dropped 2.19% pricewise, but added 0.09% in total. Global markets and small caps were particularly weak, with the MSCI All Cap World Index shedding 4.58% on price (-2.15% total return) and the Russell 2000 dropping 5.85% (4.40% total return) respectively. The most notably poor performing asset class was the High Yield Corporate Bond Index (as represented by HYG) which had a negative total return of 4.75%.

While the S&P 500’s performance was seemingly flat, the underlying performance in specific stocks tells a vastly different story. Through the course of the year, 534 total stocks were in the index at some point (due to corporate actions, compositional changes, etc). The average return of those 534 stocks was a negative 3.94%. 301, or 56% of the stocks in the S&P ended negative. 200 stocks experienced double-digit losses, compared to 142 double-digit gainers. 11% of the stocks in the S&P lost one-third or more of their value, versus 5% that gained more than one-third in value. Fourteen stocks shed over half their value, while 5 added that much. There are two notable points worth emphasizing:

1. Dispersion between the winners and losers in 2015 was extreme.
2. If you look around the market, there was far more pain than there was gain to be had.

This was the second consecutive year of markets littered with minefields. We feel good that in our commentary last year we forewarned “the death of commodities as an investable asset class” and saw “much pain” in the MLP space. While we are not wavering longer-term in our conviction that “the benefits [of cheaper commodities] in nearly all respects outweigh any reason for concern [about declining capex],”¹ we think we missed an opportunity to approach this belief with more patience. In several cases, we thought the investor base in some high quality, non-energy companies would be willing to look past some of the nearer-term headwinds.

Investors spent most of the year wondering if and when the Federal Reserve would raise interest rates, thus ending the Zero Interest Rate Policy (ZIRP) that commenced in an effort to stave off the Great

Financial Crisis. It took until halfway through December to get an answer and after seven years, rates finally moved up to 0.25%. We long argued that the first rate hike would be a reflection of economic strength and with the November unemployment rate at 5.0% (we do not know year-end as of the time of this writing), that certainly is the case.

Throughout the year, market commentators blew a lot of hot air prognosticating about “the FANGs” and concerns about China’s long-term GDP growth rate. In case you have not heard of The FANGs (you would be better off for it), that is the acronym coined for the four most significant standout performers in 2015: Facebook, Amazon, Netflix and Google (the company formerly known as Google, now Alphabet, but who would let a technicality ruin a good narrative?). One of these is not like the other ones (hint: it’s the one we own). In fact, it is so different as to render the narrative a vapid, but marketable headline.

In our first two sections below, you will see that there is a yin and yang side to each of the major themes from this past year and how they setup for the future. Each strength came alongside a form of weakness. These forces do not truly offset each other and we will attempt to wrap it all together for you.

**Consumer Tailwinds:**

*The Prolonged Benefits of Low Rates, Part 1:*

The benefits of cheaper financing aren’t going away. One of our favorite charts for a few years has been household debt service as a percent of disposable income:
The difference from 2006 to today is massive and serves as one of the clearer lenses through which to see a primary force behind the Great Financial Crisis: household expenditures on the interest component of debt was at its highest level in recent history. This improvement is consequentially related to the low interest rate policy at the Fed. Many overemphasize gross debt levels as a source of risk, to their detriment. The debt service situation for households is as healthy as it has been in over three decades.

Let’s talk through the benefit of low rates even further: people who bought houses or refinanced their mortgages to longer duration, lower rate structures have locked in prices for the single largest annual household expense. Per the BLS, the average household with a married couple dedicated 30% of their total expenditures to “Housing.”

Housing includes more than just shelter; however, shelter accounts for somewhere around 60% of that amount. This means the average household that owns a home spends 18% of their budget on shelter, or what would be covered by mortgage principal and interest payments. With just shy of 64% of households owning houses, the affordability of housing will improve every year for two-thirds of American households.

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2 http://www.bls.gov/news.release/cesan.nr0.htm
A little exercise helps highlight the long-term benefits. Let’s take a sample household, who for the sake of simplicity spends $100 per year. Assuming the 18% spent on shelter is in a fixed mortgage. Each year, $18 will go towards housing and $82 to everything else. The Fed sets its target rate of inflation at 2%. On one hand, average inflation over the past century has been closer to 2.5%; on the other hand, we have been below trend for the past decade. For arguments’ sake, let’s set the inflation rate at 2%. With this, we will assume that wages grow at the inflation rate, and further that expenditures grow at the same rate as wages. In 10 years, the sample household will have $121.89 available to spend. $18 will still go to housing, but now $99.96 will go to everything else. In effect, this household will have about 0.3% per year extra to spend on the “everything else” category, which over 10 years adds up to 3.23%. This might not seem like a lot, but in 10 years, given the average household spent $53,495 in 2014, this will leave an extra $1,727.88 for households to spend in other areas. Multiply this by the 115 million plus households in America and that is a big number for the economy. These benefits increase quickly if inflation accelerates above 2%.

For context, here is average hourly earnings versus core CPI:

![Graph showing average hourly earnings versus core CPI](myf.red/g/32At)

When the yellow line is above the blue, workers are benefitting from real wage growth. Real wage growth means the purchasing power of the average employee is rising quicker than his or her expenses. Note that
since 2000, average hourly earnings have grown at a faster clip than CPI excluding food and energy. Thus we think this scenario outlined for an average household above is a modest example of the benefits that will accrue to nearly two-thirds of American households.

The Oil Dividend

The longer-term impact of low rates combines nicely with 2015’s second biggest story for consumers. In 2014, the average weekly price for gasoline was $3.358. In 2015, this average fell to $2.429 and a gallon ended the year at $2.034. On average, gasoline was 27.7% cheaper in 2015. If gas prices stay flat in 2016, they will effectively be 39.4% below the 2014 level. According to the BLS, the average household spent $2,468 on “gasoline and motor oil” in 2014. At 27.7% cheaper, this is a $683.64 savings per household, and at 39.4%, it is a $972.39 savings. This understates the true savings from cheaper energy, as heating bills, energy bills, and several other expenses tied to energy decline apace.

It takes time for people to judge whether the oil savings are a temporary or long-term effect. Now that we are more than one year past the most severe portion of the decline, people are beginning to accept cheaper gas as a normality. The Atlanta Fed, on its Macroblog, put out a great piece last year on the consequences of the energy price decline and they conclude that as far as consumption is concerned, “there is a short-run drag before the longer-term boom” (the short-term drag is misleading considering “consumption” measures all expenditures including those on gas. If gas declines and all other spending stays constant, consumption in aggregate will decline). 3 We see evidence that consumers are embracing cheaper gas when we look at vehicle miles traveled:

Only this past year did Americans drive more than the pre-crisis level and this enthusiasm was backed up by continued strength in car sales, with SUVs a notable standout.\(^4\)

**The Strong Dollar, Part 1**

Last year we jokingly labeled a section “The Strong Dollar Yellen Fed (take THAT conventional wisdom)” and lo and behold, the strong dollar got even strong. Our jab was meant to be ironic considering many were concerned that Yellen was too willing to embrace policies that were negatives for the dollar. Thus far we can draw one of two conclusions:

1. Yellen is actually a hawk in disguise.
2. Fed policy matters less than meets the eye, especially in the short run.

Good thing that we believe in nuances and that such dichotomies are not truly mutually exclusive options. On the year, the trade-weighted dollar index rose 23.1%:

Since we import a lot of consumer goods into the US, the strong dollar helps improve the affordability of many items that households buy on a regular basis.

**The Earnings Recession**

*The Prolonged Benefits of Low Rates, Part 2: The Hunt for Yield Turns Sour*

This is one of the most nuanced topics out there today. In part this section could have been written as a strength; however, it’s important to speak to some of the risks right now. Cheaper financing will be a part of many companies for a long time. Financing is not going to get materially more expensive—despite the rate hike—anytime soon. A chart showing net debt to EBITDA on the corporate level is the equivalent of our household debt service chart above for companies:
This is a similarly constructive setup, especially when combined with our discussion from last year about how non-financial corporations were the sector of the economy most ripe to add leverage.

So far, everything we said is a positive, so why is this in the “yang” section? If you will recall our letter entitled “The oil investors who don’t even know it,” we expressed concern about the extent of exposure in high yield bond indices to energy. This year, that exposure came back to bite in the form of a significant widening in energy-specific spreads, but also a broader de-risking in the high yield bond space. The best way to show this is with the spread of high yield debt over Treasuries:

5 http://www.rgaia.com/the-oil-investors-who-dont-even-know-it/
The impaired values of energy sector bonds have taken their toll on other sectors by decreasing investor willingness to buy new high yield issues.

*Oil (ex-) Dividend, The Earnings Recession:*

High yield bonds were not the only victim of corporate energy’s woes. The earnings in the S&P will actually register a decline (also known as an “earnings recession”) in 2015 (the yellow line in the chart below):
The market tends to follow the direction of earnings over longer timeframes. You can see in the above chart the gravitational pull of this relationship. Excluding energy, the S&P will register modest growth in 2015; however, the 36% drop in energy sector earnings was too much to outweigh everything else. Take a look at our September commentary for a deeper look at the sectoral breakdown of earnings.\(^6\)

Oil’s impact spreads beyond the energy sector through the industries that help service and build out energy production and transportation capacity. In the aforementioned Atlanta Fed piece, they offered an estimate of the near-term woes in capital expenditures and when to look for a leveling off. While this was published after the most acute phase of the oil decline, prices continued to drop throughout the year:

The effects of this capex shock will begin to subside early in 2016 and will be gone by 2017. With the economy near full employment, the potential for a negative feedback loop should be contained, as workers laid off from energy-impacted jobs can transition to other areas of need.

*The Strong Dollar, weak profit:*

The strong dollar was the other force conspiring against S&P earnings growth. The U.S. is home to many multinational companies who do considerable business abroad. When the dollar rises, the value of foreign earnings declines proportionately.
When earnings growth declines, investors take down the multiple they are willing to pay for a given earnings stream. This was particularly acute in the August selloff. Investors *en masse* went from paying a near 19x multiple of forward earnings to just shy of 17x during the month. This down move and subsequent snapback represent some of the uncertainty and angst on the part of investors. Will the woes in the oil, mining and industrial sectors spread into deeper economic contagion? Or will the benefits of cheaper goods accrue to consumers and create a virtuous cycle for the economy?

A corollary of the strong dollar is how multinationals based outside of the US actually get an earnings tailwind from a falling currency. This has been one of the key premises behind our interest in high quality European companies who do most of their business outside of the Eurozone. While the currency translation has been a drag on stock performance in the short run, we have finally started to see accelerating earnings growth attract higher multiples from investors.

**Where does the next recession come from?**

Last year we proclaimed the following:

> Importantly, we think the next recession will come from an economy that accelerates too much and must be slowed down via a tightening of monetary policy, rather than one where a credit contraction puts us on the precipice of deflation. In other words, the next recession will be of the run-of-the-mill variety, which are never fun, but are far less troubling than once-in-a-lifetime financial crises.  

With a rate hike behind us, we are increasingly convinced this will be the case. This is especially true given how tight the unemployment situation is today and the tailwinds that will support consumer spending for some time thereafter. This is exactly what was needed to get inflation back to the Fed target. The question from here begs whether the Fed will let inflation get ahead of target to make up for lost time spent deeply below it, or whether they will try to cool things off before they get even hotter?

As the calendar turns to 2016, market participants are focused intently on the risks out of China. Many of you clients live on Long Island and are probably more attuned to a major trend than the average person: there has been a big flow of Chinese money (and to an extent wealthy people) out of the country, and to the US (with Long Island real estate experiencing a huge influx of both). We can see some signs of this in looking at two lines from China’s Balance of Payments:

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We do not have end-of-year data for this yet; however, as of the third quarter, a net total of $330 billion of dollars has left China in “Other Investment” and a total of $162 billion has left via “Net errors and omissions.” Roughly speaking, China has offset some of this outflow by using its reserves to defend the Yuan and we can see that in the form of the largest reserve drawdown as a percent of total reserves China has seen since opening its economy and accumulating US dollars (see chart on next page):
Two points are worth noting:

1. In late 2014 when the outflows started hitting the Balance of Payments, and the reserve drawdown began, China opened its domestic equity market “A” shares to foreign ownership.\(^9\) Previously, foreign investors had to invest in China either via Hong Kong listed shares, or foreign domiciled proxies. This opened the floodgates for inflows. While foreign purchases of equities temporarily held the net outflows in check, it was a mere pause before a big acceleration. In many respects, the opening of shares was a sinister ploy to improve the Balance of Payments more so than a move in the direction of financial openness. This is further evidenced by the huge valuation premium assigned to Chinese A shares verse their Hong Kong counterparts, and what at that point were soaring and obscene market valuations relative to any prudent measures of value.

2. This money flowing out of China has to go somewhere. While China is selling dollars and Treasuries (note, both have gone up despite the China selling pressure, thus the fears about China

spiking US rates seem misplaced), Chinese private sector players are buying global properties and building bank accounts abroad. In effect, this money is going from passive, low velocity reserves, to active, high velocity assets and goods.

These forces collectively create volatility for global financial markets, but what they do not do is change the trajectory for the US economy. Oil is the primary mechanism through which the US economy does get impacted, and as we discussed above, that is a nuanced effect with lower capital expenditures hurting investment in the short run, but the greater consumer purchasing power accelerating growth in the mid and long-term. Despite these concerns about the global economy and industrials, the US economy continues to chug along. What we said two years ago is still relevant today:

... the economy is moving faster and in the continued process of acceleration. As we know from Newton’s Second Law of Motion, the greater the mass, the greater the force needed to change its direction. When an economy the size of the U.S. is accelerating to the upside, it would take an extremely massive force to first, derail its momentum and second, change its course 180 degrees.10

We discussed rising wages above. Two further forces bode well for the US economy in the coming year the end of the fiscal drag and the tightening housing supply. Both are supportive of increasing employment. With the fiscal drag ending, the US government (Federal, States and Municipalities collectively) will increase spending for the first time since 2010: 11

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Drag No More
In 2016, spending and tax policies among federal, state and local governments will make a positive contribution to growth for the first time since 2010.

Fiscal contribution to growth as percentage of GDP

As the chart above shows, from 2011-2015, this has been one of the larger forces holding back the economy. In fact, 2013 saw government spending chop over 2% from GDP growth. The inflection point from negative to positive offers a nice accelerant. Meanwhile, housing supply creation has now been below population trends for longer than it was above it during the housing bubble. In other words, over
the fuller cycle, we have underbuilt what is necessary to support demand. Housing starts should continue to surge:

![Chart showing stock performance over time]

Employment is already tight with the unemployment at 5%, yet the end of the fiscal drag and continued expansion in housing starts will keep demand for workers strong and help offset the pain that energy-related industries will experience. Herein lies the problem: these forces will push inflation upward in the coming year. This is exactly why the Fed commenced a rate-hiking cycle with the global economy looking uncertain. We will thus repeat, because it is so important: the next recession will come from inflation accelerating to the point where the Fed is uncomfortable and must act to stop it. China is merely a sideshow, but an important one nonetheless.

**What do we own?**

Much like with broader markets, performance dispersion across positions was the major theme for our holdings. Our European positions generally performed well, even when translated into dollars; however, for the second year in a row our considerable overseas holdings exposed us to the drag inflicted by a strong dollar. Two of the three losers no longer appear on our position roster (Bed Bath and Beyond and Siemens), while each of the winners remain.

Returns reflect US dollar denominated returns over our holding period.
The Leaders:

Alphabet (NASDAQ: GOOG/GOOGL) +46.6%

Groupe SEB (EPA: SK) +42.6%

Markel Corp (NYSE: MKL) +29.4%

The Laggards:

Bed Bath & Beyond (NASDAQ: BBBY) -36.7%

Johnson Outdoors (NASDAQ: JOUT) -29.0%

Siemens AG (OTC: SIEGY) -27.1%

We wish you and your families a healthy, happy, and prosperous 2016. Thank you for your trust and confidence, and for selecting us to be your advisor of choice. Please call us directly to discuss this commentary in more detail – we are always happy to address any specific questions you may have. You can reach Jason or Elliot directly at 516-665-1945. Alternatively, we’ve included our direct dial numbers with our names, below.

Warm personal regards,

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