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Episode 34: A Market Review of the First Quarter of 2016, and an Outlook for the Rest of the Year

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The first quarter of 2016 was very volatile to say the least. The first six weeks of the quarter were marked by a significant decline in the market (over 10 percent) only to finish positive at the end of the first quarter with a huge rally in the last six weeks of the quarter. Despite all the volatility, the S&P 500 Index actually eked out a small gain of 1.35 percent for the quarter, however, the Russell 2000 Index and the NASDAQ composite actually declined, 1.5 percent on the Russell 2000 and 2.4 percent for the NASDAQ. Higher yielding stocks were really the standout performers for the quarter, telecommunications and utilities were up over 15 percent as investors flock to yield-oriented instruments. Emerging markets stocks also made a nice comeback in the first quarter after being hit particularly hard in 2015. The MSCI Emerging Market Index ended up over five percent for the quarter. Bonds also did really well, they returned about three percent as measured by the Barclays Agg. Credit-sensitive areas in particular did well, emerging-market debt was up over five percent and high yield actually—after being very weak last year—bounced and returned 3.25 percent for the quarter. Cal munis also had a good quarter, returning about 1.6 percent and once again, the 10-year yield actually fell during the quarter from 2.27 percent to 1.77 at the end of the first quarter.

The biggest thing that happened in the first quarter was that economic forecasts for the average investor and consensus out there was for about 2.5 to 3.5 percent growth in the U.S. economy in 2016 and the market was fully expecting about four interest rate increases because of the strength in the U.S. economy at year end. By the end of the first quarter, these expectations had changed dramatically. Most economic forecasts have been reduced to the 1.5 to 2.5 percent range now for 2016, and the market now fully expects only one or two rate increases as opposed to four at the beginning of the year, which is exactly why treasury yields fell during the quarter, why bonds did so well, and why high yielding stocks did so well. This change in rate expectations has a major impact on different sectors in the U.S. economy and one of the big impacts is on the U.S. dollar. The rise in the dollar had caused significant earnings problems for many large multi-national companies over the last year and a half. With the back off in interest rates expectations, upward pressure on the dollar has been relieved and so now what we have seen is emerging market currencies have finally started to stabilize and actually go up in the first quarter, which I believe is good for the market overall and good for stocks in particular.

The Fed has made it very clear that they are not trying to engineer a recession by raising interest rates. They are not oblivious to what has been happening overseas (the slow growth that we have seen in Europe, Japan, and many emerging markets, such as Brazil and Russia). The Fed is simply trying to normalize interest rates and get them back to more reasonable levels and get off zero so they have more flexibility in future policy decisions. There has been a dramatic improvement in the labor market over the last year, but Janet Yellen has made it very clear that she prefers to err on the side of too much inflation as opposed to potentially fighting deflation, which is what Japan has been dealing with since essentially the early nineties. The playbook for the Fed in terms of fighting inflation is very clear. They have figured out how to do that back in the early nineteen-eighties. Simply by raising interest rates, you can choke off inflation at some point in time.

Our forecast for 2016 remains unchanged. We believe the domestic economy will grow at a very modest rate of 1.5 to 2.5 percent and avoid a recession and corporate earnings should grow in the mid-single digit range, as well as stock-market returns. We believe oil has finally bottomed out because domestic shale producers and major international oil companies have dramatically reduced their capital spending on the order of 40 to 70 percent. This type of supply reduction along with natural depletion rates will ultimately reduce excess supply. Demand hasn't been and still isn't the problem in the oil markets, demand has continued to grow globally and been very sound. The problem has been excess supply and it looks like that is finally being addressed. This is important because stability in the price of oil and weakness in the U.S. dollar will help stabilize reported profits for many of the companies in the S&P 500. These earnings estimates have been sliding over the last couple of years. Stability and top-down forecast for earnings growth for the S&P 500 should lead to better stock-market returns as we move forward.

The interesting thing about what's happening in the market is despite not much action in the indices overall, the S&P has been appreciating and hovering between zero and plus five percent over the last 18 months really. There continues to be significant dispersion in how individual sectors behave. Higher yielding sectors, as I mentioned earlier, such as telecom, utilities, and REITs, were unbelievably double-digit return performers in the first quarter whereas industries such as oil and gas, manufacturing exporters, industrial companies, railroads, and a lot of emerging markets, have been close to or in a recession over the last 18 months have finally started to show some signs of stability. Health care on the other hand, which has been very strong over the last five or six years, has gotten hit very hard over the last three to six months due to concerns about the sustainability of drug and bio-tech pricing. Also, banks have continued to struggle with continued pressure on their net interest margins as interest rates, particularly the yield curve, have continued to compress. We would argue that these rolling recessions and corrections in various industry groups over the last two years helps mitigate the risk of a more broad and serious market decline because there has simply been corrections in these different industries at different times.

The other key point about this type of market—when you have significantdispersioninperformance—isitprovidesalot of opportunity for active stock pickers to add value relative to the index. So stock selection which really wasn't very important from the market bottom in 2009 through the middle of 2014 where all an investor really had to do was just get in and buy anything in equities which was going to go up. Stocks and sectors across the board were appreciating fairly rapidly during that time period. Since the middle of 2014, however, stock selection has become very important. Prices across the board are not appreciating at the rate that they were, we don't expect them to going forward, and we think the stock selection is really key in this type of environment.

We think volatility will continue for the rest of this year. There's numerous cross currents coming up, we've got a Brexit possibility in June, which may cause some dislocation in the European markets and the U.S. We've got Fed watchers which are going to continually guess over the next 12 to 18 months if and when the Fed is going to raise rates at least one or two more times. And we've got a contentious presidential election that's causing many observers to question who our next president is going to be. But I think a disciplined investment approach combined with a long-term quality orientation, which we obviously always employ, should continue to pay off as we move forward. As we have done over the last three decades, we will continue purchase high-quality businesses—even in this volatile environment—that we believe can perform well in both good or bad times, whenever they occur. We thank you for your continued trust and confi dence and welcome any questions you have. Feel free to call us at any time. Thank you.