MISSION®
MANAGEMENT & TRUST CO.

QUARTERLY COMMENTARY
October 21, 2015

The vast majority of U.S. stocks began to form a broad, rolling top back in November 2014. Historic price volatility has marked the months since then, as the world's major central bankers have intervened with verbal or monetary support whenever market prices threatened an uncomfortable decline. Slowing economic fundamentals, however, limited subsequent rallies to the area of prior trading ranges. The S&P 500 peaked in May at 2134. In mid-August, prices broke support dramatically with the widely watched Dow Jones Industrials plummeting by more than 2200 points in just four trading sessions, taking prices back to the levels of May 2013. More frenetic volatility characterized the remainder of the quarter, with the S&P 500 shedding 6.4% over the full three-month period and registering a 5.3% loss for the year-to-date.

Notwithstanding still abundant central bank stimulus, most world markets have been weaker than those in the U.S. Even after the rally that opened the fourth quarter, the vast majority of world markets remain down for the year and virtually all are trading beneath their 200-day moving averages. It was striking to note at quarter-end that the MSCI All Country World Index (excluding the U.S.) was at the same level as in March 2000, despite the powerful market rally since 2009. Longstanding Mission clients may well remember our counsel as we entered the new century that we were likely entering a long weak cycle that could last for two decades. It remains highly likely that the U.S. and the rest of the world will ultimately see stock prices below their March 2000 levels before this long weak cycle ends.

In my September 8 blog (Worldwide Bear Market? Probably), I outlined numerous reasons why it is probable that a significant bear market has begun. Fundamental as well as technical conditions continue to point to the same conclusion.

The domestic and world economies are weak and weakening. The Organization for Economic Cooperation and Development and the International Monetary Fund have both recently lowered their U.S. and global economic forecasts. The IMF believes there to be a 50% chance of global growth declining below 3% next year – "equivalent to a global recession." Citigroup's research team raised the odds of such a global recession to 55%. Former Treasury Secretary and ex-presidential economic advisor Larry Summers describes the danger facing the global economy as more severe than at any time since the Lehman Brothers bankruptcy in 2008. He makes his case for no near-term rate rise by stating that many industrialized economies are barely running above stall speed and can ill afford a negative global shock. He sees monetary policymakers lacking the tools to respond if a recession were to unfold.

3567 E. Sunrise Dr., Ste. 235 ♦ Tucson, AZ 85718-3250 ♦ www.missiontrust.com ♦ info@missiontrust.com ♦ Phone (520) 577-5559

The weak macro picture is compounded by erosion at the micro level as well. Third quarter corporate earnings are expected to decline year over year, and early reporting companies are offering weak forward guidance. Goldman Sachs recently warned that deterioration of balance sheet health is "increasingly alarming" and will only worsen if earnings growth continues to stall amid a global economic slowdown. According to Bloomberg, corporations have loaded up on debt. In the aggregate they owe more interest than ever before, with interest coverage at its lowest since 2009. Major corporations such as Hewlett Packard, Deutsche Bank, Caterpillar and Halliburton have all recently announced intentions to lay off many thousands of employees. Such announcements are likely to multiply.

Since the end of the 1990's, I have pointed to excessive debt as the primary threat to the domestic and world economies. The debt problem is so severe that seven years of unprecedented central bank stimulus has failed to promote growth even approximating the historic norm. Growth of real per capita U.S. GDP is less than half the normal growth over the past two centuries. To promote even that meager result, the Fed has built a balance sheet debt mountain more than four times what it was just seven years ago. Following the Fed's lead, other central bankers have similarly attempted to boost their economies on the back of more debt. In the last two decades, overall worldwide debt has grown from $40 trillion in 1995 to $200 trillion last year, while global GDP grew by a far more modest $45 trillion over the same years. Worldwide debt now far exceeds the 2007 crisis level. As became clear in the 1920's and 1930's, when all major economies face severe debt overhangs, no single country can serve as the world's engine of growth. It's an environment that spawned destructive currency wars in the 1930's, and we are seeing the early signs of such beggar-thy-neighbor policies today. History demonstrates clearly that there is no easy escape from extreme debt levels.

All debt, of course, is not created equal. In a zero interest rate environment, desperate investors hunt far and wide for yield. In recent years, vast amounts of relatively free borrowed money found its way into emerging economies. When money is essentially free, massive misallocations are likely with serious mispricing of risk assets. Emerging markets have experienced huge asset inflation despite commodity disinflation. With the prospect of rising U.S. interest rates making those investments more expensive, hundreds of billions of dollars have been fleeing those emerging economies in recent months. Very likely, banks have lent trillions that will never be repaid. Defaulted loans obviously penalize both debtors and creditors, and widespread defaults can spiral into a worldwide crisis.

Further complicating life for investors is the second factor that contributed greatly to both of this century's stock market crashes – extreme overvaluation. TV's talking heads continually refer to current valuation levels as "fair" or "not too bad." While valuations are not as extreme as those of the dot.com mania at the turn of the century, any honest evaluation of a broad array of the most commonly used measures of value shows stocks to be selling at or above the levels at the 2007 market peak and all other market highs throughout U.S. history but for the 2000 fantasy level from which prices were more than cut in half over the next two and a half years. The valuation work of such renowned market historians as Nobel Prize winner Robert Shiller, John Hussman and Jeremy Grantham point to probable annualized equity returns over the next 10 to 12 years ranging from negative to positive by very low single digits. Intermittent serious declines are highly probable.

Despite seriously deteriorating economic and corporate conditions, stocks have rallied off the September 29 price lows. In fact, the deteriorating conditions, both here and throughout most of the world, seem to have emboldened stock traders. European and Japanese central bankers remain committed to Quantitative Easing. Negative economic and market conditions appear to have the Federal Reserve afraid to raise short-term interest rates even to a minimal 0.25%. The IMF and others are counseling the Fed to delay any rate rise at least until 2016, some warning of panic in emerging markets with any rate increase. Cherishing the fuel of free money, traders have taken the perverse position that bad news is good news. Some of the recent rally's strongest days have accompanied the worst economic announcements. Traders apparently value the medicine more than they fear the disease. While there is no way to know how long such a condition can prevail, we can maintain with certainty that it cannot continue indefinitely. Markets are left vulnerable to severe declines--even panics like the 1100 Dow point decline on August 24. The most profound danger is that investors lose confidence in central bankers remaining willing and able to keep market prices elevated. The 50% and 57% stock market declines in the earlier years of this century both unfolded despite aggressive attempts by the Fed to support the economy and markets. The Fed doesn't always win, and we remain firmly convinced that it's just a matter of time before investor confidence in the Fed wanes again. For now, however, traders appear ready to celebrate the prospect of more free money, no matter how severe the underlying conditions necessitating such rescue efforts.

Nevertheless, the potential for a more significant near-term market decline has increased. In the U.S., the quality of market rallies over the last several quarters has weakened. Fewer stocks are rising and, at quarter-end, more than half of all U.S. stocks were down more than 20% from their recent highs. Only 37% of common stocks are trading above their individual 200-day moving averages. Trading volume is increasingly concentrated in declining stocks; and the internal characteristics of the current rally are far weaker than those in 2010 and 2011 that both eventually led to new price highs. It looks far less likely that the current rally will see prices move back to earlier highs.

Traditional investment alternatives are similarly not very attractive. Thanks to Fed policy, risk-free returns remain near zero. Investment quality fixed income securities continue to trade near historic low yields. At current levels, a mere 50 basis point rise in rates would create a negative full-year return on a 10-year U.S. Treasury note.

With debt levels as elevated as they are--both here and abroad--severe accidents can happen. Maintaining a portfolio with a traditional asset allocation is a bet that serious accidents will not happen, despite conditions that have historically penalized portfolios. Mission has long believed that a more flexible, strategically allocated portfolio will better protect and grow assets in such a highly uncertain environment.

Thomas J. Feeney
Managing Director
Chief Investment Officer