MISSION
MANAGEMENT & TRUST CO.

QUARTERLY COMMENTARY
July 2016

Notwithstanding brief periods of weakness, both stock and bond markets have experienced remarkable success for more than seven years running. Through that period, those who have continued to highlight various dangers as reason for caution have been perceived as boys who cried "wolf". Copious quantities of newly printed money have flooded the equity and fixed income markets, keeping prices at elevated levels. Those without much investment experience or historical perspective might view this phenomenon as normal or in some way the birthright of investors willing to accept market risk. Nothing could be farther from the truth.

Informed investors must recognize the monumental bet they are making. (And I use the word "bet" advisedly.) Positive returns remain possible over the next few years if the Fed and other world central bankers remain willing and able – two separate considerations – to keep stock and bond prices elevated. Confidence in their price support has been a winning bet since 2009. Traditionalists who believe that fundamental conditions will prevail, as they always ultimately have, see great danger in the extraordinary combination of slow economic growth, stagnant corporate earnings, extreme overvaluation, suppressed interest rates and unprecedented debt levels. Reversion to historic means could produce destructive losses. In my nearly half century in the investment industry, I have never before seen such a clear divergence between underlying fundamentals pointing in a negative direction and powerful central bankers aggressively promoting higher securities prices.

In a May article, "'Normal' Returns Are Unlikely In A Far From 'Normal' Environment," I outlined the extraordinary economic and market conditions that make historically normal returns highly unlikely. By way of quick summary:

1) Risk-free cash equivalents have provided an essentially zero return for the past eight years.
2) Longer fixed income securities are at all-time low yields throughout most of the world. Over $11 trillion of securities now trade at negative yields.
3) Common stocks are near all-time valuation highs, second only to the period around the dot.com mania peak, from which point stocks were trading more than 50 % lower nine years later.
4) The US and world economies are extremely slow. The IMF, OECD and World Bank all continue to ratchet down their estimates of domestic and world economic growth. The US remains in its slowest recovery from recession in three-quarters of a century.
5) Corporate profits in this country are essentially unchanged from four years ago, despite stock prices having progressed significantly higher. Earnings and revenue estimates have been far too optimistic for several years.
6) Debt levels in the US and around most of the world are extreme and dangerous. Current debt levels are far above levels that have led to significantly below normal economic growth throughout history.

Access the article here for a fuller exposition of each of these points.
http://www.missiontrust.com/blog/2016/05/normal-returns-are-unlikely-in-a-far-from-normal-environment/

Tom Feeney provides frequent economic and investment commentary on our blog at www.missiontrust.com/blog.

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

Having appraised this confluence of precarious conditions, two of the greatest living investors have turned decisively bearish. Stanley Druckenmiller, whose hedge fund returned 30% per year for a quarter of a century before being closed to the public, indicated recently his belief that investors should sell all stocks and own gold. George Soros, one of the legendary early hedge fund operators, recently returned to money management from philanthropy. Soros believes that opportunities on the short side are sufficiently attractive to draw him back to his earlier extremely profitable pursuit. He also expressed his currency preference to be gold. In addition, just weeks ago, Goldman Sachs did the unthinkable for a major investment firm, saying that it could see no reason to own stocks. Druckenmiller, Soros and Goldman Sachs could all be wrong, but, at the very least, it should be a sobering consideration that they all see great risk in the stock market.

Reversion to the mean has been a process that has characterized securities markets throughout history. At current levels of overvaluation, it is logical to expect that significant price declines may realign stock and bond prices with underlying fundamentals. There is, however, another long-appreciated aphorism, widely attributed to John Maynard Keynes: Markets can stay irrational longer than you can stay solvent. In other words, while markets will almost certainly mean revert, they might not do it on your timetable. That, again, frames the bet investors must make: Do you bet on historically normal mean reversion, leading to a highly defensive stance, or do you bet on a continuation of central bankers' successful exercise of experimental monetary policies?

Factors in any risk-assumption analysis are not just the probability of one outcome or another but also the consequence flowing from each alternative. With interest rates at multi-century lows, the potential return from fixed income is not only severely limited, there is a possibility of substantial losses if interest rates should rise rapidly. For all the factors profiled earlier, while stocks could still advance, it is highly unlikely that they will make dramatic gains. On the other hand, having declined by 50% or more twice already in the past 16 years, equities could repeat such aggressive bear market behavior if investor confidence in central bankers should wane.

With upside potential limited and downside risks substantial, maintaining traditional portfolio allocations and the widely followed buy and hold approach is likely a prescription for substantial portfolio damage in the years ahead. Organizations and individuals with little potential to replace lost capital should be particularly careful about betting on continuing central bank success.

Thomas J. Feeney
Managing Director
Chief Investment Officer