



QUARTERLY COMMENTARY

October 2016

At our annual client conference on October 6th, we were pleased to host a large number of guests. I presented what I believe to be the most important issues I have addressed in my 47 years in the investment business. While I will reprise those comments here in necessarily abridged form, we would be pleased to provide annotated copies of the conference's presentation materials on request.

Investors today are faced with the greatest dichotomy in the history of financial markets. Interest rates are hitting record lows while stocks are near record highs. Bonds are pricing in Armageddon, while stockholders have pushed prices of the majority of companies to unprecedented levels of overvaluation.

The Bet

This unique paradox forces investors to make a critical bet. I use the word "bet" advisedly, because the resolution of the bet, at least over the next year or two, depends on factors independent of traditional investment analysis.

Investors have to choose between the following alternatives:

1. Worldwide, stocks and bonds are more overvalued than ever before, yet global economic growth is scarcely above recession levels. If stock and bond prices revert to their historic valuation means, portfolio values could fall precipitously and stay down for years. Throughout history, prices have always ultimately reverted to their means.
2. Our Federal Reserve and other central banks around the world are flooding their respective economies with newly created money. For the past 7 ½ years, central bankers have overcome weak fundamental conditions, while stock and bond prices remain near all-time highs. This could continue.

Central Bankers Good For Stock Prices

At least ostensibly, historic levels of central bank stimulus have been designed to boost the economy and stabilize the currency with about a 2% level of inflation (to lessen the negative effects on overindebted companies and governments). Unfortunately, while that stimulus has had extraordinarily powerful effects on stock and bond prices, it has done precious little for the underlying economy.

The positive effect of the various iterations of the Fed's quantitative easing efforts is obvious when a graph of stock market prices is overlaid with one that traces the growth of the Fed's balance sheet. Since 2009, stocks have powered higher each time the Fed has authorized additional money creation. Yet stock prices have fallen from 13% to 17% at the end of each quantitative easing episode, only to have the declines halted by new central bank reassurance that monetary authorities stood ready to continue to support securities prices as needed. In recent months, individual central bankers have quickly voiced their support to halt declines of as little as 2% or 3%, as though afraid that their entire monetary experiment will unravel if equity prices experience a significant decline.

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

Can This Continue?

Any analysis of the potential for the vast collection of domestic and international stimulus efforts continuing to work should include former Fed Chairman Alan Greenspan's comments:

“This is an unprecedented period in monetary history. We've never been through this. We really cannot tell how it will work out.”

“Monetary policy is largely economic forecasting. And our ability to forecast is significantly limited.”

Paraphrasing comments to the Council on Foreign Relations:

- Boosting the economy via bond buying has not worked.
- Boosting asset prices has been a terrific success.
- I don't think it's possible for the Fed to end its easy-money policies in a trouble-free manner.

Negative Interest Rates

Normal central bank tools, even carried to historic extremes, have neither lifted economies, nor raised the level of inflation. European and Japanese central bankers have even resorted to negative interest rates to rev up their economies and inflation.

Today, there are over \$15 trillion in negative yielding securities worldwide. Even corporate bonds have begun to show negative yields. One commentator recently indicated that 16% of European Union investment grade debt is trading at negative yields. The holders of such bonds are guaranteed to lose money if they hold the bonds to maturity. The only way to realize a profit is for interest rates to go even further negative and for the investor to sell the bonds at that lower yield. That is an incredible condition and threatens the viability of many banks and insurance companies. And unless circumstances change dramatically, many pension plans will fall far short of meeting promised retirement benefits in the years ahead. This shortfall could have immense negative consequences for the broader economy.

Negative interest rates have yet to improve the economic outlook where implemented. Ironically, in almost every country in which central banks have moved interest rates into negative territory, equity prices have suffered.

Central Banks Buying Stocks

Having tried virtually everything else without apparent success, a few central banks have decided to buy stocks, hoping that the resulting wealth effect would boost the overall economy. Japan has been the most aggressive buyer, with China, Hong Kong, Israel and Switzerland actively participating, the latter possibly as a surrogate for others (perhaps the US). The European Central Bank has recently speculated about buying stocks. Within the past month, Fed Chair Janet Yellen floated a trial balloon about our Fed buying corporate bonds and stocks, ostensibly to help in an economic downturn -- a disastrous idea on so many levels! When will Congress step up and rein in the Fed, which has assumed powers far beyond what was ever envisioned when they established the central bank in 1913?

Costs of Central Bank Intervention

All this economic masterminding comes at a cost. In its first 95 years of existence, the Fed grew its balance sheet to a bit over \$800 billion. In the past eight years, the Fed has grown that debt level to five times what it had taken nearly a century to produce. This is our generation's gift to our grandchildren and their grandchildren. But all this financial legerdemain has produced record stock and bond prices for this generation. Can they be sustained?

Risks To Bondholders

On the bond side, risks are that interest rates rise and/or companies or countries default. If interest rates rise, as is inevitable eventually, a great deal of money can be lost, even in very creditworthy bonds. The ten-year US Treasury note, for example, trading today at 1.79%, would provide a negative total return for a year with a rate increase as little as a quarter of one percent. Many investors shrug off such concerns, because they expect to hold their fixed income securities to maturity. And certainly, if the issuing company or country does not default, the investor will get back principal and interest. There is however, no guaranty of what that money will buy at maturity. In the last rising interest rate cycle extending from early 1941 to late 1981, for example, a typical portfolio of government and corporate bonds lost over 2% of its purchasing power per year despite collecting regular interest payments. Even unmanaged, risk-free US Treasury bills outperformed almost all bond portfolios for more than four decades. Investors apparently do not recognize the dangers as they pour extraordinary amounts of money into bonds at historically low interest rates. They can't buy yesterday's performance, only tomorrow's.

Risks To Stockholders

On the equity side, dangers lurk in several areas. As indicated earlier, the majority of stocks are at their most overvalued levels ever. When calculated by a composite of the most commonly employed valuation measures, the entire market is at its second most overvalued level, slightly behind valuations in the dot.com era at the turn of the century.

It is ironic that investors are so enthusiastic about stock ownership with the US and world economies sluggish and in many instances slowing. Just weeks ago, the International Monetary Fund lowered its global growth forecast to 3.1% for 2016, a number they have been steadily lowering. This is barely above recession level for world growth. The Federal Open Market Committee of the Federal Reserve Board also recently dropped its estimate of long-term US growth to 1.85%, the lowest level on record. Despite unparalleled stimulus, the US continues in the slowest recovery from recession in three-quarters of a century.

Not surprising in a weak economic environment, corporate profits have been declining year over year for the past five quarters. And measured on a Generally Accepted Accounting Principles basis, profits are approximately back to 2007 levels. Over the past six quarters, profits have fallen by about 20%. Thanks to central bank support, stock prices are up in that time period.

Declining earnings growth is not limited to the US. According to Goldman Sachs, world earnings per share have increased over the past decade by less than 2% per year. On average, European countries have actually seen earnings per share decline by more than 2% per year over that decade.

Debt A Threat

Those who have attended our conferences or who have read our commentaries over the years know that I consider extreme levels of debt in almost all major countries around the world to be the single most dangerous threat to our long-term economic wellbeing. In recent years, dramatically growing debt levels, on top of already excessive debt loads, have been controlled by central bankers piling on even more debt while effectively printing previously inconceivable amounts of new money. History argues convincingly, however, that for centuries countries with debt levels even lower than most today have suffered extended economic malaise, often accompanied by significant inflation and severe market disruptions.

Investment Stars Voice Warnings

Over the past few months, some of the most successful investors of our era have sounded alarms about the danger in today's markets. Stanley Druckenmiller, whose hedge fund produced 30% per year returns for 25 years before closing to outside money in 2010, summarized his concerns with: "Get out of all stocks." George Soros, a hugely successful hedge fund pioneer, returned to investment management from philanthropy to take advantage of opportunities on the short side. He sees "a serious challenge which reminds me of the crisis we had in 2008." "The world is running into something it doesn't know how to handle." Jeff Gundlach, CEO of DoubleLine Capital, a very successful bond manager, recently counselled: "Sell everything. Nothing here looks good. Sell the house. Sell the car. Sell the kids."

So far, those concerns have not played themselves out in US markets. Equity prices in most other countries, however, have moved appreciably lower than they were at their highs a year and a half ago.

But More Stocks Going Up Than Down

Notwithstanding all those negatives, many more stocks in the US have been advancing recently than declining. And markets generally show a marked deterioration in such advance/decline figures before forming major tops. To this point, central bankers continue to prevail.

Mission's Approach

Where does Mission stand? As a deep discount value manager, we won't bet heavily on the more speculative "central bank winning" side of the bet. We are, however, willing to increase the risk-assumption level of any portfolio for clients who want that exposure. We have, though, been in a similar position twice before in the past two decades where we leaned against the prevailing trend and ended up benefiting our clients handsomely.

At the turn of the century, we warned aggressively that equity prices were on thin ice because of the unhealthy combination of extreme levels of debt and unmatched levels of overvaluation. The vast majority of our clients employed our Risk Averse strategy, which targeted absolute, rather than relative returns. Equity prices began a major decline in 2000. Despite our concern with the overall market level, our bottom-up individual stock selection process found quite a few stocks that met all our purchase criteria. Over the 2 ½ years from April 1, 2000 to September 30, 2002, Mission's average client portfolio grew by over 17% while the S&P 500 declined by almost 38%, including dividends paid. Mission's stocks actually rose while most stocks fell precipitously.

By 2007, amidst massive speculation and the never-to-be-forgotten housing bubble, we were far more defensive than in the earliest years of the new century, but still finding some stocks that met our purchase criteria. The S&P 500 plummeted by more than 50% from November 1, 2007 to February 28,

2009. Mission's stocks lost money also in that horrendous decline but nowhere near as much as the S&P 500. Because we had cut back so substantially on our risk exposure, our clients emerged from that excruciating bear market with a total portfolio loss of less than 1%.

Because we did not believe that the weak cycle that began in 2000 had ended, even after the initial 2000-02 bear market, we remained cautious and had limited risk exposure during the strong stock market rally up to the peak in 2007. That caution was eventually rewarded, as we avoided the portfolio decimation that many investors experienced in the 2007-09 decline. In the almost nine-year period from early-2000 to early-2009, Mission's risk-averse portfolios outperformed the S&P 500 by 10.6% per year.

As a manager that bases investment decisions on proven, historically sound data, Mission has been unwilling to assume significant market risk since 2009, a period in which, in retrospect, risk assumption was well rewarded. Central banker largesse has overcome far below normal fundamental data and Mission has lagged behind those willing to accept substantial risk. If central bankers win "the bet", it's unlikely that Mission will keep pace with more aggressive managers. On the other hand, if history plays out as it always has before, I expect Mission will again catch and pass those assuming substantial risk in the current, very dangerous environment.

Consequences As Well As Probability

While we can't know the probability, at least in the short term, of which way the bet will be resolved, it's important to evaluate the potential consequences of whatever the outcome might be. On the upside, we know what historically normal returns have been: about 10% per year for stocks, 5+% for bonds and 3.5% for risk-free cash equivalents with inflation about 3%. These are 90 year averages, and, logically, they are computed from average levels of interest rates, valuations and economic conditions. Today, not one of those conditions is average or normal, and because of that, we're not likely to experience historically normal returns over the next few years.

On the other hand, there is significant danger to both stocks and bonds should investor faith in central bankers falter. If investors begin to doubt either the willingness or effectiveness of central bank efforts to keep stock and bond prices aloft, a nonsupportive air pocket exists below current stimulus-supported levels. Not knowing the details of market history, most investors underestimate the damage that major bear markets can inflict. The most recent serious decline that ended in 2009 brought stock prices back to their 1996 level, erasing 13 years of price gains. That drop was actually less painful than the carnage unleashed by three prior US bear markets which erased price gains of 16, 18 and 28 years. The bear market that began in Japan at the end of 1989 leaves prices today at levels of three decades ago.

Because markets have bounced back so robustly from the two precipitous declines since 2000, many investors have lost their fear of big declines. It is important to recognize that those rebounds were precipitated by unprecedented government support. And government may be running out of ammunition. It is sobering to recognize that prior to the last two major declines, it took 12, 16 and 24 years for stock prices to permanently exceed the price peaks at the beginning of the three big bear markets in the mid-to-late 20th century.

The Investor's Dilemma

Every investor and investment manager has to decide how much of each side of the bet to accept. If you choose to align yourself with underlying economic and market fundamentals, yet prices continue to rise in response to central bank stimulus, you'll inevitably wish you had assumed more risk. If, on the other hand, you bet on central bankers and market conditions revert to their means as they always eventually have, you may be nursing portfolio wounds for years to come. Any individual's or organization's ability to withstand such a risk undoubtedly depends on the depth of current resources and future earning power. As indicated earlier, Mission will not bet heavily on central banks winning for any further extended period of time. We may assume controllable risks on a strategic basis, but we anticipate that the next significant opportunity to profit from substantial stock and bond holdings will come with patience and at far more attractive valuations. That approach has proven extremely beneficial twice since 2000, and we believe that the probabilities lie heavily on the side of at least one more repetition until the debt and valuation excesses are significantly reduced.

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