Measuring Markets

August 2015

Market Monitor*	1-Year Annualized	3-Year Annualized	5-Year Annualized
Barclay's Global Aggregate Bond Index	(6.0)	(1.1)	1.4
Barclay's Municipal Bond Index	3.6	2.8	4.4
FTSE All-World Stock Index	3.5	13.5	10.9
Bloomberg Commodity Index	(28.2)	(13.9)	(7.3)
FTSE/NAREIT Global REIT Index	27.4	13.2	16.0
HFRX Global Hedge Fund Index	(0.2)	3.0	1.3
U.S. CPI – Unadjusted	0.2	1.4	1.8

*As of July 31, 2015

The recent sell-off of risk assets has been described by some as the much-anticipated and long-awaited correction. But corrections only occur when uncertainty and anxiety arise, not simply because investors expect them. And while it is one thing to say that you are expecting a correction, it is entirely another when you are experiencing one and need to act accordingly. For long-term investors, the important question is whether the indiscriminant selling is being driven by "signal" or "noise". In our opinion, it is both and the ability to separate the two and identify the root causes of the anxiety can lead long-term investors to appropriate removal of investments tied to a changing thesis or attractive buying opportunities.

The world is awash with commodities and productive capacity

Data points are emanating from certain regions of the world that should be viewed as a "signal", specifically from those economies that are heavily reliant on the export of either commodities or manufactured goods. As such, investors should make tactical shifts to dampen downside risks and preserve capital. On the other hand, data from those economies that are major consumers of commodities and manufactured goods remain stable and the sell-off and accompanying sentiment should be viewed as "noise", thus presenting excellent buying opportunities for the long-term investor.

Excess supply is outstripping uneven global demand for raw materials and manufactured goods

Perspective is your ally when uncertainty increases and anxiety rises. Aside from the rare overnight event, changing economic conditions tend to unfold over a series of months and years, it is just that the timing and magnitude of change are hard to identify in real time. For more than a decade now, many have speculated about where the negative effects of easy-money monetary policy would show up, for certainly there would be unintended consequences of such unprecedented actions. The stunning breakdown of commodity pricing and corresponding cracks within some key emerging-market economies may be expressing the consequences of mal investment associated with the many years of cheap capital.

It is apparent that the world now has an ability to supply massive quantities of raw materials and manufactured goods, outstripping global demand by a growing margin. For a few decades, globalization has, in part, been a race to generate productive capacity as a means to compete and grow a local economy. For those with large and relatively cheap labor forces, manufacturing offered a path of growth to join the modern world, while those with abundant natural resources were presented with an opportunity to supply the raw materials required to support the expanding manufacturing and global infrastructure. When combined with capital that was/is both cheap and available, the ingredients were in place for a period of explosive globalization.

Consumption nations stand to benefit while producers suffer from weaker prices

In many respects, China has been the epicenter of this globalization, investing vast sums of capital into infrastructure and productive capacity for manufacturing. While many other nations made similar investments as a means to participate in the global economy, the modern world has never witnessed the scale of urban investment made by China. And the resources required to support the growth of fixed-asset investment within China came from

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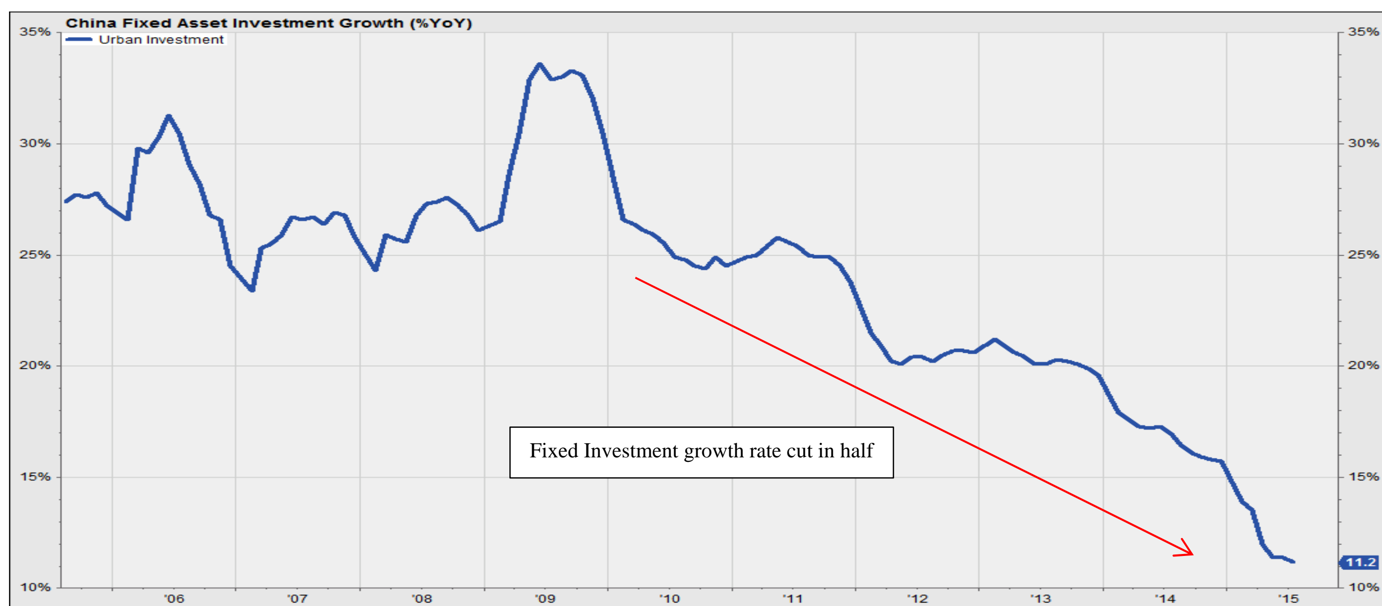
commodity-rich countries around the globe: Australia, Brazil, South Africa, Canada, Russia, Malaysia and Indonesia – each of which supplied raw materials indigenous to their geographies in exchange for cash which was then reinvested into their local economies. The key ingredient has been capital, and it was supplied in massive quantities and at very low cost by central banks around the globe.

When the demand for a good out paces its supply, the price of the good is certain to rise. Oil is the most obvious commodity that participated in globalization and China's insatiable desire to grow. The price of West Texas Intermediate Crude Oil (WTI) escalated from near $20 per barrel in the mid 1990's, to near $150 per barrel in the summer of 2008. But when supply begins to eclipse demand, the price of the good is destined to decline in similar fashion.

During the better part of the last 15-20 years, with the aid of technological advances and enormous amounts of invested capital, the natural resource-rich countries have become incredibly productive in supplying a dizzying array of commodities – from oil and gas to copper and iron ore, all to support China's urbanization efforts and similar endeavors in other fast-growing economies around the world. As has occurred throughout history, when too much capital chases opportunities that are not vetted with appropriate assumptions, the risks of mal investment arise. In this instance, investors were willing to fund natural-resource extraction projects under the belief that global demand would maintain extraordinarily high rates of growth. But the urban investment being made by China and others has been unsustainable, as depicted by the following chart which shows the deceleration of fixed-asset investment (infrastructure) within China over the past few years.



As the productive capacity to supply increasing amounts of raw materials has continued to ramp higher in recent years, the demand for them has been waning, decelerating to levels that are more sustainable over the longer term but not strong enough to soak up supply. The result has been a dramatic collapse of commodity prices over the past fifteen months. Global access to cheap and available capital, created by unprecedented monetary actions in the U.S. and abroad, presented an environment of false long-term demand curves and excessive investment into capacity across a wide spectrum of industrial commodities.

We are not suggesting that the global demand for commodities is collapsing, more that the growth trajectory assumptions associated with demand from places like China have simply been too high and capital too willing to fund capacity expansion at lower and lower hurdle rates. We still expect global economic expansion to continue and, therefore, greater demand for a wide array of commodities. But any increase in the demand for commodities will take a long time to soak up the glut of supply that exists and will require the removal of capacity to bring demand and supply in balance. The oil market is a good example of this dilemma. Global demand for crude oil is on the rise – the world will consume more oil in 2015 than in any year in history, but with the help of technological advances, the ability to extract large quantities of oil from shale has accelerated the available supply at a rate faster than the growth in demand. U.S. oil production has nearly tripled in the last 10 years, now approaching 20 million barrels per day against a backdrop of an estimated 94 million barrels of global demand. Once again, the huge increase in the supply of oil, as with so many other commodities, has been met with only a marginal

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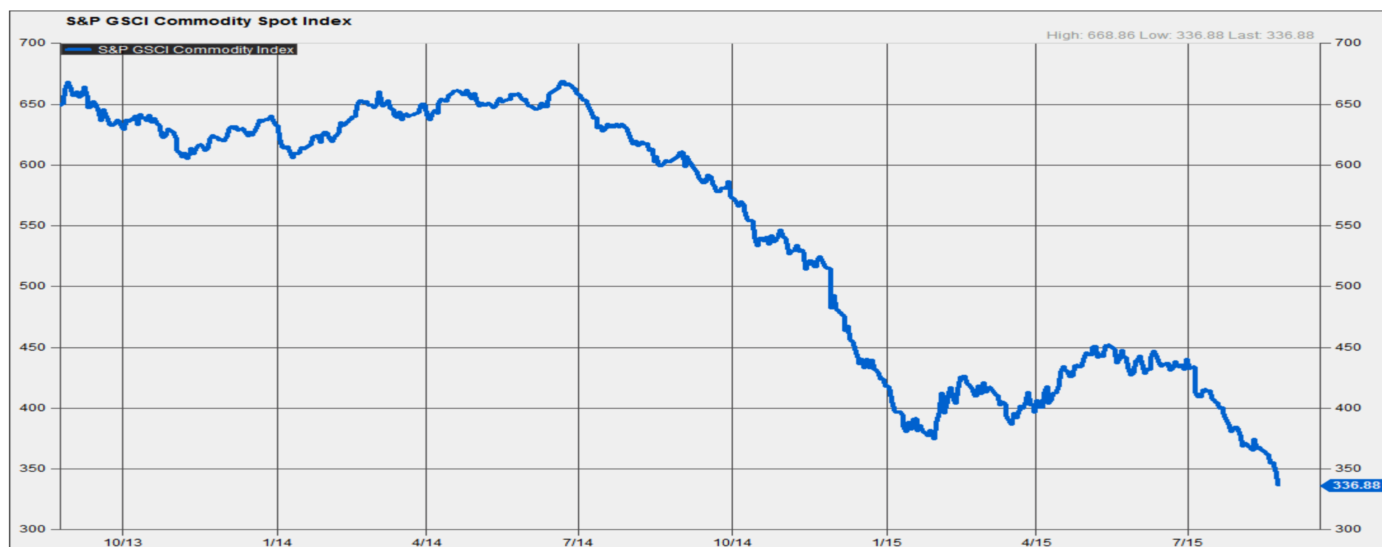
increase in demand, leading to excess supplies and a corresponding drop in prices. The fate of so many commodities has been the same, and the fall has been swift and dramatic as highlighted by the 2-year chart of the S&P GSCI Commodity Index below.



When supply and demand remain out of balance for too long, imprudent investment is eventually unveiled, and all of those leveraged to the investment feel the pain as it is realized within public and private markets. In addition to oil and gas, the proliferation of mining capacity around the world has driven prices of almost every industrial metal down to levels that no longer meet the cost of production. This will eventually resolve itself as marginal producers (those that cannot recoup their cost of capital at market prices) will be forced to shutter their mines and cap their wells until the demand for commodities catch up to supply at levels that move market prices back above the cost of production.

The “signal”, which investors must embrace, is that the world currently faces a global glut of raw materials and productive capacity at a time when the demand for these goods is decelerating. The collapse in commodity pricing has its greatest negative impact on commodity-producing nations, most of which are emerging markets countries with outsized commodity export exposure relative to their own domestic consumption. In recognizing this environment, we have actively reduced direct and indirect exposure to emerging markets within our global bond and global stock allocations over the past year. There will be a time to increase exposure to emerging markets once again, but a bottoming process for many has yet to be reached and we suspect the fallout will go beyond the observable declines in their currencies.

While the excess supply of commodities is placing pressure on many emerging market economies, and slowing demand for manufactured goods is a struggle for economies that rely too heavily on exports, these same attributes are a net positive for economies that are driven by consumption and services. The United States, Europe, Japan and India stand to be significant beneficiaries of cheaper commodity prices.

The Eurozone is a large importer of commodities, energy in particular, so the savings for private and public sectors of this region’s economy are significant. Combined with large central bank monetary measures, these stimulants are supporting economic stability in the face of a challenging political crisis and economic fallout of southern periphery members.

The United States may be the greatest beneficiary as near 70% of our GDP comes from consumer spending. Lower prices at the pump and cheaper sources of heat for the upcoming winter season keep more discretionary dollars in the pockets of consumers. Disposable income has been rising for U.S. consumers in recent years, in part due to repaired balance sheets and lower overall debt payments, and we expect a more confident consumer to spend more in the coming quarters.

Nothing brings more confidence to a consumer than job security. At a four-quarter-moving-average real GDP near 2.5%, the U.S. economy is creating jobs at a nice pace, above 200k average per month so far in 2015. As the five-year history of job gains and unemployment rate illustrate in the chart below, the consumer has moved into a much more favorable employment position. In fact, we believe we are seeing the early signs of wage-growth acceleration for the first time in years, particularly in the college-educated category where the unemployment rate has dropped below 3%.

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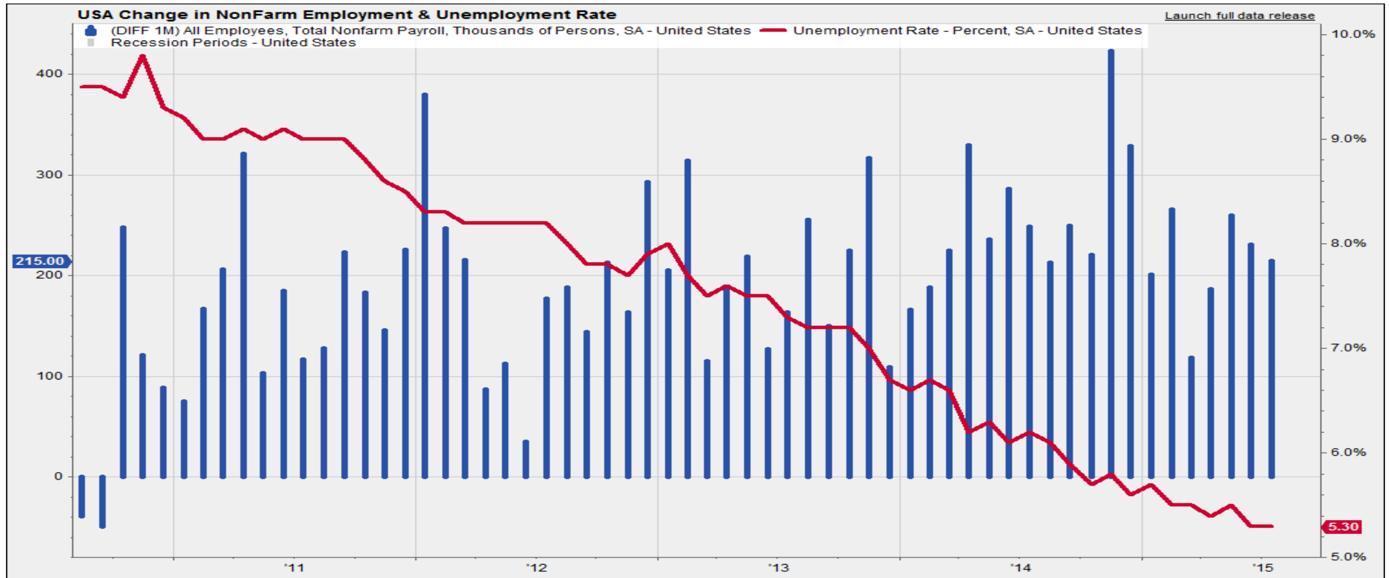
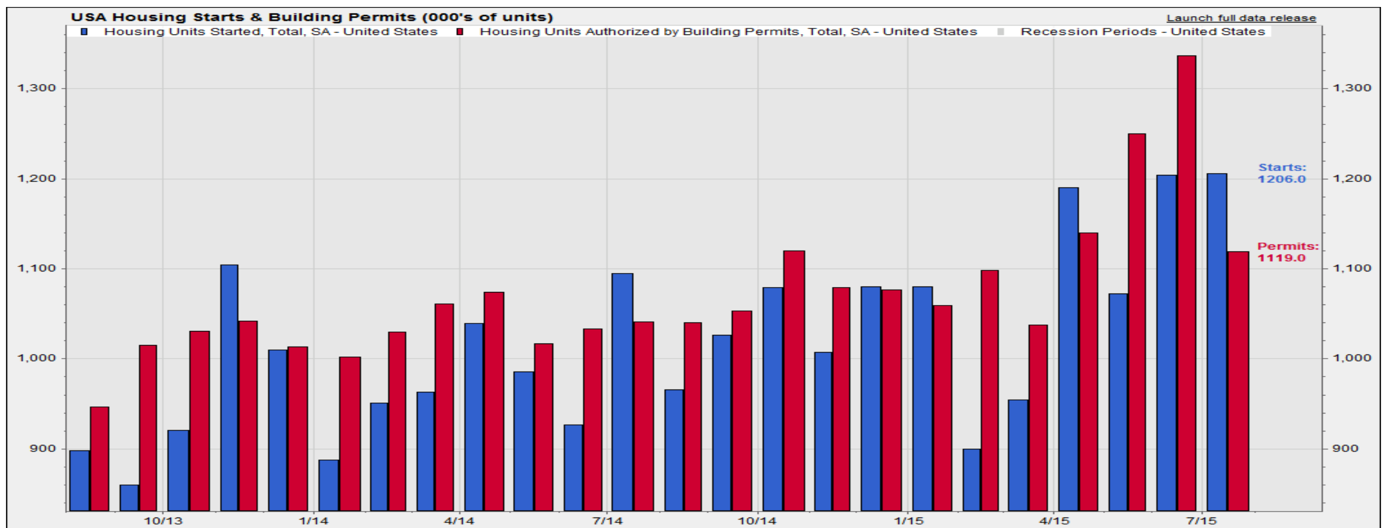


The global manufacturing slump and the pressure on U.S. energy fields are headwinds for the U.S. economy for sure, but other key economic measures are pointing to increasing strength. Auto sales are another signal of consumer confidence, and at an annualized sales rate of over 17 million units, this segment of the economy is booming. Americans will drive more miles in 2015 than any other year, and airlines are filling planes with travelers at record levels – the U.S. travel and leisure industry is doing fantastic.

Housing and related spending are nearly 8% of the U.S. economy, and while the recovery of the residential real estate market has been slow to come, sales of existing homes, sales of new homes and sales prices associated with both, have been on the rise. Optimism regarding housing is high among the homebuilders and companies associated with spending on the home have provided positive commentary over the last few months. The monthly tracking of new home starts and building permits is a helpful leading indicator of the health of residential real estate. As the chart below illustrates, both of these measures have moved markedly higher in recent months to a new trend line that is healthy and strong after having spent many months below the one million annualized-unit rate.



Our favorite data sets for assessing the real time health of economic activity have always been the ISM and PMI surveys for manufacturing and services. Each month, the Institute of Supply Management provides results of its survey of purchasing managers, broken into two important categories: Report on Business Manufacturing in the U.S (blue line) and Report on Business Services in the U.S.(red line). Any reading above 50 indicates expansion while anything below 50 suggests contraction.

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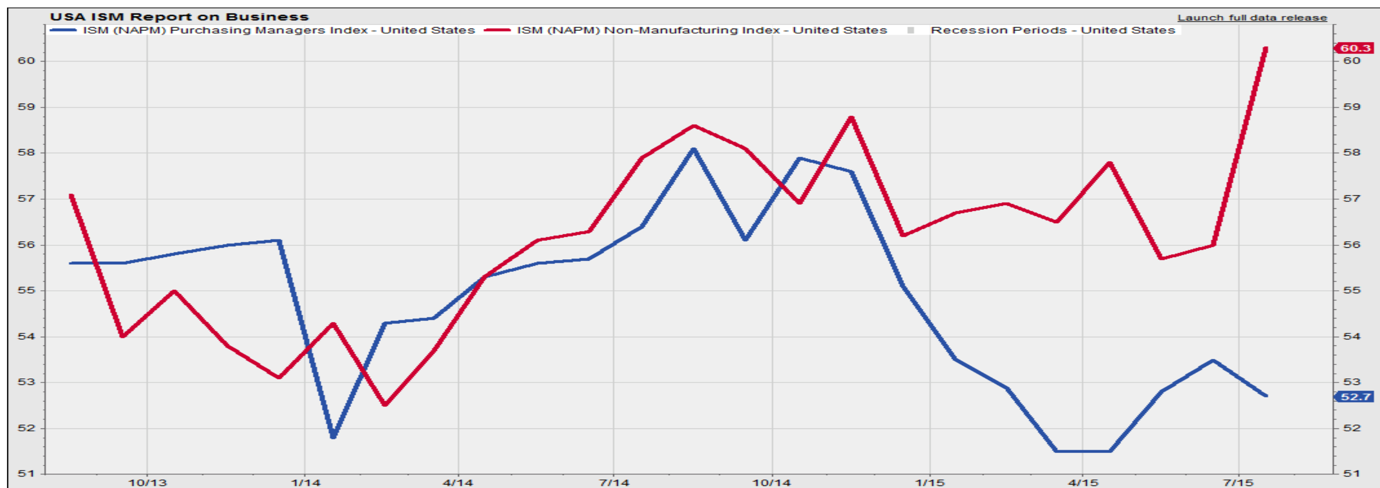

There is significantly more detail associated with these surveys, offering important insight, but even at a surface level there are a few important takeaways from this chart: (1) The divergence of the two indices in 2015 is stark and reflects the fact that manufacturing (blue line) is dependent on global conditions (which are currently weak), while services (red line) are delivered more locally and are currently very strong; (2) at near 53, the manufacturing index is well off its highs but still a healthy distance above contraction, despite the headwinds of a strong $U.S. dollar, large declines in capital spending on oil and gas production, and a general slump in global manufacturing output; (3) the U.S. economy is dominated by the services sector which has accelerated to fresh two-year highs. Based on this and other data, we conclude that, on the whole, the U.S. economy is expanding and doing so at an accelerating rate as the year progresses. 1Q GDP proved to be better than initially thought, 2Q GDP is likely to be revised above 3%, and 3Q GDP estimates are currently expecting near 3% quarter over quarter growth. On this score, we view recent volatility across the financial markets as "noise" that should be bought by long-term investors, specifically those portions of the markets that are domestically oriented.

At the beginning of the year we highlighted our expectation for diverging central bank policy as the year progressed and suggested that these events would create anxiety for financial markets. We still expect the Federal Reserve to begin lift-off from its zero-interest-rate policy before the year is through. A U.S. real GDP rate in the mid 2% range is far from robust, but it is also well removed from requiring emergency measures. Inflation indicators remain benign for the time being, but tighter employment rolls have the ability to change that outlook substantially and we suspect higher wages are in the offing in the coming quarters, forcing the Fed to move despite softer economic conditions overseas. Some of the recent volatility across markets reflects the anxiety associated with higher interest rates, but we expect the rate changes to be small and measured with inflation creeping only marginally higher.

Financial markets have a long history of spooking investors, despite investors professing their readiness for volatility. The speed at which market conditions and sentiment can change is always surprising, but for long-term investors who were already positioned with appropriate risk, emotion should not be the reason to waiver from strategy.

Economic data points and rising financial market volatility are sending "signals" that risks in certain international markets, particularly within emerging markets that are commodity driven, are on the rise and support action. But volatility that is accompanied by solid economic and corporate fundamentals in the U.S. is merely "noise" and investors are advised to stay the course and anticipate buying opportunities amongst the fear.

Finally, extreme market moves emphasize the merits of fully-diversified portfolios that hold a variety of risk profiles. Our portfolios are tailored to the unique objectives of each client and their specific needs and they contain asset class and specific security exposures designed to dampen overall volatility and produce an appropriate risk / reward profile.

We expect the higher levels of volatility of late to continue for some time, there is simply a lot for markets to digest and sort through. In the end, we believe separating signal from noise will place the long-term investor in the best position to weather any storms and, ultimately, profit during their time horizon.

We are grateful for the opportunity to share our perspectives on the markets and, as always, we welcome your questions and comments.

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