# Déjà vu All Over Again

*September 30, 2015*

*Reflections & Perceptions*

Almost 7 years into the current bull market, large cap stocks sold off broadly in 3Q 2015 with only one of the S&P 500's sectors reporting a positive return (Utilities, 5.40%) while the Index was down 6.44%. Some of the reasons behind the sell-off include concerns over earnings predictability due to the strong dollar, and slowed growth in emerging markets, especially China, and weak commodity prices.

With a continued growth in supply of crude in North America and no slowdown in production from Saudi Arabia or Russia, the price of Brent crude was almost 24% lower at the end of the quarter compared to the beginning. It comes as no surprise the Energy sector continues to struggle in this environment, with the sector reporting the worst performance in the Index for the quarter, -17.41%. The Materials sector, another victim of weak commodity pricing, had the second worst quarterly return at -16.90%. Usually considered to be an anchor to windward shore during times of volatility, the Health Care sector also reported a double-digit negative return in the quarter, at -10.67%. This sector underperformed dramatically in the last two weeks of September (-5.53% vs -1.62%) in response, we believe, to the tweet made by Presidential candidate Hillary Clinton about a drug price control plan. We believe this is politics and should not have a lasting impact on healthcare stocks.

Another reason for the recent volatility is that stock prices have increased faster than earnings over the past several years, resulting in price/earnings multiple expansion to levels slightly above their 10-year averages. Given the expectation of a Fed rate increase, the sell-off is also likely a reflection of the market's concern over the impact of higher rates on valuations. That said, we continue to believe that domestic equity indices stand a good chance of producing positive total returns during the next tightening cycle based on past interest rate cycles, as highlighted in last quarter's *Reflections & Perceptions*.

Predicting when the Fed will make a move has been like "Waiting for Godot" in this cycle: It feels like it may never happen. Strategists and other commentators believed the odds were widely in favor of a Fed Funds rate increase in September. Yet, the Federal Reserve once again delayed action citing economic weakness in the emerging markets and the stronger dollar.

We do not believe the state of the economy merits a 0% Fed Funds rate as business and employment statistics, as well as corporate balance sheets, are in infinitely better shape than the emergency rate would warrant. Yet, the stable price/low inflation portion of the Federal Reserve's dual mandate does not dictate much tighter money right now, either. Consequently, we expect the Fed to raise rates very slowly, with potentially long pauses between increases, as determined by progress in the various economic guideposts.

When higher interest rates are discussed, we note that the negative aspects get more ink or airtime than the positives. Two of the top beneficiaries of higher rates will be savers and financial institutions like banks and insurance companies. Because there are hundreds of billions of dollars in cash on the sidelines, a small change in rates will provide meaningful incremental income on a

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cumulative basis. Financial institutions have a number of ways to improve their profitability in a higher rate environment. For example, lending operations will benefit from an ability to raise the interest rate charged on loans and investment portfolios will benefit from the reinvestment of maturing bonds at higher interest rates. Most financials will also benefit as their assets will reprice more quickly than their liabilities. We have made some modifications to the Financial sector in client portfolios over the past several months to take advantage of these anticipated dynamics. In the meantime, we believe portfolio holdings offer above average return potential due to their compelling valuations, cost reduction programs, dividend yields along with future increases and share buybacks.

Another potential trend we will be looking for in the months ahead is whether consumers spend more of the money they are saving at the pump due to lower gasoline prices. As discussed in our December 2014 *Reflections & Perceptions*, we didn't expect to see an immediate economic benefit from lower energy prices. This has played out as the decline in the price of oil caused producers to precipitously cut capital expenditures, employment and wages so that the negative impact of the corporate response came through before the positive consumer response. Fast forward about 12 months to today, and the incremental negative impact of the corporate cuts are lessening. As important, overall employment numbers continue to show improvement, as do hours worked and wages. This bodes well for the low-and-middle end consumer who benefits materially from lower gasoline prices. We have already seen some of this translate into better traffic at retail and quick service restaurants. In addition, preliminary Christmas sales projections call for 3% year-over-year growth. As a result, we expect to see some of the benefits of lower energy prices flow through earnings in the next six months.

On the reverse side, we remain skeptical toward a near-term rebound in energy prices. Non-U.S. oil supply remains high in Saudi Arabia and potentially high in Iran in 2016. U.S. supply has not diminished although rig count is down dramatically. Technology has altered the energy landscape so that many companies are cash flow positive at $60 oil today versus $90 oil a couple of years ago.

Our core mantra remains the same: Earnings growth drives stock prices. Over the coming weeks, the market will be in the midst of the third quarter earnings season. We believe that these results will play a large role in the determination of the trajectory of stock prices into year-end. Positively, analysts have revised earnings expectations lower going into third quarter earnings and as a result, the bar may have been lowered to the point where the majority of firms report better-than-expected results. In addition, as we look out toward 2016, we believe that earnings growth for the overall market should resume as the negative effects of sharply lower commodity prices and strong dollar dissipate on a year-over-year basis. All told, we expect that this earnings season helps shift attention away from the macro and Fed and once again back towards company fundamentals.

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