KLS Professional Advisors Group, LLC

Complete Financial Management

The Growth, Earnings, Valuation Conundrum

Although the Dow Jones Industrial Average, S&P 500, Russell 1000, Wilshire 5000, and S&P 400 Mid Cap Index each finished the first quarter of 2016 in positive territory, (2.20%, 1.35%, 1.17% and 1.17%, 3.78% respectively) the instability and investor anxiety were underscored by a greater than 10% decline in the domestic equity market in the first six weeks of the year. The Russell 2000 Small Cap Index lost -1.53% and the NASDAQ declined -2.39% as technology shares came under pressure.

International equity markets were mixed. The MSCI Emerging Markets Index gained 5.71%. The MSCI All Country World Index rose .24% and the MSCI European Equity Index declined -2.51%.

The outlook from both central bankers and many professional investors is for slow GDP growth worldwide and challenged growth in corporate earnings. Nevertheless, financial asset valuations are elevated. In aggregate this equates to a higher level of risk.

The World Economy

Although China recently experienced a slight increase in both manufacturing and service sector activity as a result of supportive government policies and an increase in external demand (which encouraged a rally in the domestic equity markets after the close of the quarter), both economic growth in China and its demand for commodities has moderated. China's rate of drawdown on its foreign currency reserves has also recently moderated, aided by a stronger dollar in the aftermath of the Federal Reserve signaling that it will move even more slowly in raising interest rates than investors anticipated at year-end. Fears over proactive currency devaluation by China have also receded as the dollar strengthened given the Federal Reserve's stated intentions. Although the recent data coming from China indicates that a stabilization level may have been reached, we caution that China remains opaque with respect to its underlying economic data.

Oil prices experienced much volatility during the quarter. Prices firmed when it was thought by many that OPEC members would arrive at a production agreement which subsequently did not materialize. Early in the quarter oil fell below $30 only to rise again amidst great volatility, finishing the quarter near $40. Whether this is a stabilized trading range, a high to be undone, or the beginning of a higher climb is uncertain. Ultimately it will depend upon the forces of supply and demand.

Oil producing countries are again meeting next week in an attempt to freeze production levels. U.S. and other non-OPEC production and drilling activity has already declined in response to low prices, thus supporting the recent rise in oil prices. Reduced domestic activity, however, negatively impacts industry employment.

The European Central Bank continues its stimulus efforts with its version of quantitative easing, and continues to state that it will not stop until the Eurozone economy resumes an acceptable growth and inflation trend. Nonetheless, deflationary pressures continue and minimal GDP growth is anticipated in the near term. The refugee/immigration crisis in Europe continues to stress individual European governments and their economies. Terrorism and the increased cost of security are also burdening European governments. Uncertainty continues as to whether the UK will exit the European Union pending the June referendum in the United Kingdom. The economic consequences of a "Brexit" are uncertain and have the potential to further destabilize the European Union.

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The Japanese central bank continues its efforts to stimulate growth in consumption and export activity by aggressive monetary policy targeting a weaker currency. Nevertheless the Japanese central bank is not the only arbiter of currency relationships. Recently, the yen strengthened against both the US dollar and the euro as a result of individual central banks working at cross purposes. It has become apparent to many that the ability of individual central banks to impact their economies has waned as individual economies have become more interdependent and integrated in the broader world economy.

The expansive monetary policy deployed in Japan and Europe include negative interest rates on deposits with the central bank and negative interest rates on shorter-term bonds. As risks and valuations of financial assets have increased, interest rates on longer-term sovereign debt in Japan and many European countries have declined below zero. It is estimated that 65% of Japan's sovereign debt presently has a negative yield. In Europe, the percentage of bonds issued by individual sovereigns that trade with an interest rate below zero ranges from 14% to 65%. By comparison, U.S. yields, even at approximately 1.7% for the 10 year Treasury bond, are attractive to foreign investors further depressing US interest rates, notwithstanding that the Fed desires to have interest rates rise, albeit slowly.

The rate of growth in the U.S. economy is anticipated by economists to be approximately 2 – 2.5% for calendar year 2016. We note, however, that there is uncertainty in the data utilized to arrive at such estimates as evidenced by the divergent views of the New York and Atlanta Federal Reserve Banks as to first quarter GDP growth. Domestic employment appears to be solid, yet hourly wage growth has only recently recorded a slight increase and the labor participation rate still remains low. The Federal Reserve remains cautious as to raising interest rates too quickly (although the voting members of the FOMC are divided in their views) as the Fed's preferred measure of inflation is still below its 2% target. The Fed's caution is further underscored by weak commodity prices (evidence of sluggish economic activity), and concern that higher interest rates in the U.S. would strengthen the U.S. dollar, adversely impacting corporate earnings and equity market valuation (which could dampen domestic economic activity in the event of a sell off in the equity markets). Finally, corporations appear not to have experienced productivity gains during the quarter. Longer term considerations weighing on future growth include higher debt to GDP ratios in major economies worldwide resulting from post crisis stimulus and the labor participation rate challenges that come with aging populations here and abroad. Nevertheless, the U.S. economy is presently growing at a faster rate than Europe and Japan.

Earnings and Valuation

Corporate earnings declined in calendar 2015 as compared to 2014 and are anticipated by analysts to decline for the first quarter of 2016 as compared to the first quarter of a 2015. At year end we observed that S&P's earnings per share estimate for 2015 for the S&P 500 and the analyst composite estimate significantly differed, with the analyst composite reflecting considerably higher earnings for the year. While estimates can differ, it is more troubling to us now that 2015 actual operating EPS calculated by S&P as compared to the 2015 actual analyst composite materially differs, with the analyst composite 17% higher (the difference presumably due to exclusions of negative impact items deemed not to be recurring). The outlook for 2016 EPS, however, is approximately the same although S&P is projecting significant growth while the analyst composite is projecting virtually no growth in earnings.

If we were to use S&P's 2015 EPS, eliminate the currency drag attributable to a strengthening dollar in 2015 and assume a normalized long term historical growth rate of 5.5%, we estimate that the S&P 500 is trading at approximately 19.0x 2016 earnings. The current 2016 S&P and analyst composite estimates

would imply a multiple of approximately 17.5. The uncertainties surrounding the earnings outlook cannot be overstated. For example, at the close of 2015 both S&P and the analyst composite projected earnings per share of approximately $125 for the S&P 500. Each have revised down earnings projections since the start of the year by more than 5%. Analysts are also projecting a major year over year decline in first-quarter earnings for 2016 although analyst estimates continue to reflect a strong second half of the year. Finally, we continue to lament investors' focus on non-standardized operating earnings rather than earnings calculated under generally accepted accounting principles or a more standardized approach.

As to the quality of earnings, we note that negative and low interest rates discussed above weigh heavily on the earnings of financial sector companies including banks and insurance companies. We also caution that energy company earnings are likely to continue to disappoint given low oil prices. This also has negative implications for financial service companies that have loan exposure to the energy sector. Finally, in 2015 S&P 500 companies did not achieve revenue growth. The outlook for 2016 is muted at best.

In a period of slower economic growth and slower earnings growth, multiples or the price-earnings ratio used to value equity shares should be tempered.

By comparison to equities, bond prices reflect yet higher multiples of their inherent yield. For example, the 10 year treasury is trading at approximately 59x its 1.7% yield. High quality corporate bonds and municipal bond are trading at multiples that far exceed even equity multiples though not near treasury bond levels which benefit from their perceived safety. On a relative basis, the high price/low yield bond market continues to support equity valuations as investors have limited alternatives.

Portfolio Construction

The valuation risks outlined above coupled with slow growth and opacity in earnings, continuing geopolitical risks, slow economies abroad, and uncertainty in commodity and oil prices, bode for a more defensive or balanced (between equity and fixed income) portfolio. As of this writing, equity markets are nevertheless continuing their climb.

We continue to be invested for most clients in the equity markets, the fixed income markets, and cash. By investing a significant portion of the portfolio in high quality intermediate-term municipal bonds, cash, and high quality sovereign, corporate and U.S. government debt, overall portfolio risk is lessened. We have endeavored to strike the appropriate balance given the artificially low rate of interest available in the fixed income markets as a result of Federal Reserve policy which has at the same time inflated and supported equity values.

April 13, 2016

The above commentary represents the economic and market views of our firm. We remind you, however, that each client's portfolio is managed individually. Please speak with your KLS advisor with respect to your personal circumstances and individual portfolio performance.

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