Q1 2016 Economic Commentary

"Anheuser-Busch gives two free cases of beer to its employees at all of its parks, like Busch Gardens. That's a comforting thought the next time you're getting ready to get on the roller coaster!"

Jay Leno

Thrill seekers seem to enjoy the pounding heartbeat, faster breathing and nervous perspiration that comes with the most spine-chilling of roller coaster rides. Those type A personalities love to push the envelope to see how much fear they can tolerate but ultimately feel a sense of satisfaction in enduring the ultimate anxiety. Thriving on the uncertainty and needing to expose themselves to experiences that are out of the routine are things most people consider hair-raising. The ultimate satisfaction comes when the scare is actually over. These people surely enjoyed the opening quarter of 2016.

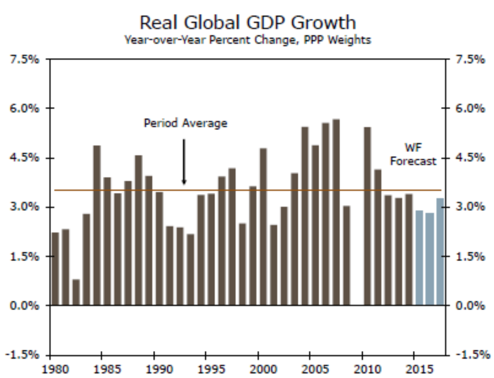
While many would point to the stronger early February economic data reversing the increasing alarms of a pending U.S. recession, the catalyst for the market reversal to us was more apparent. After opening the year with a swift decline of almost 11%, the S&P 500 index sat at 1829 on February 11th. That day also corresponded with the lows in WTI oil prices of $26.19 and near the peak in the value of the trade-weighted U.S. dollar. After acting as a major headwind for corporate earnings and investor psychology since the recent market peak of May 2015, both oil prices and the U.S. dollar reversed course in early February (charts below).

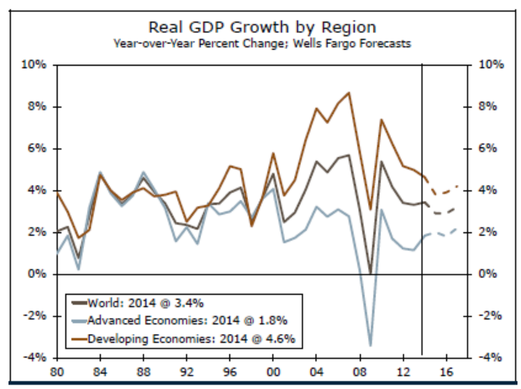
Perhaps of equal import may be the theory that some type of central bank accord was reached at the G20 meeting in Shanghai on February 25th & 26th after palpable fears of deflation caused by a dramatic devaluation of the yuan from the Peoples Bank of China (PBOC) shook markets in the early days of the new year.. Previously, we have discussed our concerns with diverging central bank policies and this was a major reason why we anticipated no rate hikes from the Federal Reserve in 2015. Though we find it difficult to envision the reality of a G20 agreement, it is less challenging to see where central banks implored the Fed to consider a pause. The quote below from Federal Reserve Chairwoman Janet Yellen in late March confirms this sensitivity.

"We have to take into account the potential fallout from recent global economic and financial developments, which have been marked by bouts of turbulence since the turn of the year."

Europe is still in a slow growth, deflationary struggle and coping with the U.K.'s possible exit. Japan continues to see weak growth while China and the emerging economies that were considered the engines of the global economy during the last decade are underperforming. With this as a global backdrop, the U.S. contributed 23% to global growth in 2015 and is expected to account for 21% this year according to the World Bank. This would represent the highest contribution since 2003. The U.S. has again become the global engine of growth.

It appears that the global economy grew approximately 3% in 2015, a level below the annual growth rate of 3.5% that has been the average for the prior 35 years and the slowest rate since the 2009 downturn (the IMF now forecasts 3.4% growth for 2016). The real softening was primarily in the developing world as aggregate growth in the developed world economies actually strengthened in 2015 to 2.0%. Yes, that is worth re-reading.



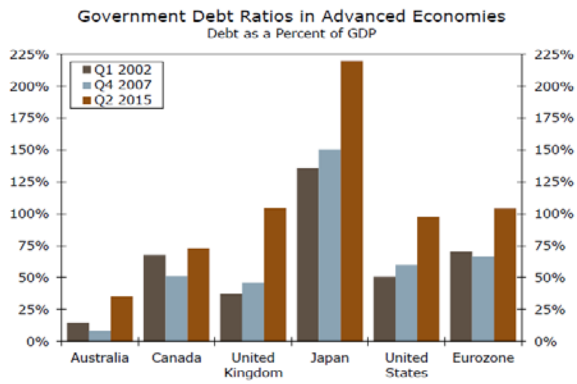


With manufacturing and exports in the U.S. contracting from the effects of softening global demand and a strong dollar reducing competitiveness, the U.S. consumer becomes the key component of both domestic and global growth. Indeed, aided by two consecutive years of the strongest job gains in 15 years and the tailwind of cheap energy prices, consumer spending (which accounts for more than two-thirds of U.S. GDP) adjusted for inflation did grow 3.1% in 2015, the fastest full year pace since 2005.

The U.S. continues to mire in a slow, "muddle-through" range for Gross Domestic Product (GDP) that we anticipate will remain between 1.75% and 2.25% for 2016. The headwinds from the impact of a near 20% increase in the value of the trade-weighted U.S. dollar over the last 18 months are starting to fade. We had downplayed the impact on the U.S. economy of a slowdown in manufacturing feeling the collective fears of an imminent recession were misplaced and recent data appears to support that view.

However, we are recently noting an increase in the propensity to save by the U.S. consumer to levels we had not anticipated. The consumer continues to benefit via lower energy costs and modestly rising incomes but this is not translating into higher credit expansion or spending growth consistent with these cash flow gains. In short, the consumer has the ability but not the propensity to spend. This is an unexpected though modest impediment to economic growth and corporate profitability for now. However, it must be noted that current savings is tomorrow's consumption. The consumer is in much better and even improving financial condition. The underpinnings of consumer spending during this recovery, albeit slow, are on a more solid foundation.

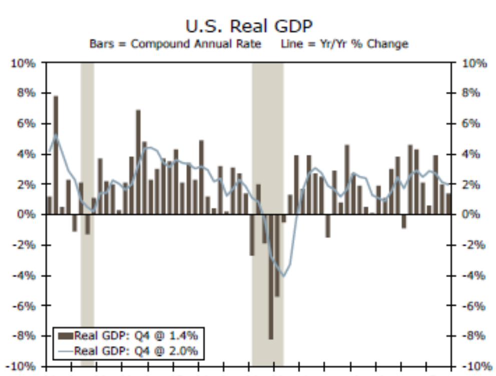
We have argued before that the current global malaise is not 2008. The global economy and the U.S. banking sector along with the U.S. consumer are in far better shape than was the case seven years ago. At the time, the largest component of the household balance sheet (the home) was deflating at a record rate. The common theme is that the indebtedness has never truly gone away; rather, it has just transferred onto the balance sheets of global sovereigns (see chart below on select government debt ratios).

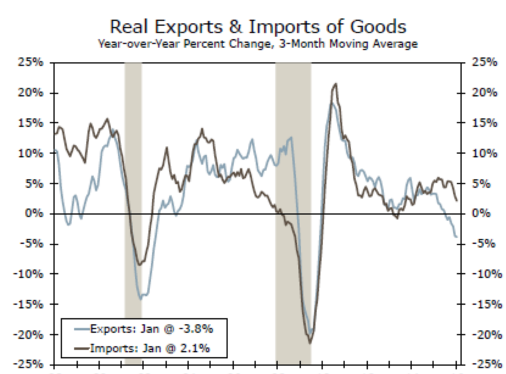


The long-term concern is still that slowing nominal global GDP may be insufficient to service the debt, a concern that has grown over the last few months. After all, total global debt-to-GDP (government, corporate and household) ratios are actually higher now at 290% than they were before the great financial crisis at a level of 270%. With global central banks having far fewer bullets left in the chamber, confidence in global central banks to provide the correct monetary policy response is waning.

UNITED STATES:

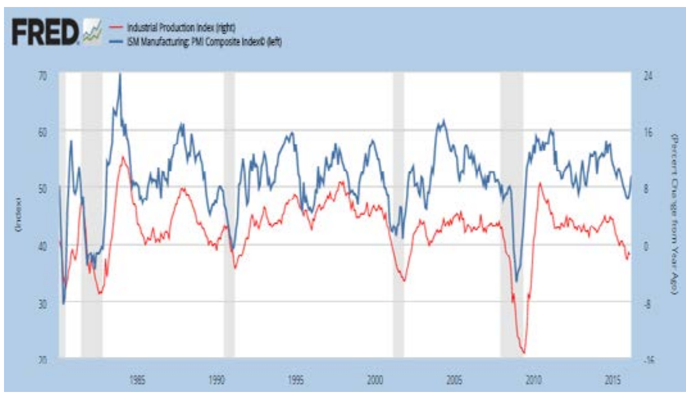
For the full year 2015, U.S. GDP grew at a revised 2.4% rate with the final quarter slowing to 1.4% (originally released at 0.7%) from the reading of 2.0% in the third quarter. Consumer spending slowed in the 4th quarter to an annualized pace of 2.4% but was still up 3.1% for the full calendar year, the fastest since 2005.Though there may be some plateauing in the rate of growth in housing, residential investment still advanced at a rate exceeding 10.1% in the 4Q release. Net exports (the difference between exports and imports) trimmed 0.6 percentage points off of topline real GDP growth in 2015 as headwinds from the strong currency combined with weak global demand. We anticipate that real net exports will continue to exert modest but lessening headwinds to overall GDP growth as we move through 2016. Though foreign demand is still sluggish and domestic demand (aiding imports) still solid, we feel that the headwinds of a rising dollar should lessen through the balance of the year.



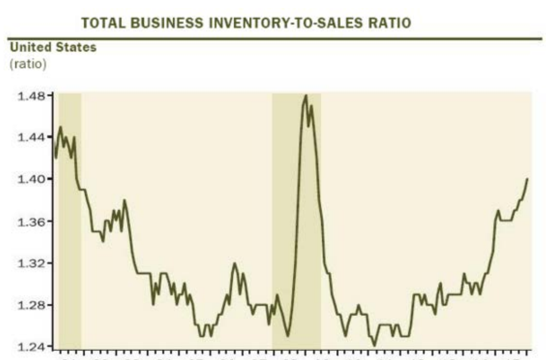


Many economists had increased the recession odds for 2016 (we did not) based on the continuing malaise in the manufacturing sector. It's true that contractions in the Institute of Supply Management (ISM) index this late into the business cycle have often coincided with the onset of recession. Indeed, the index had been declining (a level below 50) for five consecutive months through February. Industrial production (a measure of total output for manufacturing, mining & utilities) turned negative on a year-over-year basis in January, a pre-condition for most recessions.

However, we noted in our annual commentary our disagreement with the recessionary view given much of the manufacturing sector's weakness was due to factors that should decelerate, specifically the strength in the U.S. dollar and energy prices. Though overseas weakness along with the dramatic pullback in energy exploration and production are also factors, it has been our view that this area would stabilize. While it is still too early to determine if oil prices and the dollar have reversed their prior trends, the rate of decline has surely slowed and after surprising to the upside in February with a reading of 49.3, the ISM index moved to expansion with a solid reading of 51.8 in March. The manufacturing component of industrial production (IP) has also exhibited gains over the last two months. In the following chart, we compare the ISM manufacturing index (index level in blue LHS) with industrial production (annual rate of change in red RHS). The ISM usually leads the IP reading by one to two months. We anticipate an uptick in industrial production moving it back into positive territory over the next couple of months.



However, we do have some concerns of a slowing economy again on the horizon as two of the strongest contributors to recent gains moderate. While housing should still contribute to economic growth, the National Association of Homebuilders index (NAHB) appears to indicate a relative plateauing in housing. We have also shared our thoughts that auto sales may be peaking most recently evidenced by the weaker than expected level of March auto sales. Though the consumer remains in excellent and improving shape, much of that is going into savings to repair under-investment and excess debt. The result recently has been an elevation in inventory-to-sales ratios that represent the highest level since the recession (see chart below).



Such a high reading augurs a pullback in inventory builds to bring this metric in line with historical averages. We expect this to remain a headwind to GDP growth over the next few quarters absent increased consumer spending.

THE FEDERAL RESERVE:

While Janet Yellen and the Federal Reserve have continually positioned their decisions as dependent on incoming data, the FOMC meeting in March appears to have contradicted that. Core inflation is back up to the 10-year average (core PCE) of 1.7% and moving quickly towards their “alleged” 2% target. The unemployment rate is currently at their long-term expectation of 5% (10-year average is 6.7%) and may move to the mid-4% level later this year.

The Federal Reserve is clearly concerned about the potential impact of rate increases on the financial markets and in being in opposition to the increasing easing of the European Central Bank (ECB) and the Bank of Japan (BOJ). Yellen’s speech in late March could not have been more dovish in emphasizing this concern with the global economy at large. We have anticipated that position and are not in complete disagreement. We find Janet Yellen to be somewhat boxed in. In a historical environment, the current U.S. economic environment in no way warrants such emergency positions by the Federal Reserve. However, we are also concerned about the potential link between the capital markets and the consumer side of the economy should downside volatility spike. Might a major market correction precipitate a negative economic feedback loop that starts with a cautious consumer?

Perhaps of the Fed’s own making, Yellen is now in an untenable position acting not as the U.S. Central Bank chair but as the world’s central bank chair. Due to unprecedented leverage, the global financial system is quite fragile and reliant on continued liquidity. However, she knows that the Fed could be forced into a series of aggressive rate hikes if they were to wait too long to normalize interest rates. Though the dovish course may be the lesser of two evils, she must now navigate waters that have caused many a recession in the past.

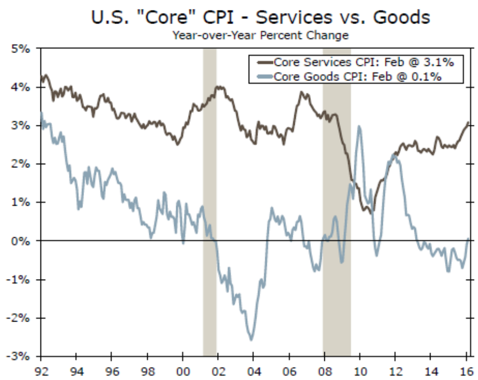
OIL, U.S. DOLLAR & INFLATION:

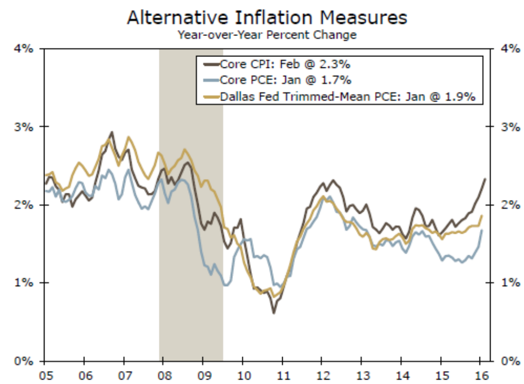
As noted above, the price of crude oil has clawed back from the early January low of just over $26 per barrel to over $37 per barrel entering April. The EIA has reported in early March that oil output from the U.S. is retreating and expected to move to a four-year low of 8.19M barrels per day by 2017 from 8.67M this year. This has yet to manifest in early production figures from January and there remains skepticism about the ability of major oil producers to finalize an agreement to freeze production later in April. However, it is said that the cure for low prices is low prices and we are hopeful that this may reflect some stabilization in the oil markets.

Entering 2016, the most crowded trade may have been to be long the U.S. dollar which we noted in many meetings with clients. Following those dovish comments by Yellen on March 30th, the U.S. dollar moved to the lowest level against the euro in seven weeks and posted the biggest quarterly decline in five years. After accelerating by as much as 20% year-over-year through mid-2015, the rate of change in the currency has now flattened out over the last year (chart below) and may present less of a headwind to exports and profits from U.S. multinational companies over the next few quarters.

We note that this is still a relative analysis and the chart of the U.S. dollar above is only on a year-over-year basis. Looking at the chart on page 1 (the absolute level of the trade-weighted dollar), we must note that the currency is still almost 17% higher than levels of mid-2014. U.S. exports are, therefore, less competitive unless prices are cut and profit margins reduced. Depressed GDP and S&P profits figures have already reflected this.

However, the Bureau of Labor & Statistics (BLS) does calculate inflation on an annual rate of change basis. As the impact of the sharp rise in the U.S. dollar in 2015 start to fade (down 4% in March alone) we are noting the strength in core goods prices which rose 0.1% year-over-year, just as we were getting accustomed to outright deflation. Core goods pricing has a greater exposure to global forces and is sensitive to a stronger currency through lower import prices. A stronger U.S. dollar was a clear headwind for most of 2015, but the negative impact of the strong dollar is already far in the rear view mirror in this calculation.





We noted in our annual commentary our expectation that the core inflation rates as measured by both the Consumer Price Index (CPI) and the preferred measure of the Federal Reserve, the Personal Consumption Expenditure (PCE) deflator, would rise and converge with the headline rate near the Fed target of 2%. This appears to be occurring even earlier than anticipated. After rising by the most in four years in January, the core CPI added another 0.3% increase in February raising the year-over-year increase to 2.3%. Though the February PCE core index remained flat at 1.7% y/y, we expect that to approach 2.0% by mid-year.

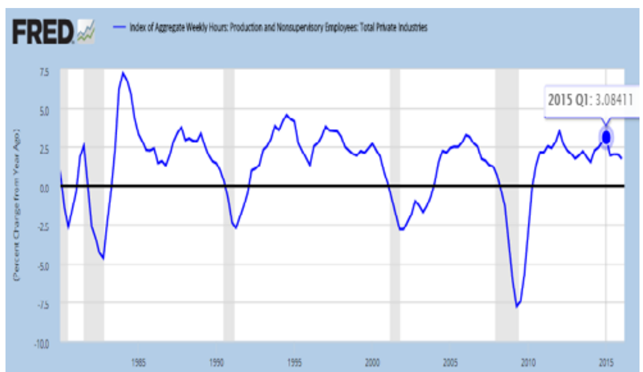
As a final note, if the Federal Reserve continues to hold policy rates below the rate of inflation (negative real rates) we may finally see the rising impact of a reflationary environment with slow growth. An environment of stagflation (for those of us old enough to recall) is not historically good for capital markets.

EMPLOYMENT & WAGES:

The labor market continues to make steady progress. Over the past year through March, nonfarm payrolls have reported gains averaging 223,000 per month. The BLS estimates that given an aging demography and the resulting slower growth in the labor force this may be almost three times faster than the job growth needed to maintain the current unemployment rate of 5.0%.

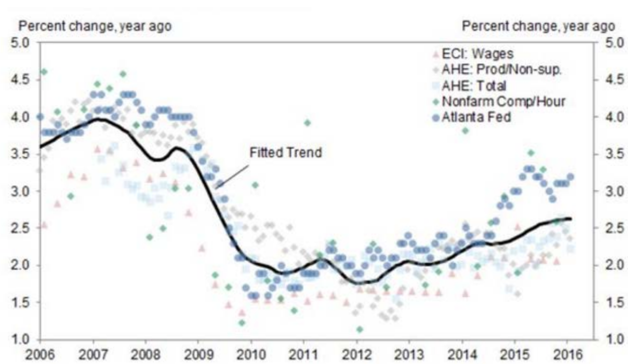
Strong job growth and modestly increasing wages may finally be starting to draw workers back and, over the last year, almost 2.4M people have entered the labor force (chart on next page top left), 1.9M in the last four months alone. Indeed, the labor force participation rate has finally started to recover following a long decline to a trough in September 2015 at 62.4%. The most recent report brings this rate back up to 63.0%, the highest since March of 2014. The large majority of the decline in the participation rate from the peak is attributable to the aging of the adult population. In narrowing this analysis to just the population between 25 and 54 (to minimize the demographic impact), the participation rate (chart next page top right) stopped declining in 2013 and has edged up 0.8% (March reading of 78.0%) since hitting its low point. The employment-to-population rate of 25-54 year-olds has increased 3.0% since reaching a low in 2009 and 2010 and wage gains in this vital cohort are reflecting this up 3.6% y/y.

One essential item of note that continues to bear scrutiny is aggregate hours worked. This critical input into overall GDP growth is starting to lag slowing from a year-over-year rate of growth of 3.1% in the first quarter of 2015 to the most recent level of 1.7% (chart below). Why is this critical to watch? As productivity wanes, corporate executives will seek to protect profit margins. To do so would indicate a likely slowdown in prospective hiring.



The most closely watched wage figure, average hourly earnings for all employees, advanced only 2.3% y/y in March from a year earlier. Our view has been that this wage figure would move closer to 3% by the end of 2016.

With such a tightening in the labor force, why are aggregate wages not increasing more? We feel they are, especially when viewing an aggregate of all of the wage measurements as seen in the chart from Goldman Sachs below.



Source: Goldman Sachs Global Investment Research

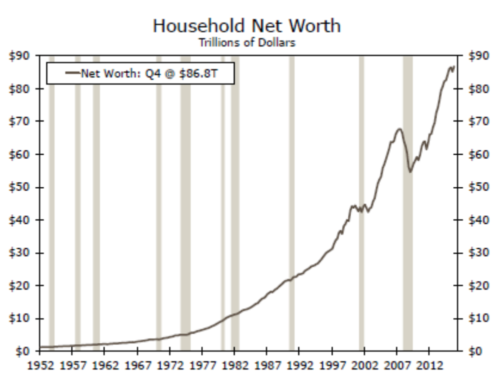
However, there are also the same demographic issues restraining aggregate wage growth just as with the labor force participation rates.

On average, older workers are paid more than younger workers. Work by J. P. Morgan estimated that the median age of workers rose from 37.9 years in January 1980 to 42.5 years in December 2009, or nearly five years in total. However, from December 2009 to the latest data in late 2015, the median age barely increased. The earlier aging of the workforce represented the aging of the baby boomers. The recent slowdown in this decade reflects increase in retirements of that generation. This can have a significant impact on overall wage growth.

As noted previously, median hourly earnings for U.S. "prime-age" workers (between the ages of 25 and 54) grew 3.6% (chart below) in the 12 months through March 2016, marking the fastest pace since January 2009, according to a measure compiled by the Federal Reserve Bank of Atlanta. Median hourly earnings growth for all workers was 3.1 percent on a year-over-year basis for the third straight month.

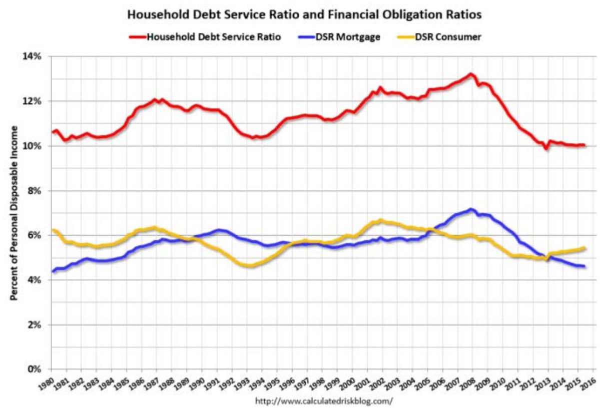
CONSUMER:

Household Net Worth data (primarily real estate and financial assets) available quarterly via the Flow of Funds report was up 3.1% y/y in 4Q. With the rate of appreciation in financial assets having slowed during 2015, this represents the lowest annual increase since 2011. However, accompanying this release, is the data for real disposable income (chart below right) that are running over 2.7% y/y, a rate that is above the level of much of the last decade.



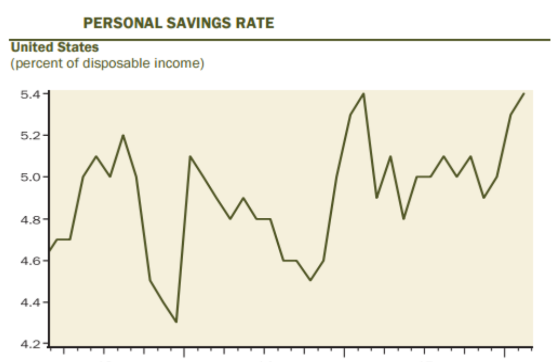
Total net worth had plunged $13 trillion from 3Q of 2007 to 1Q of 2009 as the U.S. housing and capital markets crashed. Since that trough, the asset side of the balance sheet is now up over $32.5 trillion. Against the backdrop of a rebound in financial assets has been a negligible change in household personal debt that is up only $405 billion during this six-year time frame. Every key measure of household indebtedness has now improved dramatically from the credit bubble peaks. While we are painfully aware that the asset side of the balance sheet may be ephemeral, it is very comforting to understand that the gains in household net worth contain considerably less leverage than the credit-fueled debt binges that preceded the financial crisis.

For the U.S. consumer, the debt-to-income ratio now sits at 104.7% as of 4Q 2015 near the lowest level since 2002 and way down from the peak of 133% in late 2007. The debt-to-asset ratio is now 13.8% near a 15 year low and down from almost 20% in 2009. The household debt service ratio (mortgage and consumer debt payments as a % of disposable personal income) sits at 10.1% a level representing a near record low for a series that dates back to the 1980s.



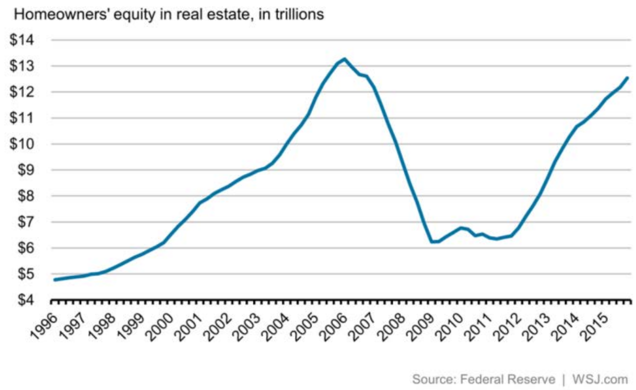
As noted above, wages continue to move modestly higher in early 2016 and we would not be surprised to see wage growth (as measured by average hourly earnings) move to 3% by year-end. Amid all the worry, consumers maintain solid levels of optimism about their employment and income prospects. This is typically a good precursor to home buying and spending for big-ticket items, such as motor vehicles and other consumer durables.

Despite this, consumer spending appears to have softened in the early months of this year. We are now projecting spending to rise at a much softer pace than the 3.1% annualized rate of 2015. Year-over-year real spending through February (chart below left) has now slowed to just over 2.7% and the early reads from the first quarter are closer to 2%. The consumer is still benefitting from but not spending the reduced costs of gas and heating and the savings rate (chart below right) has moved up to 5.4%, the highest level since late 2012. We continue to remind that our methodology in calculating growth (GDP) is highly predicated upon current consumption. Increasing debt to fuel spending is additive to growth, higher savings is not. The long reparation of consumer balance sheets continues and we see the consumer in solid shape. Whether this translates to increased spending in the near term may be a risk given heightened domestic and geo-political uncertainty.



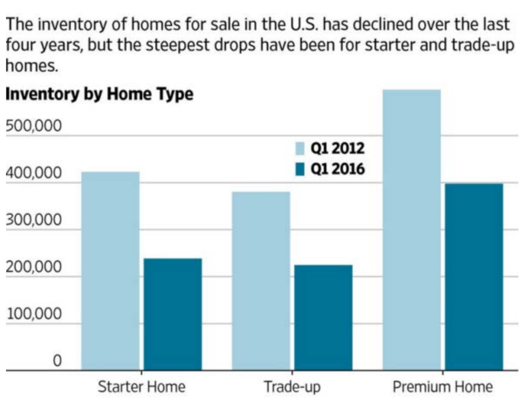
HOUSING & AUTOS:

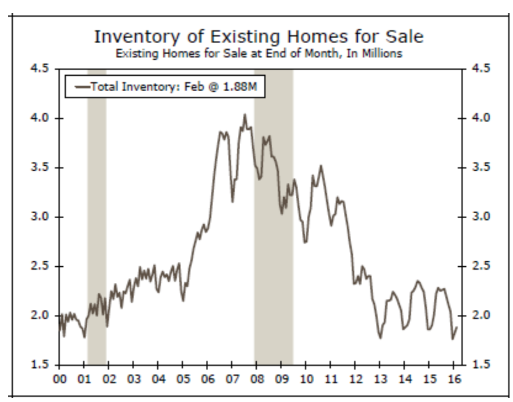
The housing collapse of 2006-2009 reduced household net worth by $7 trillion. Plummeting home prices combined with low down payments and home equity, precipitated 5.6 million American households to lose homes through foreclosure, according to RealtyTrac. At its worst, more than 25% of homeowners had paper losses as their mortgages exceeded the value of their properties. Since then and with the tailwind of low mortgage rates, the value of homeowners' equity in real estate has almost doubled from a low in the first quarter of 2009, according to data released by the Federal Reserve.



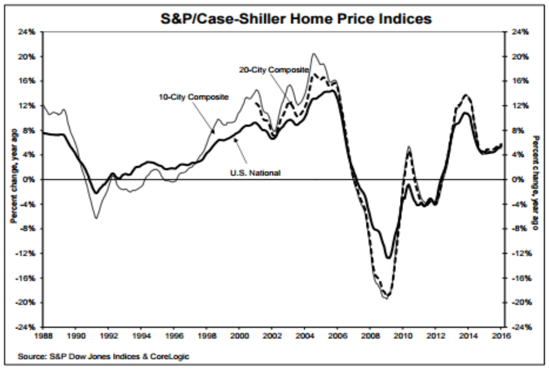
Even in the worst-hit markets, home equity is being restored. Rising home values have freed about 10 million homeowners from negative equity in the past four years, leaving six million homeowners (about 13 percent of everyone with a mortgage) underwater by some amount at the end of 2015. Rising home values were a primary objective of the actions of the Federal Reserve in multiple rounds of Quantitative Easing (QE). However, for all of the gains, the recovery in home equity (much as in most financial assets) has been uneven and many homeowners are so far underwater they may never resurface. Across the country, more than 820,000 homeowners owe the bank twice what their homes are worth. Inventory is already low, and negative equity is keeping potential additional stock from becoming available. Rising home prices are not always positive.

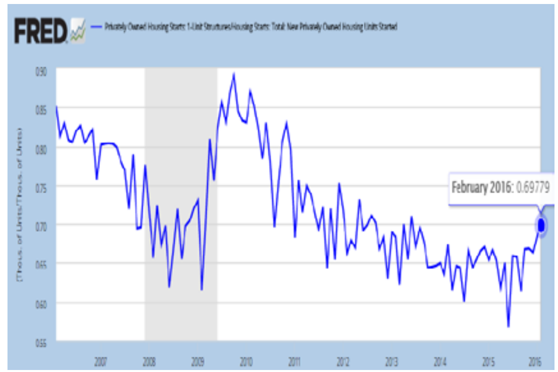
An analysis by real-estate analytics firm Trulia, shows that inventory of starter homes (defined as the bottom third tier with a median price of $150K) has collapsed nationally by 44% over the last four years (chart below left). Overall inventory (chart below right) is now at a 4.4-month sales supply (a 6-month supply is considered a healthy balance in the market). So, despite improving employment (up 700,000 over the last five months, a 16-year high) and wage gains for the 25-34 year old cohort synonymous with first-time home buying, gains in this area have been disappointing. Tight supply has engendered home price increases at a pace exceeding that of income growth. The stagnation of this part of the housing market has a stunting impact on each rung of the house price ladder.





National home prices as measured by the Case-Shiller Index rose in January to a 5.4% annual rate (chart below left) corroborating the 6.9% y/y gain noted by another real estate tracking firm, Core Logic. We are optimistic but not confident that we may now be starting to see a change, as the new housing starts for single-family homes for February were the highest since late 2007. The single family share of total housing starts declined from a historic average of 75%-80% to 57% in June of 2015 as the demand for multi-family (rentals) units surged. This appears to be changing and single-family starts are now up to 70% of the total (chart below right).





Despite these concerns, housing is making continued and increasing contributions to overall domestic growth. In the most recent reports through February, single-family starts jumped 7.2% to 822K on an annualized rate (a/r) in the month, reaching a new high for the expansion and now up a whopping 37% y/y. Though multi-family starts have trended lower in recent months, they are still way above historic levels. With this backdrop and the accompanying solid job and wage growth we expect, it appears as if real residential investment that feeds into GDP will enjoy a solid 2016 growth rate of over 7%.

Real residential fixed investment has historically averaged over 4.5% of GDP peaking at over 6.6% during the housing boom before collapsing below 2.5% in 2011. Now at about 3.5% of GDP (chart below), housing growth should continue to contribute to overall GDP at an increasing rate along with employment as hiring in this sector is now up 7% a/r over the last six months.

The U.S. auto industry has continued to be one of the strongest components of economic growth. 2015 represented the best year ever for sales of new cars and light trucks at 17.5 million units and the strong pace has carried into the early part of 2016. Purchases of used cars (of which many are subprime borrowers) also are increasing, according to the National Automobile Dealers Association. We have noted before that easy lending has been a prime reason for the sales pace and concerns over a default wave in this area are rising.

The total volume of U.S. auto loans is also now at an all-time high of close to $1 trillion According to Equifax over 20% of these are made to subprime borrowers. J.D. Power estimates that the subprime delinquency rate may exceed 17.5% this year fast approaching the 19.6% peak during the period preceding the great recession. The average amount of a new-vehicle loan in the United States rose by $1,170 in the fourth quarter from a year earlier to a record high $29,551, and the average monthly payment was nearly $500 according to Experian. Currently, 72-month car loans represent 34% of sales. We remain less concerned over the economic impact of rising defaults but note that these easy to get larger and longer-term loans both cannibalize future sales and present the rising risk of negative equity in the car loan for longer periods.

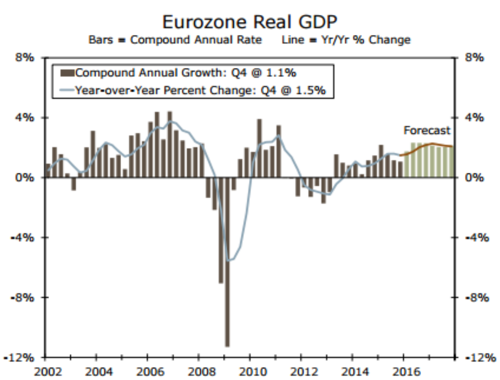
We noted in January our view that we may be nearing peak auto sales. The March reading seems to corroborate this view as the annualized pace slowed to 16.57M vehicles from 17.5M in February according to auto industry analyst, Autodata Corp. Though we expect a slower pace than 2015 in the months ahead, these are still solid totals.

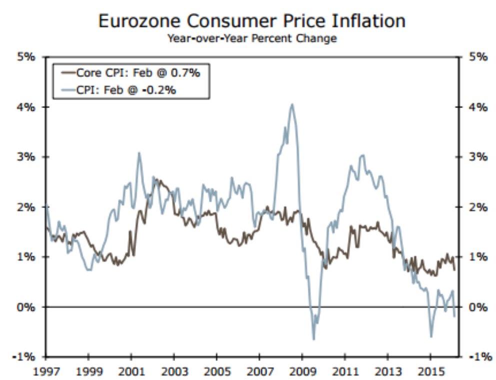
INTERNATIONAL:

EUROZONE:

Though slowing to a 1.1% annualized pace in the final quarter of 2015, GDP growth in the Eurozone (EZ) still hit our estimate of 1.5% growth for the full year. With fixed investment remaining weak in recent months, consumer spending continues to be the primary driver of growth in the euro area.

Most frustrating to the central bankers of Europe has been the persistent inability to generate inflationary pressures. Indeed, the headline rate of CPI inflation for the Euro Area again fell back below zero in March, while the core rate also dipped and is now just 0.9% higher than a year ago.





In further attempts to ignite inflation in the region, the European Central Bank (ECB) chose to ease policy further at its March meeting. In addition to further cuts to its refinancing rate of 5 bps to 0.00%, the ECB also trimmed its deposit rate 10 bps to -0.40% and lowered its lending rate 5 bps to 0.25%. It also increased the pace of QE purchases to €80B/month from €60B, expanding assets available for purchase to include corporate bonds and announced new long term refinancing operations.

Despite exceeding market expectations, we believe these policy efforts will have only a marginal effect on the Eurozone economy. Indeed, as ECB President Mario Draghi noted “there to be no need to further reduce interest rates”, a reversal in the desired decline in the euro materialized. The ECB has not been as successful with its efforts to weaken the euro as hoped. While the ECB’s initial move to cut interest rates into negative territory in June 2014 sparked a sharp plunge in the euro, further cuts last December and last month have had little effect on the currency that is up 4.6% this year through the end of 1Q. With many central bankers attempting to use the lever of lower interest rates to weaken their currencies and spur export growth, they are in effect cancelling each other out.

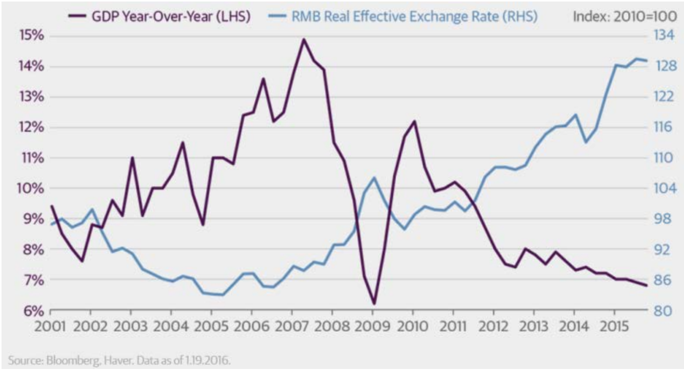
It will take broader structural reform among member countries in the EZ to achieve sustainable growth. Aging societies, debt overhangs and lack of productivity growth are common factors holding down economic expansion in many industrialized countries. The EZ faces additional idiosyncratic factors that reduce fiscal capacity and hinder its recovery as the absence of a federal budget and deposit insurance negate part of the pass-through effect of monetary policy to member states.

CHINA:

Chinese economic growth continued to edge lower in Q4 2015, as real GDP grew 6.8 percent on a year-over-year basis. Full year growth for 2015, at 6.9 percent, was about 0.5 percentage points below the rate registered in 2014. Consistent with authorities' explicit goals, growth in fixed investment continued to slow while consumer spending accelerated further.

With the renminbi tied closely to the dollar over the last few years, trade has been greatly impacted raising fears over the ability of China to maintain economic growth while implementing reforms and shifting towards more services and domestic spending. The newest trade figures from February highlight this challenge as exports declined -25.4% from a year earlier. Though heavily influenced by the longer than usual Chinese New Year holidays, this data represents the worst trade performance since the height of the global crisis in 2009.

The Chinese need the renminbi to weaken to help keep the economy competitive with other nations that have allowed their currencies to depreciate. The chart below juxtaposes the exchange rate of the renminbi with the annual GDP growth. The relationship between the two illustrates how critical the exchange rate is for growth in an export-driven economy such as China's.



It is true that China's direct impact on the U.S. economy may be small. Exports comprise about 13% of US GDP, and only about 8% of our merchandise exports go to China. Therefore, our economy's direct exposure to China is technically just above 1%. However, the ancillary impacts of a major slowdown in the world's second largest economy should not be underestimated. Trade to China from Japan and the Eurozone are a much greater proportion of GDP for those regions. Trade-related weakness can then spread further to the U.S. as these economies slow which can impact exports, profits and even employment for many U.S. multinational companies.

Additionally, the impact from such a slowdown is felt most strongly in the commodity area where the growth in China's infrastructure over the last 20 years led the commodity boom. Much of this growth was funded with huge amounts of public debt. With the construction boom over, the slowdown in China creates the potential risk of another financial crisis resulting from huge amounts of debt accumulated in that country as well as in other emerging markets.

Moreover, we remain of the view that the Chinese government has the resources and the willingness to ease fiscal policy to support the economy, should it deem such measures necessary.

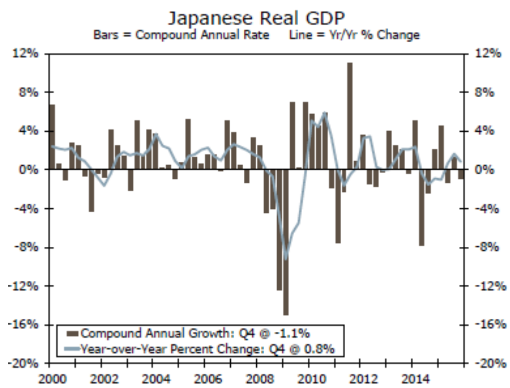
JAPAN:

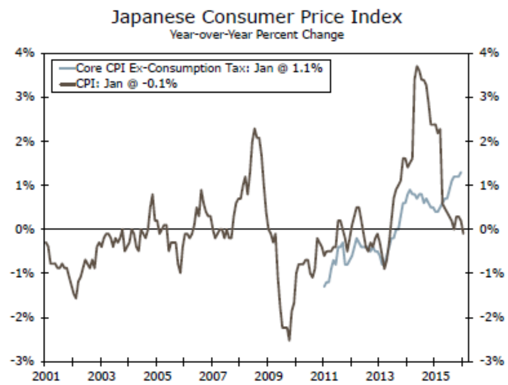
Japan has been fighting deflationary pressures and rolling recessions in their country for the last 30 years. Japan has now endured over a quarter century of virtually zero growth. Nominal GDP is barely higher than where it stood in 1989! The internal struggle with an aging population, lack of savings (a 24% rate in 1974 and less than 3% now) and accelerating debt/GDP ratios (now 250% of GDP) continue to plague economic prosperity. Moreover, over 16% of Japanese tax revenue is required to pay the interest on the debt alone (compared to less than 6% in the U.S.). This is the eventual impact of extreme debt loads all over the globe as productive spending and investment is crowded out by debt service. It is a primary reason as to why we expect global rates to remain low as countries simply cannot afford to let rates (and thus debt payments) rise and will do everything possible to prevent this.

Japan Prime Minister Shinzo Abe promised unprecedented monetary easing upon taking office in late 2012, looking to kick-start growth and spur inflation. In concert, the Bank of Japan (BOJ) flooded the economy with cash by kicking off a bond-buying program. As expected, the yen declined almost 50% against the dollar from October 2012 to June 2015 allowing exporting companies to more aggressively compete with the U.S. A falling yen should also fuel inflation via rising import costs and this may be the most important reason for the desired weaker currency.

However, despite the Bank of Japan’s efforts to push down its currency and jump-start the economy with negative interest rates, the yen is up over 7% versus the U.S. dollar this year and is at its strongest level against the dollar since October 2014. European central bankers are having similar problems containing the strength of the euro and other currencies. In a collective race to the bottom in currency wars, no one wins.

Though sustainable growth remains elusive for Japan (real GDP +0.5% for 2015 and down four of the last eight quarters) there exist embryonic signs that they are clawing their way out of deflation. Despite flat headline readings, core CPI has been accelerating for the most recent quarters and is now +1.1% y/y. Of course, much of this is due to the prior drop in the value of the yen that declined over 12% on a trade-weighted basis from the middle of 2014 to the middle of 2015. The recent rise in the yen may pressure this progress.





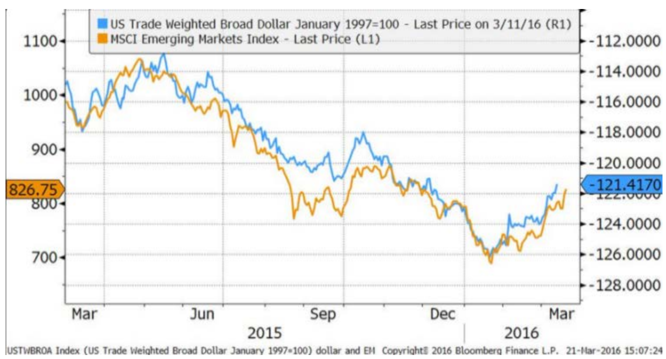
EMERGING MARKETS:

Emerging market GDP growth has slowed from 7.4% in 2010 to 4.6% for full year 2015. Though these rates of economic growth would be the envy of the developed world, emerging economies concluded 2015 with the fifth consecutive year of decelerating growth. The changing of the calendar has not altered that trajectory as the prior collapse in commodity prices along with rising debt levels and slowing demand have stirred recollections of prior turmoil in these regions.

Emerging economies in aggregate now account for about 40% of total global output (not marginal growth).This critical economic impact precipitated a plea from the International Monetary Fund (IMF) to the Federal Reserve to hold off on any rate increases until at least 2016. Though this did not occur, emerging markets have been the largest beneficiary of the recent pullback of the dollar.

With dollar denominated debt in emerging economies having risen over 60% in the prior five years to over $9T, debt markets were hemorrhaging as their currencies declined over 20% thus increasing the debt service burden as the currency translated cost increases. With growth already challenged, risks of loan defaults increase.

The U.S. dollar index (that is valued primarily versus the euro and yen) began to slide over the last two months after rising more than 20% over the prior two years. The longer this respite lasts, the louder the exhale will be felt from emerging markets. The negative correlation between the emerging market index is almost precise and shown in the chart below.



MARKETS:

Only two other times in history, have the major averages declined over 10% during the 1st quarter and rebounded with a gain of over 10% (2003 & 2009). Interestingly, both of those occurrences represented a market trough and the start of cyclical bull markets. That is how rare the rebound witnessed in this quarter was. Both of those reversals followed bear markets, however, and after a six-year bull market run we feel the comparison to be tenuous.

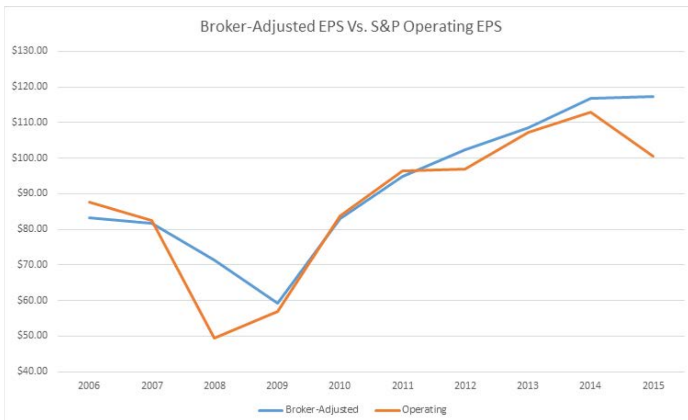
Following a decline of over -11% to an intraday low on February 11th, the S&P 500 finished the quarter with a total return gain of +1.3%. As the rebound in the energy patch was the major catalyst for the turnaround, it is not surprising that the Russell 1000 Value index returns exceeded that of the Russell 1000 Growth by +2.2% to +0.5%. This has been a rare occurrence over the prior three years.

The respite from declining oil prices and dramatic currency moves, propelled the Emerging Market index (MSCI EM) to enjoy a gain of over +13.2% in March and a full +5.7% for the quarter as a whole. The developed international EAFE index also rebounded in March though still ending the quarter with a decline of -3.0%. The Barclays Aggregate total bond index returned +3.0%. Though part of that gain was surely attributable to a “flight to safety” trade during the quarter, we also note that the more volatile Barclays High Yield index gained +3.5%, consistent with the valuation attractiveness for this asset class that we noted in our annual commentary.

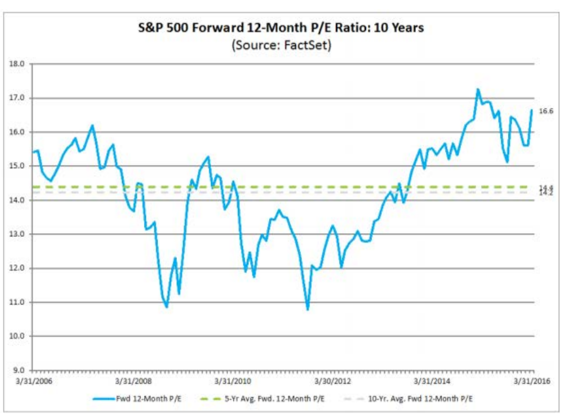
According to data from Factset, the full year 2015 S&P 500 earnings declined -1.1% to $117 with profits for the 4th quarter dropping over -5.5%. This is in line with our below consensus call following 2014 and marks the first time the S&P has seen three consecutive quarters of EPS declines since Q1 2009 through Q3 2009. Earnings for 2016 are anticipated to grow +3% to $120. We remain slightly more cautious and maintain our below consensus view of a modest full year decline. Beneath these numbers, one must also understand the quality of these earnings and how they are calculated.

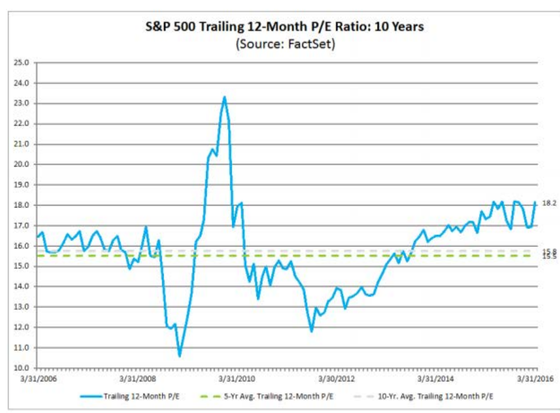
The estimates and earnings releases most frequently reported are usually “broker-adjusted” figures. This methodology is used by all Wall Street brokerage houses and by financial data companies such as Factset and Thomson Reuters. They attempt to give a "pro forma" earnings number that better depicts the underlying and ongoing, operational performance of the company. They come to these numbers by excluding items such as restructuring charges, merger & acquisition costs and other expenses viewed as non-recurring. Another approach is to use operating earnings from Standard & Poor's themselves. While they also do exclude some items such as discontinued operations and other truly unusual expenses, they apply a consistent methodology and are much less aggressive than Wall Street analysts. Historically, these approaches are close and there is some merit to both.

Recently the disparate methodologies have diverged and in 4Q of 2015, pro forma earnings exceeded the S&P operating earnings by over 29%, the largest gap since 4Q 2008. Though many are quick to look to the large write-downs in the energy sector, there remained a 14% gap excluding this sector. The chart below compares the earnings growth with the two approaches. Note that the current trailing 12-months S&P operating earnings per share is now basically flat with where it was after 3Q 2013.



Readers of this commentary know that we often focus on valuation metrics more historically correlated to long term (7 to 10 year) expected market returns. Those analyses have been flashing some caution for more than three years but have a low correlation to short-term market moves. Rather, they more accurately frame a realistic expectation for long-term returns. The current pause in earnings growth combined with the recent move up in equity prices have elevated current valuations on forward and trailing 12-month earnings to levels about 15% above their respective 10-year averages.





Over the past few years, we have written often about record levels of profit margins, their impact on morphing tepid revenues into solid earnings gains and their mean reverting history. The secular impacts of lower interest rates, tax rates, and labor costs have clearly benefitted margins over the last quarter century and they may have begun an inevitable reversion (chart below right).

Tighter labor markets, rising employee costs and weak productivity growth may all be conspiring to pressure profit margins. This continues to underscore our long held theme of Main Street over Wall Street with the labor share of national income continuing on the rise (chart above left). Benefits are accruing to labor via higher wages and non-cash compensation and there exists a corresponding negative impact on corporate profit margins. Ultimately, it is the rising aggregate demand from higher income growth that should sow the seeds for future economic growth and work back into corporate revenues and profits.

We have noted in the past that the economic recovery is still highly correlated to the markets (as is the Fed) and, though stronger, still vulnerable to more volatility. We witnessed in the first quarter what a normal market correction of 10%+ can do to a still fragile recovery and investor psychology. This is precisely why we at Coho Partners always strive to construct a differentiated portfolio populated with high quality companies with resilient earnings streams, growing dividends, strong balance sheets and reasonable levels of expectations and valuations.

Sincerely,

Rick S. Wayne, CFA