CCR
WEALTH MANAGEMENT

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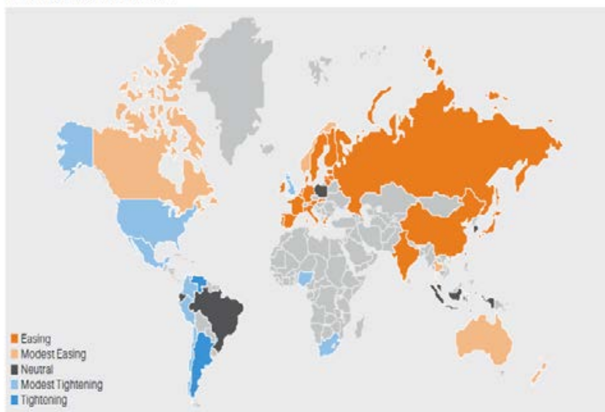
"…[R]ising valuations, rising interest rates, anemic global growth, and an exceptionally strong US dollar present headwinds against an organically improving economy and kinetic assistance of low oil prices. We hope investors view these expectations as encompassing a foreseeable future, and not as forecasts of a twelve month period certain."

--CCR Wealth Management Outlook, February 2015

As we alluded to a year ago, investors and the media have a penchant to compartmentalize time into 12 month blocks that begin on January 1 and end on December 31. Of course this is natural because so many other aspects of our lives run on this annual clock, with tax periods being perhaps the most relevant connection to investing. Certainly the media jumps on this New Year period to pass judgements on previous predictions and to seek out new predictions for the coming twelve months. We suppose it is helpful as a mental short-cut to be able to easily recall past periods by an assigned "name", abbreviated into a calendar year: *2008 was a terrible year in the market*, *1996-2000 were fantastic years*, *2011 and 2015 were tough years*, and so on.

The flaw in this compartmentalized thinking for an investor, though, is that we tend to place too much weight on the investment outcomes of a particular calendar year—when in fact it bears virtually no impact on long term investment results. Weighting the calendar oftentimes leads to weighting the annual predictions that come with the calendar too heavily—and even worse, making judgements and taking action on these short term predictions. We still occasionally field the "so what are we doing this year?" questions—an implicit suggestion that now that the calendar has turned, so must our investment strategy.

Historical data reflects performance over many different business cycles and economic conditions, which we might call *regimes*. Several different regimes can coexist (overlapping each other, and influencing each other). No regime pays great respect to the calendar and predicting the complex interaction of disparate influences these regimes have on security prices (globally) in a calendar year is impossible. Currently, we stand amidst several different overlapping regimes. The most prominent and influential among them (right now) are a rising interest rate environment in the US (one month old), a generally falling interest rate regime in most of the rest of the world (about 2-3 years old), and



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a slow-down in Chinese economic growth (about 8-10 years old). Additional multi-year regimes include collapsing commodity prices and a convergence of global GDP to very low levels, and of course the ongoing southern European fiscal fiasco(s).

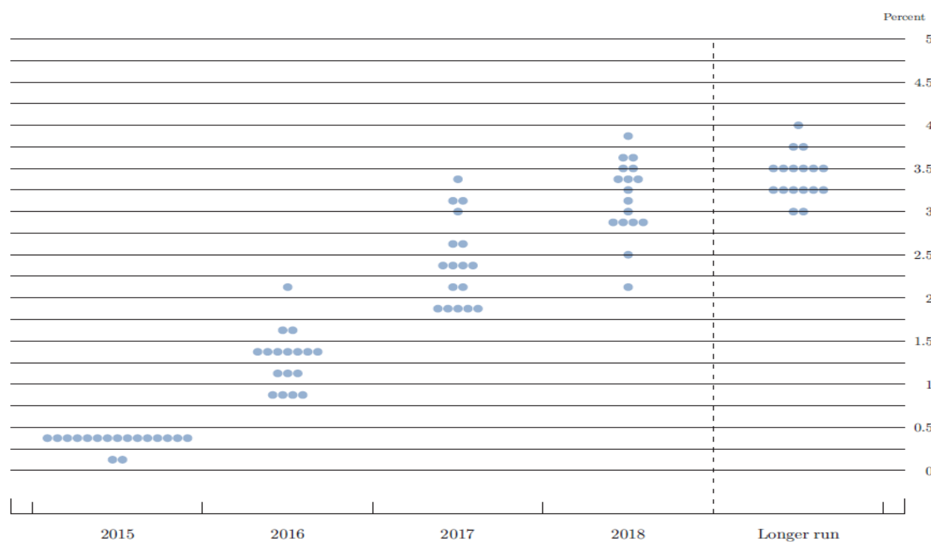
CCR Wealth Management has commented on most of these market conditions repeatedly over the last couple years. In reality, the only thing that *has* changed recently, as we write in early January, *is* the calendar. Surveys of market outlooks across a broad selection of asset managers and economists are essentially little changed on a macro-economic basis. We opened this piece quoting ourselves in last year's Outlook because to some extent, we think past is prologue as we ponder the "foreseeable future".

We have attempted to condition our client's expectations of capital market returns in these pages, and in our in-person interactions for the "foreseeable future", as being more modest on-average, than the returns coming out of the financial calamity of 2008.

Equities (US):

We continue to believe that equities will outperform bonds over the next two to three years, though as mentioned, these returns will likely be muted. Furthermore, we expect these modest returns to coincide with continued higher volatility. The Federal Reserve's monetary policy over the last eight years has acted as a wet blanket on market volatility. With this suppression lifted, we expect sharper reactions in the equity markets to political events in Europe, growth concerns over China, and of course let's not forget the Fed itself.

There are more rate hikes ahead in 2016. The question—and therefore the concern for equities, is how many? The chart below is the somewhat notorious "dot plot", taken from the December FOMC minutes from the Federal Reserve's website. Each dot represents the forward views for interest rate levels (Fed funds rate) from each voting member of the Federal Reserve Open Market Committee (FOMC). In attempting to discern an "average" view, it would appear the average Fed. Governor sees rates one year from now at approximately 1.25%. This suggests three rate hikes of 0.25% in the coming



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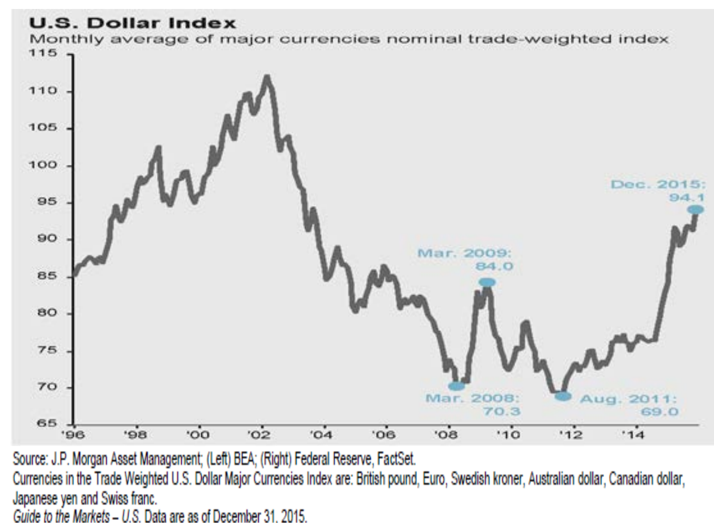
year. There is also a notable jump in rates seen by the Fed itself for 2017 from current levels. Keep in mind that the targeted rate after last month's hike is 0.25%-0.50%. The truth is, the Fed has been consistently overly optimistic in their GDP forecasting since the end of the recession. Asset managers we have surveyed and the Fed Funds Futures contracts both *expect fewer rate hikes this year than suggested by the dot plot*. Never-the-less, we view this ongoing interest rate drama to remain a major source of market volatility in 2016, with possible volatility spikes surrounding the FOMC meetings themselves, as well as dates of regular economic data releases.

Given the divergent paths of Central Banks around the world, we expect to see continued US Dollar strength. Strong currency moves like that of the Dollar last year tend to lag in their effect on the economy. We believe last year's move will seep into Q4 '15 GDP (not released at this writing) and will produce headwinds to earnings in 2016 for major US exporters. For this reason, mid-cap stocks may find more traction, having lower levels of exports, and lower exposure to the Dollar.



Source: J.P. Morgan Asset Management; (Left) BEA; (Right) Federal Reserve, FactSet.
Currencies in the Trade Weighted U.S. Dollar Major Currencies Index are: British pound, Euro, Swedish kroner, Australian dollar, Canadian dollar, Japanese yen and Swiss franc.
Guide to the Markets – U.S. Data are as of December 31, 2015.

A year ago we wrote that "divergence drives differentiation" and we expected more significant differentiation within US market sectors. The Russell 1000 Growth index actually *rose* 5.75% in 2015, while the Russell 1000 Value index *lost* 3.67%. But this 9.42% divergence between growth and value, while significant, belies the "churning" that occurred within the style categories. For example, healthcare, which ended up ~6% for the year, seemed poised to turn in yet another double digit return by mid-year (up 12.16% in late July), but it still belies a significant and on-going correction in Biotech stocks. Energy, materials and transportation stocks continued the route that began in 2014, and while financials were essentially flat, technology was a clear winner. CCR Wealth Management still believes this differentiation will continue in 2016, *however we do not expect the same patterns to repeat*. There is talk of energy finding a bottom later in the year and talk of financials benefitting from the lift-off of interest rates. Our view is that "betting" on sectors in this environment should take a back-seat to true, bottom-up fundamental analysis. Therefore we favor active management for this rather than index exposure.

Non-US Equities

Over the summer we cited China as being a potentially more concerning flash-point than the Greek drama that was playing out at the time. While expectations of slowing growth in China have abounded for the last eight years or so, the world's faith in China's ability to micro-manage their economy was shaken by what the Wall Street Journal called "ham-fisted efforts

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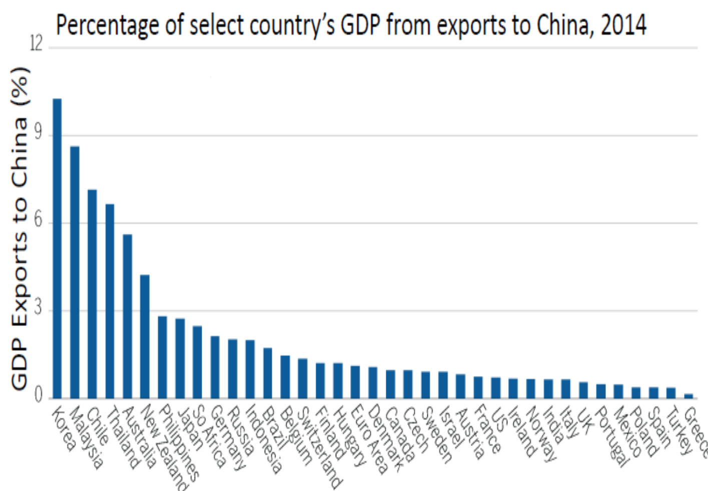
to stop a stock market bubble from deflating, and a bungled loosening of the peg between its currency, the yuan, and the dollar". At a lunch meeting we attended last September, former Fed Chairman Ben Bernanke actually opined that he thought the Fed was a bit "surprised" by the reaction of global markets to the unfolding Chinese fiasco (hence their demurring a rake hike September). Our view is that in terms of US markets, rising interest rates (or their prospect) will continue to manifest as a hyper-sensitivity to economic discord anywhere in the world.

China's "official" growth target for 2016 is 6.50%. Numerous asset managers we have polled see likely growth this year at 6%, but there is a fear in the market-place that China could be heading for a hard-landing rather than a shallow glide-path. This would be defined as growth of 4% or even less. The opacity of the Chinese markets and financial system helps fuel this fear.

China's neighbors and commodity exporters are most exposed



China's neighbors and other emerging markets have much more economic exposure to China than do developed markets.

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.
Sources: IMF, Haver Analytics, Wellington Management

[1]

We do not view China's economic slow-down as a *direct* threat to US GDP, as our direct trade with China is a very low single-digit percentage of our GDP. Interestingly, it would seem falling oil prices would most benefit the world's largest energy consumer. However, the Chinese yuan being pegged to a strengthening dollar (linked to falling oil prices) made the currency increasingly uncompetitive with the Euro and the Yen. The recent aggressive devaluation of the Yuan has sent an unsettling ripple throughout the global supply chain. Alas, China does not fully realize the beneficial bump low energy prices should convey. Continual disruptions among China's fellow emerging and developed market trading partners would likely have an *indirect* impact on US GDP given the global trade dynamics of today's economy.

The reality is that it will take a very long time for China to "work off" the excess capacity they have built up over the years, and financed with both public and private debt. The Wall Street Journal recently pointed out that "China's combined private and public debt have surged to 244% of gross domestic product from 148% is 2008, even as growth decelerated to an estimated 6.8% from 9.6%." A more mindboggling statistic comes from Canadian economist

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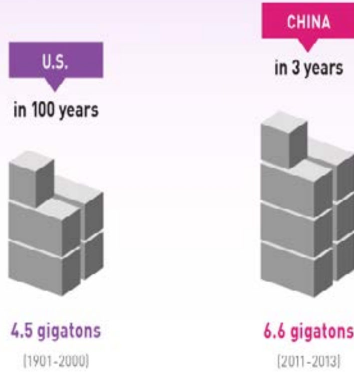
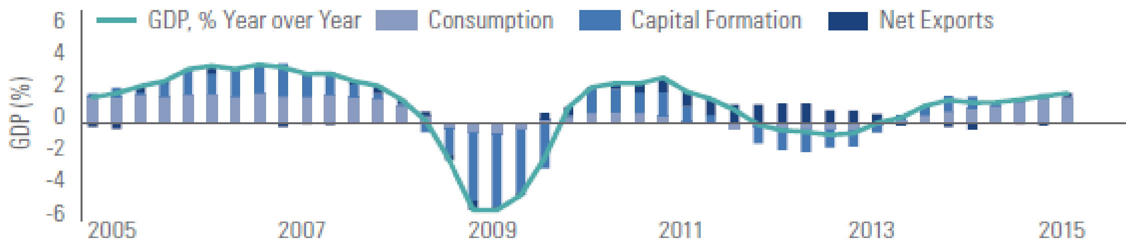
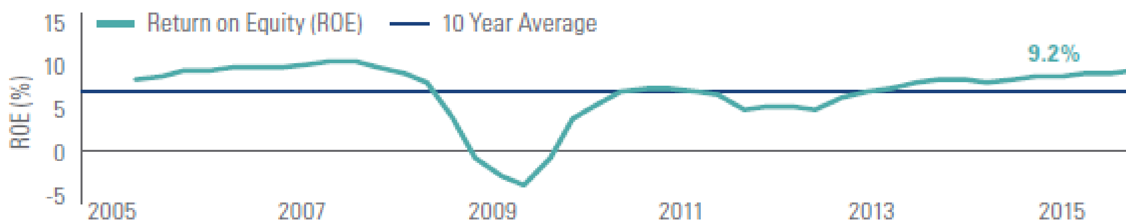


Vaclav Smil, who points out that China has produced and used more cement in the three year period from 2011-2013 than the United States used in 100 years! Unfortunately much of this cement has taken the form of brand-new, but still-empty luxury apartment buildings in nearly vacant cities.

We do not believe all the news out of China is bad—and it is easy for us to imagine some of the fears expressed by investors may even be overblown. Evidence of reforms are sprinkled in with these tales of excess. Last May supply-side tax cuts were announced for small businesses, and December's reform of the hated "One Child Policy" have caused some analysts to speculate on a mini-baby boom in nine months (both are an immediate economic plus). That said, CCR Wealth Management is not keen to call a bottom on China, and in fact we swapped our remaining (small) emerging market's positions in favor of European and Japanese small caps some months ago.

Our thesis on non-US developed markets remains little changed from a year ago, though it is clear non-US equity markets have responded more to Chinese economic concerns and geo-political events than to domestic monetary stimulations over the last 7 months. Relatively more attractive valuations, rising consumer consumption driving GDP in Europe, structural reforms driving ROE in Japan, and accommodative monetary policies in both regions continue





Top Chart Source: Haver and GSAM. Bottom Chart Source: Bloomberg and GSAM.

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to differentiate these markets as genuinely attractive investment opportunities, particularly for equity investors. As previously mentioned, CCR Wealth Management has added non-US small cap equities as a component of our non-US equity mix. Small cap stocks generally outperform larger companies in early business cycle phases. That the MSCI (ex-US) Small/Mid Cap Index was perhaps the best performing broad market index last year (+9.59%) helps link the economic impact of these structural and monetary measures to actual investment performance. However, given the unrelated concerns around the world—from China's growth, to Southern European politics, to geopolitical tensions world-wide, *investors will need to allocate a higher degree of patience than just a single calendar year allows* to realize returns on these investments—but we remain confident these are the shrewd buys for the long-run.

Fixed Income:

The fixed income markets performed as we expected in 2015. We expect more of the same in 2016 and 2017. In short, the Barclay's Aggregate Bond Index returned about one-half a percent in *total-return* terms last year (0.55%). Here, it is important to understand that returns for both fixed income and portfolios as a whole are measured in total return. Total return is broken down into two distinct components of return: income return and price return. All things held constant, income return should always be positive. *Total return* will be positive so long as price return does not turn more negative than income return is positive. For example, a hypothetical bond fund began the year with a dividend yield of about 5.50%, meaning 5.50% was paid out to shareholders throughout the year in interest payments. The fund's year-end *total return* was 2.64%. This essentially means that while the income return was positive by 5.50%, the price return lost approximately 2.86% to arrive at the 2.64% total return.

The implication here is that as interest rates rise at a modest pace the value of bonds can be expected to decline at an equally modest pace. However, bonds can and generally will remain positive contributors to overall portfolio return as long as the rate of contraction in pricing remains below the rate of coupon-interest paid by the bonds. If, however, you are reinvesting these monthly dividends (from bond funds), then you are investing them in a declining asset price (NAV)—you may be better off in the short-run by paying them to cash if you are concerned with interest-rate and bond market volatility over the short term. Please understand that reinvesting dividends in a declining asset price (in the short term) will ultimately lead to higher returns in the long term, as you systematically reduce the cost basis of the fund. If our thesis holds about 2016 and 2017, it is reasonable to assume paying dividends to cash as opposed to reinvesting may incrementally boost short-term bond portfolio performance. *It should be noted, however, that this short-term improvement will likely come at the expense of longer-term returns were those dividends reinvested.*

This concept is related in some ways to the topic of non-traded REITs we began in these pages some years ago in anticipation of higher volatility in both the stock and bond markets ahead. While non-traded REITs provide an income from a less volatile asset (commercial real estate), here we illustrate that the income received from a fluctuating asset (bonds) need not

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necessarily be reinvested into more volatility. Considering *total portfolio returns* in 2015, it easier to see how cash dividends vs. reinvested dividends may offer a marginally smoother ride in the short term if our thesis is correct and the current market regime is with us for a while.

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