The Equus Report

—BY BARNABY LEVIN

IPSO FACTO

Our Outlook for the Year Ahead

January 22, 2016

Ipso Facto[1]

From 2012 to 2014, the S&P 500 was up 72% -- mostly, according to William Priest, [2] because Price/Earnings ratios expanded to historical highs in a Zero-Interest-Rate world: “There are only three drivers of stock market returns – Earnings, Price/Earnings multiples and Dividends. Quantitative Easing,[3] which has been the driver of valuation metrics, is ending in the US and UK – nor is it going to have much more of an effect in Europe or Japan – and P/E ratios will be flat or down from here.”[4]

In truth, says Oscar Schafer, last year already proved to be the start of a “stealth” bear market: “70% of stocks in the Russell 2000 were down more than 20% from their 52-week highs; 49% of the S&P 500; and 68% of the Nasdaq Composite”[5] and, as the chart below shows, the S&P 500 in 2015 would have been negative without the help of a few large stocks, including Facebook, Amazon, Netflix and Google. Those four stocks increased by 83% on average.

"Markets." Bloomberg.com. Bloomberg. Web. 12 Jan. 2016.

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[1] “Ipso Facto” a Latin phrase meaning that a certain phenomenon is a direct consequence of the action in question.

[2] In this report – because I agree so much with what they have to say – I will be frequently referencing a number of comments and outlooks from Barron’s January 18 Roundtable with Jeff Gundlach (DoubleLine Capital), Abby Joseph Cohen (Goldman Sachs), Scott Black (Delphi Management), Oscar Schafer (Rivulet Capital), Felix Zulauf (Zulauf Asset Management) and William Priest (Epoch Investment Partners).

[3] Central Banks buying assets in an effort to lower interest rates

[4] Barron’s Round Table,” January 18, 2016

[5] Barron’s Round Table,” January 18, 2016

Yet, within the first two weeks of the New Year, this became quite apparent as markets gave Crisis in October 2014 – but for the past two years. back all their gains – not only since last August when China devalued their currency, or the Ebola

Source: FactSet Research Systems, Inc.

One of my Partners[6] at HighTower coined a term to describe the four, primary causes of this sell-off as "**C.O.R.E.**" – **C**hina, **O**il, **R**ecession fears and a slowdown in **E**arnings – and, since the sentiment is so negative in each, it behooves us to take a few moments with them one at a time.

China reported 6.8% GDP growth for Q4, suggesting a modest slowdown in the face of a property and shadow banking bubble and attempts by policymakers to transition from an export-driven to a consumption-oriented economy. The fear is that this will result in a "hard landing." But, whether it does or not (I'm in the "Not" camp), the journey will, at best, be riddled with uncertainty and skepticism and, therefore, volatile – exacerbated from time to time by a policy mis-step or two. Right after the first of the year, for example – in response to a falling stock market – the People's Bank of China tried in vain to support it through direct intervention and only spooked investors more. That said, as a "command economy," China continues to adjust and adapt in ways no other country can and they still have the Balance Sheet to do it. They will continue to intervene when the spread between the value of the onshore- and offshore-Yuan diverges and, when it comes to

[6] "Ad Hoc," The Bahnsen Group at HighTower, January 20, 2016

the markets, Vice President Li Yuanchao has said they are determined to "do whatever it takes" to get things right[7] so I wouldn't, as George Soros recently did in Davos, count them out just yet.[8]

Oil, at $27.50 per barrel, is back where it was in 2003 – and it's not because of Demand, which is at an all-time high. It is because of Supply, built up through a frenzy of investment between 2009 and 2014. Yet, in my opinion – for markets to act better in this regard – it isn't that oil needs to go back to $40 or $50. It simply needs to *stop falling*. The "good" news, as they say, is that the best cure for low prices is low prices and, even as we speak, exploration has nearly come to a halt; the number of bankruptcies are beginning to increase; and this, in turn, might be just enough to offset the 500,000 barrels per day that Iran plans to unleash in short order.

Recession fears are stemming from already tepid growth and Larry Summers has called the current economic environment one of "secular stagnation"[9] in which most members of the OECD[10] have inflation rates below 1%. This has clearly been a challenge for policy makers around the world. Also, as the Chinese economy has slowed, this has impacted – not only commodity producers from Russia to Brazil – but, with the devaluation of the Renminbi, China's other trading partners in the Pacific Basin as well.

From 2009 to 2014, according to Scott Black, Gross Domestic Product only grew by an annual average 1.4% a year when the *normal* postwar rate is 3%[11] and the Federal Reserve Bank of Atlanta is forecasting that real GDP, adjusted for inflation, is only running at 1% today.[12] But, whether it's 1 or 1.4%, this leaves little room for the Fed to raise rates or for further weakness without throwing us and the rest of the Developed World into recession.

What we need, according to Black, is a huge tax-policy overhaul to bring jobs back to America; investment tax credits for manufacturers; and a major infrastructure program. Yeah…right. As I said in "A Mean Reverting Mechanism,"[13] our Democracy has become one in which, as Jean Monnet once said, "People only accept Change in Necessity and see Necessity only in Crisis." And this, according to Jeff Gundlach, will be exacerbated by demographics: "Japan went into a demographic tailspin 20 years ago. China now is where Japan was then. Italy will lose a third of its labor force in the next generation. Russia is on the verge of the greatest implosion of population in the history of the world, absent famine, war or disease."[14] The bottom line is that – if you have fewer people working as a percentage of the population – you need that much more economic growth from those who *are* productive and we seem to have already squeezed all the "productivity" we can from *them*. After three demographic waves that propelled the global

[7] "China Vice President Vows to 'Look After' Stock Market Investors," John Micklethwait, Bloomberg News, January 21, 2016

[8] "George Soros says he expects hard landing for China economy," Bloomberg, January 21, 2016

[9] "US Economic Prospects: Secular Stagnation, Hysteresis, and the Zero Lower Bound," Lawrence H. Summers, Business Economics, Volume 49, No. 2

[10] Organization for Economic Cooperation and Development

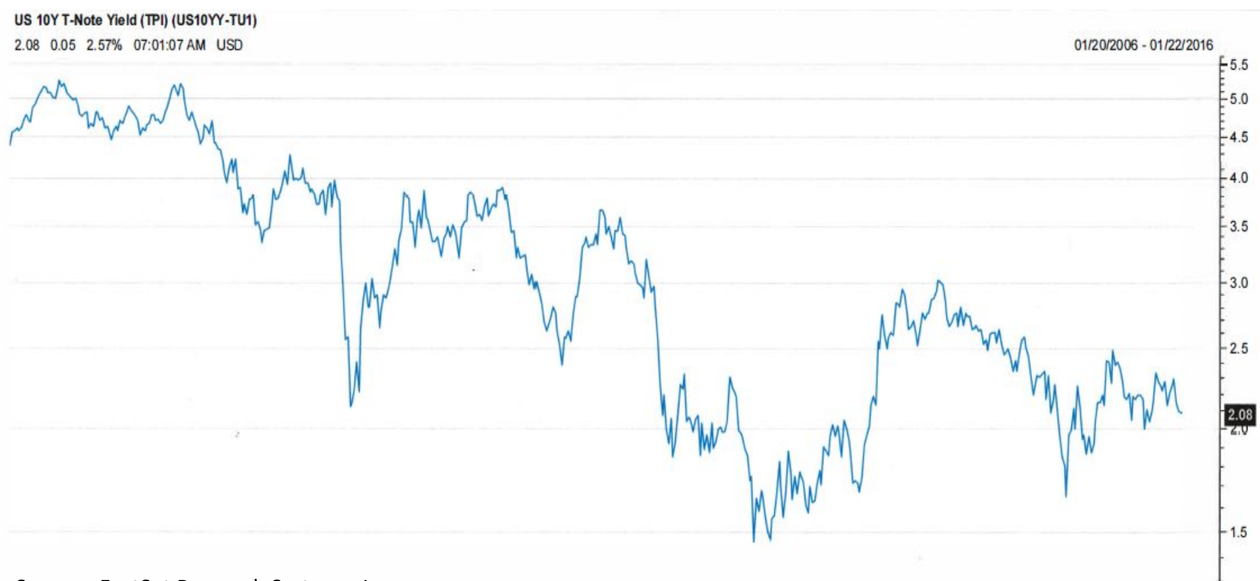
[11] Barron's Round Table," January 18, 2016

[12] Barron's Round Table," January 18, 2016

[13] "A Mean Reverting Mechanism," Barnaby Levin, HighTower Advisors LLC, September 15, 2011

[14] Barron's Round Table," January 18, 2016

economy over the past three decades – The Baby Boomers; the emergence of Eastern Europe; and China – "that," he says, "is all over now." But even more pressing, he adds, is debt: "The world economy has levered up since the early 1980s, and economic subjects have hit their borrowing-capacity limits. By definition, that means lower demand."[15] Yet – even as people have once more been fleeing to the relative safety of US Treasuries – Treasury *yields*, he says, have a way of bottoming gradually, then suddenly. Gundlach manages the DoubleLine Total Return Fund – the largest bond fund in the world – and he believes that we are in the "gradual phase" now: "The two-year Treasury bottomed almost five years ago at 15 basis points. Five- and 10-year Treasuries bottomed in July 2012. The 30-year Treasury bottomed a year ago. And one reason rates could rise in this environment is because of liquidation by foreign holders. Liquidation by central banks and sovereign wealth funds seems to be overwhelming the flight-to-quality demand for Treasuries."[16] Today, "the duration of a total bond-market index is 5 1/2 years and, if rates rise by 40 basis points, which is possible, it would take away all the gain."[17] (Ouch)



Source: FactSet Research Systems, Inc.

[15] Barron's Round Table," January 18, 2016
[16] Barron's Round Table," January 18, 2016
[17] Barron's Round Table," January 18, 2016

Earnings, as I pointed out in "China Syndrome"[18] last fall, already started to turn negative last June so this is an area that will be of little help as a catalyst for any *sustainable* recovery soon.

Date	EPS	Earnings Growth (%) Y/Y
31 Aug '15	28.89	-4.3
31 Jul '15	29.17	-3.4
30 Jun '15	29.99	-0.7
29 May '15	30.23	0.1
30 Apr '15	30.28	0.3
31 Mar '15	30.75	1.8
27 Feb '15	30.94	2.5
30 Jan '15	31.27	3.6
31 Dec '14	32.54	7.8
28 Nov '14	33.03	9.4
31 Oct '14	33.18	9.9
30 Sep '14	33.62	11.4
29 Aug '14	33.65	11.5

Source: FactSet

Some – like the Apples, Amazons and Googles of the world that offer unique, value propositions in goods or services – should continue strong. But the damage to the Energy and Materials sectors will last for some time as capacity is removed from the system; companies downsize or go out of business; and the Saudi/Iran standoff is somehow resolved and we, therefore, need to be even *more* "bottom-up" in our choices. As P/E ratios either remain flat (so we can grow into them) or (through corrections like the one we just "enjoyed") that ratio falls, the rising tide won't be floating all boats and stock selection will be more critical than ever.

To Summarize, as I said in "China Syndrome", our own markets are inextricably linked to those of **China** and, if *they* can put in a bottom and begin to recover, so might we. With **Oil**, all we need is for it to stabilize so Supply and Demand can converge, whether that's in the high $20's or low $30's. With regard to the possibility of **Recession** here in the US, see above. What we and China both need is time to get our arms around our respective debt loads in the face of deflationary headwinds that won't allow either of us to inflate our respective ways out of the problem. Excess debt will threaten to cause a sudden increase in yields at any time as Central Banks are forced to liquidate Reserves, offset by an inability of companies to raise prices in a globally-integrated world in which, with today's social media, news travels instantaneously and

Hedge Funds, having the ability to go long or short, respond in fractions of a second. And, finally, with regard to **Earnings**, they'll be lackluster at best and odds are that – with wild swings in which

[18] "The China Syndrome," Barnaby Levin, HighTower Advisors LLC, September 3, 2015

200 point moves up and, yes, down in the Dow along the way are becoming commonplace – our market will most likely tread water throughout the rest of the year.

There is no doubt that the increased volatility creates concern and we fully understand how that makes investors, including ourselves, feel. But while we can't, of course, predict where the market will trade in the short term, we have been aggressively raising cash once more and are already in a position to take advantage of opportunities.

As always, we are doing everything within our power to stay on top of things on your behalf. However, we welcome any feedback you might have so please don't hesitate to reach out to us with any and all questions. We are here to serve.

Barnaby Levin
Partner | Managing Director
HighTower Advisors LLC