3RD QUARTER
2016

SBH NEWSLETTER

Thoughts on the Current Environment

Ralph M. Segall, CFA, CIC
Chairman, Investment Policy Committee; Principal

In theory, theory and practice are the same. In practice, they are not.

- Anonymous

A long time ago (in a galaxy far, far away?), I was in graduate school. If it had been addressed, the notion of negative interest rates would have been taught as an example of a unicorn: a mythical situation that could not actually occur in nature. To be sure, there was an example of negative rates briefly occurring in the Great Depression in the 1930s, but that instance turned out to be a technical problem. Banks had to buy U.S. Treasury bills, even at a premium to face value, simply because they were required as collateral under the rules governing bank deposits by municipalities.

That was then. What was thought to be impossible in nature has proven to be achievable by the experimental efforts of all the good Doctors of Finance in the central banks around the globe. At the end of the second quarter, roughly a quarter of all investment grade debt outside the U.S. was trading in negative territory.[1] Sovereign debt in more than 10 countries trades at negative rates out to nearly 10 years (please see Exhibit 1 on page two for a breakdown of negative-yielding sovereign debt by country). While a yield of 1.47% on a 10-year U.S. Treasury note might not seem very attractive, it looks mighty good to an investor confronting a negative return in his or her home-country market.

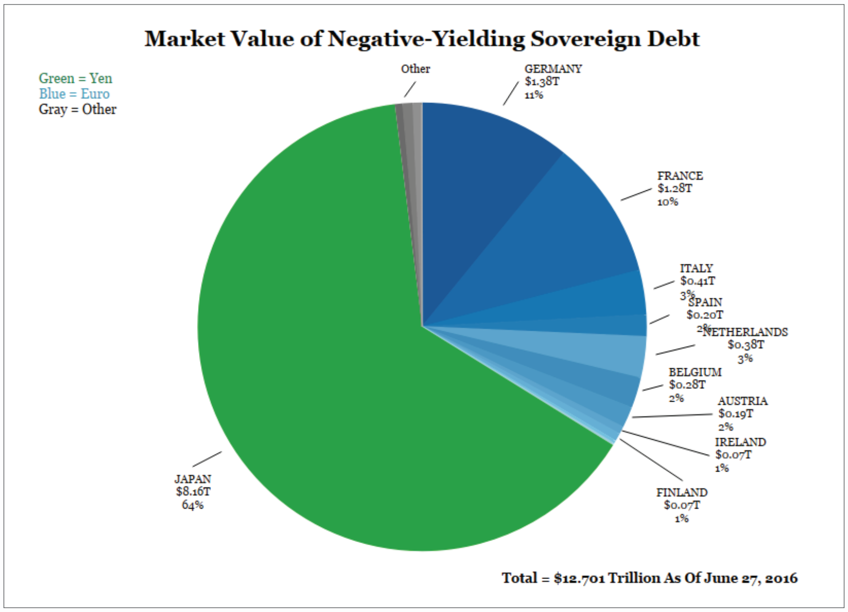
How has the world found itself in this place? How do we extricate ourselves from this position? And what is an investor to do, especially in light of the market volatility following the UK's decision to exit the EU late in the quarter? We will try to answer these questions, briefly with the first because it has been addressed before, speculatively with the second because there are a lot of moving parts to consider, and (hopefully) more substantively with the third because that's what we get paid to do.

Our view of the world order is built on a not-too-complex hypothesis. The global economy has not been able to reach an adequate growth rate in the aftermath of the Great Recession for two reasons. First, the Chinese economy, which had been the engine of incremental growth since the late 1990s, has stalled for a variety of reasons and will likely not reach the old growth rates again. Indeed, there is some risk that just the opposite could be happening. Although the Chinese economy seemed to be picking up earlier this year, recent data has suggested that it was the consequence of a sharp increase in credit from the People's Bank of China (PBoC), an amount equal to an unsustainable 40% of GDP on an annualized basis. Second, demographic forces in China—in the form of slowing population growth and aging populations—are exerting strong downward pressure on prices and on real growth. Largely because of the Chinese slowdown, the global economy has not been able to shrug off the deflationary weight of the debt overhang that was left in the aftermath of the collapse of residential real estate values in North America and Europe. Asset values come and go, but debt is forever, goes an old saying in finance, which has been proven true yet again.

[1] Source: "Bloomberg Global Debt Map," Bloomberg L.P. Data as of June, 28, 2016.

In this framework, policy makers have had to operate under certain burdens. Elected officials, who would be the ones that could implement fiscal policy measures—such as tax cuts and spending programs—were initially hobbled by the blame their electorates placed on them for the problems immediately after the crisis developed. The only stimulus bill that was passed by the current administration occurred in 2009, at the height of the crisis and when the Democrats controlled both houses of Congress. Since then, gridlock has been the order of the day, and the policy focus has been reduced to assigning blame. In lieu of criminal charges against those who "caused" the problems, we have seen an enormous increase in regulations designed to prevent it from ever happening again. (The General Staff of the French Army that designed the Maginot Line was not consulted.)

Exhibit 1:



Source: Bloomberg © 2016 Bianco Research, L.L.C. All Rights Reserved

In due course, the crisis did abate, but job opportunities—which typically appear in the aftermath of a downturn—did not materialize. Making policy when the pie is not growing is an entirely different exercise than making policy for an economy in which the pie is growing steadily. In the latter case, demands from various groups can be met by diverting resources from growth to them. If the pie is not growing, allocation becomes a zero-sum game, and politics take on a much larger role. When that occurs, the game is usually not played in a spirit of mutual trust. As a result, it has proven difficult for politicians to take controversial positions to promote growth if those positions do not address the immediate needs of their constituents. This issue, in a variety of local dialects, has played out for the last eight years across democracies around the world. One can read the recent "Brexit" as a current example of that phenomenon: the electorate has lost faith with the elected officials who lead them.

As a result, it has fallen to monetary policy, which is usually in the hands of central bankers, who are appointed to terms rather than elected, to shoulder much of the burden of kick-starting economies. We have written a number of times about the failure (to date) of monetary policy to generate growth. That said, central bankers have continued to push the envelope of monetary policy. Interest rates in the U.S. peaked in 1981 at 15% during an era of persistent inflation. Rates have moved steadily lower over the ensuing 30 years, in large part due to the grinding out of inflationary expectations from the mindsets of consumers, borrowers and investors. If one is a central banker and observes that going from 6% (say) to 5% produced a favorable growth outcome, one can easily extend that line of reasoning to conclude that going from 0% to -1% might be helpful, too.

The problem with experimental strategies is that they are just that: experimental. In experimental conditions, the Theory of Unintended Consequences operates powerfully. In Japan, which has been in a deflationary spiral for almost 20 years, negative rates have been applied vigorously by the Bank of Japan (BoJ), but to no avail as of yet. Doubling down on its bet, the BoJ has taken interest rates to deeply negative yields. Paradoxically, the Japanese yen has since strengthened and the Nikkei stock index has fallen. This is just the opposite of what the BoJ thought would happen. Likewise, in the Great Depression in the 1930s, the U.S. Federal Reserve (Fed) took actions to defend the dollar in an attempt to improve the economy; however, many economists now view these actions as extending and deepening the severity of that downturn. Finally, in their efforts to foster demand, the current Fed's actions to boost asset prices may have served to exaggerate income and wealth inequality. The approved treatment for inflation is far better understood than the approved treatment for deflation. As a result, the risks of a serious policy mistake are higher than would be preferred.

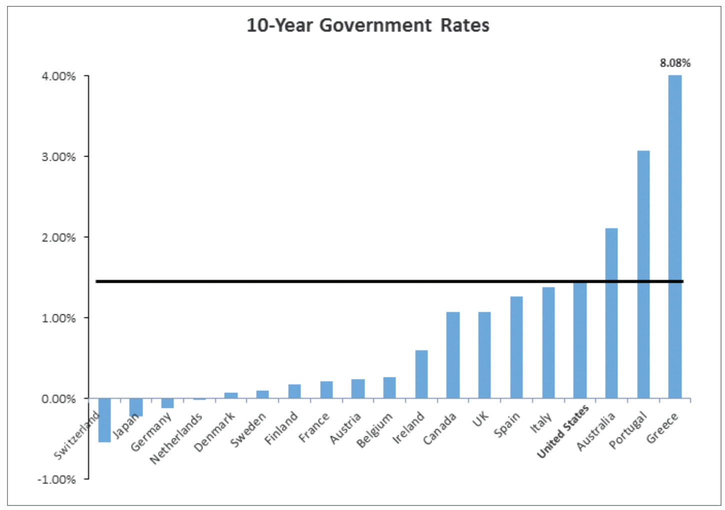
In the U.S., the question on the table has been whether the Fed should finally tighten interest rates after pinning short-term rates near zero for seven years. To tighten or not to tighten has been the raging debate for the last six months. Tighten prematurely, and any incipient recovery could be snuffed out. Tighten too late, and run the risk of letting slip the dogs of inflation. Mothers, don't let your children grow up to be central bankers. It's a tough job.

If monetary policy is showing itself an unreliable base on which the framework for recovery can be built, what could help? It is possible that the post-election environment could be the solution. Irrespective of which candidate wins (and we are excluding the possibility of the Libertarian Gary Johnson for this purpose), there are reasons to think a fiscal deal can be cut. Whether it takes the form of a Keynesian spending program or a supply-side tax cut or anything in between, it is likely that both political camps will find it is in their interest to be seen as working to promote growth policy initiatives, thus breaking the logjam of the last eight years. Whether such a policy will be effective is, of course, unknowable right now, but the mere idea suggests that there might be a pathway out of the morass. It will be important that the U.S. produces a successful set of policies because the rest of the global economy does not have the right factors in place to function as a lead dog. Europe is facing existential issues in light of the UK's decision to withdraw from the EU, coupled with widespread social unrest over the migration issue. China's problems are well documented. Those parts of the emerging markets not tightly tethered to China are neither large enough nor sufficiently coordinated in their activities to produce a reliable kick-start to the global economy.

Exhibit 2:

Source: SBH, Federal Reserve (Long-Term Treasury Bond Yields 1/1925 -6/2000; 20-Year Treasury Constant Maturity 7/2000-6/2016)

Exhibit 3:



Source: SBH, *Financial Times*

Which brings us to our third question: In the face of uncertainty about the ability of the policy makers to implement successful measures to promote growth, what is an investor to do? In such an environment, no asset class comes without imperfection. (Is there ever a time they do?) Bonds or stocks or alternatives or cash as an asset category have significant flaws as investment opportunities at the moment. Some observations to conclude:

- The risks of a policy mistake are higher than usual. Policy makers have little to no experience with deflation and cannot fully assess the consequences of their experimental policies. In balanced portfolios, a little gold might not be a bad insurance policy against a loss in confidence that would follow from the effects of a major mistake.
- Interest rates may seem absurdly low by recent historical standards, but as we pointed out in our last *Quarterly Review*, they are within historical experience going back to the 1920s and 1930s. Compared to negative rates in a number of countries, U.S. rates at least offer a positive rate of return and a hedge against the risk of deflation.
- Bonds selling at negative interest rates, on the other hand, are simply a greater-fool investment.
- The U.S. stock market is not cheap. At June 30, 2016, the broad market as measured by the S&P 500 Index was priced at 18.0x current earnings and 16.7x expected earnings. Such a multiple is not unreasonable by historical standards, but if interest rates do go up, that multiple could be vulnerable. While industry observers say that a quarter-point point rise in interest rates is meaningless, the charts on page four show that even slight changes in rates can affect equity markets. If stocks responded favorably when rates were cut/money was added, why would they not react negatively if rates rose?

Exhibit 4:

QE Return Table

Periods	Beginning Date	End Date	Point Change	Return
QE 1	11/25/2008	3/16/2009	-97.92	-11.50%
QE 1 Expanded	3/17/2009	3/30/2010	419.38	55.63%
QE 2	8/27/2010	6/28/2011	249.45	23.82%
Operation Twist	8/26/2011	4/3/2012	254.11	21.92%
No Twist End Date	6/6/2012	8/16/2012	130.01	10.11%
QE 3 Hinted	8/17/2012	11/28/2012	-5.58	-0.39%
QE 3 Implemented	11/29/2012	4/30/2013	187.64	13.31%
Taper Tantrum	5/1/2013	9/16/2013	100.03	6.26%
Tantrum Off	9/17/2013	12/16/2013	88.94	5.24%
Tapering QE 3	12/17/2013	10/27/2014	175.09	9.80%

Non QE Return Table

Periods	Beginning Date	End Date	Point Change	Return
No QE 1	3/31/2010	8/26/2010	-126.05	-10.74%
No QE 2	6/29/2011	8/25/2011	-137.40	-10.60%
Twist End Date Suggested	4/4/2012	6/5/2012	-127.88	-9.05%
No QE 3	10/28/2014	6/17/2016	108.61	5.54%

Exhibit 5:

- Conversely, if rates do not rise, it will be because the economy is not strong enough to warrant a rate hike. An economy that weak is not an economy capable of supporting profit growth. The market could be at risk of a disappointment.
- Viewed in this fashion, the immediate significance of Brexit may well be that it was the catalyst that crystallized all the market's concerns and started a decline.
- It is, of course, a Market of Stocks, not a Stock Market. Each of the SBH equity teams constructs portfolios based on a consistent approach and philosophy. Each team has experienced managers and analysts who have been around the block a few times. Experienced judgment is not the sole answer, but it surely is a large part of it. As the true implications of Brexit are revealed, the opportunities—and pitfalls—confronting companies and their investors will change. And we will be ready to take advantage.

MARKET BAROMETERS
AS OF JUNE 30, 2016

	Dec 31, 2015	1Q16 / 2Q16	Jun 30, 2016	Low	High
Dow Jones Industrial Index	17,425.03		17,929.99	15,660.18	18,096.27
S&P 500 Index	2,022.50		2,090.20	1,807.80	2,109.10
Russell 3000 Stock Index	1,206.10		1,236.62	1,067.34	1,252.20
Russell 2000 Stock Index	1,135.89		1,151.92	953.72	1,188.95
Russell Midcap Growth Index	738.40		749.41	636.09	761.98
Barclays Cap Aggregate Index	1,916.49		2,018.31	1,916.49	2,018.60
Barclays Cap Muni Bond Index	1,136.69		1,185.92	1,136.69	1,187.74
Gold (Price/Oz) London AM Fix	1,062.25		1,317.00	1,062.25	1,324.60
Goldman Commodity Index	2,170.61		2,384.66	1,860.66	2,497.27

Source: Bloomberg

SEGALL BRYANT & HAMILL

540 West Madison Street
Suite 1900
Chicago, IL 60661

Phone (312) 474-1222
Toll Free (800) 836-4265
Fax (312) 474-0521

www.sbhic.com