Stegent Equity Advisors Investment Letter

Stegent Equity Advisors, Inc. **April 2016**

First Quarter 2016 *Key Takeaways*

It was a tale of two halves in the first quarter of the year for global financial markets. Stock markets plunged early on, falling 10% to 16%. Broadly speaking, the decline was due to ongoing fears of a hard landing in the Chinese economy, a continuing plunge in oil prices, weaker-than-expected U.S. economic data, growing fears of a global recession, and a contagious loss of market confidence in the ability of global central banks to stimulate real economic growth with increased concern that current monetary policies (e.g., negative interest rates in Japan and Europe) are now causing more harm than good.

Then on February 12, everything changed. Oil prices spiked higher, stock markets rallied, and the dollar declined (serving as a tailwind for foreign equity returns). Emerging-markets stocks were among the highest-returning asset classes. Core bonds, which had rallied earlier in the year, fell and the 10-year Treasury yield moved higher.

March Benchmark Returns (Preliminary)

Large Cap Benchmarks	Mar	1Q	YTD
Vanguard 500 Index	6.8%	1.3%	1.3%
iShares Russell 1000	7.0%	1.2%	1.2%
iShares Russell 1000 Growth	6.7%	0.7%	0.7%
iShares Russell 1000 Value	7.3%	1.6%	1.6%
Mid-Cap Benchmarks			
iShares Russell Mid-Cap	8.1%	2.2%	2.2%
iShares Russell Mid-Cap Growth	7.2%	0.6%	0.6%
iShares Russell Mid-Cap Value	9.2%	3.9%	3.9%
Small-Cap Benchmarks			
iShares Russell 2000	8.0%	-1.5%	-1.5%
iShares Russell 2000 Growth	7.6%	-4.6%	-4.6%
iShares Russell 2000 Value	8.3%	1.8%	1.8%
Other Benchmarks			
Vanguard FTSE Developed Markets ETF	7.2%	-1.9%	-1.9%
MSCI World ex USA Index	6.9%	-1.8%	-1.8%
Vanguard FTSE Europe ETF	7.0%	-2.2%	-2.2%
Vanguard FTSE Emerging Markets ETF	12.7%	5.9%	5.9%
Vanguard REIT Index	10.4%	6.2%	6.2%
Vanguard Total Bond Mkt Index	0.9%	3.1%	3.1%
BofA Merrill Lynch U.S. High Yield Cash Pay	4.4%	3.2%	3.2%
Vanguard Intermediate-Term Tax-Exempt	0.3%	1.6%	1.6%
S&P/LSTA Leveraged Loan Index	2.8%	1.5%	1.5%
Citigroup World Govt. Bond Index	2.7%	7.1%	7.1%

The rally continued in March, on the back of better economic news in the United States and the Federal Reserve's decision to not raise the federal funds rate and also to lower its projection for the number of rate hikes for the remainder of the year. Markets also reacted positively to dovish European Central Bank actions during the month, as well as additional monetary and fiscal stimulus in China.

Looking ahead, however, with consumer price inflation and market inflation expectations rising, stock and credit markets and oil prices rebounding, and the dollar no longer appreciating, the Fed may soon turn more hawkish again. (In fact, just a few days after the March announcement, several Fed governors suggested the Fed could raise rates at the April meeting.) This could trigger market reactions that reverse these recent reflationary trends.

More generally, global monetary policy is moving deeper into uncharted, historically unprecedented territory, bringing with it unknown and unintended consequences. How and when will the current extreme monetary policies be "normalized" and how will they impact the global economy and financial markets? No one knows.

The extreme market turmoil we experienced in the first quarter vividly illustrates why we invest in diversified investment portfolios. It also points out the unpredictability of short-term market movements. Our approach is to carefully analyze long-term risk and return potential and build portfolios that balance these considerations and are resilient across a variety of market scenarios.

Portfolio Positioning and Outlook

The investment outlook—both in terms of potential return drivers and risks—has not materially changed over the past quarter. But in the context of the market's recent gyrations, we should review our reasons for concern that the relative performance trends *may* continue downward for a while longer, justifying the conservative positioning of our portfolios.

Another interest rate hike is likely before the election, probably by the end of June, even though the Federal Reserve cut its estimate of the most likely path for rates this year. Several indicators are signaling such a move:

- In its official statement released on March 16, the Fed said the economy is growing at a "moderate pace," (Fed's opinion) which is better than the slowdown referenced in Fed comments of late last year.
- Second, the Fed noted the recent pickup in inflation, which means it's focused on "core" measures of inflation, which exclude food and energy.
- Third, although the Fed said global developments can pose risks, it took out the reference to "closely monitoring" those developments.
- Perhaps the most important change to the statement, which was reiterated by Fed Chief Yellen in her press conference, was that the US economy is growing moderately "despite" global developments. In other words, all the fear and turmoil earlier this year overestimated the damage it would cause to the US and the Fed is unlikely to put as much weight on negative foreign developments again. In addition, Yellen when out of her way at the press conference to mention potential upside risks from abroad as well as from the recent rebound in oil prices.

Raising interest rates, even modestly, in the face of declining GDP estimates (from 3% to 2% and now 1%) will not ease market concerns over slowing global growth.

US productivity is falling sharply and jobless claims are trending higher, even while the unemployment rate is falling and average hourly earnings and hours worked are rising. Such wage inflation provides the Fed cover to raise rates further.

Demand for credit in the broader economy continues to decline, diminishing credit market liquidity, which, in turn, increases risk in all financial markets.

And of utmost importance to stock investors, sales and profit growth continue to *contract* and are on pace for the third consecutive quarter of declines. U.S. profit margins have been coming down, but are still high relative to history and are likely to continue lower if wage pressures continue to build as the labor market tightens. Higher interest rates (and therefore higher corporate borrowing costs) would also be a negative for margins. Current corporate profit margins have been negatively correlated with future earnings growth. That is, historically high profit margins are associated with low five-year forward earnings growth and vice versa. If top line revenue growth remains subpar and profit margins decline, earnings growth will remain under pressure. See the following table for more details:

FOR ANOTHER QUARTER, CAN'T BUY'EM ON EARNINGS

S&P EARNINGS ARE TRACKING NEGATIVE FOR THE 3RD CONSECUTIVE QUARTER

SECTOR	SALES GROWTH (% CHG)	EARNINGS GROWTH (% CHG)	#REPORTED
S&P 500 (Aggregate)	-0.6%	-8.1%	130 / 500
Energy	-30.3%	-51.0%	3 / 38
Materials	-11.0%	-19.5%	7 / 27
Industrials	-3.4%	-10.9%	25 / 65
Consumer Discretionary	4.8%	19.2%	24 / 85
Consumer Staples	1.5%	-2.0%	9 / 37
Healthcare	14.0%	8.9%	8 / 57
Financials	-4.8%	-17.0%	32 / 90
Information Technology	0.3%	-5.9%	21 / 67
Telecom	0.6%	3.0%	1 / 5
Utilities	0.0%	0.0%	0 / 29

Source: BBG

DATA SOURCE: BBG HEDGEYE 2

Meanwhile, on the valuation side, there is little room for market-multiple expansion in the United States. The 12-month trailing price-to-earnings ratio for the S&P 500 is 24x, and the 12-month forward P/E ratio is 18x (using analysts' consensus forward earnings estimates). These are both historically high levels. The best case scenario assumes the P/E multiple contracts over time, bringing it in line with longer-term historical averages. Putting it all together, it means poor expected returns for U.S. stocks.

Preserving, as opposed to growing, capital continues to be paramount in the current bear market. Therefore, we have further increased our defensive positioning into the second quarter of 2016 by raising cash from 15% to 17.5% of targeted equity exposure and raising fixed income from 15% to 17.5% of targeted equity exposure. The net result is a 35% tactical reduction in risk assets as compared to each portfolio's static target risk weighting.

Concluding Comments

Markets are cyclical, and for the past several years our portfolios have been facing some meaningful cyclical performance headwinds given our tactical asset class positioning and, more broadly, our long-term, active, valuation-driven investment approach. As discussed above, the headwinds to a strong momentum driven market may indicate the market pendulum is starting to swing in our favor.

Even if the recent positive market trends turn out to be short term or reverse course, we remain confident that our disciplined investment process and risk-management process, consistently executed over time, will pay off over the completion of this *full* cycle, and through future cycles as well.

It is impossible to consistently time short-term market moves, trends, and reversals. As always, patience, discipline, and fortitude remain key to achieving one's long-term investment goals, and to avoid getting swept away by the pendulum's unceasing swings.

As always, we are grateful for the opportunity to continue to serve as your trusted advisor.

Loyd J. Stegent, President
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