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Q3 2015 MARKET INSIGHTS

The Old Normal: Volatility Resumes, China Puzzles, and Reasonable Valuations Return

VOLATILITY DÉJÀ VU

Within seconds of the opening bell on August 24, the S&P 500 lost more than 5% (while the Dow fell nearly 1100 points). Investors got a taste of something many had forgotten about: volatility. Since the most recent peak around July 20, major U.S. stock indices are down about 10% (as of this writing) and the bumpy road has some investors nervous. 2012, 2013, and 2014 each saw not only double-digit returns for the major U.S. large cap indices, but also near-historically low volatility. The fact is, we believe we're seeing more of a "return to normal" in terms of stock market gyrations than a harbinger of something more worrisome.

When expressed in terms of standard deviation, 2012-2014 exhibited about one-half of the volatility we typically expect in the U.S. stock markets. During that three-year stretch, the S&P 500 had a standard deviation of about 11.5% vs. 20.5% during the prior 35 years. Since the recent market peak in July, the standard deviation of the S&P 500 has jumped to 22.1%, but that's well within a normal range. It just doesn't seem normal because of the protracted calm of the prior three years.

Standard deviation may seem somewhat abstract. Let's dissect how that plays out in the real world. Assuming a normal distribution, "one" standard deviation is the range around the average that will capture roughly two-thirds of the expected outcomes. It doesn't matter what you're measuring: height of people in an auditorium, leaves on trees, or stock market returns, two-thirds of your data points will fall within plus or minus one standard deviation from the average.

Here's an example: If we assume the average annual stock market return is 8%, using the more recent muted standard deviation of 11%, then we would predict that two-thirds of future years would fall between -3% and +19%. On the other hand, if we use the more historical 20% standard deviation, that two-thirds range is now -12% to +28%. Note that by using the more normal standard deviation of 20% we would expect not only a greater frequency of negative (or positive)

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returns, but also a greater magnitude of negative (or positive) returns. In short, a larger standard deviation suggests a wider range of positive or negative outcomes—and enhances investors' reactions of fear or greed.

We should keep in mind that the higher level of "risk" suggested by a larger standard deviation does not foretell doom. Since 1980, the average intra-year peak-to-trough decline in the S&P 500 has been more than 14%. Yet the index ended the year in the black in 27 out of those 35 years. It is a simple fact that volatility is back. And, with greater uncertainty about the strength of the Chinese economy, a pending U.S. election, and divergent monetary policies across the globe, a return to normal might be here to stay.

READING THE TEA LEAVES ON THE RENMINBI

In August, when China's monetary authorities devalued their currency against the dollar by 1.9%, it may have been the biggest cut of the renminbi in years. Big by Chinese standards; however, it was relatively insignificant compared to countries with floating exchange rates. But size was beside the point. The Chinese were sending a signal. Subsequent speculation about its meaning sent reverberations throughout the global markets.

At best, some media outlets claimed the move was simply a way to keep China's export prices more attractive to foreign buyers. This is a reasonable explanation, especially after the rally over the last 12 months in the U.S. dollar (which the renminbi is pegged to). At worst, it proved fodder for the 24-hour news stations and current U.S. political campaigns suggesting that China is stoking a currency war.

What was China's true motivation? Looking at the realities, China has suffered given the peg to the dollar, which has increased the value of the renminbi relative to the yen, euro and other currencies, particularly over the last 12-18 months. We find it interesting that the market believes China is "manipulating" its currency lower, when in fact, China has had to spend significant reserves to support its currency and keep it within their targeted +/- 2% range of the dollar.

Regardless, there are expectations that the move should act as a form of economic stimulus: sure, but 1.9% isn't going to make your iPhone noticeably cheaper. A currency war is a long shot, although this may accelerate competitive devaluation of several other, much smaller, emerging

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market currencies. We believe the truth, as always, is more nuanced and may mostly be driven by a third factor. To wit: This was a small step towards allowing the value of the renminbi to ebb and flow with the market, which may help foster China's longer-term desire that it take on a greater role in global transactions.

At the time of the devaluation, China also made a change to the way the peg works in the hope that its currency will become part of the International Monetary Fund's (IMF) Special Drawing Rights (SDR) basket. The SDR is an international reserve asset, created by the IMF in 1969, to supplement its member countries' official reserves. Its value is based on a basket of four key international currencies: the U.S. dollar (USD), the pound sterling (GBP), the euro (EUR), and the Japanese yen (JPY). The IMF only reassesses the constituents of the SDR every five years; 2015 is an assessment year. The renminbi is the only other currency that meets what the IMF calls the "export criteria"; the inclusion of the renminbi into the SDR would be a symbolic step in legitimizing China's currency as a building block in the global economy.

Furthering that effort, on October 6, SWIFT announced that the renminbi currency has entered the top four of world payment currencies by value, overtaking the Japanese yen. For those worried about USD hegemony, this ranking has China reaching a 2.79% share of global payments vs. the USD at 44.82%, EUR at 27.20% and the GBP at 8.46%. Granted, this is a stellar increase in the value of renminbi currency traded compared to its .85% share (#12 ranking) a mere three years ago.

CHINA'S BOOST IN GLOBAL MARKET SHARE: CAVEAT EMPTOR

China's maneuvers to be included in the global financial system have been in the works for quite some time now. In 2002 they announced the Qualified Foreign Institutional Investor program (QFII), which was one of the first steps to begin to allow, on a selective basis, global institutional investors to invest in its capital markets. Specifically, this opened up China's yuan-denominated "onshore" A share class. In April 2012 the foreign quota was increased from $30 billion to $80 billion – yet that still only represented less than 1% of the total market cap.

These moves began the inflow of foreign investment into China. Then, on November 17, 2014, China launched the Shanghai-Hong Kong "Stock Connect." In what may be one of its biggest financial advances to date, China connected the Hong Kong stock exchange to the Shanghai

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stock exchange. Daily trading volume quickly grew to more than 4.5x what the exchange had averaged the two years prior. What followed was the doubling of the Shanghai Stock Index over the next six months—from about 2500 to more than 5000—and then its collapse. It eventually settled around 3100. Even after the wild ride, this exchange has still produced better 12-month returns than any other major market. There are plans to open a "Stock Connect" to the Shenzhen exchange as early as next year.

This is significant, because by the end of the second quarter this year, China's stock market became the second largest in the world by market capitalization. It is also the world's most active in terms of trading volume. Shanghai and Shenzhen combined have more than 2,500 stocks, with more than 1,000 having a market cap of greater than $1 billion. China currently makes up about 23% of the widely used MSCI Emerging Markets (EM) Index, making it the largest country represented. And the MSCI-EM doesn't even include the onshore shares like those traded on the Shanghai and Shenzhen exchanges.

The gap between China's relative size in the global economy (~15% of global GDP) and its publicly traded market cap (~9%) is closing. This represents a huge opportunity, as investors will have additional access into a very large capital market that has been effectively closed to outside investors. Yet investors should proceed with caution. One portfolio manager we work with estimates that only about 20% of China's publicly listed companies have accredited auditors. Caveat emptor.

THE TPP—AND GLOBAL GROWTH

Another development that has come to a head in the last several weeks is the culmination of over five years of negotiations related to the Trans-Pacific Partnership (TPP). The TPP brings together nearly 40% of the global economy (with the notable absence of China). According to the Office of the United States Trade Representative, the effort is expected to "support jobs, drive sustainable growth, foster inclusive development and promote innovation across the Asia-Pacific region."

Generally speaking, freer trade should support more fluid capital allocation and allow for marginally faster growth than may have been likely without such agreements. While the TPP has yet not been approved by U.S. and/or foreign legislatures, the culmination of an agreement is a healthy sign and could provide a tailwind to cross-border transactions.

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While we know this will be an expansion of prior global trade agreements like the North American Free Trade Agreement (NAFTA) and General Agreement on Tariffs and Trade (GATT), as of right now there is relatively little transparency into the negotiations of the TPP. Some have demonized it as if it were opening up a Pandora's Box of human rights violations, pollution, and a further widening of income inequality. Fueling conspiracy theories is the fact that President Obama has requested that Congress grant him Fast Track Trade Authority. Under Fast Track, the House would be required to vote within 60 days and the Senate within 90. Fast Track prohibits Congress from amending the legislation and limits floor debate to 20 hours. All told, we would like to stay optimistic, as any tailwind we can muster would be a welcome event given the relatively muted level of current economic activity across the globe.

The International Monetary Fund (IMF) recently lowered its global growth forecasts to 3.1% for 2015 and 3.6% for 2016, although it raised the U.S.'s forecast by .1% to 2.6% for this year. So far this year, the U.S. has seen a fairly wide range as the 2nd Quarter showed a strong rebound (+3.9%) from a moribund and weather-hampered 1st Quarter (+.6%). Reviewing the 3rd Quarter, the combination of a strong U.S. dollar (+~18% year over year), rising inventories, weakening capital investment from energy, and slowing demand from China suggest a weaker GDP print. If the IMF is right, we'll need to average almost 3% growth for the 3rd and 4th Quarters in order to reach the ~2.6% level.

THE WAY FORWARD: INTEREST RATES, REASONABLE VALUATIONS, AND RISK ASSETS

Unfortunately, the recent shenanigans of the Fed's "will we or won't we raise" discourse has increased uncertainty in interest rate policy, making it difficult for investors to determine which assets may (or may not) be a near-term risk. While some pundits have suggested it was a mistake for the Fed to put off (again) their first interest rate increase, we believe it was a prudent move given the current data. That said, it has also created a bit of a hitch in market sentiment and an air pocket in terms of risk-asset buying. We saw evidence of this with the sharp increase in volatility and market correction referenced at the start of this letter.

The upside to the recent volatility is a near-term return to "reasonable valuations" across equity markets. With the pull back, the S&P 500 is back below the 25-year average forward P/E of 15.8X. In fact, by most measures of valuation (i.e., Shiller's CAPE, Dividend Yield, Price to Book,

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Price to Cash Flow, and Earnings Yield Spread over High Yield) our market is back below the average of the past 25 years. This is all the more impressive given that the Energy sector's contribution to earnings has actually been negative so far in 2015. This is not to say that U.S. stocks are destined for a rally; as mentioned in previous communications, valuations make relatively poor timing tools.

Since our 2nd Quarter 2014 market outlook "Pigs Get Slaughtered," we have not had a strongly bullish outlook on risk assets. While we did not forecast a 50%+ decline in oil, or recommend selling risk assets outright, we have been cautious about investors' seemingly heedless attitude towards risk- and yield-seeking activities. We view the recent market volatility as a healthy way to reinvigorate a prudent level of analysis relative to required rates of return. If investors perceive that an asset can only go up, they will quickly drive the value of that asset to the point where there is no forward-looking positive expected return.

We need markets to stay within a reasonable range of belief and skepticism to help create a sustainably up-trending market driven by long-term secular improvements in demand. Whether or not we've seen the lows of the year for stocks is anyone's guess, but it behooves investors to remember that today's correction is the foundation for tomorrow's market increase.

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