HCM | Hengehold Capital Management LLC

HCM Brighter Future™

Third Quarter 2015 Recap

Index	YTD (as of 9/30)	Third Quarter
Bank of America/Merrill Lynch US T-BILL 3 Month	0.02%	0.01%
Barclays US Aggregate	1.13%	1.23%
Barclays Global Aggregate X - US	-4.82%	0.64%
Barclays US High Yield Composite	-2.45%	-4.86%
MSCI EAFE (TR) Gross	-4.91%	-10.19%
MSCI EM (Emerging Markets) Gross	-15.22%	-17.78%
Russell 2000	-7.73%	-11.91%
S&P 500 Composite	-5.29%	-6.44%

Increasing concern over China's economic growth, accompanied by a surprise, albeit modest, devaluation of China's currency, the yuan, helped trigger a sharp drop in global equity markets in late August, with the S&P 500 falling 12% from its high reached just a month earlier. This marked the first 10%-plus correction for the U.S. market since 2011, an unusually long stretch given that historically corrections occur roughly once every twelve to eighteen months. There have only been two longer stretches without a correction. One occurred in the early to mid-1990s and the other in the mid-2000s. The S&P 500 has had a 10%-plus correction 52 times since the end of World War II. Corrections are the norm, not the exception.

Given the market's valuation and historical pattern of corrections, we've mentioned the likelihood for a market decline in previous commentaries. So we weren't surprised when it finally happened. That's not to say we were *predicting* when it would happen or what the triggers or catalysts might be. In our view short-term market predictions are a fool's errand. But knowledge of market history and cycles are useful for putting the present moment into context and thinking through different potential risk management scenarios and investment opportunities.

It's also worth noting that, based on our analysis, since 1950 the S&P 500 has experienced 20%-plus declines nine times—the common definition of a bear market. Put differently, bear markets have historically happened about once every five years on average. The current market has gone more than six-and-a-half years without waking the bear. The longest stretch without a 20%-plus decline was the 12-plus years ending with the bursting of the tech stock bubble in 2000.

Coming back to the present, the S&P 500 bounced briefly from its August low but dropped an additional 2.5% in September, ending the quarter down 6.5%. This marks the first negative quarterly return for the index since 2012, an unusually long span of uninterrupted profits.

Developed international stocks were down 10% for the quarter. European stocks did a bit better, losing 8.5% in dollar terms and 7% in local-currency terms.

Emerging-markets stocks fared the worst for the quarter, dropping 18%. That decline includes several percentage points related to dollar denominated issues as a result of the depreciation of emerging-market currencies against the U.S. dollar.

We continue to view emerging-market stocks as attractive over our three to five-year investment horizon. The recent sell-off improved valuations and, as a result provided us with the opportunity to both rebalance and make a modest tactical increase in our emerging-markets equity position. We believe this tactical equity shift improves our portfolios' long-term return potential.

Moving on to the fixed-income markets, the performance of core bonds during August was a bit out of character. The core bond index gained about 1% during the U.S. stock market's 12% intra-quarter drop. We'd typically expect core bonds to generate greater positive returns during a risk-off or risk-averse period due to fears of slowing global growth. Given the magnitude of the stock markets' selloff, it was a very modest gain for bonds. Moreover, core bonds actually had a slightly negative total return for the month of August. While this was strong *relative* performance versus most other (riskier) asset classes, with yields on core bonds around 2.3%, their potential to generate strong absolute/positive returns over any meaningful time frame is very limited. This is true not only over our three to five-year tactical horizon, but also over shorter periods as well. For example, our analysis indicates the 10-year Treasury yield would need to fall a full percentage point (to around 1.2%) for core bonds to generate even a 6% total return over the next 12 months. We view that as an outlier scenario and assume that if it does happen stock markets will likely be in bear market territory.

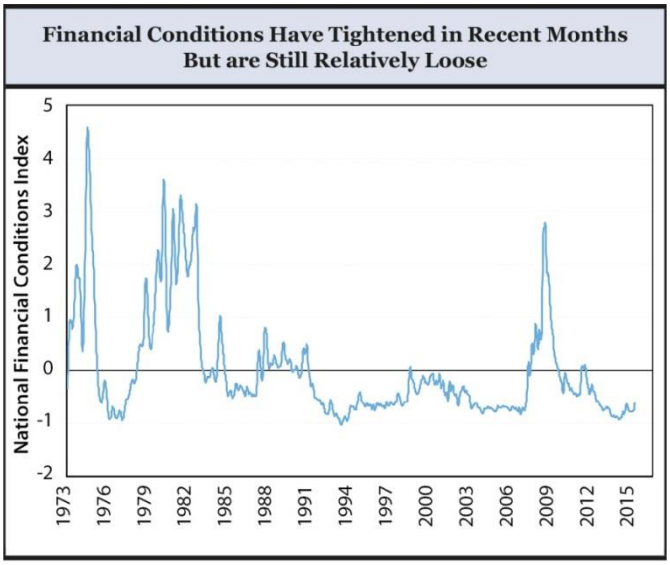
The Federal Reserve

When discussing bond yields these days, the elephant in the room is the Federal Reserve. Once again, the markets metaphorically held their breath in the lead-up to the Federal Open Market Committee (FOMC) meeting and their interest rate policy announcement on September 17.

While we are on the topic of the Fed, the answer to a question we regularly get is, "no, our investment decisions are not based on short-term forecasts of what the Fed will do" as we know we obviously don't have an edge over anyone else in making that type of prediction. Nor are our decisions based on what we think the markets will do in response to whatever the Fed decides since the market's reaction is consistently unpredictable, and not the basis of a repeatable and disciplined investment process. However, it is quite apparent that many others do play the Fed guessing game and make investment decisions driven off it. Current market prices should reflect these views, so if the Fed does something unexpected, market volatility is likely to ensue. The Fed generally doesn't like volatility, so it does all it can to telegraph what it intends to do.

However, that's a challenge when a data dependent Fed itself isn't sure what it will do next or when it's going to do it.

No one really thinks that, in and of itself, a 25 basis point increase in the federal funds rate (from its current level near zero) will move the economic needle or snuff out economic growth, no matter how weak it may be. No one really thinks that the Fed's first move—whether made in October, December, January or next March—will make a fundamental economic difference. The pace and magnitude of subsequent rate hikes is much more important than the timing of the first rate hike. Even with this widespread recognition, there are short-term players at work in the market. How they will interpret and react to the Fed's first moves or their timing is an unknown. And, for better or worse, this dynamic within financial markets impacts the real economy. They are interdependent and interacting. Widely held market views can trigger behaviors that reinforce and perpetuate those views in what can become a self-fulfilling/self-reinforcing feedback loop (with beneficial or adverse effects). It's why we invest based on a long time horizon, avoid short-term market forecasts, and consider a wide range of potential macro scenarios, rather than committing to a single outcome.



Source: Federal Reserve Bank of Chicago. Data as of 9/18/2015.

As it turned out, the Fed decided not to raise the fed funds target rate at their September meeting. The Fed stated that "recent global economic and financial developments may restrain economic activity somewhat and are likely to put further downward pressure on inflation in the near term." In her press conference, Fed Chair Janet Yellen pointed specifically to the recent developments in China and emerging markets as factors that gave them pause. She also noted the "tightening of financial conditions" due to the stock market declines, a stronger dollar, and wider credit spreads since the FOMC's last meeting. In addition, the Fed's preferred measure of inflation (core PCE) is still well below its 2% target, at 1.3% year over year. On the positive side, the Fed highlighted the continued strengthening in the U.S. labor market, with unemployment down to 5.1%. However, wage growth remains restrained (e.g., average hourly earnings growth remains around 2.2% year over year). Thirteen out of the 17 Fed policymakers indicated they expect to raise rates at least once this year, with six of the 13 expressing a preference for two rate hikes. However, the fed funds futures market is skeptical, showing less than a 50% probability of a rate hike this year. So following the October 28th FOMC meeting, we may go through this all over again!

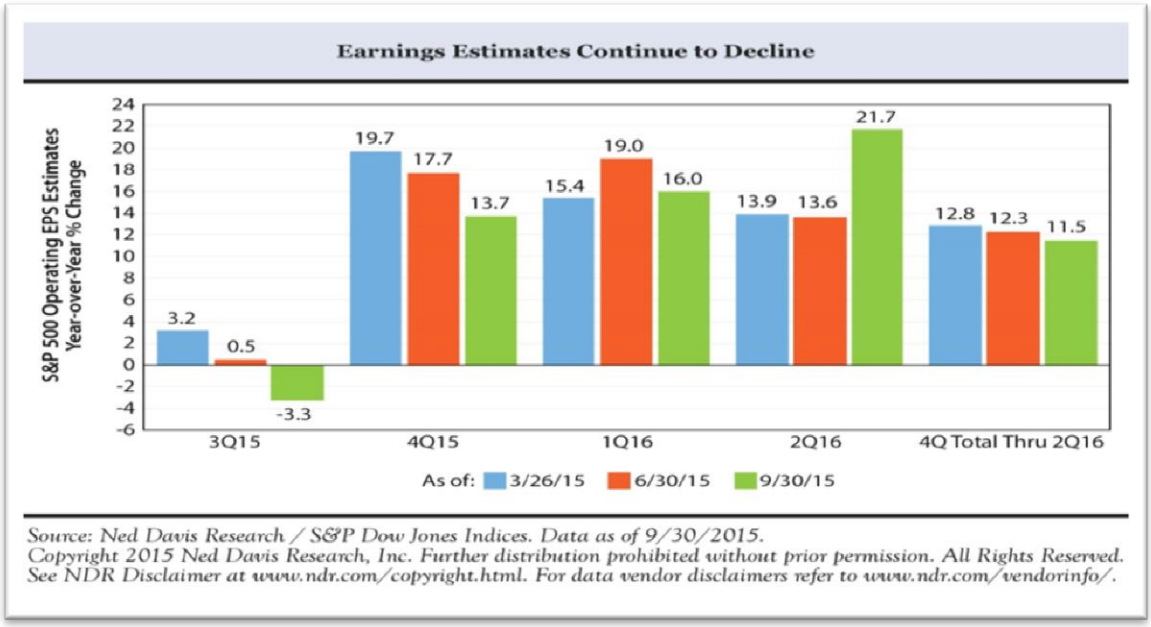
The Fed's decision had little immediate stock market impact, suggesting that the markets had been adequately discounting or expecting this outcome. But, the announcement did lead to a meaningful drop in bond yields by the end of the day, with the 10-year Treasury yield dropping from around 2.3% to 2.2%. The next day, global stock markets sold off sharply (down 1.5% to 3%, depending on the market) while bond yields fell again (i.e., bond prices rose), suggesting the markets were interpreting the Fed's decision as indicative of increased risks to global growth (e.g., does the Fed know something bad about China that we don't?).

This is an *extremely* short-term look at the market response. But, the fact that stocks fell sharply and bond prices rose sharply was probably *not* what most observers would have expected had they known the Fed wasn't going to raise rates in September. So this is yet another example of the futility of trying to consistently predict short-term market responses to Fed announcements.

Impact of the Market Volatility on our Asset Class Views and Portfolio Positioning

United States Stocks

Our analysis still indicates that over a broad range of scenarios, expected returns for U.S. stocks over the next five years remain in the low to mid-single digits. Valuations are still stretched and earnings are well above normalized levels for a variety of reasons (e.g., due to unsustainably high profit margins). Earnings estimates also continue to decline. So we see a risk of earnings disappointment and valuation-multiple contraction, implying a risk for subpar returns.



Emerging Markets Stocks

After recent declines in emerging-market stocks, we view those markets as more attractive, to varying degrees, than U.S. and European stocks. Specifically, using what we believe are quite conservative earnings growth and valuation assumptions for emerging markets, we now estimate five-year annualized returns in the low double digits in our bearish scenarios. These returns are comparable to what we expect from U.S. stocks in our optimistic scenarios and from European stocks in our base case scenario. This means we believe the risk/reward of adding to emerging-markets stocks is now attractive. Importantly, we think our assumptions adequately capture the risks stemming from a slowdown of growth in China and other emerging-market countries. As mentioned above, we recently rebalanced and modestly increased our emerging market exposure. With so much gloom priced in, emerging markets are likely to benefit if global economic and earnings prospects take a turn for the better. That would also support the chances of improved performance from commodities, which would be especially encouraging to the commodity-sensitive emerging markets.

European Stocks

We continue to have a positive view of European stocks. We believe European stock valuations are more attractive than those of U.S. stocks, while European corporate earnings are well below normal (unlike in the United States where earnings are well above their long-term trend). As such, in our base case and more optimistic scenarios, we see potential for both improved earnings growth as well as some multiple expansion, implying outperformance for European stocks compared to the U.S. market over our three to five-year outlook.

Fixed Income

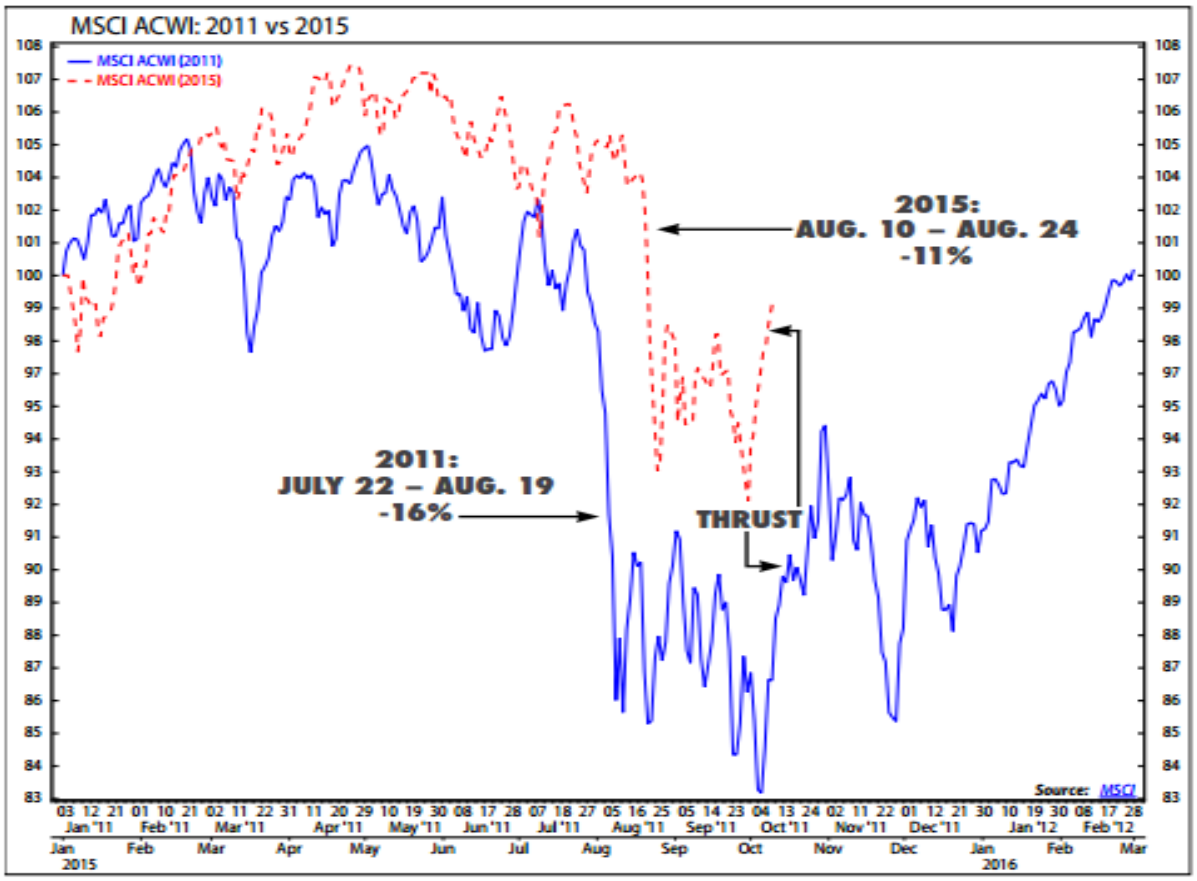
The events of the latter part of the third quarter did not lead to any material changes in our fixed-income asset class views or positioning. We continue to view the expected returns for core bonds as likely to be very low (1%–2%) looking out over the next several years in almost any reasonably likely macro scenario. This is why we have invested a large portion of our fixed-income allocation in unconstrained and flexible bond strategies. Based on our analysis of each fund's strategy and our strong positive assessment of the managers' strengths, we think these funds have the potential to generate returns several percentage points above the core bond index over the next three to five years, across a broad range of macro scenarios. Nevertheless, we still maintain exposure to core bonds because of the risk management role they play—smoothing overall portfolio volatility and mitigating some of the downside risk of owning stocks in the event of a global growth scare, recession, or worse.

We believe the fundamentals for floating-rate loans remain healthy, as interest coverage levels and overall leverage levels are reasonable, while the amount of debt maturing over the next couple of years is extremely benign. As a result, we believe that over the next couple years, defaults will remain well below the historical 4% average. At current

price levels, our view is that floating-rate loans offer attractive fixed income return potential over our investment horizon. In our base case scenario we believe returns for floating-rate loans will approach 6% annualized over our three to five-year investment horizon. We continue to own the asset class to benefit from and protect against rising short-term rates and unexpected inflation.

Concluding Thoughts – What's Ahead for Global Stock Markets?

Over the past several weeks, we have been closely monitoring our indicators for an indication of a bottoming process. A number of market developments have occurred to lead us to believe that the correction's lows are in place, which included a successful "retest" of the market lows that occurred in late August. We have also seen a decisive rotation out of defensive sectors and other risk-off proxies into commodity-related stocks reflecting expectations for rising demand and economic traction globally. As a result, we have begun the process of positioning portfolios for a global year-end rally. The global stock market appears to be tracking the sharp decline and recovery of 2011 in a nearly lockstep pattern as referenced in the following chart.



Fears of China-driven contraction contagion, the extreme pessimism that drove China-sensitive and commodity-based indices to relatively cheap and oversold levels is giving way to an upturn in confidence that the global economy will survive. Our modest tactical increase in emerging markets, explained above, was the first response to these developments. Further improvement in our indicators will call for future increases to our equity allocation.

As always, we would like to thank you for the confidence you've shown Hengehold Capital Management. If you have any questions, please contact us at your convenience.

Hengehold Capital Management LLC