The Long & Short of It

Quarterly Newsletter
Third Quarter 2016

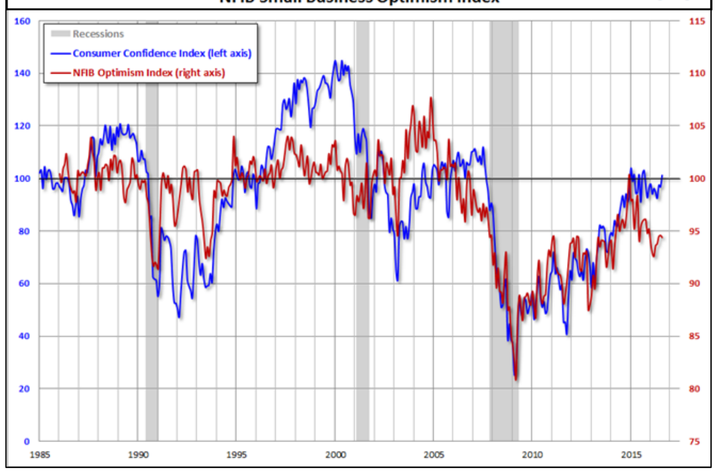
Where to from Here?

As the parties jockey for position, the markets appear paused, waiting for something definitive to happen in the country's search for its 45th president. Although stocks delivered solid returns in the third quarter, economic activity, corporate profits, and the gross domestic product (GDP) remained sluggish. In either scenario—whether Mr. Trump gains traction and brings increased policy uncertainty sooner, or Mrs. Clinton wins and brings increased policy uncertainty later—increased policy uncertainty is inevitable. We will remain in a defensive investment posture. As history has repeatedly shown, the first year of a new administration following a two-term administration often leads to investor uncertainty and stock market volatility as the new administration seeks changes in federal policy.

Although performance of the major stock market indices was strong in the third quarter (S&P up 3.9%, NASDAQ up 10.0%, and MSCI All World Index Ex USA up 7.0%), investors and consumers still seem cautious. Consumer and business-owner wariness influenced several measures of economic activity during the quarter, including: consumer and small business confidence, home ownership, and the Federal Reserve's deployment of the bully pulpit (Fedspeak 3.0).

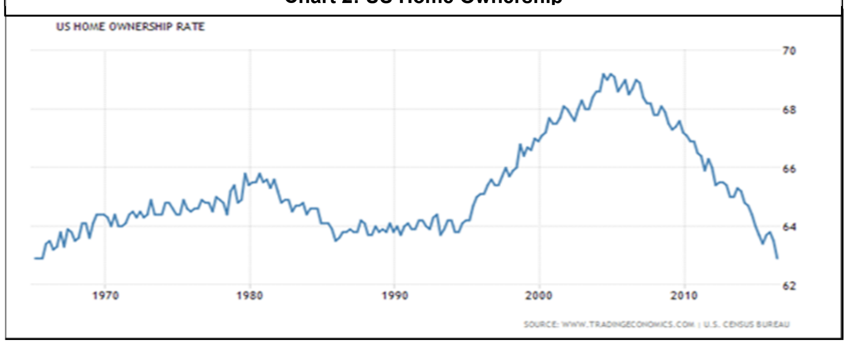
Most indices of business activity, from manufacturing data to non-manufacturing data, are currently flat or declining. Indices of consumer confidence and business optimism, on the other hand, are different because their measurements can be somewhat forward-looking. In the last three recessions, the National Federation of Independent Business Small Business Optimism Index (see Chart 1) has anticipated both economic strength and weakness (as illustrated by the gray bars). Beginning in early 2007, this index has tracked the Conference Board Consumer Confidence Index very closely. Since their interim peaks in December 2014 and January 2015, however, they have diverged. Is this split foreshadowing greater economic instability?

Chart 1: Conference Board Consumer Confidence Index
NFIB Small Business Optimism Index



As we mentioned last quarter, the consumer has been hesitant to spend and/or take on debt. This is reflected in the rapid decline in home ownership as shown in Chart 2. When investors restrain risk-taking or consumers postpone spending, the impact is never neutral but rather causal of a loss of support for prices and economic activity. Whether that weakness eventually reverses, dissipates, or builds on its own downward momentum depends on many factors.

Chart 2: US Home Ownership



Dual Mandate Double Talk

As for the Fed and its dual mandate to balance employment and inflation, here's some data to consider. Unemployment remains weak as tracked by changes in the Labor Market Conditions Index (Chart 3), with the May 2016 reading of -3.7% being the worst since June 2009. Deflation appears to be a problem as the Fed appears to be losing control over inflation expectations that are dropping at an accelerating pace (Chart 4). Although jobs are being created, wealth is not. As noted by Harvard economics professor Robert Barro (*Wall Street Journal,* September 20, 2016), "The post-2009 period is not a jobless recovery; it is a job-filled non-recovery."

As the adage goes, “Watch not what the Fed says, but what it does.” Traditionally, the Fed engages in limited, carefully scripted opaque commentary called Fedspeak in front of Congress. Fedspeak 3.0 was the name given in 2014 to the Bernanke Fed’s more frequent and clearly descriptive language issued from its bully pulpit.

Chart 3: Change in Labor Market Conditions Index

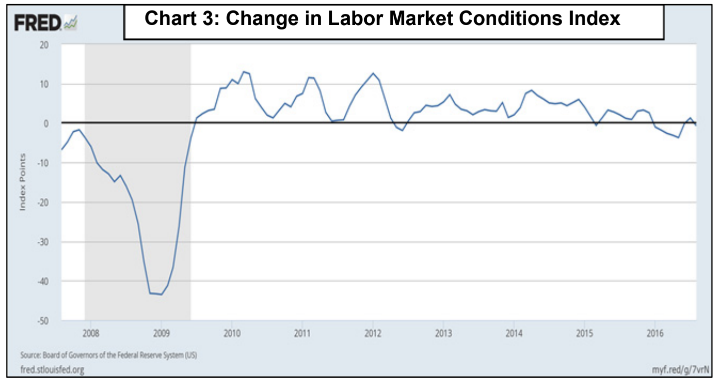
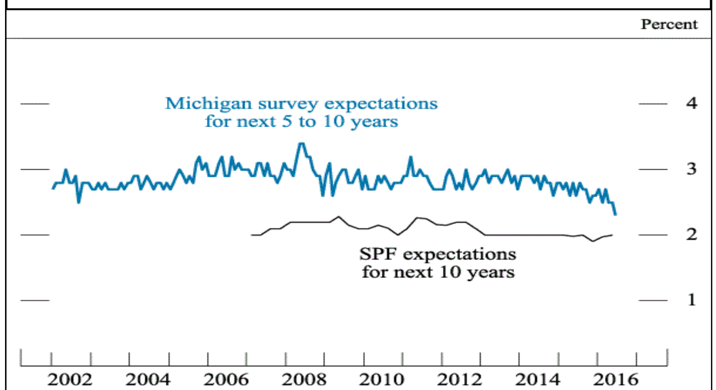


Chart 4: Median Inflation Expectations



NOTE: The Michigan survey data are monthly and extend through June 2016. The SPF data for inflation expectations for personal consumption expenditures are quarterly and extend from 2007:Q1 through 2016:Q2. Michigan survey data for June are preliminary.
SOURCE: University of Michigan Surveys of Consumers; Federal Reserve Bank of Philadelphia, Survey of Professional Forecasters (SPF).

Beam Me Up Scotty

Whereas the Bernanke Fed could be viewed as the Lewis and Clark of Fedspeak 3.0, Janet Yellen’s Fed is a veritable Star Trek franchise, committed “to boldly go where no man has gone before.” Investors now see ongoing attempts to stimulate confidence, consumption, and risk-taking through public comments brimming with optimism. After enumerating the current challenges in May 2016, Fed Governor Jerome Powell said, “Despite these downside risks…[t]he economy is on track to attain the Committee's dual mandate of stable prices and maximum employment.” In June 2016, Yellen claimed, "The overall labor market situation has been quite positive"—contrary to what most of the data says. Today’s Fed policy appears to be an exercise in wishful thinking, as if repeatedly insisting, “Everything’s so good, we will soon need to tighten” will stimulate the recovery.

The mere fact that our stock market is now heading for a record eight sequential calendar years of positive total returns should give prudent investors pause. Add to this the significant slowing in economic activity and profits, coupled with the inevitable increase in uncertainty about policy direction in Washington, and it suggests cause for concern about the elevated levels of many stocks. Slowing economic growth is likely to continue until new policy directions have been found. Resolution will require an election, subsequent ugly sausage-making, and/or the calming influence of gridlock. However, in these days of executive orders, even gridlock may not have the benign effect of years past.

In times like these, it is important to remember that volatility will create opportunities. When high-quality, industry-leading companies become out of favor, go down in price, and sell at low multiples relative to their fundamental measures of valuation, it will be time for us to go bargain hunting for our clients.

Thank you for the opportunity to serve your family and your portfolios.

Amy Abbey Robinson, CIMA
amy@robinsonvalue.com

Charles W. Robinson III, CFA
charles@robinsonvalue.com