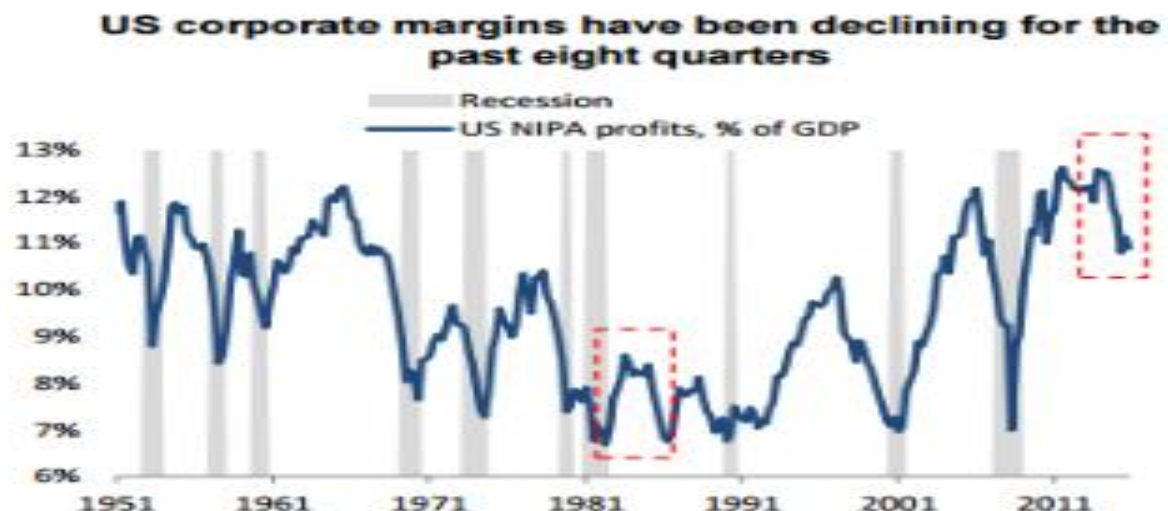


## 4<sup>th</sup> Quarter 2016 Market Commentary

The market is likely to be volatile heading into the U.S. presidential election, due to election uncertainty and because of the Federal Reserve's decision in December whether to raise interest rates. In this commentary, we will discuss some of the headwinds facing the next president, as well as, some long term tailwinds that have been propping up equity prices.

### Headwinds:

Regardless of who wins the next election, there are some headwinds the next president will encounter. Unfortunately, American corporate profit margins have been sinking for eight quarters, and earnings on the S&P 500 have fallen for five quarters. At the same time American companies have loaded up on cheap debt, and now the corporate debt to GDP is the highest it has been since 1986 (Deutsche Bank). If interest rates rise on inflated balance sheet liabilities, earnings could continue to suffer. Typically, companies will look to correct declining profitability by cost cutting and layoffs. Another round of corporate belt tightening could very well tip the American economy back into recession from its current weak growth outlook.



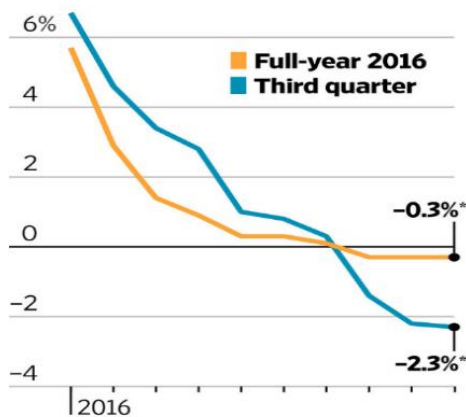
Regrettably, the decline in earnings is coming at a time that economic activity is slowing several important sectors such as transportation. According to the Wall Street Journal, orders for new big rig trucks have fallen to a level last seen since the great Recession in 2009. (WSJ 10-5-16) Rail traffic is also weak, off close to 7% this year due in large part by large declines in coal and oil shipments (Association of American railroads).

Uneven job additions, and continued growth of the population have also led to large numbers of underemployed. Since the start of economic recovery of 2009, men have been disproportionately affected by the weak level of growth. According to the Wall Street Journal, if male employment were benchmarked against a 1965 level, a "male jobs deficit" of 10 million people, even after taking into account an older population and more adults in college, currently exist. (WSJ 9-2-16). The next president will have to address this lack of growth in jobs, while at the same time institute policies that can get corporate America's profits growing again so that employers are willing to take on more workers. This is not an easy task. If the situation is not corrected, the above average equity valuations we now enjoy could likely revert to lower levels.

### Low Expectations

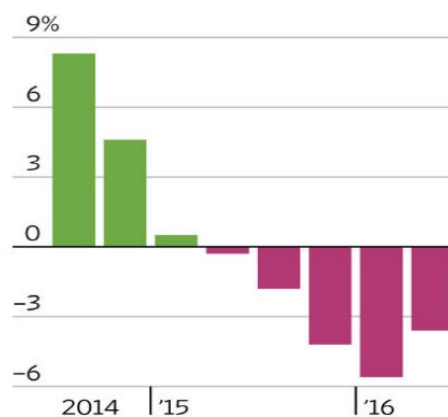
Analysts have cut their forecasts for U.S. corporate-earnings growth and expect the slump to continue in the third quarter.

**Analysts' forecasts, S&P 500 earnings, change from a year earlier**



\*Estimate as of Sept. 23 Source: FactSet

**S&P 500 earnings, change from a year earlier**



THE WALL STREET JOURNAL.

### **Tailwinds:**

There is some good news on the horizon, with energy prices advancing over the last few months; revenue growth is set to return for companies in the S&P 500 for the first time since the end of 2014, according to analysts polled by FactSet. (WSJ 9-26-16) This is due to the large energy sector in the US economy.

In addition, there are some structural benefits that are strengthening the market in spite of the economic problems discussed above. Namely, low interest rates and a declining supply of companies traded on American stock exchanges help support stock market valuations. Low interest rates prop up stocks prices because it encourages investors to buy securities in order to try to get a higher return on their money. The dividends that companies pay have historically been lower than what an investor could obtain in the bond market. This is no longer the case. Dividends on the S&P 500 average just over 2%, while the interest rate on the 10 year US Treasury was only 1.5% just a week ago. Nominally, the difference in the rates may seem inconsequential; percentage wise, it is significant.

The falling supply of companies trading on American stock exchanges helps the valuation levels of the remaining companies because the same amount of money is now going towards fewer investments. Thus, supply is limited and demand remains the same, therefore equity prices rise.

### **Low Interest Rates**

We believe that absent strong economic growth, interest rates will remain low by historical standards, even if the Federal Reserve does another rate hike in December. With major economies in Europe and Japan still using negative interest rates in a bid to restart flagging growth, many U.S. economists believe Treasury yields will remain at exceptionally low levels by historical standards. The 10 year bond yield has risen from its historic closing low of 1.366% in July, but remains below the 2.273% logged at the end of 2015, and is still near all-time lows. Moreover, the weak economic growth and relatively low inflation implies that the economy does not seem to be overheating. A strong economy

is the criteria which is normally associated with increasing interest rates. The October ISM manufacturing index left it consistent with annual GDP growth of only around 1.5%, again very close to economic stall speed, and usually not a number that would trigger an interest rate increase.

In addition, we believe that the U.S. debt has gotten so large that it will be much harder to raise interest rates to levels seen historically. We do think the Federal Reserve Bank will try to raise interest rates, however. They will do this because they want to help the large banks that benefit from the higher interest rate spread between bank deposits and loans caused by the higher interest rates. But, with almost 20 trillion dollars in national debt, we think Congress will put a lot of pressure on the Federal Reserve to not let interest rates increase too much.

Remember that for every 1% increase in interest rates, the interest to carry that debt increases by almost 200 billion dollars. That is money that does not pay one soldier's salary or fill in one pot hole on the street. A historically low interest rate of only 5%, would now cost the government 1 trillion dollars of additional interest every year. To put that into perspective, according to J.P. Morgan, the 2016 federal government revenue before borrowing will total 3.31 trillion dollars. Of that amount Medicare and Medicaid spending will total 1.061 trillion, Social Security will cost another 910 billion dollars, and Defense will cost 579 billion dollars. So if you add another 1 trillion dollars on for debt service, these four programs will consume all of the government revenue before borrowing.

Furthermore, the U.S. corporate debt to GDP ratio is now pushing 45% according to Deutsche Bank, so corporate America is also opposed to large increases in interest rates as higher interest cost will start to directly cut into their profits. Debt is not just a U.S. problem, but international as well. The International Monetary Fund came out in September and announced that global debt now tops 152 trillion dollars (225% of global GDP), meaning that overseas interest rates will most likely also remain low. Low overseas rates put less pressure on the Federal Reserve to raise rates here. For these reasons, we think interest cost will remain low by historical standards.

Since we believe interest rates will remain low by historical standards, investments that produce income, and that are consistent and safe should do well because income will be hard to find. Keep in mind that 10,000 Americans are turning age 65 every day, and they are looking for steady income and security. Thus, one of the largest demographics in American history is propping up dividend paying stocks when interest rates are low because there is not a lot of other options for income. This in turn will help keep equity valuations high, and will be a source of buyers on any stock market dip.

### **Fewer Publically Traded Companies:**

As mentioned earlier, another source of strength for the U.S. stock market, and one which few researchers have commented on, is the fact that the supply of stocks has been declining. Over the last 16 years the number of publically traded businesses in the United States has declined dramatically. This has helped push equity valuations higher because there is more money chasing fewer investments. There are two leading reasons for the decline in the number of publically traded corporations.

First, in an era when economic growth has been averaging 1-2%, large corporations have become serial acquirers to maintain their growth rates by buying other companies. For example, Apple has made 18 acquisitions in just the last two years (Wikipedia, newswire). Intel has acquired another 10 companies, including the gigantic 16.7 Billion dollar takeover of fellow semiconductor maker Altera over the same time period (newswire). The companies in the Standard & Poors 500 have been able to grow faster than the economy itself in large part by buying other companies to boost their own revenue growth, and they have increased profit growth by streamlining the new buyouts once they acquire them. Case in point, Dealogic estimates that 2016 will be the third year in a row that merger activity tops 1 trillion dollars.

In aggregate, the number of publically traded U.S. companies has declined from a peak of 7,459 in the year 1997, to only 3,659 this year, which can be seen in the number of companies in the Wilshire 5000 index (so named because it originally included 5000 companies). The almost 50%

decline in companies puts the number of U.S. companies traded on an exchange at level last seen in the 1970s.

## PUBLIC COMPANIES DWINDLE

The number of actively traded public companies has declined from its peak in 1997. Companies in the Wilshire 5000:



**NOTE** 2016 number as of Aug. 31

**SOURCE** Wilshire Associates  
George Petras, USA TODAY



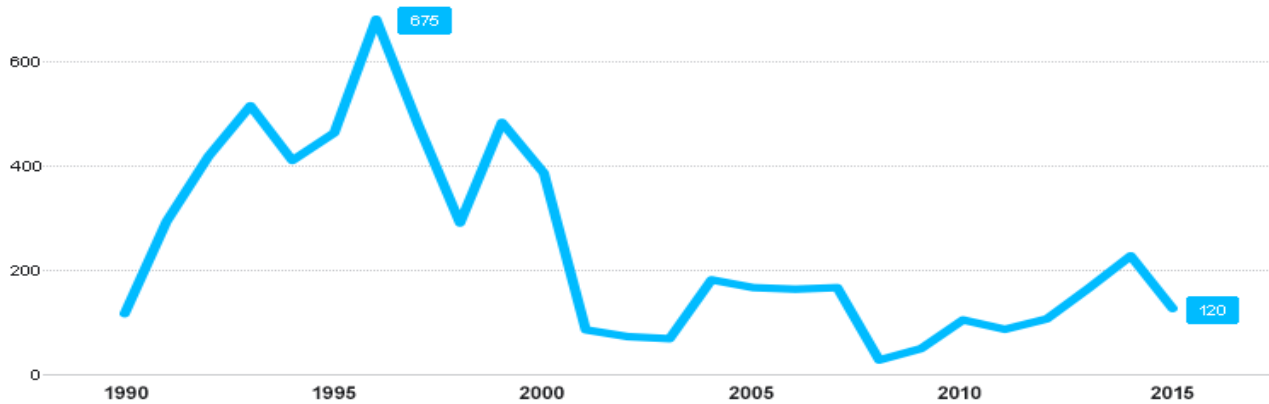
The other major reason for the decline of publically listed corporations on American stock exchanges has been the drought in new Initial Public Offerings (IPO). Part of the decline of new public offerings has been legal. Executives face increased legal scrutiny, and are now personally liable for financial statements. Indeed, Marc Andreessen, the founder of Netscape, whose company started the .com boom, has publically stated that the cost of complying with government regulations on public companies and the hiring of the accompanying army of lawyers, accountants and compliance officers was not worth the cost (The Vanishing American Corporation). Moreover, with the growth of private equity valuations, and the growing market for buying and valuing private companies, it is now possible for many new start-ups to avoid the stock market all together.

A leading reason for the decline in the number of new publically traded corporations has been money. Or, more precisely the lack of need for it. Businesses 20 years ago used much more capital than today. In the past, the stock market and banks worked in tandem to provide capital to growing corporations that needed to supply the huge continental sized American market with goods and services. Corporations needed huge factories, massive distribution facilities located across the country, armies of salespeople, and legions of managers to control their operations. This all took lots of money. Today, with the rise of outsourcing, the internet, cloud computing, social media advertising, temporary, on demand employees, companies need far fewer employees and infrastructure (and therefore money) to get the same results. For example, Blockbuster at its height had 83,000 employees and 9,000 physical stores, while Netflix today has 2,200 employees, no retail offices, and rents server capacity from Amazon. Vizio, with about 200 employees in 2007, sold as many televisions in the United States as Sony, which had 150,000 employees (The Vanishing American Corporation). Other examples include Airbnb, which is one of the world's largest renter of hotel rooms, yet owns no physical property. Same thing is true with Uber. They are the world's largest taxi service, yet own no cars and employ no drivers.

Creating a large continental sized corporation made sense when the assets were long lived. But, in many industries today, companies are coming and going at a fast rate. Thus, the increased cost of becoming a public company has persuaded many companies to stay private and focus on profitability over size.

Although the decline in the number of public companies has caused equity valuations to increase due to supply and demand, the overall affect for the economy may not be positive. Private corporations tend to pay less, and offer less generous benefits than their public peers, and they tend to be less transparent.

**U.S. IPOs HAVE PLUNGED, DECREASING FROM AN AVERAGE OF 436 A YEAR IN 1990s TO 120 LAST YEAR.**



Sources: (top) U.S. Census Bureau; World Bank; World Federation of Exchanges; (bottom) Professor Jay R. Ritter, University of Florida

In conclusion, we continue to see a slow but weak economic recovery. The next president will have to focus on reigniting economic growth if he/she wants to prevent the current earnings slowdown from morphing into another recession. Growth is also needed to bring unemployed and underemployed back into the workforce. As far as the market is concerned, we expect an increase in market volatility due to the discussed economic weakness, but we think that low interest rates and a decline in the number of publically traded companies will act as support in any market weakness. We also think that dividend paying stocks and investments with consistent earnings, which can do well in good or weak economic environments will continue to perform well. We continue to believe that investors will seek investments in larger, stronger companies that pay more than the bank savings, CD's accounts, and bonds, as a relative safe haven in this low income environment. As always, we appreciate your support and look forward to any questions.

Sincerely,

William H. Schnieders  
Principal

James F. Schnieders, CFA  
Principal

John C. Schnieders, CFA, CFP®  
Principal