Investment Newsletter

January 8, 2016

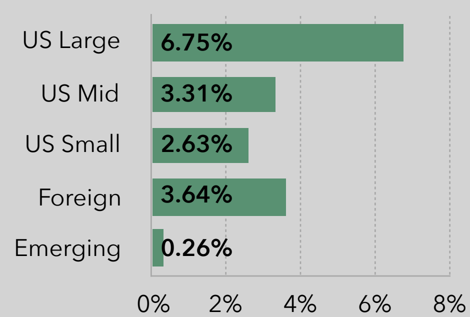
Fourth Quarter 2015

Economic Data

- 3Q GDP grew at a 2.0% annualized rate, down from 3.9% in the 2nd Quarter
- Year over Year Inflation (CPI) was 0.5% through November
- A record 17.5 million automobiles were sold in 2015
- 842,000 jobs were added during the quarter and the unemployment rate dropped to 5.0%

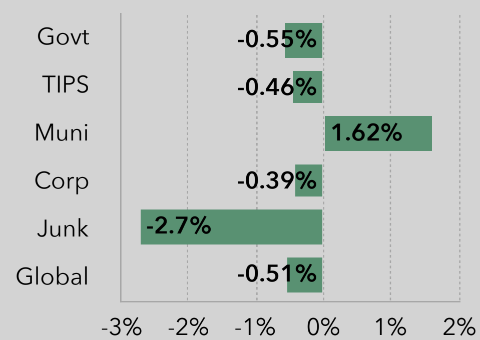
Stocks

4Q15 Returns



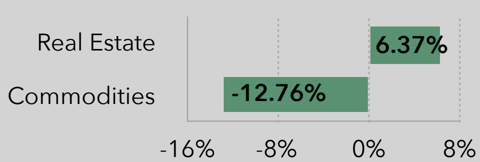
Bonds

4Q15 Returns



Alternatives

4Q15 Returns

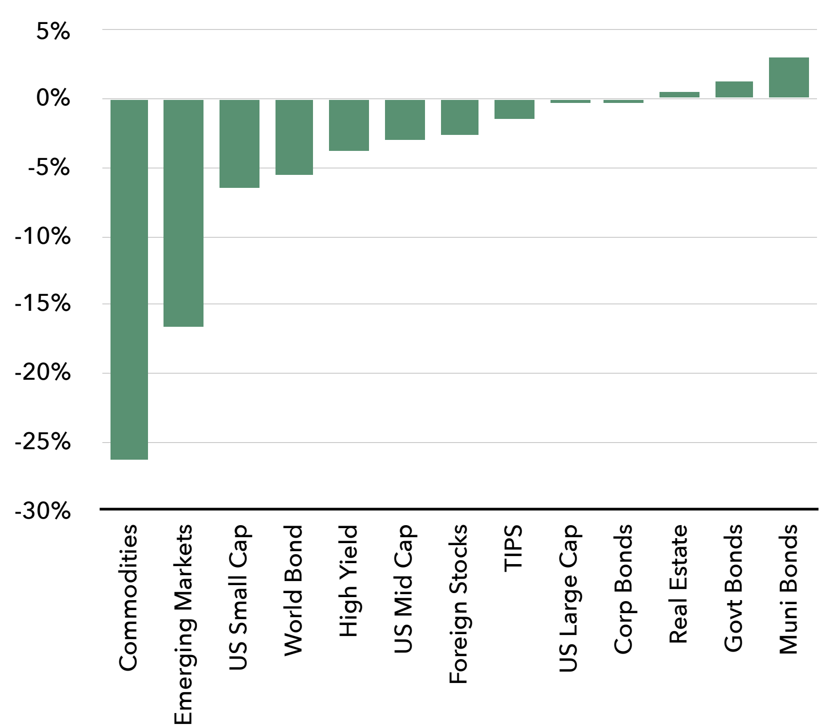


Index data provided by Morningstar.

2015: Better than 2008

Let's get this out of the way right off the bat – 2015 was not a great year for investors. Even legendary investor Warren Buffett struggled with shares of his holding company, Berkshire Hathaway (ticker: BRK.A), down 12.48%. Some have gone so far as to call 2015 "the hardest year to make money in 78 years," but how can that be when everyone got destroyed in '08? To be fair, 2015 was not nearly as disastrous to wealth; they are merely pointing out there were not as many places to make money. At least in '08 the Treasury bond market – which was $6 trillion in size at the time – was up over 12%, and other large segments of the market like agency bonds and international bonds did pretty well, too. In 2015, however, a 3% return in municipal bonds was the new "killing it".

2015 Asset Class Returns



Index data provided by Morningstar.

China's slowing growth and a glut of oil supply drove commodities prices off a cliff. As China is the largest constituent of Emerging Markets equities – and as many other emerging markets economies like Russia and Brazil rely so heavily on oil – these stocks suffered as well. Furthermore, sustained low commodity prices are having a negative affect on the junk bond market as a number of Energy and Materials & Mining companies are starting to find it difficult to pay their bills.

Still, I would take 2015 over 2008 any time because the economy we have today is in far better shape. GDP growth started the year off weak due to cold weather, a strong dollar, and a port strike on the West Coast, but grew at 3.9% and 2.0% rates the following two quarters. 2.65 million jobs were created this year, 17.5 million automobiles were purchased (the most ever, surpassing the previous peak set 15 years ago), and home prices rose 6.3% for the 12-month period ending in November.

It's not all good news – manufacturing activity, for example, has declined for six straight months in large part due to the strong dollar – but the economy has been doing well enough that the Fed finally decided to raise interest rates for the first time in almost a decade, bumping their target range up a quarter point. Fed Chairwoman Janet Yellen was careful to point out that rates are likely to remain low "for some time" and future rate increases will be "gradual." This reduces uncertainty, which is a positive for the market.

Too Much of a Good Thing?

In 2015, oil prices dropped 35% and are currently trading near a 12-year low. U.S. crude oil inventories ended 2015 near levels not seen for this time of year in at least the last eight decades, according to the Energy Information Administration. There is just too much supply.

Many OPEC countries (like Venezuela) are hurting badly because of lower oil prices. Even the mighty Saudi Arabia is burning through its cash reserve, but they still refuse to cut production to lift prices, trying instead to squeeze out higher-cost producers in the U.S. and elsewhere. They can do this because Saudi Arabia has responsibly used budget surpluses from oil exports over the years to reduce their debt-to-GDP ratio to below 2%.

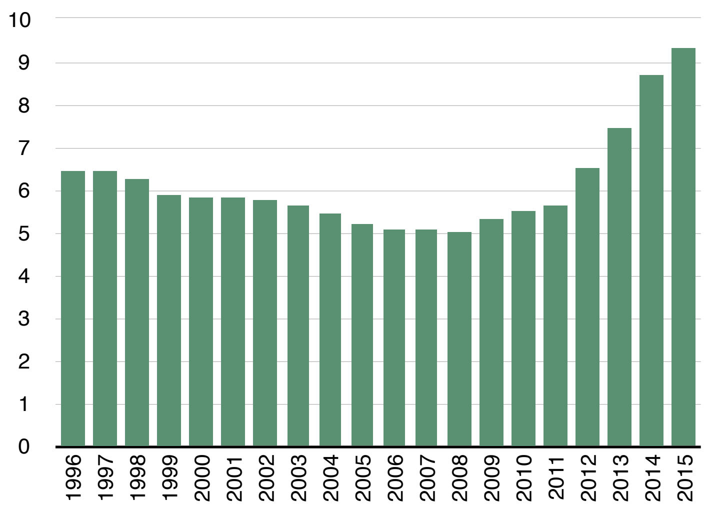
They also don't tax their citizens, who enjoy some of the most generous government benefits in the world. This is a potential source of revenue they could tap into if times get too tough – albeit one that might come with demands from the citizenry like, I don't know, perhaps the right to vote? What I'm saying is the headlines about how the country will run out of cash in five years paint a much more dire financial picture in Saudi Arabia than is reality. I mean the U.S. has been out of cash since 1837, and it hasn't seemed to slow us down.

This has ruffled the feathers of the weaker members in the cartel – particularly Iran – who desperately need prices to climb. It probably does not help relations that the Saudis recently executed Nimr al-Nimr, a prominent Shiite cleric, and that Iran retaliated by torching the Saudi embassy in Iran. The Saudis have broke off diplomatic and economic ties with Iran, and Iran has now banned all imports from Saudi Arabia and told Iranians they can't join pilgrimages to its holy cities of Mecca and Medina. Whoa, this is starting to get real!

Five years ago even the slightest whiff of a war between these two OPEC juggernauts would've sent oil through the roof. So where did the geopolitical risk premium go – why are oil prices at a 12-year low?

Well, since 2008, U.S. oil production has reversed trend, climbing from 5 million barrels per day to an average of 9.33 million barrels per day in 2015. The 87% increase – largely attributable to technological innovations such as hydraulic fracturing – has helped us to become the world leader in oil production. Sorry OPEC, we're just not that into you anymore.

U.S. Crude Oil Production (million barrels per day)



Source: U.S. Energy Information Administration

Low gas prices have been a boon for drivers, leaving more money in their pockets to spend elsewhere in stores and restaurants. Low oil prices are great for pretty much every part of the economy, except of course the Energy sector. However, we are probably at the point now where it might be too much of a good thing.

Sustained low oil prices aren't good for the environment as they are likely to hinder advancements in renewable energy and slow down what was looking like a very promising electric car revolution. Conspicuous conservationists have already purchased their Model S's, and the $80,000 price tag leaves most of everybody else out of the market. Even when they release their more affordable Model 3 – rumored to cost around $40,000 – in 2017, I find it difficult to believe the average consumer will pony up to buy one when gas is only $2/gallon.

Tangent: I like Tesla; it's a great company and they make great cars. It's just not a good stock (ticker: TSLA), in my opinion. Tesla is now the third largest U.S. automobile manufacturer by market cap, still behind Ford (ticker: F) and GM (ticker: GM) but now twice the valuation of Fiat Chrysler (ticker: FCAU). Twice the size of Chrysler! Chrysler makes two times as much in *profits* as Tesla does in *sales*, and it is only worth half as much? Tesla isn't even profitable and they only sold about 50,000 cars this year. The stock is priced for perfection and I don't see perfect happening, but I digress.

I think about the future of oil often and wonder if it is not a dying industry? At a time when so many Energy stocks are in the bargain bin, it is quite tempting for a contrarian to want to go shopping. But what if this is just the opening act of a decades long decline, and any money invested in the Energy sector is just dead on arrival? Not likely. Even if everyone in the U.S. switched to pure electric cars overnight, gasoline only accounts for about 47% of our oil consumption. The rest is used to build our roads, heat our homes, gas up or jets, fertilize our crops, package our foods, produce our chemicals, make countless different things out of plastics, and the list goes on and on. It is the lifeblood of our economy, and it is not going away this generation.

We believe crude oil prices are well below the levels required to encourage sufficient investment to meet demand beyond 2017. Reduced investment will mean declines in output, which will eventually help markets rebalance but it will take some time.

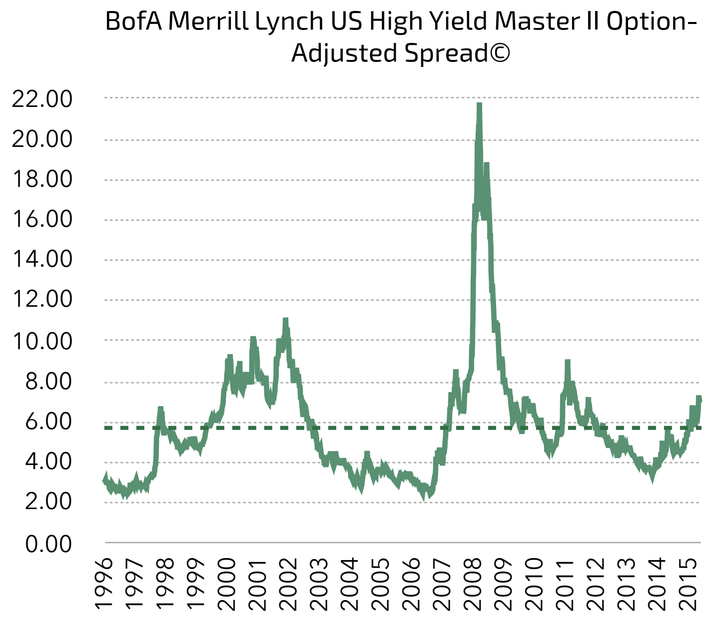
Junk in the Trunk

Junk bonds have been getting beat up lately, and the troubles stem almost exclusively from – surprise, surprise – the Energy and Mining & Materials sectors, which accounted for 90% of defaults in the third quarter, according to Fitch Ratings. About 22% of the overall high yield market is represented by these two industries, and about half of that debt is already trading below 80 cents on the dollar. The default rate was about 3.3% in 2015, and that is likely to climb this year as oil prices remain depressed.

Junk bonds – otherwise known as high yield bonds – are debt issued by companies with below investment-grade credit ratings (less than BBB). As one might expect, junk bonds have a higher default rate than investment-grade bonds – 4.22% from 1981-2012 according to S&P. The worst year for junk bonds during that period was a default rate of 11.05% in 1991, amidst the Savings and Loan Crisis.

Investors demand higher yields to compensate them for this increased credit risk. In the simplest of terms, the investor hopes the excess yield (also known as the spread) above Treasury bonds will be higher than the default rate. The spread is a buffer of sorts against defaults, which are inevitable when you are swimming in this end of the credit pool.

A default does not necessarily mean the investor will go home empty-handed, though. In a separate report S&P showed the average discounted recovery rate from defaulted bonds between 1987 and 2009 was 38.2%, meaning investors recovered $38.20 for every $100 of face value.



Source: BofA Merril Lynch

Option-adjusted spreads for high yield bonds were just over 7% for most of December, above the long-term average of 5.80% (since 1996) and at levels not seen since the end of 2011 when the European Debt Crisis was in full swing. With spreads above average at 7% and defaults still below average at 3.3%, we believe investors are getting adequate compensation for the risk they take on.

Portfolio Positioning

The party is long over for bonds. They still serve a purpose in portfolios by providing diversification and rebalancing opportunities, but expected returns are very, very low. The high yield space could become attractive this year, but we are not ready to jump in with both feet just yet. Accelerating defaults are likely to spook investors further and create a much better buying opportunity down the road.

Stocks have opened 2016 with their worst start since 1991 as China continues to be the turd in the punch bowl. It's worth noting, however, that stocks ended 1991 up 30.23%. This earnings season is likely to be rough, but with valuations reasonable – in our opinion – and interest rates on the rise, stocks are still much more attractive to us than bonds.

We continue to favor domestic stocks but also see some potential for developed international stocks in 2016. Many emerging markets are likely to continue to struggle this year, but we expect them to be the best investment over the next decade and have no interest in abandoning them.

Commodities will remain volatile and we don't see oil prices pulling out of their slump this year. Slowing growth in China will also weigh on other raw materials. We have been parking our small allocation to commodities in gold and will continue to do so for the time being. While we don't expect big things here, gold does tend to act as a safe-haven in times of market distress and reduce overall portfolio volatility. There is also somewhat of a floor to gold prices with the all-in sustaining cost (AISC) of gold production currently around $900/oz, according to the World Gold Council.

After a rocky start, we believe 2016 on the whole will be a better year for investors than 2015. All we need to do is stay rational and take advantage of the opportunities when they present themselves.

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About EmeraldSpark

EmeraldSpark Investments, LLC is a registered investment advisor based in Chicago, IL. We were founded by Ryan P. Layton, CFA in 2015 to provide outsourced investment management services to community bank trust departments and independent trust companies, as well as fiduciary investment management for select individuals. Our investment process blends the foundations of Modern Portfolio Theory with the latest research in the field of behavioral finance. We specialize in asset allocation and investment due diligence to help provide our clients with investment strategies personalized to match their specific goals and risk comfort zone.

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