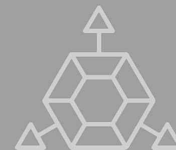
1Q16 Investment Newsletter

April 5, 2016

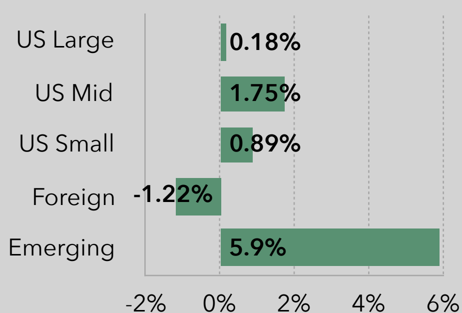


First Quarter 2016

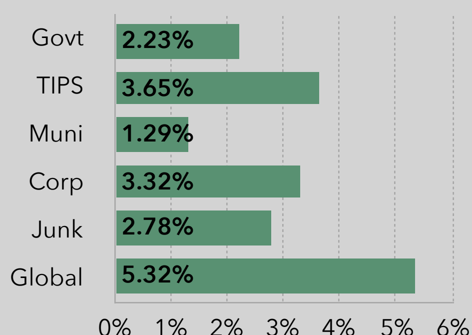
Economic Data

- 4Q GDP grew at a stronger-than-expected 1.4% annualized rate
- Year over year inflation (CPI) climbed to 1.0% through February; core (ex-food and energy) heating up at 2.3%
- 632,000 jobs were added during the quarter and the unemployment rate dipped to 4.9% before ending the quarter at 5.0% as 1.45 million people entered or re-entered the strong labor market.

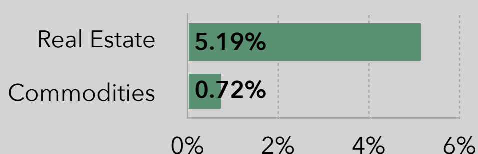
Stocks



Bonds



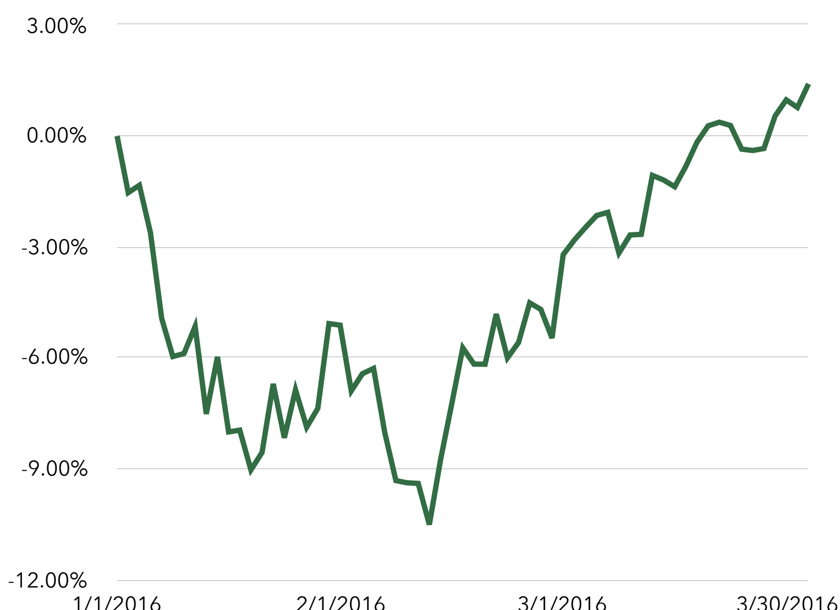
Alternatives



Benchmark data provided by Morningstar.

A Boring Quarter?

If you are just now taking a look at the stock market for the first time this year, you could be forgiven for thinking not much has happened. You would see the price of the S&P 500 was up 0.77% in the first quarter and think 'oh, well I guess it was a pretty boring quarter.' Truth be told, though, for the first twelve trading days of the year it was the worst – or second worst, depending on your gauge – start to the U.S. stock market based on available data that goes all the way back to 1897.



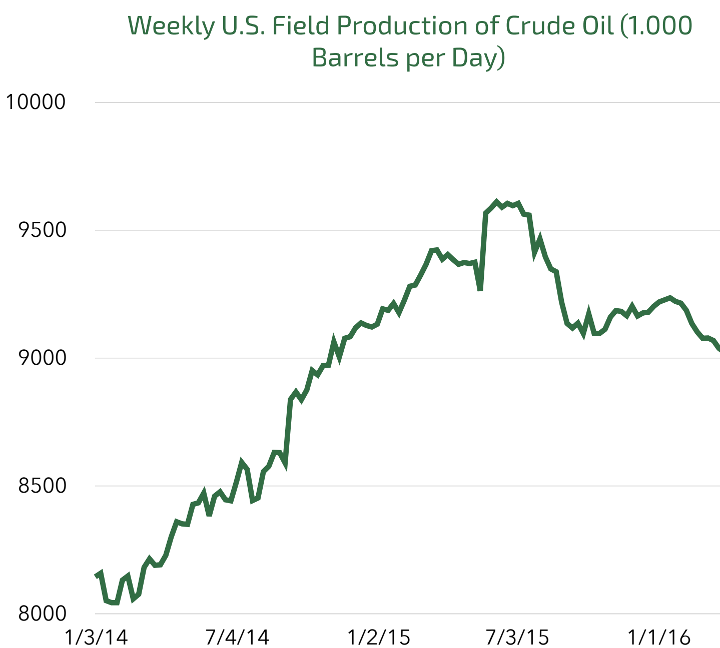
Markets were driven lower by the usual suspects – oil, China, and the Fed – but recovered nicely after it was decided that for some reason these three things didn't matter much anymore. It was anything but a boring quarter.

Saudi TT

Economic sanctions against Iran ended in mid-January causing oil prices to plunge as low as $26 by February 11, their lowest levels in 13 years. But production increases in Iran ended up being much less than expected in February, bringing some relief to downward price pressures. Additionally, a handful of producer countries including Saudi Arabia and Russia agreed to freeze output at January 2016 levels to help reign in the supply glut. Oil rebounded and ended the quarter where it started, around $38 a barrel.

But the Saudis are only going to freeze production if Iran – the Iceman to their Maverick – and everybody else plays ball too. That may not happen as Iran is eager to regain its market position after decades of sanctions were finally lifted, allowing them to re-enter the global economy. Imagine being in prison for 37 years and then someone asking you to take a vow of celibacy the day you were released.

Production is declining here at home. The U.S. pumped an average of 9.43 million barrels per day last year, according to government figures. That was the highest level since 1972 and represents an impressive growth of 89% since 2008. But U.S. oil field production actually peaked at 9,610,000 barrels per day the week of June 5 and has fallen over 6% since then.



The futures market currently expects oil to end the year around $40 per barrel and we anticipate prices to stay in the $30-$50/bbl range for the next year or so. According to Rystad Energy, it costs an average of $36.20 to pump a barrel of oil out of the ground here in the U.S., which is about where prices stand right now. Anything below that and we are in the danger zone!

Speaking of Danger Zone, let's travel back to a time when Kenny Loggins was helping to create the greatest movie soundtrack of all time. The year was 1986, and U.S. oil production had climbed to almost 9 million barrels per day. In an attempt to regain pole position as the world's largest oil producer, Saudi Arabia, turned all the taps wide open and sent oil prices tumbling over 60% in three months to just above $10 per barrel. The U.S. industry collapsed, triggering almost a quarter-century of production declines, and the Saudis stayed at the top of market share.

Fast-forward to last year, where U.S. oil production had clawed its way back to – and beyond – 9 million barrels per day thanks to fracking. Once more the Saudis talked about maintaining market share by keeping the spigot open to force higher-cost producers out of the market. And so the market was again flooded with a glut of oil and prices cratered.

And why shouldn't they? Too many people are quick to blame the Saudis for a problem the U.S. oil industry created. Still, it is curious to me. The Saudis could easily cause oil prices to skyrocket if they just refused to pump for a few months. The only reason for the Saudis to try to maintain market share at lower prices today instead of just leaving it in the ground until prices rebound is if they think there will be drastically less demand in the future. And keeping prices low also reduces the economic incentive for investments in alternative energy, thus keeping oil relevant longer.

They have about 75 years worth of known reserves at their current production levels. The Paris climate agreement will likely accelerate the phase out of fossil fuels. What if they didn't think oil would be relevant in 75 years? What if they didn't think it would be relevant in 20? Well then it would make sense to pump as much as they could while there was still a decent market for it.

As it turns out, the Saudis have a 20-year plan to diversify away from oil. They are going to IPO Saudi Aramco, the state-run oil company, and transfer the shares into what they hope will be a $2 trillion Public Investment Fund (PIF). Over the next two decades they plan to gradually sell those shares or spinoff the company's subsidiaries to eventually become an economy supported not by oil, but by investment income.

How much is Aramco worth? According to its 2014 annual report, Aramco has 261 billion barrels of proven oil reserves. If that's true, it's more than 18 times the proven crude oil reserves of the largest public oil company, Exxon Mobil. According to Rystad Energy, Saudi Arabia's cost of production is only $9.90. Those

261 billion barrels could net them about $7 trillion in earnings at today's prices. Estimates of what the company might be worth range from at least $1 trillion all the way up to $10 trillion. At any rate, it is by far the most valuable company in the world.

But What About Junk Bonds?

Spreads (excess yields above Treasury bonds) on junk bonds blew up in the first few weeks of the year hitting as high as 8.87% before closing the quarter back where they started down around 7.

Standard & Poor's recently warned that a stunning 50% of energy junk bonds and 72% metals & mining bonds are "distressed," meaning they have an increased need for capital and are at risk of default. Most of the companies on the list are small and mid-sized, but a few – like Chesapeake Energy (CHK) and Transocean (RIG) – are larger threats.

Smaller oil companies are dying. They were built with expensive drilling equipment paid for with debt backed by $100 oil. Last year, 81 oil and oilfield services companies filed for bankruptcy, according to law firm Haynes and Boone.

The 1986 oil crash caused a similar spike in defaults and, like today, the country was not in a recession at the time. There was a flood of oil equipment on the market in the wake of all the bankruptcies, and it was being auctioned off for pennies on the dollar. Anecdotally, after Quicksilver Resources collapsed in March of last year, it took 10 months to auction off their assets and the price they fetched was only about one-fifth of what the company had valued them at.

More defaults are on the way and, with so many in the industry restructuring at the same time, it seems unlikely that recovery rates for bondholders will be in line with historical averages. On the positive side, larger oil majors with deep pockets should make out fairly well at the asset auctions.

Hey, Why Don't You Pay Me to Take Your Money?

After a single quarter-point liftoff in December that helped contribute to the market slide at the beginning of the year, the Federal Reserve has held interest rates steady and made it pretty clear there won't be a hike in April either. They are now broadcasting two further rate hikes this year instead of four, but don't be surprised if that number falls to one or none or "to hell with it, let's cut them again!" The Federal Reserve appears to be guided by the global economy and the stock market, instead of its dual mandates of price stability (check) and full employment (check).

The world used to be simpler. Interest rates could go as low as zero and surely no further. But now we have negative interest rates. And we're not just talking about some quirky little country conducting an ill-advised experiment. The Eurozone, Japan, Sweden, Switzerland, and Denmark have all adopted negative interest-rate policies (NIRP). Welcome to Bizarro World!

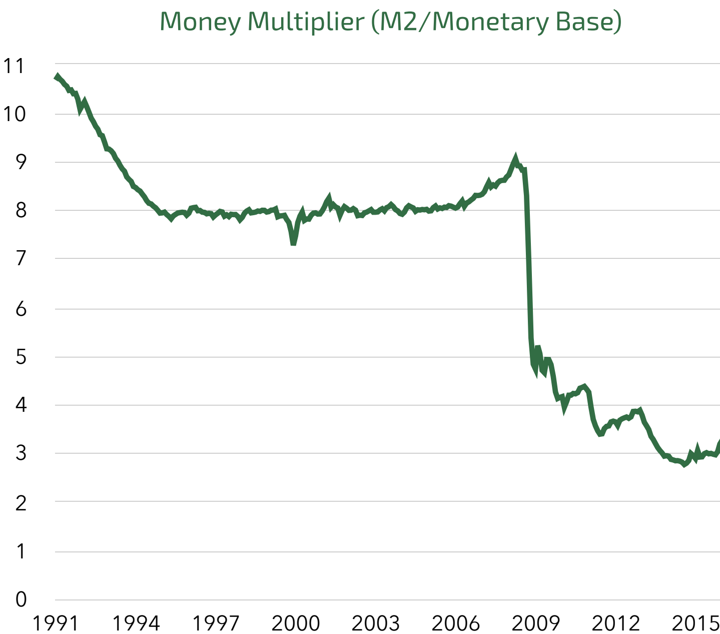
To be clear, this doesn't mean that individual depositors are paying to keep their money at the bank. If this were the case it would very likely cause a run on the banks and the whole system would collapse. Rather, it means banks are having to pay to keep certain reserves at the central banks. The move is intended to discourage banks from hoarding cash instead of lending it out to consumers and businesses. In essence, they are trying to get banks to leverage up and take more risks; to create demand for loans where demand doesn't exist. Zero Hedge actually reported the occurrence of negative interest rate mortgages in Denmark! Don't worry, 2008 never happened.

NIRP is also having an impact on government bond yields. Bloomberg reported on February 9 that "more than $7 trillion of government bonds offered yields below zero globally… making up about 29 percent of the Bloomberg Global Developed Sovereign Bond Index." Why would anybody buy an investment guaranteed to lose money? Well, a slightly negative yield on government bonds is better for the banks than a larger negative yield on reserves at the central bank.

Surely nothing as foolish would ever happen in the U.S.; right? "We're taking a look at them ... I wouldn't take those off the table," Federal Reserve chair Janet Yellen recently said at a Congressional hearing. Wait, what?! One would think the economy would need to be a dumpster fire before something like this would ever be considered. To hear the Fed chairwoman discuss NIRP as a possibility is a little frightening.

The Fed is very effective at curtailing lending. They can use open market operations to remove money from the system (or just raise interest rates until nobody wants to borrow money). It's a lot harder to compel commercial banks to lend. If they flood the market with more money, there is no guarantee that lending will increase. It's like pushing on a string.

There are about $2.4 trillion dollars of excess reserves of depository institutions at the federal reserve today. Before 2008 this number was so close to zero it wasn't worth paying attention to. Before 2008 that money would have been lent out, and through the miracle of the fractional reserve system (sorry for making you think back to your econ classes) would have multiplied by a factor of about 8. The money multiplier today is closer to three. It's dead.



The quantity of money is now determined from the inside by the behavior of banks and their customers, not from the outside by the Federal Reserve.

This is BRAZIL!!!

I have written about China in every newsletter I have published so far, so I'll keep it short this time. China is still struggling; the fake government number for Chinese economic growth in the 4th quarter came in a little light at 6.8%; and Standard & Poor's cut its outlook for China's credit from stable to negative on March 31. The markets seem to be shrugging off the bad news, so I would rather write about Brazil.

Brazil's two-year probe into kickbacks at Petrobras, the state oil company, has escalated and President Dilma Rousseff has been implicated. In an attempt to rebuild support in Congress, she appointed popular former president "Lula" to her cabinet. The move backfired as it was viewed as an attempt to shield him from a money laundering investigation, because under Brazilian law, only the Supreme Court can try high-ranking cabinet members.

Citizens will tolerate a certain level of corruption when economic times are good, but Brazil's economy shrunk 3.8 percent last year and is forecast to contract another 3.6 percent in 2016. The people are demanding her removal and the lower house is expected to vote on her impeachment by mid-April.

Growing speculation that Rousseff will be removed from office, making way for a government that can restore Brazil's finances, has already sparked a massive rally this year that's made the Ibovespa the best-performing equity market in the world. Additionally, Brazil's currency, the Real, has strengthened by 9.9% on the hope that she will be impeached. If her 11% approval rating was not a clear enough indication, the market is showing just how disliked she is.

Brazil is the upcoming host of the 2016 Olympic Games, which should prove interesting. People weren't happy with how much the government spent on the World Cup two years ago, and the political climate is obviously much worse today. They still haven't sold half of the tickets for the Rio games and there are legitimate concerns that the construction of some Olympic facilities will not be complete in time. Let the games begin!

Thanks, Brazil, for making sure the U.S. is only the second most embarrassing political theater in the world!

Portfolio Positioning

I would love to tell you that this is the last, best chance to underweight bonds and reallocate to stocks, but I'd probably be wrong. Again. The 10-year Treasury yield is 1.79%, but who's to say it doesn't go a lot lower? It's far more attractive than the 0.12% yield on German 10-year bunds or the 0.09% on Japanese 10-year government bonds.

All I can tell you is the S&P 500 is paying out 30 bps more with a dividend yield of 2.09%. From a rational perspective, stocks are a much more attractive place to be than bonds, so we continue to overweight them.

Within bonds we have been overweighting Treasury Inflation Protected Securities (TIPS) and bank loans (floating-rate notes). The TIPS overweight has paid off well as real yields have fallen to 0.16% this quarter from 0.77% (yields go down, prices go up). Bank loans lagged for us this quarter, only up 1.12%, but we believe they are still the most attractive area of the debt market right now. They give you a comparable yield to fixed-

rate junk bonds with a lot less exposure to energy (3%) and mining & materials (1.5%) companies. We continue to slightly underweight foreign bonds, although they could see a boost soon as Brazil makes up 20% of our allocation.

Within stocks our patience with emerging markets is finally being rewarded. Meanwhile, developed foreign stocks were at the bottom of the heap, pulled lower by banking stocks struggling with negative interest rates. The migration crisis in Europe also makes the possibility of Britain's departure form the European Union very real. Some recent surveys even find a majority of Britons now in favor of the break-up. There is a referendum vote scheduled for June 23 on the "Brexit" question. We expect continued volatility in European markets leading up to and in the aftermath of that vote.

It was a great quarter for our alternative investment portfolio. REITs continued to perform well and gold earned its keep shooting up 16.5% to $1,234 an ounce. Gold benefited from the market turmoil and increased skepticism of the power of global central banks to bolster their economies. Not seeing much opportunity for other commodities, we will likely keep gold as a safe haven and portfolio diversifier for the time being.

We remain on the lookout for good rebalancing and tactical opportunities, as that is the best way to make money in sideways markets like the one we've been in for the past year-and-a-half. The world might lose its mind from time to time, but we will try to stay rational.

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About EmeraldSpark

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