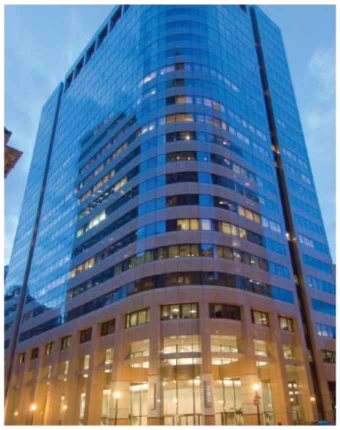
TFC FINANCIAL
The Financial Counselors

COMMENTARY | 3Q
October 14, 2015

OUR VIEW



Repricing Risk in the Equity and Bond Markets

Generally speaking, equity markets climb stealthily to new high ground, but fall off precipitously when investor sentiment turns negative. Sentiment and emotion move financial markets in the short run. Secular economic trends seem to drive markets in the intermediate timeframe. Asset class relative valuations (i.e., what investors are willing to pay for an expected stream of corporate earnings, or projected stock dividend pay-out, or discounted fixed income cash flow), provide a variety of frameworks for investors to sort through their longer-term options. The direction of investor sentiment is volatile and relatively easily discerned in our interconnected age and, for the most part, media driven.

Federal fiscal policy in Washington (at the moment in political limbo), except for the creeping regulatory burden, clouds the U.S. business and economic outlook. In contrast to negative *investor* attitudes, *consumer* sentiment is positive and consumer spending (70% of U.S. GDP) is rising at a 3+% rate. Last Friday's Labor Department New Jobs report sent economists back to their computers to rerun U.S. economic outlook models with a less optimistic set of longer term consumer spending assumptions.

When bad news is good news.

The relatively weak Jobs report also provided additional validation for the Federal Reserve's (Fed) reluctance to take its first step towards interest rate normalization. But when the much anticipated announcement of an initial interest rate increase failed to materialize, gratuitous criticism of Janet Yellen from the punditry was rife. The Fed has struggled mightily since to clarify its ambiguous intentions.

For economists and financial market soothsayers, all this was upsetting; and for some embarrassing. For equity investors, the once again delay toward interest rate normalization was the kind of bad news to be interpreted as indicating at least another three to six months of "free" money; a continuation of the accommodative Fed monetary policy to which the markets have become addicted. Thus bad news for the economy is good news for the stock market and cheap money continues to drive investment risk-taking equations. The can has been kicked farther on down the road. Policy mavens at the Fed once again gain the day.

Thus emboldened, sophisticates in the bond market, hooked on relatively costless cash, bid up bond prices and yields continued to decline. As a result, the term structure of interest rates ratcheted downwards another notch, making bonds as an asset class, by default, even less attractive than equities.

Some Further Thoughts on China

China concerns continued this quarter. While the substantial stock market rally and subsequent bubble bursting made headlines early in the summer, we don't view this as a global financial risk. China company shares can trade on the Shenzhen Exchange (A-shares), or on the Hong Kong exchange (H-shares). The A-share (available primarily to local Chinese investors) market doubled from January to June only to fall by more than 40% since the peak. The median forward Price-to-Earnings (P/E) was 56x at its peak in May, but had declined to 30x by the end of August. This bubble and eventual bear market were experienced mostly by Chinese investors. Only 7% of the

Chinese urban population owns stocks, and two-thirds of those accounts have balances less than the equivalent of $15,000 U.S. Given the small number of investors and minimal account size, we do not anticipate any downstream impact to their overall economy. Despite the hyperbolic headlines, the mainland Chinese market is still up year-to-date.

For the H-Share market, available to foreign investors, performance was much more muted. TFC portfolios have less than 2% of equity exposure to the H-share market, 25% below our MSCI ACWI benchmark weightings. The median P/E of the H-Shares market peaked at 14x, but fell back to 10x by the end of August.

Global investors appear more concerned with the integrity of the official data and continued Chinese economic slowdown. The central government is targeting 7% GDP growth for 2015. This is down materially from the double-digit growth rates of recent history. While many analysts project slower growth in the 5-6% range, an outright recession risk seems very limited.

China continues to rebalance toward consumption.

Housing is often discussed as a potential weakness. Residential construction accounts for 24% of the Chinese economy. For comparison, U.S. housing construction did not exceed 10% of GDP at the housing market peak in 2006. On its own, China's residential construction situation seems ominous. Add in prior media reports of "ghost" cities with empty roads, malls and apartments, and a foreboding global economic risk seems real. However, of the housing construction, 70% represent replacing older communist-style housing projects and 30% represents new housing capacity for rural-to-urban migration, or new household formation. The problem is that most of the cities are running out of old housing stock to replace. The Chinese government wants to rebalance their economy towards internal consumption as this residential investment trend decelerates.

While longer term, rebalancing towards consumerism represents a challenge, over the shorter term, there are several positives that make a "Lehman" moment of global contagion unlikely. First, the average Chinese home buyer is not highly levered and still saves a large portion of income. Of all home buyers, 15% in 2014 paid in cash. When a mortgage is used, 30% down payments are required. Second, it is true that housing prices have risen dramatically, but per capita disposable income has increased by a larger margin. Thus the consumer can afford more house, not less. Third, many apartments are purchased pre-construction to get a better price. Once the buildings are complete, many residents do not move in immediately, instead waiting for public services like transportation to catch up to the growth. Many of the "ghost" cities have actually been occupied. Finally, the leverage in the system sits mostly with the developers and local governments. Longer term, the government cannot allow outsized debt growth indefinitely, but given the $3.6 trillion in reserves, and the majority of the leverage at local government level, the government has the flexibility to promote new construction above trend in the short term while the economy rebalances away from investment towards consumption.

Both the equity bear market in mainland China and slowing residential construction appear to have not impacted consumption. Retail sales and gasoline consumption were both up this summer. Domestic car sales have declined this year, but SUV sales are up 34%. New home sales are up 21% year-over-year. Express parcel deliveries are up 47% year-over-year in July. That equates to 10 billion packages delivered in the first seven months of the year. Online shopping is booming. Finally, over 65% of GDP growth now comes from consumption which points to the rebalancing policy process taking place.

China comprises just under half of the global consumption of nickel, zinc, aluminum, copper, and iron. The slowing infrastructure investment has materially impacted commodity exporters to China like Australia, Brazil, Chile, and Russia, but a global recession risk due to continued economic deceleration in China seems minimal.

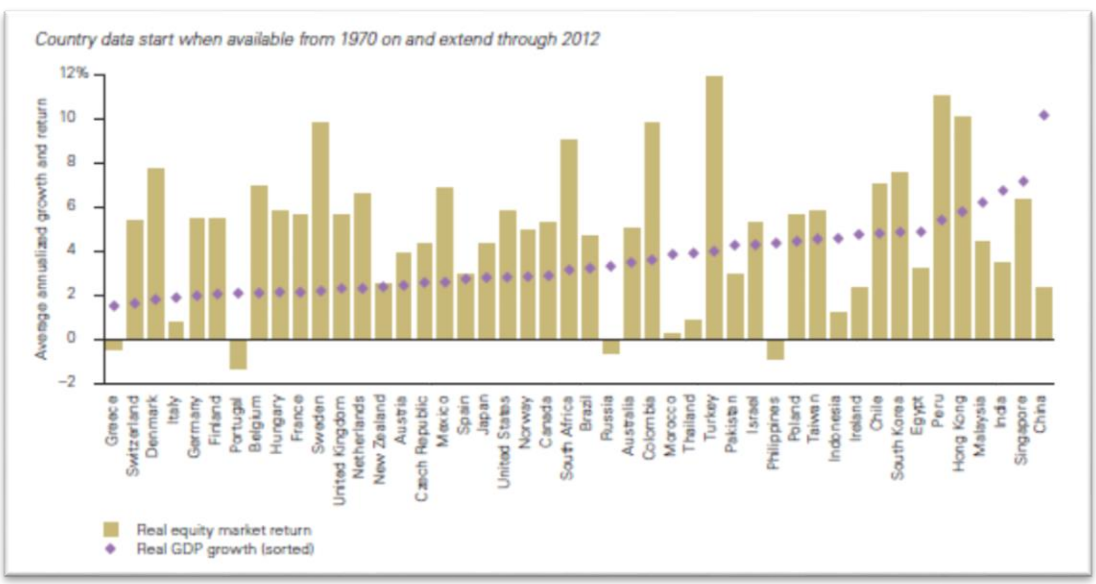
Most perplexing about China this summer was the small devaluation of the Renminbi (RMB) the week of August 10th. Some analysts believe this was to boost Chinese exports, but in context of a government-engineered 30% RMB inflation-adjusted appreciation since 2005, this latest move seems insignificant. Others have speculated it pertained to the desire to have the IMF (International Monetary Fund) include the RMB in the Fund's Special Drawing Rights (SDR) currency basket. This also seems inconsistent, since the August devaluation doesn't make the currency more market-oriented. Regardless of the reason, this policy misstep did dramatically increase capital outflows. The result has been reduced liquidity which caused the government to spend over $100 billion of its reserves in August to stabilize the currency. It will be interesting to see where this goes.

A dilemma for equity investors.

GDP Growth Does Not Necessarily Correlate with Stock Market Returns

Speaking of growth, investors sometimes mistake high economic growth as a corollary to high stock returns. This assertion was made in the early 2000's for China and India. But, according to Vanguard, over the 42-year period from 1970 to 2012 the relationship is weak, at best, between economic growth and stock returns. The chart below shows countries ranked by GDP growth (purple diamonds) and the real stock returns (brown bars).

GDP Growth vs. Stock Returns



Source: Vanguard

The business cycle and economic growth are important determinants of long-term stock performance, but it is not as straightforward as often assumed. Stock prices tend to be anticipatory to changes in business environments and macro policy conditions. GDP growth rates by contrast are issued with a lag and subject to multiple revisions.

Investors are faced with a dilemma—look at GDP growth from prior periods and extrapolate into the future, or make assumptions about the future and forecast growth looking forward. A 2014 study by Credit Suisse tested both options. Using previous GDP growth figures as an extrapolation, countries with the *lowest growth* rates tended to have the highest real (inflation-adjusted) stock market returns!

Assuming a clairvoyant forecast of *future* economic growth, the Credit Suisse study confirmed the highest growth economies (over 1-5 year timeframes) also had the highest real stock returns. The onus then shifts to forecasting economic growth. The 2013 Vanguard study also showed that using a consensus growth forecasts had zero correlation with future stock returns.

Economic surprises, defined as the difference between forecasted growth and the actual realized growth, do tend to be helpful. If growth turns out higher/(lower) than forecasted, stocks tend to perform better/(worse). This link is insightful, but according to Vanguard only explains about 25% of the variability of the next 12-month returns.

There are many reasons why earnings growth and economic growth are not perfectly correlated. The chart below shows that while higher economic growth in emerging markets did translate into higher earnings growth, other factors are also at work. First, economic growth can translate into earnings for companies outside the country of origin or region. Second, to the extent growth is driven by private companies or state-owned enterprises, publicly traded stock returns may not be impacted. Newly created companies can add to economic growth, but not to public companies' earnings or stock returns. Finally, the price paid for expected earnings (forward P/E ratios), or cash flow, is paramount. If investors overpay, they face a stiff headwind.

The price paid for a given dollar of earnings (P/E ratio) is key.

Difference between Earnings Growth and GDP Growth

Notes: The figure shows the average annualized growth in earnings and GDP in nominal U.S. dollar terms. The countries represented are the members of the FTSE Developed and FTSE Emerging Indexes as of December 2012. GDP growth is based on aggregated data for those countries as reported in the IMF's April 2013 World Economic Outlook database. Earnings growth is inferred from the price index and P/E ratios of the same indexes.

Source: Vanguard, based on data from the IMF and FTSE.

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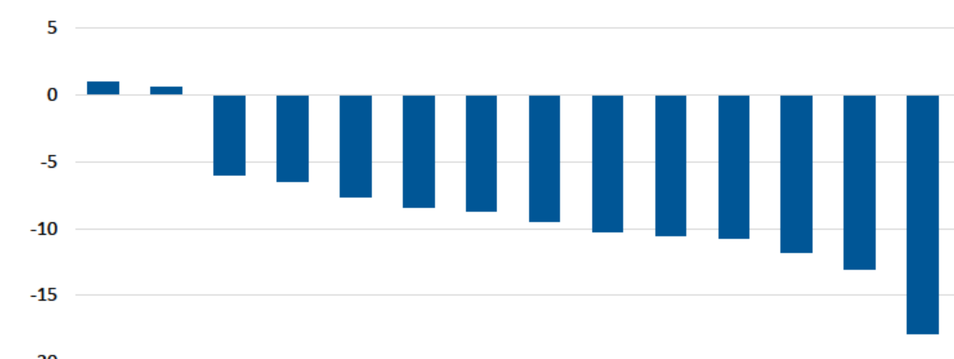
Global Equity Recap (Quarter ended September 30, 2015)

Historical Asset Class Returns

Quarter To Date Returns 9/30/2015

Historical Asset Class Returns



	Short Term Muni Bonds	Short Term Bonds	Intl. Small Growth	S&P 500	Intl. Small Value	US Large Value	Europe Stocks	Global Stocks	Intl. Large Core	Frontier Markets	US Small Value	Intl. Value	US Small Growth	Emerging Markets
QTD	1.0	0.6	-6.0	-6.4	-7.7	-8.4	-8.7	-9.5	-10.2	-10.6	-10.7	-11.8	-13.1	-17.9
YTD	0.5	1.4	4.9	-5.3	0.4	-9.0	-5.2	-7.0	-5.3	-13.4	-10.1	-8.1	-5.5	-15.5
Full Cycle*	0.0	3.0	1.1	5.0	1.0	3.6	-2.1	0.7	-1.8	-4.8	4.1	-2.8	6.0	-4.1

TFC Chart
Source: Bloomberg Data
* Full Cycle is the annualized return from October 2007 peak to present.

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The dispersion of negative returns amongst equities during the last quarter provides an opportunity to rebalance.

As can be determined by the above chart, every major equity asset class was down at the end of the September 30th quarter. Stock markets around the world declined in sympathy as more investors became concerned about the slowdown in the Chinese economy and the timing of the Federal Reserve first rate increase. International Developed Small Company Growth stocks (-6.0%) and U.S. Large Company stocks (-6.4%) declined the least during the quarter. Interestingly, International Developed Small Company Growth and International Developed Small Value stocks still have positive returns for the year at 4.9% and 0.4%. U.S. Small Company stocks struggled more than the broader market. Emerging markets declined by almost 18% for the quarter and are now down 15.5% for the year.

From the recent peak in May, U.S. stocks fell 9% and U.S. Small stocks have declined 12%. International Developed stocks declined 15%, while Frontier and Emerging Market stocks were down 12% and 22% respectively. As we discussed last quarter, the purpose of bonds is to diversify away some of the risk of large price swings of your equity positions and provide a cushion against the downside volatility experienced during the past few months. Thus last quarter's return dispersion amongst equities has provided an opportunity for rebalancing this quarter. In the days ahead, where applicable, some incremental portfolio reorientation would seem appropriate.

As always, we welcome your comments and questions.

Sincerely,

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