Market Commentary - May 2016 View this email in your browser

We continuously monitor both short-term and long-term trends in corporate profits because corporate earnings are the lifeblood of stock prices. Recent profit announcements have been disappointing. Overall profits have been down three quarters in a row, the worst showing since the 2008-09 financial crisis. In the most recent quarter, reported earnings were down 6%, or 1% ex-energy. Even companies that managed to beat earnings expectations often reported weaker outlooks which hurt their stock prices. This partially explains why stocks are struggling to reach new highs.

Growth in earnings is expected by many analysts to resume later this year and accelerate into 2017. We remain skeptical. We agree that **earnings comparisons** will be easier in the second half but Wall Street's 2017 anticipated 10% gain seems unattainable. Why? Slowing GDP growth abroad, slow growth here (see below), falling profit margins, weak U.S. manufacturing, and a strong U.S. dollar will all limit earnings growth. **If you assume flat price-earnings ratios (at best), it is difficult to see how stock prices will rise significantly in the short-term. This may be the case until the 2017 outlook becomes clearer.**

Rough Patch or Recession Watch?

GDP estimates for Q1 2016 had been reduced several times, but last week's release still surprised most investors. With the first quarter's paltry 0.5% rise, GDP growth has been 1% over the last six months, about half the disappointing average growth rate since the Great Recession. (Since 2000 GDP growth has averaged only 1.76% annually.) The key personal consumption expenditures rose just 1.9%, the weakest in a year. Almost half of that went towards rent and healthcare. **Why is this so important? Real GDP growth, now barely positive, is one of the key drivers of equity returns. It helps boost corporate revenues and profit growth.**

The jury is still out on whether the economy has simply hit a speed bump or may be facing a more severe slowdown (recession?). Either way, investors should brace for the latter. Since valuations are at bull market highs (17x 2016 estimated earnings) with earnings growth expectations modest at best.

As a result, we anticipate staying in conservative mode for the rest of this cycle. Here is what we have done to prepare in case of a downturn in stocks:

- **Own large cap (> $10 billion) and mega cap stocks.** These large companies have survived multiple recessions and their balance sheets are strong and not overly levered.
- **Overweight traditionally defensive areas such as health care and consumer staples stocks.** Almost half of both core equity and dividend growth portfolios are currently invested in these two sectors.
- **Emphasize higher yielding dividend stocks for new purchases.** Yield-hungry investors remain attracted to this subgroup of equities.
- **Lower portfolio beta (risk).** Beta is a measure of either an individual stock or overall portfolio's potential price volatility and is based on a number of factors including historical price volatility and various other risk characteristics. Conservative portfolios typically have a beta coefficient less than the market's beta of one. Both our core and dividend growth strategies have betas significantly below the market at this point so we are positioned for less portfolio volatility than the overall market. Beta is not a foolproof measure but it does help quantify potential volatility relative to a benchmark.

None of these strategic measures guarantee relative outperformance to a benchmark or positive absolute returns. They do, however, represent important shifts that, over time, should help protect portfolio principal in challenging markets.

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