

## ADKINS SEALE CAPITAL MANAGEMENT, LLC

Investment Commentary  
January 6, 2017

### Dear Clients:

Heraclitus, a Greek philosopher circa 535-475BC, is believed to have said (roughly translated): "If you do not expect the unexpected, you will not find it, for it is not be reached by search or trail." Even in early times, history and effort were not "safe" means for forecasting the future!

Seemingly, all of the "safe" bets for 2016 turned out not so. Early in the year, interest rates were poised to rise due in part to expected tightening by the Federal Reserve Board (Fed), but what we saw was a decline in the 10 year US Treasury note to a low of 1.4% in the summer as the Fed kept delaying the initiation of a higher federal funds rate due to concerns about the pace of economic activity. This surprise was accompanied by the market "acceptance" of negative yields on the 10 year government notes issued by the likes of Germany, Switzerland, and Japan. Global bond markets were apparently spooked by the British vote to leave the European Union and buoyed by central bank commitments to lower interest rates as the miracle cure for economic malaise. These events were followed up on by the historic upset in the US Presidential election where the upstart disrupter defeated the ultimate political insider and the Republican Party arose from the ashes of disarray to maintain control of the US Congress and increase its influence at the state governmental level. Then, despite the expectation for rising premiums for risk assets, the US stock market increased dramatically from election day through year end on the back of higher price/earnings multiples (aka, even lower risk premiums). At year end, we are left pondering whether the "promised" reductions in tax burdens and regulatory over-reach will produce the substantial improvement in economic growth, thus confirming the animal spirits on display in the current quotes of stock prices.

All of this observed disorder calls to mind the writings of Nicholas Taleb and Peter Bernstein. Among Taleb's several books are [The Black Swan](#) and [Fooled by Randomness](#). Both of Taleb's books deal with difficulty of accepting the unexpected as normal, the tendency to extrapolate the recent past into the distant future, and the habit of blaming randomness for bad outcomes but not good ones. Bernstein wrote [Against the Gods: The Remarkable Story of Risk](#) near the end of his varied career in academia, commercial banking, founder and publisher of the Journal of Portfolio Management, and investment management. In this book, Bernstein pays tribute to the advances in modern finance through applied mathematics (primarily probability theory) but cautions against the risk of assuming that quantitative modeling and statistical analysis are as reliable as the users of such means would like. Clearly, we are in a period of economic and political disruption, which makes the task of managing investment portfolios all the more challenging. Discerning the difference between riding a strong and durable trend in higher valuations from following the lemmings over the "over-priced" cliff has never been more difficult.

### Investment Market Returns as of December 31, 2016

Market returns for the quarter ended December 31, 2016 was a decidedly "tale of two cities" event. From September 30 through November 8, equity market returns were broadly negative, with the S&P500 Index and the Russell 2000 Index down by -1.1% and -4.4%, respectively. Returns on fixed income, REITs, and commodities were also negative, perhaps signaling either a continued rise in interest rates and/or an unexpected or unfavorable electoral outcome. By the end of the day November 9, the equity markets had begun a significant reversal. By the end of the year, the S&P500 Index returned 5.0%, and the Russell 2000 Index adding an amazing 13.9%. For the full quarter, US large cap stocks returned 3.8% including a dividend return of about 0.50%, while US small cap stocks including dividends posted a total return of 8.8%. Apparently, the campaign promises for lower income taxes and reduced regulation encouraged market players to raise earnings expectations and/or reduce further already low equity risk premiums. The Shiller PE ratio was around 26x pre-election, but it finished the year over 28x despite a clear signal that interest rates had begun to rise. For the full year, US large cap stocks and US small cap stocks produced total returns of 12.0% and 21.3%, respectively, reflecting a continuation of the recent trend of prices rising more rapidly than underlying earnings.

The story was somewhat different for non-US stocks. The fourth quarter total return on stocks in developed countries outside the US was a -2.8% through November 8 but a positive 2.1% after the election resulting in a modest loss for the quarter and a full year total return of 1.0%. In contrast, the return on emerging market stocks was a strong 16.0% for the year through November 8, but finished the quarter weakly losing -4.2% resulting in a full year return of 11.2%.

Fixed income returns were also somewhat volatile. In the US, taxable investment grade bonds returned 4.9% for the year through election day but declined by -2.1% afterward for a total year return of 2.6% or a slight premium to the annual interest coupon. The return on the Barclays Global Majors exUS bond index was up 10.7% before the election but gave back -7.7% afterward for a full year result of 2.1%.

Alternative investments were a mixed bag with pre- and post-election returns moving in different and somewhat contradictory directions. The year to date returns through November 8, 2016 reflected the impact of rising interest rates as the broad commodity index and gold were up 6.9% and 19.9%, respectively. However, post-election, commodities

added another 4.5%, while gold fell 9.8%. US REIT shares were up only 2% year to date pre-election, but rose strongly by 4.6% post-election. The price movements in these assets seemingly signaled a slower rise in future interest rate, improved business conditions, and lower demand for gold as a hedge against social unrest.

### **Our Look Forward**

The post-election strength in US stock prices appears to be based in large part on the expectation for an improved operating environment for business. No doubt lower income tax rates, especially on business, and a less burdensome regulatory environment would lead to improved business earnings and as a result, higher stock valuations but not necessarily higher prices. Valuations are determined by estimating the present value of all future net free cash flows created by an enterprise using a rational discount rate to reflect uncertainty and duration. Prices, particularly in the short term, are set by the animal instincts of the herd (aka market participants); in the short term, prices can be substantially above or below rational valuation.

As we go to press, the expected annual return from US stocks is somewhere in the range of 7% and 8%, assuming real growth of 2% and annual inflation of 2%. If all of any reduction in US corporate income taxes were to go directly to the bottom line, we estimate lowering the US corporate income tax rate to 25% or 15% would result in a 15% or 30% increase in base earnings. However, we know that some portion of corporate income taxes are born by consumers through elevated product prices and by workers through lower wages. We say shareholders should be delighted to retain half of any income tax reduction. Now, an investor must also consider the probability that such benefits will actually happen to a meaningful degree and the number of future periods required for lower taxes and reduced regulation to filter into the economy. The legislative and administrative sausage factory through which these proposals must pass will undoubtedly create unexpected wrinkles in the final products.

The other major source of volatility in future stock prices relates to the maintenance of historically low interest rates and resultant high price/earnings multiples (aka, low discount rates). Today, the S&P500 Index is priced at a price earnings multiple that is about 40% **above** long term averages. Since the US bond market (investment grade) is currently yielding about 2.5% versus a long term average of 4.5%+/-, much of the higher equity price multiple can be attributed to low bond yields. We know interest rates have been rising lately and that the Fed has adopted a posture to continue raising rates over the coming year. In our opinion, the economy would function better with higher interest rates through more effective capital allocation decisions and more equitable treatment of savers and pension beneficiaries. However, our expectations are far from certain to materialize since we have expected this mean reversion to have occurred as early as 2010.

Our assessment of current market conditions continues to suggest caution in the allocation of risk assets. US stocks and fixed income globally remain richly priced and offer a smaller margin of safety from the impact of unexpected events. Non-US stocks appear to have more attractive risk premiums but also higher currency and political risks as offsets. We continue to maintain "dry powder" in client portfolios through lower than normal equity allocations and fixed income duration.

### **In Closing**

We look forward to visiting with each of you about your investment results and expectations for the future and to make sure your portfolios are aligned with your specific circumstances. We greatly appreciate the opportunity to serve as your investment adviser and pledge our best efforts to meet your expectations.

P. Michael Adkins, CFA  
[mikeadkins@ascm-llc.com](mailto:mikeadkins@ascm-llc.com)

J. Richard Seale, CFA  
[dickseale@ascm-llc.com](mailto:dickseale@ascm-llc.com)

333 Texas Street, Suite 2235 Shreveport, LA 71101  
318-703-3641 800-304-6588