Traub Capital Management 2016 Outlook

April 5, 2016

Introduction

The first quarter of 2016 has come to a close. Judging from where the quarter started and where it ended, you would conclude it was a very boring period. The S&P 500 index barely moved. Including dividends, it closed up about 1% for the period. The quarter, however, was actually anything but boring. The overall index dropped a full 10% in the first six weeks of the quarter. It was one of the most rapid declines in the history of the markets. Then, in the last seven weeks of the quarter, the overall index rallied, in one of the more dramatic rallies, to finish just above where it started. At the same time, the market leadership changed somewhat, from the "go-go" stocks –Amazon, Netflix and Google, to the ultimate boring telecom sector. Verizon and ATT were major market leaders in the first quarter.

It is not the least bit unusual to see changes in market leadership. If any one type of equity always was the leader, investing would be pretty easy and just picking the winner would be simple. Changing leadership in the markets are very often accompanied with the type of volatility we have seen – rapid declines as investors sell their historic market leaders and rapid increases as they buy new ones.

The quarter also saw what we expect to be the beginning of an overall shift from growth stock leadership to an improvement in value stocks. Whereas growth stocks have soundly beaten value stocks over the last 9 years (ending 12/15), with a return 59% better than value stocks, value stocks finally beat growth for the first quarter of 2016.

More pronounced was the change in healthcare stocks. The substantial return margin that healthcare stocks had midway through 2015 had all but vanished by the end of the first quarter of 2016. As most of you know, we do not chase past returns, which has paid off by not chasing the large gains in healthcare stocks through 2015, as healthcare stocks wound up with losses by the end of the first quarter of 2016. However, we do believe that the large declines in some of the stocks in the healthcare sector now offer attractive points to purchase some of these equities and we will discuss one controversial healthcare stock later in this report.

The 2016 Outlook

Our outlook for 2016 is unchanged from where it was at the end of 2015. We still are looking for reasonable economic gains in the domestic US economy, very tepid improvements from Europe, flat economic prospects for Japan and no "hard landing" for the Chinese economy. This outlook is identical to our forecast three months ago. Despite the very volatile markets during Q1, very little has changed in the fundamental economic outlook for either the domestic, or the international economies.

In the US, the jobs growth was robust, which is a better indicator of the health of the US economy than is our measured GDP. At the same time, unemployment ticked up a bit indicating more people are entering the labor force and looking for work. We will not see pressure for wage growth, so long as this pattern of entering workers continues. It is interesting that consumer sentiment is not reflective of the general health of the economy. Sentiment actually declined a bit in the quarter and people remain skeptical of the economic improvement, thereby setting up a dichotomy of better economic conditions and worry – a perfect environment for continued gains in the stock markets as it climbs the wall of worry. In the

Chinese economy, the index of Purchasing Manager sentiment jumped, actually indicating a favorable economic scenario going forward.

We continue to forecast an overall earnings per share from the S&P 500 index of $124. This earnings level is up from $119 that represented the consensus forecast at the end of the first quarter of last year. In the first quarter of this year, the earnings of energy companies had a distinct negative impact on the S&P earnings as the price of Brent Crude Oil declined by 42% from a year ago, on top of the already 38% decline from the end of March 2014 to the end of March 2015. (Please note that a 38% decline followed by another 42% decline does not equal a decline of 80%. These two successive declines leave you at 36% of where you were initially, a 64% decline). At this point going forward, we do not see a further negative impact from the energy sector as the price of oil has stabilized and actually increased some. (You probably have seen a recent spike in the price of gasoline at your local service station. Locally, it took a long time for the price of gas to get down to as little as $1.50 per gallon, but it was back to $1.90 per gallon or so in the space of about a month as oil recovered 49% from its February lows.)

The P/E ratio of the S&P 500 now sits at 16.1x the next twelve month's earnings projections. This is a bit high based on the historical average for the past 15 years of 15.8x, but it is down from a recent high of 17.2x and probably reflects the recently improved earnings outlook of the energy sector. The price of the major energy stocks (Exxon Mobil, Conoco, BP & Royal Dutch Shell) have collectively fallen by about one-third of their value in the two years where the price of a barrel of oil declined 64%. There is not nearly a direct correlation of the majors' stock prices to oil prices as they have other parts of their business such as refining that is not hurt by lower oil prices (and arguably helps their profits). Overall though, earnings of the major oil companies plummeted, more so than the price of the stock which had the effect of bringing the earnings multiple up. We expect that multiple to come down a bit as earnings of the energy companies recover and the earnings of the balance of the economy continues to show small increases. Valuations are marginally higher than the average of the past 15 years, but we do not see the market's price earnings ratio at "scary" levels that you frequently see in the media. But then again, we do not need to have a scary headline for people to read our economic outlook. We hope that having a cool head and a good investment track record will keep you interested in what we might be writing.

The Fed

Interest in the actions of the US Federal Reserve ("the Fed") continues to be very high. The Fed made a very modest increase in their short-term rate late last year. The consensus forecast at the time was for at least three more small increases in 2016. It appears that the Fed will delay the first projected increase in 2016, citing that the global economic outlook is weaker than they expected in December and that they should "proceed cautiously in adjusting policy". These statements were interpreted to mean that it is not likely that the Fed will proceed with an increase in the Federal Funds rate at their meeting in April. We certainly expect at least one, or perhaps two, more small hikes in the Federal Funds rate yet this year. Generally, the impact of the first and second increase in the Federal Funds rate does not have a detrimental impact on the investment markets, but the third increase usually signals that economic expansion will likely be slowing in the future and the markets typically react with increased selling on that outlook. We are still at least several months away from that event.

The Race for President?

Oh my! We don't recall any prior election where the two front-running candidates were truly disliked by so many. For the current front runners: from Benghazi to emails, Mrs. Clinton casts a long shadow of questionable decisions. And Mr. Trump, well, is just continuing to be “The Donald”, now scoring over 70% unfavorable ratings with women. Our, extremely limited survey, does not uncover many people that are real happy with what are likely to be the choices come November.

We cannot predict how either of the front running candidates will impact the markets, or the economic balance in the world, nor can we make any kind of reliable prediction of the election outcome. It is our view that neither of the front running candidates will have a distinct and positive impact on the markets. Mrs. Clinton’s push for higher taxes, lack of reform of the tax code, and basic support of labor could bode ill. Mr. Trump’s protectionist views could also bode ill along with his loose cannon approach to his actions which creates the uncertainty that markets truly dislike.

It is, however, somewhat more clear that neither the Democrats nor the Republicans will be handed the Presidency as well as bullet-proof majorities in both the House and the Senate. Given a division of power, the pace of change is likely to be reflective of the clearly demonstrated ability of no one at the federal level able to get along with each other. No one getting along and no one having an ability to act separately will mean that no big changes are likely to ensue. Markets generally do not like uncertainty, nor do they like major changes in the distribution of wealth that results from new legislation. So, as much as no newly elected President will walk into the White House with the solid backing of a vast majority of the citizenry, the overall impact might not be as bad as each candidate’s opposition would have us believe. We do certainly hope so and we do not see any enormous market shift from a Presidential victory from either party.

What Do We Expect for the Rest of 2016?

We expect the balance of 2016 to mostly match our outlook from the Q1 economic outlook, although we do see some moderation in the strength of the dollar relative to last year. In fact, most of the dollar’s gains from last year were erased in Q1. We projected a low single digit increase in both US and international equities. Although that forecast looked a bit in doubt in mid-February, we continued to hold and publish that view – a small increase for 2016, with some probability for a bit larger improvement and less probability for a negative one. As a result, we continue to hold portfolios with close to normal “risk” positions that are tilted to value oriented companies.

Stock Spotlight: What Are You Thinking?

Some of you have noted that we hold Gilead Sciences in your portfolios (for most clients where we choose stocks). This is the same Gilead that has been accosted from politicians of every sort for the high price of their new drugs aimed at curing Hepatitis and for relieving HIV. “How can they charge $1,000 per pill?” ask the politicians and Maura Healey, Massachusetts Attorney General. Some of you may be asking “How can we buy or own that stock?” Indeed, the stock fell from $122 down to a recent low of $82, falling roughly in line with a broad selloff in biotech stocks late last year and early this year. The stock has since recovered about 11%.

Politicians can make great press by beating up on pharmaceutical companies and blaming them for the continuing increase in the cost of health care. A bit of digging into the facts reveals that, at $82 per share, or even its current price of $95, we believe Gilead is undervalued. You can get a more in depth analysis of our logic on our website (http://traubcapital.com/images/Research_Reports/GILD_0216.pdf). But to summarize, Gilead has recently introduced a very effective cure for some discernable strains of Hepatitis. Their cost to manufacture the drug is basically nothing, so they have a patent and a 95% gross margin. The drug has a 95%+ cure rate. It prevents further complications of the liver, eliminating the need for vastly more expensive liver transplants for patients down the road. It actually costs less than previous treatments that were nowhere near as good. Now, it is really hard to criticize a company that develops a cure for an ornery disease and then charges a price for it that is less than existing therapies. It is sort of like chastising the army of scientists should they come up with a cure for breast cancer that you can take as a pill. Everyone in our society would react to the inventor of that drug as an absolute hero and this is exactly what Gilead has done.

Our bet is that the dilemma will be resolved in favor of Gilead. There is no legislation that says a company cannot invent an effective new product. There is no legislation that gives the Federal government the right to steal an invention because it works too well. And Gilead has been very, very careful to seek out and accommodate various groups and come up with acceptable compromises in the drug cost vs. the drug benefits. Even Ms. Healy has calmed down quite a bit since Gilead offered to work out a plan to get the drugs needed to the people in her jurisdiction that need them.

The same cannot be said for a couple of pharmaceutical companies that were totally unwilling to accommodate anyone. The heat is still on those companies. In the meantime, Gilead stock is up to $95 per share – a 16% increase from its lows in early February. We see the possibilities for further increases in Gilead going forward based on other drugs in its current portfolio, the long patent protection on the drugs, the strength of their management to determine great opportunities for their technology, and on the depth of their development pipeline.

Conclusion

As was the case at year end, we do not see big changes in financial markets for 2016. We pointed out the danger of increased volatility and that danger continues to be a hazard going forward. We expect to weather the upcoming storms of volatility as we have done with the last couple. Hopefully, we will be able to recognize when the markets have a very poor economic outlook, coupled with declining earnings and react accordingly as well. We continue to monitor those conditions carefully.

As always, we thank you for your continued support of Traub Capital Management and please do not hesitate to give us a call to discuss any of the above or to reflect how the current economic and market outlook impacts on the positioning of your individual portfolio.