Palouse Capital Management, Inc.

Investment Commentary

2Q 2016

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MARKET OVERVIEW

“It’s like déjà vu all over again.” This famous quote attributed to Yogi Berra is appropriate (not just because it is baseball season) but also it describes the market movements of the second quarter. They had an eerie resemblance to the first quarter, in which there was a lot of volatility at times yet in both cases the S&P 500® Index generated small positive returns for each quarter.

In the first quarter it was the concern over the effects upon emerging markets of the December FED rate hike as well as worries over the effects of low oil prices upon the banks’ exposure to energy loans that caused volatility. In the second quarter, it was guessing about what the FED would do next as well as the vote in the UK to leave the European Union that created volatility.

In both cases, markets became reassured that the FED and other central banks stand ready to be even more accommodative if necessary. This central bank support as well as programs in Europe and Japan to push interest rates even lower have combined to keep US equity valuations on the high side of normal despite no earnings growth (S&P earnings have actually declined over the past 4 quarters).

The vote in the UK to leave the European Union (even though it was close) was a big surprise for the markets. The British pound lost about 10% of its value, so the UK is a good place to visit (a US dollar goes 10% further there), but not such a good place to live, since the cost of imported goods rose by 10%. The exit is likely to be a long drawn out process which is likely to create a cloud of uncertainty over not just the UK economy but also the EU, especially if other members feel encouraged to follow the UK. Countries that have been subject to austerity programs dictated by the EU as well as countries that have been subsidizing countries with struggling economies may be subject to nationalistic pressures to leave the EU.

The vote may also represent a growing revolt against the political establishment, which is becoming more evident in other EU countries as well as in the US.

The other major development during the quarter was the continued efforts by the Bank of Japan and the European Central Bank to push interest rates even further into negative territory. At this writing about $11 trillion of government and corporate debt over the globe has negative interest rates. In other words, investors that buy these bonds and hold them until maturity will lose money. Pushing rates into negative territory appears to be an experiment to push money out of banks and into the economy to stimulate growth. Although the theory appears to be inflationary, it may turn out to be deflationary as cash withdrawn may hold its value more than cash deposited at banks. These steps have not had the hoped for effect of lowering the value of the Euro or the Yen in comparison to the US dollar, so the markets are not giving a positive response to these negative interest rate programs. In contrast, the US markets responded in a positive fashion when Janet Yellen, the US FED chair, said negative interest rate programs are not being considered by the FED.

How all these factors affect the US dollar is of importance to equity investors, as the strong dollar in 2015 hurt multinational corporate earnings. Since the dollar has been stable over the past year, there is a possibility of corporate earnings growth picking up in the second half of the year. Expectations are that S&P 500 earnings will decline by about 5% in the second quarter of 2016.

MARKET OVERVIEW CONT.

From July 1, 2015 to June 30, 2016 the S&P 500 index increased 1.03%, not including dividends, in a very bumpy fashion. Between August 18, 2015 and August 25, 2015 the market lost 11% of its value in five trading days over worry about the Chinese economy. It then regained everything it lost by November 2, 2015, closing above 2100 on November 2 of last year. The market then corrected again, falling a little less than 12% from December 29, 2015 to February 11, 2016. Investors were once again worried about the world economy and plunging crude prices (crude oil fell about 30% in the same time frame). Then, repeating the same type of pattern as before, the S&P 500 Index climbed all the way back to 2100 by mid-April, 2016.

The market then bounced around that level for a few months – and then along came Brexit. The market lost a little over 5% in two trading days at the end of June. Panic would not be the right word to describe investor attitude on those days, however, the Brexit issue dominated the press and created a lot of worry about equity markets for a short time. Then the S&P 500 closed the quarter at – you guessed it – 2100, rising 4.9% between June 27, 2016 and June 30, 2016. All the worry about Brexit was for nothing, at least as measured by the S&P 500 Index at the end of June.
The market has done a great job of erasing three "corrections" in the past 12 months. With interest rates as low as they are, long term investors have few options other than equity investments. Pullbacks in the equity markets have created three buying opportunities that were quickly recognized by investors in the past year.

While the equity market has bounced off of a flat line for the past year or so, earnings for the S&P 500 Index have dropped. Other things being equal that means that the P/E ratio for the S&P 500 Index has risen, and is right now at a relative high point. The forward P/E ratio for the market is now a little less than 18x, the highest point in a decade. While we have been concerned about the market P/E ratio, as well as the P/E ratio for some sectors and stocks, the equity market has shown resiliency in its ability to erase corrections. We do remain cautious about market and stock valuations as we head into an earnings season that could see further negative guidance revisions based on developments in the world economy. If earnings continue on their negative trajectory, then the market P/E ratio will be even higher before the summer is over.

STRATEGY FOCUS

Equity & Fixed Income Strategies
With Brexit dominating the news and creating a global downturn, we still ended the quarter with a rebound. Within the S&P 500 yield securities carried the way, as telecommunication services and utilities performed the best, up 21.83% and 21.23% respectively, YTD. Financials continue to lag, off 4.15% to close the quarter. Health care saw signs of life at the end of the first quarter, and continued to gain as we ended the first half of 2016, posting a YTD return of 14.26%.

As to be expected, our dividend focused strategies performed well in this yield-focused market environment, with our Diversified Income Strategy again leading the way. While individual stock selection in consumer discretionary and no exposure to utilities had a negative impact, overall stock selection, primarily in health care and consumer staples enhanced our positive performance. This was also the case for our Total Return Strategy.

Our Small/Mid Cap Value Strategy under-performed for the quarter, with positions in information technology having the most significant impact. Not surprisingly, information technology was the worst performer in the S&P 500 for the month of June, down 5.47%. The Large Cap Value Strategy posted a negative return for the quarter, with consumer discretionary positions pushing the return down.

[1] PCM obtains all financial/performance data cited herein from Bloomberg, S&P Dow Jones Indices, and Russell Investments, as applicable.

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Palouse Capital Management, Inc., formerly Ken Roberts Investment Management, Inc., a boutique asset management firm founded in 1994, providing active asset management nationally to high net worth individuals, foundations and endowments, corporations, and public funds. The firm's fundamental "value" philosophy is consistently applied across the core equity strategies; Large-Cap Value, Large-Cap Value Total Return and Small/Mid Value. The firm also offers a Diversified Income Strategy for those clients seeking income from diversified asset classes, which may include fixed income, equities, preferred stock, REITS, and other income producing securities.

