Palouse Capital Management, Inc.

Investment Commentary

3Q 2016

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MARKET OVERVIEW

What's wrong with this picture? So far in 2016, the S&P 500 index has risen in each quarter of the year, while earnings of the companies in this index are expected to be down (analysts are expecting a decline of 1.5% for the third quarter ended September 30) for each of the first three quarters of the year. Of the 3 quarters thus far in 2016, the third quarter has been the best one of the year for stock prices.

What gives? The markets have historically been forecasting mechanisms, and it could be that the market is forecasting and pricing in a pick-up in earnings later this year and into 2017. In fact, the current analyst estimates forecast an increase in S&P 500 earnings for the fourth quarter and a 13% increase next year.

Another reason for the disconnect between earnings and stock prices may be the impact of central bank policies in other parts of the world (notably the European Central Bank and the Bank of Japan). Specifically, one component of these policies has been the aggressive purchase of bonds by these central banks, which has resulted in government bond yields being in negative territory. The concept of negative rates (in other words, paying someone else to keep your money for you) is hard for us to wrap our minds around, since we have had rates above zero for our lifetimes.

It appears that the central banks believe that if the rates are below zero it will incentivize the commercial banks to make loans since it will cost these banks money to park their excess cash with the central bank. At one time during the year, there was $11 trillion of government and corporate debt yielding a negative interest rate. Here in the US, where we have positive interest rates, investors from other parts of the world are investing money in the US. Not only do US investments offer a higher rate of return, but the US market is considered more liquid and the geopolitical risk appears to be lower.

We discussed in the last quarter strategy letter the problems associated with negative interest rate policies. Since it is now appearing that these policies are not helping these countries' economies, these central banks may abandon them (fortunately the US Federal Reserve had the sense to not go down the negative interest rate path). These negative interest rate policies also can weaken the banking system, and Europe doesn't need any more problems there.

If the US economy continues to strengthen and if these foreign central banks move away from negative interest rates, we could witness increases in interest rates worldwide. This could cause some problems for the US market, but more importantly, it could create a change in leadership; whereas industries that may benefit from higher rates (such and banks and insurance companies) could benefit, and industrials could benefit if the US economy picks up speed. Other groups, such as utilities and bonds, could suffer.

Another thing to watch in the last quarter of the year is the US election. Political commentators have said that candidates "will say whatever they need to get elected, then if they get elected they will do what they think is right". That might be good to remember since both major candidates are proposing a number of things that may impact the markets but in the end very few of the things that are being proposed are likely to be enacted.

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MARKET OVERVIEW CONT.

Heading into the 3Q16 earnings season, our concerns about market valuation have remained about the same as at the end of last quarter. While the S&P 500 index advanced about 7% so far in 2016, the EPS for the index has been flat. As a result, the P/E ratios for the index have remained on the high side for some time. As of the time of writing, the forward P/E ratio for the S&P 500 index was just shy of 17x, which is above the weekly average of 15.3x calculated since the end of the tech bubble in the autumn of 2002. Some market watchers point out that when the general level of interest rates in the economy are very low (as is now the case) that P/E ratios should be higher than "normal". While this makes sense theoretically, it is difficult to prove quantitatively (we have tried).

While a forward P/E ratio in this range is higher than we would like to see – after all, we are value investors – it is not currently so far outside the normal range to make us uncomfortable. Our market model, which examines the estimated earnings and consensus sell side targets for each stock in the S&P 500 index, indicates an overall market upside of 11.7% as of the time of writing. That's a pretty good number in the historical context. We do note, however, that the sell side tends to adjust its valuation metrics relative to the current market picture and therefore there might be pockets of optimism that overstate the upside potential figure.

While earnings season is always an interesting time for equity investors, we think the current one is of particular interest because it coincides with a presidential election and occurs during a time of relatively high valuations and the prospect of rising interest rates. We think there could be above-average equity market volatility in the immediate future. For value investors that's not necessarily a bad thing because it can create situations in which "new idea" securities become temporarily oversold. We therefore anticipate a busy earnings season in which we will put above-average levels of cash to work for our clients.

STRATEGY FOCUS

Equity & Fixed Income Strategies

As mentioned above, the S&P 500 has posted a positive return each quarter this year; however, it has not been all clear sailing. We closed last quarter with Brexit dominating the news, and we end 3Q16 with political and financial events weighing on the markets. Historically, September is the worst-performing month for the S&P 500, and this year we find 7 of the 11 sectors posting a negative return for the month. Financials continue to be under pressure, and is the only sector to be in negative territory YTD. Energy and information technology are the main contributors to the S&P 500's positive performance YTD.

Last quarter we discussed the yield-focused environment, and that theme continued into 3Q16. Our Diversified Income Strategy again out-performed its respective indices, with stock selection within information technology and financials performing well. Our under-weight in utilities also benefitted performance. These sector attributes also contributed to our strong performance in our Large Cap Value Total Return Strategy.

Our Small/Mid Cap Value Strategy rebounded in the quarter, and performed in-line with its index, due primarily to stock selection in financials. No exposure to utilities was also a plus. Our Large Cap Value Strategy slightly under-performed the S&P 500, with positions in consumer staples detracting from the overall performance. Our individual selections in financials and information technology aided in posting a positive return.

Conference Call and Podcast

All of our clients are invited to our weekly podcast and conference call. In each of these programs, Ken Roberts and Bryn Harman discuss market developments and trends that we observe in our week to week research efforts. Please contact Bryn Harman at bharman@palousecap.com for more information.

[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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