First Quarter Thoughts by The McNamee Group

Be Cautious: Don’t be part of a stampeding herd of investors.
   It’s time to break away from the Herd!
Please focus on suitability as you review your asset allocation.

At this point, The McNamee Group at Morgan Stanley has written many letters including several ‘Our Views’ that detail investor-driven herd behavior. Those letters explain that perception and sentiment can be destructive to financial health and they show that utilizing available economic and fundamental information can lead to less emotional investment decisions which can also be financially rewarding.

To the uninitiated, it can seem counterintuitive that market hype isn’t rooted in economic fundamentals. Yet, time and time again, we’ve watched investors completely ignore important data because they are caught up in the excitement of ‘the moment’.

Rather than use logic, the herd tends to embrace the hype of a 24-hour news cycle. The herd is also infamous for throwing money at a bubble on the rise. Recent examples of this behavior include the technology/dot.com bubble of the late 1990s and the US Housing Bubble of the mid-2000s.

Over the years, The McNamee Group has shown that the herd is reactive, illogical, and prone to hysteria. Its size and spending power allows it to stampede with little regard to direction or reason.

1. As you may recall, in our 2010 ‘Our View,’ we projected that the GDP would grow at a subpar pace. We have consistently returned to that view.
   - If our present-day economic projections are correct, an opportunity is occurring.
     Were the GDP to grow at a rate higher than subpar, it could please many of us (like the US Government, the Feds, investors, etc.).

2. Previously, we stated that increasing demand could grow the GDP at a rate higher than subpar but it could be difficult to achieve. Also, we realize that tighter restrictions have been imposed on those who lend, making it difficult for many potential borrowers (therefore limiting GDP growth).

3. Since our November 2014 ‘Our View’, we’ve opined that from laymen to policy makers, many investors (i.e. the herd) continued to ignore the all-too-clear signs of the ‘slower for longer’ GDP growth, interest rates and inflation, any of which should limit stock price appreciation once valuations are extended; we continue to worry that today’s fundamentals/valuations could cause instability like they have in the past if negative issues appear (such as: if China had issues we don’t see at this time or if the oil price stayed significantly below $40 a barrel). Such willful blindness by the herd will probably become obvious when the market finally starts to correct; (that correction looks like it could be happening now). This changing circumstance, more than anything, is why we continue to focus and lecture that investors should watch tailwinds and be concerned if tailwinds turn into headwinds – but so far, so good.
The unnaturally low Fed Funds Rate can’t easily stop a stampede.

Remember, we believe that stampedes originate from F.E.A.R. – which stands for False Evidence Appearing Real.

In the middle of December, the Fed inched rates up a bit, which didn’t seem to surprise investment professionals. Regarding the raised rates, we believe the Fed saw danger at staying at a 0% Fed Fund rate (particularly due to the fact that the Fed Fund rate was stuck at 0% since 2008). At a 0% rate, we believe it’s difficult to impossible for the Fed to come to the rescue with a lower rate to help stimulate the economy.

The health of our economy is formed from many factors (i.e. monetary, fiscal policies, sentiment, and future fundamentals, to name a few). A healthy economy helps us all, so the United States, and in fact the world, is dependent on the tools we all have to keep us afloat. In our opinion, the world’s major instrument for dealing with market contractions so far have been monetary policy, but since the world is awash in cash and many countries have resorted to this policy, we believe the tool can become fairly useless.

For the United States specifically, Fed Easing was such a tool. However, it looks to us like it has been blunted through lack of lending by the financial institutions and by limited desire from those corporations and individuals who have the ability to borrow at will – but don’t borrow.

We believe that the Fed Funds rate will edge up a little more; we believe this rise in the rate is a good thing, because it allows the Fed some ability to stimulate the economy if it starts to decline. We’ve mentioned before in the ‘Our View’ letters that significant Fed tightening in an environment like the one we find ourselves in (full of high valuations coupled with unfavorable market internals) could be a very bearish event but it’s also nice to see signs that the United States is starting, to perhaps, slowly back out of this no to low Fed interest rate trap which also, over time, can create a bearish event!

At this point, The McNamee Group believes that there is no indication that global economies will overheat; we feel that subpar growth should be the norm due to low inflation, slow growth, higher saving rate, full employment (with many at or below $15 an hour) and near-zero real rates.

Since the 2015 ‘Our View’, ‘Where’s the Beef?’ (aka economic stimulus).

We have been asking ‘Where is the Beef?’ because ‘Beef’ could aggressively drive GDP growth.

We realize that the risk of deflation hovers over us these days; in our opinion, deflation seems far more likely than the risk of inflation (we feel that inflation is not an issue right now). As we speak with our clients, we’ve noticed that almost none of them are worried that inflation will strap us to an economic roller coaster which could cause higher interest rates and jump start recession fears. Rather, they seem to express the fear that the risk lies in a global economy that could fall down a deep rabbit hole, similar to the one Japan has travelled down for about 25 years, where growth is stymied and no one seems to have the magic pill to quickly grow it back to the right size.

The McNamee group suggests that all investors review asset allocations and investment suitability regularly to ensure that their investment plans are properly aligned with their goals.
Conclusion:

Since the beginning of 2016, the stock market has been very volatile. The McNamee Group strongly feels that there is light at the end of the tunnel and we believe that it is day light (…not another train on a collision course with the economy!). However, we feel that it will take time for investors to realize this (perhaps until the end of 2016).

This brings us to the current moment in time. In our considered opinion:

- The Fed has neutered itself with extremely lower interest rates (i.e. it has been lower for longer).
- Our economy has been awash with liquidity resulting in low or no returns for many investments such as commodities and many types of fixed income vehicles.
- Companies have taken advantage of the massive amounts of available liquidity. They have borrowed at low interest rates to buy back their own stock which we believe has helped support their stock prices.
  - Please realize that corporate valuations were higher at the time of our July 2015 conference call than they are today.
  - In July 2015, based on the estimated earnings for 2015, the S&P 500 was selling at about 18x. Today, based on the estimated earnings for 2016, the S&P 500 is selling at about 15x. We think this is a positive development for stock investors.
  - In July 2015, we said that the S&P 500 (which was at 2100) was overvalued. Today, based on the 2016 estimate earnings for the S&P 500 (which is 1850+) it seems to us that the S&P 500 is at an attractive valuation.
  - If our economic projections are correct, this scenario represents an opportunity for investors that seek out additional risk.

But wait – there’s more...

Here are a few reasons why we don’t see signs of a pending recession in the near future:

1. The yield curve is positively sloped. (We believe a negative sloped yield curve could cause a recession as it usually correlates with a declining stock market.)
2. In our opinion, bank financial statements (on average) are in the best financial shape that Ed McNamee has ever seen in his 49 years as a Financial Advisor.
3. The world appears to be united in their intention of preventing economic disaster; the world is focused on GDP growth and aggressive monetary policies.
4. Commodities are very low, therefore fear of inflation and rising prices are contained.
5. The US is enjoying low inflation and low interest rates.
6. We do not see any ‘bubbles’ that could take the US economy down.

In our opinion, unique issues around the world are intertwining which could affect every country (and every person) in ways that can be difficult to predict. Nothing in this world happens in a vacuum; rather, events and other variables combine in unexpected ways to shape a future that is difficult to predict with accuracy. Often, we find that it’s hard to see all these things in the current moment – but we firmly believe that a positive change can happen in, what seems to be, a blink of an eye.
So what are the greener fields that we (and the herd) are searching for these days? They should include fiscal policy changes that would be simulative to the economy; a stabilization in the price of oil; and better earnings for the stock market. As 2017 approaches, greener fields should include a population that feels optimistic about the United States and a political system that works on behalf of the people. It certainly should include job growth as well as simulative policies (think ‘our 10 Solutions’) that help the GDP grow as well as the continuation of old and new tailwinds that keep things moving forward.

So in the meantime, The McNameee Group watches and waits. We practice vigilance which we believe will allow us to continue to inform our clients and guide our investors to react to the market shifts before the fear-filled herd tramples everything in sight. This keeps us on track with our overall mission—to navigate our investors to what we believe will be greener fields just ahead.

The views expressed herein are those of the author and do not necessarily reflect the views of Morgan Stanley Wealth Management or its affiliates. All opinions are subject to change without notice. Neither the information provided nor any opinion expressed constitutes a solicitation for the purchase or sale of any security. Past performance is no guarantee of future results.

Investments and services offered through Morgan Stanley Smith Barney LLC. Member SIPC

February 4, 2016