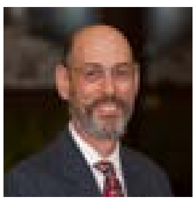
SEGALL BRYANT & HAMILL

1ST QUARTER 2016

SBH NEWSLETTER

Thoughts on the Current Environment



Ralph M. Segall, CFA, CIC
Chairman, Investment Policy Committee

"I'm walkin' down that long lonesome road, babe Where I'm bound, I can't tell"

Bob Dylan, "Don't Think Twice, It's All Right" Special Rider Music, 1968

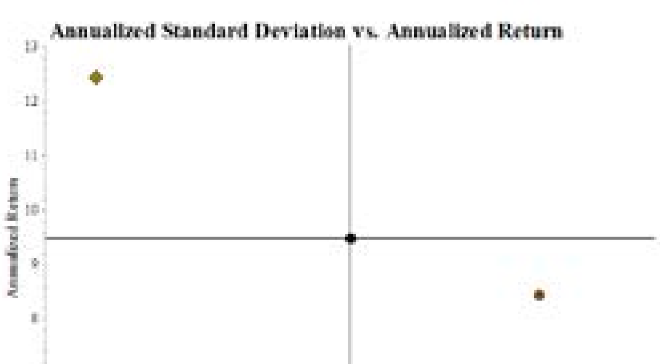
The U.S. Federal Reserve's action to raise short-term interest rates in late December brings us to the end of a long road called Unconventional Monetary Policy, a path on which the U.S. economy embarked back in 2008 as the banking crisis came to a full boil and a recession ensued. As we come to the end of this road, we find ourselves at a "T" intersection. Turning one way will bring us onto the road to growth and prosperity. On that path, the handoff from using monetary policy tools to fiscal policy tools (tax code revision, regulatory changes, spending, and budget activity) will proceed smoothly, and the journey that the current upturn represents will continue and likely even accelerate. Turn the other way, however, and the road will remain bumpy, with enough obstacles to keep the speed of our recovery journey slow and tentative. The existing potholes we have had to navigate will prove to be nothing compared to the road surface on the alternative choice, and it will be a harder and slower drive. (And it will sleet and rain, too!) Unfortunately, the signposts as we approach the intersection have been uprooted, and we can't be sure which way to turn. More importantly, we need to know what to pick up at the convenience store a block or so in front of the intersection. What we will need to bring with us will be importantly influenced by which road we travel down. While we don't know the correct way to turn, we do have some thoughts on the shopping list we should carry into the "Investors' Convenience Store" that is quickly approaching. We'll share the list in a bit.

There are some things one can know and some one can only suspect. A few things we know: entering 2016, we know that a recovery has taken hold in the U.S. economy. Employment growth is running at sustainable levels. While wage growth is modest at best, inflation has not reared its ugly head, and real incomes therefore are growing. (As a complete aside, if I could show the preceding two sentences to any economist, whether a policy maker in the government or a strategist in a private firm, back in the 1970s, they would have thought this essay to be science fiction at best. They could not imagine the economic order could have healed so well after fighting the inflation beast for so long.) Other regions of the world are not in as good shape as the U.S. In Europe, while the European Central Bank is continuing non-conventional monetary policy with gusto, a potential recovery is at risk due to the geopolitical risk of refugee flight and terrorism.

China, the lynchpin of the Emerging Market block, is pulling out all the stops to keep its economy growing at an "acceptable" rate, which the government now acknowledges will be less than the 7% it previously would have customarily assumed. Devaluing their currency further may be the next step. In short, with the exception of the U.S. and the U.K., policy makers around the globe remain actively trying to stimulate their economies, mostly with monetary tools and thus far with only tepid success.

Among those things we can only suspect: We don't know what China's growth rate truly is at the moment, but we can infer from the global weakness in critical commodity prices—oil, copper, and money—that the Chinese economy is not yet back into a strong growth trajectory. We can speculate about what the persistent weakness in commodity prices is signaling. One possibility is that income, relative to capital, remains in very short supply. As we have written on these pages before, the total burden of debt—public and private—has not declined significantly since the Great Downturn (see Chart 1 below).

Chart 1
Debt as a % of GDP (Non-Financial Sector)
G7 Region



Instead, the debt has moved from being the obligation of private borrowers to public ones, so that business and consumer balance sheets are in relatively good shape.

Governments, on the other hand, would be hard-pressed to borrow large incremental volumes. Governmental budgets could be severely stressed if central banks lost control of short-term interest rates and those rates rose sharply, thus raising borrowing costs. While that is not likely to happen, as much as savers would relish the thought of higher interest income, it remains a risk. As a result of the policy decision to keep interest rates pegged at near zero (which is what "Unconventional Monetary Policy" really means), we have seen two adverse consequences. First, the return on financial capital has been reduced (see Charts 2A and 2B below).

Chart 2A
3-Month T-Bill Yield - Past 30 Years

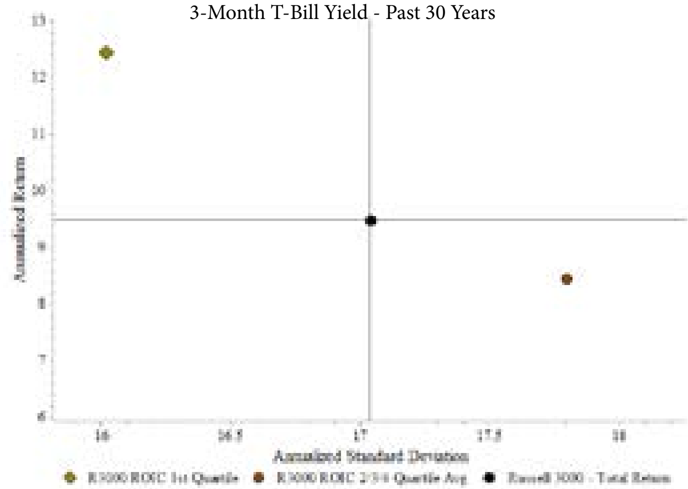
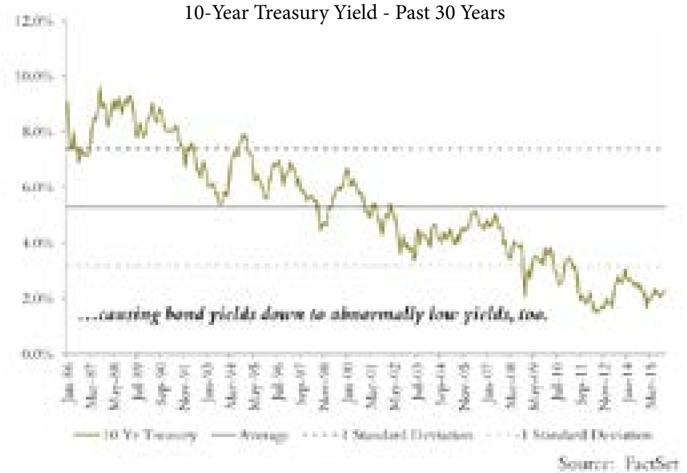


Chart 2B
10-Year Treasury Yield - Past 30 Years



Rippling out from a zero percent return on savings accounts or money market funds, investors have moved steadily out of the risk profile, either in terms of maturity or quality, to seek out higher rates. As a result, this behavior has consequently bid up prices on riskier assets to probably unsustainable levels. This motivation has also been one of the driving forces in the stock market, which has appeared to be the only game in town, and has attracted greater allocations from investors, heedless of the risks that can entail. As Chart 3A suggests, valuations are not cheap, and the driver of profit growth this cycle, the expansion in margins is at historically high levels, as shown in Chart 3B.

Outside the financial markets, real assets are experiencing the same trend. Acceptable rates of return, at least by historical standards, on real estate—from farmland to commercial development—are hard to find. Commodities are in over-supply. Precious metals prices continue to erode. Corporate managements are finding it difficult to authorize major additions to capital spending projects, such as plant and equipment. It is not a coincidence that the merger and acquisition boom of 2015 took place. Managements concluded that the best return on their capital is to buy another company and increase profits by reducing costs. An equal alternative has been to shrink the capital base by buying back stock, reducing the "excess" capital being held in cash back to their stockholders to have them figure out where to deploy it.

The good news from the foregoing is that it does not suggest that a recession is likely. Economic downturns occur because there is an excess in an economic system that has to be liquidated, a process which disrupts current activity until the excess has been dealt with. There are no excesses to speak of that could cause systemic problems. Energy supplies are more than plentiful, industrial operating rates are within normal ranges and employment growth can be easily accommodated by drawing from the group that has dropped out of the labor force. The U-6 unemployment rate, which measures that trend, has begun to fall in concert with the more conventional unemployment series. One might not want to own commodity producers (or a mine) or energy producers (or oil wells) in the next year or two, but the price of those assets can be reduced to a level that will bring supply and demand into balance, at the expense only of those in that sector. More importantly, it does not appear that these stresses will leak into the banking system to ripple broadly throughout the rest of the economy.

The bad news from the foregoing is that we have not gone through an economic cycle in which the "excess" was the capital stock.

Chart 3A
S&P 500 Price-to-Earnings Ratio

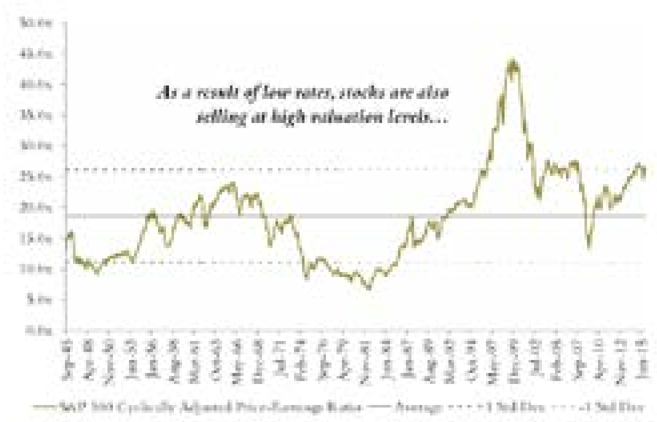
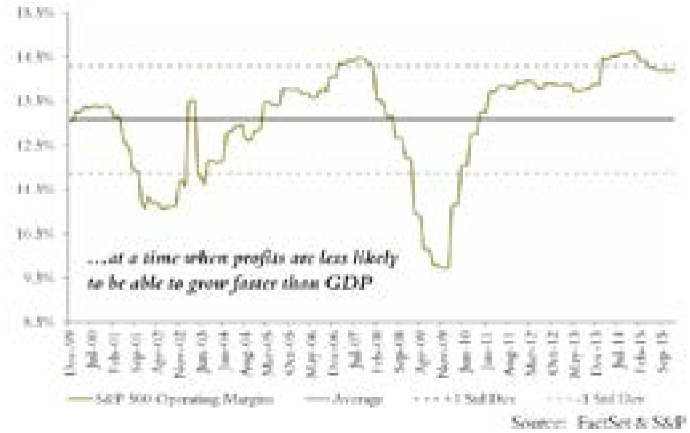


Chart 3B
S&P 500 Operating Margins



We do not know how the shortage of investment income will harm savers, whether those savers are individuals who are living in retirement on their capital, or trustees of an endowment or a municipal pension fund. We do not understand how the feedback loops which are part and parcel of any economic system will play out. Will this lack of income interrupt the recovery? Would a significant increase in interest rates or a significant decline in the stock market upset spending plans that businesses or consumers have? These are indeed confusing times.

And that brings us to our shopping list for 2016. When we pull into the parking lot of the "Investors' Convenience Store" that our investment vehicle is approaching, what should we be sure we buy for our trip in 2016? While our car is probably already packed with plenty of high Return on Invested Capital (ROIC) stocks (which are very nutritious and long-lasting, and which can carry us for a long while if we don't encounter another convenience store along the way), we probably don't want to add much in the way of fixed income securities. Our fixed income team believes that there are opportunities within the short-term segment (1 to 5 years in maturity), but they are concerned that longer-dated bonds are rapidly approaching their "sell-by" freshness dates. What we might find ourselves packing is more cash than we would normally take along. Cash, it is true, is like a zero-calorie drink in that it produces next-to-no return today; however, it also provides us with a great deal of flexibility to respond to whatever unusual set of circumstances we encounter. Flexibility and patience are good attributes for anyone taking a long journey, which investing surely is.

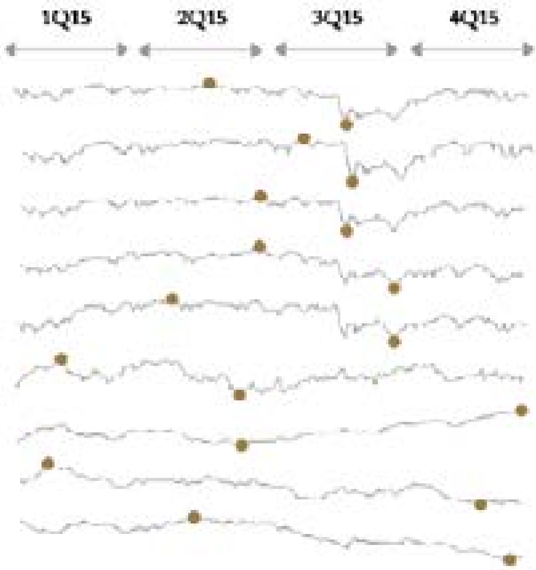
We wish you and your portfolio safe travels in 2016.

Coming Soon!

Watch for exciting new changes to our look and our newly redesigned website scheduled to launch in February 2016.

Market Barometers

As of December 31, 2015



	Dec 31, 2014	Dec 31, 2015	Low	High
Dow Jones Industrial Index	17,823.07	17,425.03	15,666.44	18,312.39
S&P 500 Index	2,027.90	2,035.40	1,856.40	2,108.90
Russell 3000 Stock Index	1,224.11	1,206.10	1,115.82	1,273.39
Russell 2000 Stock Index	1,204.70	1,135.89	1,083.91	1,295.80
Russell Midcap Index	747.89	738.40	696.23	803.63
Barclays Cap Aggregate Index	1,906.01	1,916.49	1,892.08	1,946.50
Barclays Cap Muni Bond Index	1,100.36	1,136.69	1,096.48	1,136.96
Gold (Price/Oz) London AM Fix	$1,199.25	$1,062.25	$1,050.60	$1,298.00
Goldman Commodity Index	3,212.80	2,170.61	2,124.24	3,335.08

Source: Bloomberg

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