VIRGINIA GLOBAL Asset Management, LLC

409 Yarmouth Street, Norfolk, VA 23510
P 757.962.7976 www.virginiaglobal.com

ROUND AND ROUND AND UP & DOWN WE GO AGAIN
INVESTMENT STRATEGY
MARCH 31ST, 2016

Looking Back:

In our last investment strategy piece, we said, “choppy markets, but no recession.” Although we were right on both counts, the bloodshed was even greater than we expected. From year end, the market proceeded to decline 11.5% to 1810 on February 11th, and at one point we believe that about 80% of stocks had declined 20% from their peaks in 2015. The stock market then proceeded to rally almost 14% to end the quarter with a small positive return (with dividends reinvested) of 1.35%. That is where I thought (at year end) we would be by about the third week in January. Two and a half months later, after a nasty detour, we’re there!

Looking Ahead: The Bottom Line – Higher Stock Markets by Year End, But a Trading Range until Late 3rd or Earth 4th Quarter

We continue to expect the S&P 500 to reach a value of 2200-2300 by year end or no later than the third week of January, 2017 as the market reflects 6%+ increases in Index earnings for this year and next. Since the market is an anticipatory mechanism it should be anticipating some of 2017 earnings by year end. Usually, the stock market’s year-end rally continues into January. (It did not this year!)

Reasons to be Positive: Aggressive Monetary Policies Globally

One of the key reasons we tend to be positive about the outlook is that we continue to see aggressive monetary policy almost worldwide. In Europe the ECB has recently announced a 33% increase in its open market bond purchases from Eu60 billion a month to Eu80 billion – i.e. it is putting almost Eu 1 trillion into the financial markets annually. Much of this money will end up and remain in financial assets. Japan and China have also been following aggressive monetary policies.

Furthermore, the US has backed off its hawkish(tightening) stance that has made investors hesitant to invest until very recently, as is seen in the stock market’s recovery by quarter end. With inflation at about 1.7%, the Fed undoubtedly is anxious to raise short term rates (now at 0.25%) to that level. However, the Fed clearly indicated that it was willing to take global conditions into account in the execution of policy in the US. We see this as appropriate given the globalization of trade. It is the Fed’s relative comfort with inflation levels and the softness of economic conditions worldwide that makes us think that the US Central Bank may continue its cautious stance well into the second half of this year.

These aggressive monetary policies translate to rising financial markets, and the Fed’s consideration of global conditions has led to a slightly weaker dollar. With the dollar no longer rising, the Chinese have less pressure to devalue the renmimbi removing the fear of competitive devaluations by, and bankruptcies among, the smaller countries and companies of Asia. This was the fear witnessed in the first quarter of this year.

Reasons to be Positive: Fiscal Stimulus Being Added to the Policy Mix

But more importantly, we are beginning to see a wider recognition that monetary policy alone is not very effective at creating growth without fiscal stimulus. i.e, additional spending by governments – federal, state, and local. Thus, we saw China late last year, and now Japan and the UK also adopting stimulative spending measures in addition to their monetary policies. We would expect such measures here in the US after the election, regardless of whom gets elected. Such spending is usually seen by the marketplace as creating greater investment by and profit-ability for businesses.

Several other economic factors are encouraging as well. First, China's government is prepared to have a (simulative) deficit of 3% of GDP (versus 2.3% last year). The increase is worth some $700 billion in a $10 trillion economy. The government is prepared to use its old methodology of investing in infrastructure while it consolidates its steel and iron ore industries. Both steps are good for commodity countries and companies. Thus, we have had commodity stocks rally significantly this year after a horrible 2015.

Looking at the composition of Chinese growth, we see a services/consumer sector growing at 10% plus; the industrial sector has virtually no growth as both industry consolidation and slower growth in exports and investment limit growth in this side of the economy. Having said that, the consumer sector is now larger (at 50.5%) than the industrial sector (at 40.5%), but still has a long way to go before it reaches the 60%-70% of fully developed economies. But given the importance of employment, (and therefore growth) to the Chinese leadership, we do expect investment to increase this year in order to keep employment stable. Without such investment growth statistics may show only a 6%-6.5% growth rate for China – still quite satisfactory given the size of its economy.

Risks to Outlook:

Brexit

But we have several hurdles to cross before we reach higher values for the S&P 500. The first is "Brexit," i.e. the referendum on June 23rd, on whether Britain should exit the European Union. Already the Pound Sterling is hitting new lows over fears that it will leave. A departure would leave uncertain many economic issues, among which trade agreements would be paramount. Departure might cost somewhere between 2%-6% in economic growth until the new order is created. The uncertainties would cause consternation among investors. Our judgment is that the vote will be to stay in the Union but it might be a closer call than is now reflected in the polls. It is the politics of immigration (of Syrian refugees) and the fear of letting terrorists enter the UK from other places in the European Union that has increased the "leave" vote.

US Interest Rate Increase

The second hurdle is Federal Reserve Interest Rate policy. With core inflation (i.e. without food and energy costs) at 1.7% on a year over year basis, the Federal Reserve Bank has to be anxious to raise interest rates lest it get too much behind the inflation curve. (Usually, short term rates equal the inflation rate.) But it does not wish to do so unless it can feel relatively sure that doing so will not affect global markets including those of the US, adversely – as it did in December through February. As a result, good economic news in the US is going to be seen by investors as "bad" news because of fears over the Fed's response. Historically, the stock market has not responded adversely to a normalization of rates, but normalization in this case may create at least short term stock market declines because of the fragility of the global economy.

If the Fed holds off raising rates here, it suggests that the dollar will be soft if not weak, translating to better profitability for all our globally based corporations. This too, will support the stock market. If the Fed raises rates in the April-June time period, we would expect to see a decline in US stock markets.

Greece

Our third concern is Greece – which is negotiating right now for continued financing from the EU. While we think the Greek politicians have learned that playing hardball with the EU costs them economically, and while we suspect investors may have become inured to the ever present Greek crisis, still a serious breakdown in negotiations could leave financial markets in distress.

Slower Growth in China

Our fourth concern is that China may have slower growth than the market place expects. While the service sector is now larger than the industrial sector, a lack of growth in the later will concern investors because growth in the industrial sector impacts the import of commodities which in turn helps those countries that are primarily commodity export driven. Thus, the additional investment by the Chinese in infrastructure should be helpful to growth on the industrial side of the economy. But if growth comes in at 6%, we should see, government protestations to the contrary, fears of currency devaluations and difficulties in other Asian countries in addition to China. We would expect to see government support for its currency, which given the substantial size of their reserves could well be effective.

Lower Energy Prices

The oil industry remains a concern as it will take a while before excess production (over demand) is within eyesight of being eliminated. The global industry continues to produce more oil than the world needs. The offer by OPEC to freeze production is a "non offer." The Iranians can't produce enough oil yet to regain their market share prior to the imposition of sanctions. A freeze would ostensibly prevent that. Also, the Saudi's and the Iranians (represented by the Houthis) are fighting in Yemen making Saudi hardly amenable to agreeing to a compromise over market share with the Iranians. Therefore, we expect no freeze and continued production by all at maximum output until low prices force out marginal producers, including some in the US.

If the head of Chevron's projection that starting this month oil production should begin to decline by 100,000 barrels of oil per month, the excess production could be eliminated within two years. In the 4th quarter of last year excess production was 2.24 million bpd. Rising demand for oil, given its price decline, should also contribute to the gradual reduction of the oil glut. Having said that, the rise in oil from $26 to just above $40 is not sustainable near term without at least a nominal freeze that is seen as part of a larger effort to agree on production cuts. We don't see this happening yet.

Thus, we remain convinced that oil (West Texas Intermediate) will stay about $30-$40/barrel but not much more in the near term. While a price in the low 20's is possible, it won't last very long as it would shut down production rapidly. Somewhere between $20-$30 barrel, depending on the company, the price is below the cash cost of producing the incremental barrel. Below $40 the price is impacting the ability of producers to meet their cash costs of production and service their debt.

The recent rise to just over $40/barrel is a function of market hopes that OPEC will agree to a production freeze and perhaps a production cut. The recent rise also reflects expectations of production cuts over the coming year. Price volatility can be expected as hopes or fears about the strength of global growth rise and fall. Stronger growth implies higher oil prices. As the bankruptcies and buy outs occur, we may see some distress in the financial markets, although eventually the production decline should result in better prices (which then slows the production cuts!!!) A significantly higher price than $40/barrel is above the marginal cost of much production, slowing the decline.

Political Uncertainty

And finally we come to the political uncertainty here in the US. Regardless of what the Republicans do at this juncture – whether they select Mr. Trump or someone else at a brokered convention, we suspect the winner in November will be Mrs. Clinton. We readily admit we are not very good at politics, and we are an independent, interested primarily in the economic consequences of an election. If Mrs. Clinton is elected, pharmaceutical stocks will remain out of favor, but infrastructure stocks will do well as they are associated with creating jobs.

What to Do: Market Valuation

The S&P 500 stands at a 17 price earnings ratio against expected 2016 earnings. Many observe that this is "overvalued" against the average price earnings ratio of 15 in the postwar period. However, the average valuation occurred during times when the 10 year US Treasury bond interest rates were much higher. Taking into account the competitive pricing of alternative investments in Treasuries, we view the market as still undervalued, and can easily foresee a p/e ratio of 20 before this market cycle is over.

Having said that we believe we are in a trading range between now and the 4th quarter between 1800 and 2100, and thus the title of this piece (from Chubby Checker's "Let's Twist Again Like We Did Last Summer"). We continue to hold our cash and may even raise cash in some cases. We are also looking for stocks that are undervalued in their own right and therefore pose somewhat less risk in a down market. You will see them as we put them in portfolios.

David R. Kenerson, Jr.