Altavista Wealth Management Investment Team Commentary: Steady as She Goes – February 11, 2016

The current bout of market volatility is unpleasant and each of our advisors has received inquiries soliciting our opinion on the length, depth and significance of this most recent tantrum thrown by the stock market. The kind of generalized pullbacks we have been experiencing so far in 2016 are an inevitable part of a long-term investor's experience. The exact beginning, extent and ending of these periods is unpredictable but the risks leading toward such turbulence are detectable.

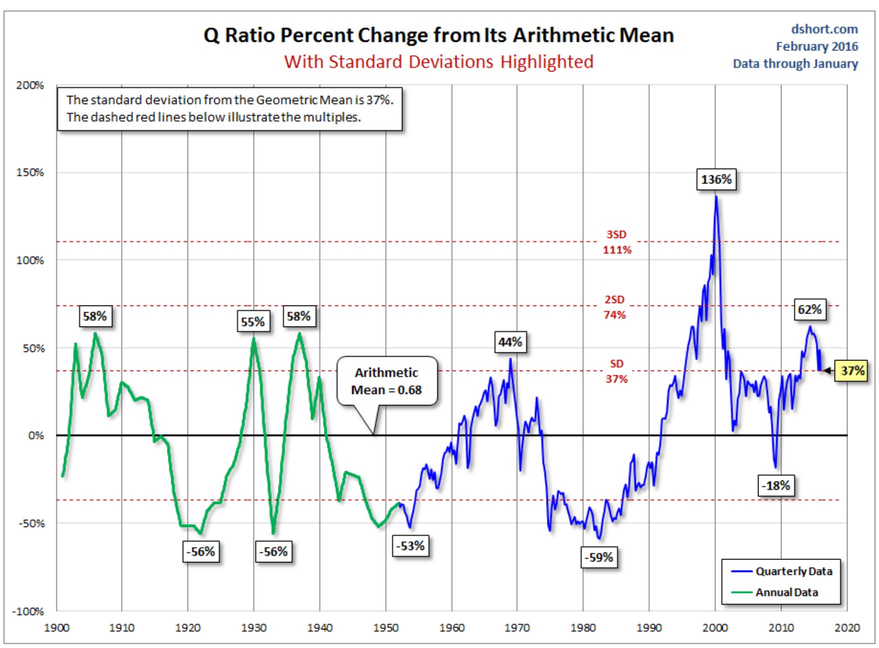
We have recently been sounding a cautious note on stocks in our communications with clients, particularly since the summer of 2014. This caution was certainly not based on clairvoyance, but by a few objective risks we have tracked since the recovery of the stock market began in earnest in 2009. Looking ahead, the market's recent decline effectively discounts these risks making them less of a concern than they were just a few months ago.

The important factors driving our recent concerns were:
1. Valuation or how expensive stocks are relative to history and other assets
2. The effect of extraordinary monetary policy pursued by the Fed and other central banks and
3. The sustainability of elevated profit margins enjoyed by U.S. public companies.

These factors were useful in charting our cautious stance of late and we believe will be valuable in making judgments regarding the current and future risks and rewards available in stocks.

Valuation

The price declines that began in the late summer of 2015 have improved the valuation parameters we track for the stock market. One of these is Tobin's Q, an estimation of modified book value for the companies of the S&P 500. In the summer of 2014 Tobin's Q was approaching a value that placed it on the doorstep of the 2nd standard deviation above its average over history.



Those of you who endured Statistics 101 in school will recognize this as a real outlier observation indicating over valued stock levels and a risk to be considered among other factors. Tobin's Q now sits just above the 1st standard deviation or almost "normal" levels.

Fed Policy
Since early 2014 it was clear the Fed's open-ended commitment to quantitative easing or "QE" was set to end. Though the timing and pace of this change and the subsequent rise in short term rates (those rates controlled by the central bank) was up for debate. Our conclusion was that when policy did change, as it finally did in December of 2015, it would be more likely to be negative than positive for stocks and so added another factor supporting a bit of caution. Now that the Fed has raised short term rates, the uncertainty associated with this policy change is reduced.

Profit Margins
Profit margins on the S&P have averaged almost twice the historical average in the last few years. There were sound reasons to believe that the average company in the S&P is structurally more profitable than in the past (think software vs. manufacturing. However, even after adjusting for the changing mix of businesses, the oversized margins enjoyed by U.S. companies seemed set to return towards average.

The very recent trend of rising wages means higher expenses and thus lower margins for U.S. businesses. This justifies our recent concern regarding lower profit margins. Analysts who provide estimates of future earnings have downgraded these estimates in part due to higher anticipated expenses. We think the current decline is at least partially recognition of the more challenging earnings picture.

It is next to impossible to reliably predict the stock markets short term advances or declines but the kinds of risks that ultimately lead to a change in market direction can be monitored. Risks to the market can be followed reliably but tend to be relevant only over the long term.

The valuation, monetary policy and earnings concerns we have espoused in the recent past are less of a concern at current market levels. We think a "steady as we go" continuation of our mildly cautious stance is warranted. Improving valuations and greater earnings visibility make it likely our next tactical recommendation is to increase stock allocations in client accounts.

– Kyle Boyd and the Altavista Investment Team

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