NOTTINGHAMADVISORS
ASSET MANAGEMENT

"The best argument against democracy is a five-minute conversation with the average voter."
-Winston Churchill

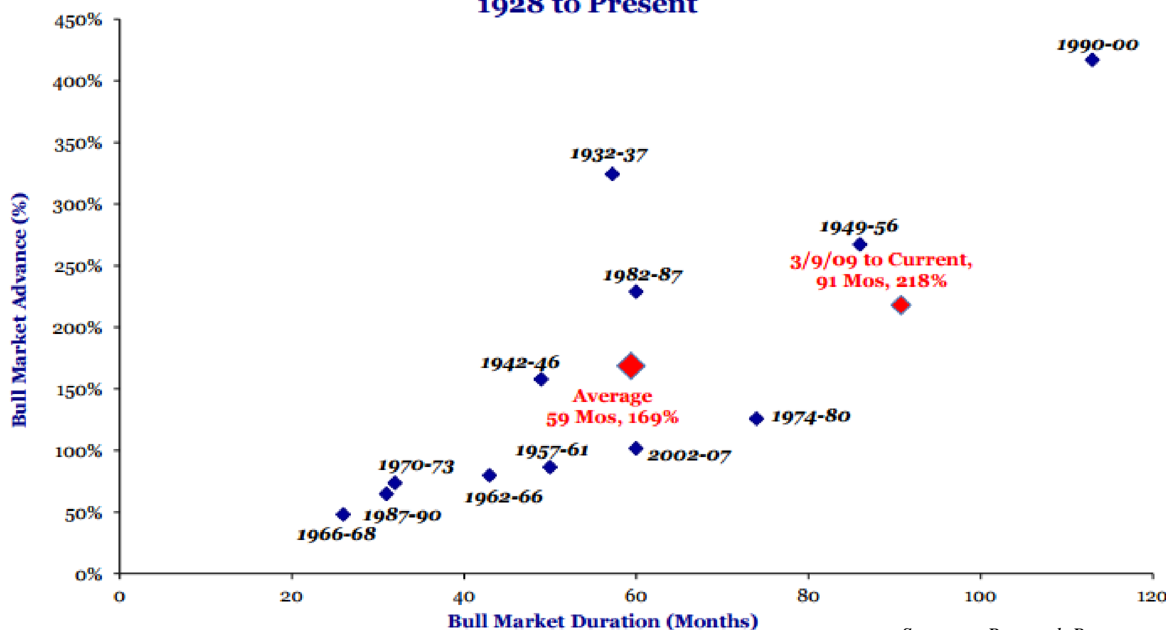
Q3 2016 Investor Letter

The Fed. The Donald. The Cubs. Will 2016 turn out to be the year of strange eventualities? Will the Fed actually muster up the courage to raise interest rates in December? Will Donald Trump overcome myriad self-inflicted wounds to claim the Presidency? Will the Chicago Cubs erase over 100 years of futility by winning the World Series? It's going to be an interesting 4th quarter to say the least!

But before discussing these possibilities a little further, let's look back at the 3rd quarter and see if we can divine some insights from the increasingly erratic financial markets. The much-hated equity bull continued to march ahead, despite growing investor skittishness and poor fundamentals. Bond investors were granted another subtle warning that rates may be headed higher. Alternative investments continued to see hedge fund closures and fee compression following five years of lackluster returns. And lastly, commodities showed some signs of life following an unanticipated surge in the price of oil. (See Nottingham's September Monthly Market Wrap here for more details).

Stocks

We may have mentioned this before in these pages, but this equity bull market is as long as it is loathed. As our friends at Strategas Research have illustrated below, although this is the second longest bull market in history, it still has a ways to go to be the biggest in terms of the market advance. And with fundamentals crumbling, our guess is that its life expectancy may be counted in months. Strange as it may seem, at Nottingham Advisors we still believe fundamentals matter.



Strategas Research Partners

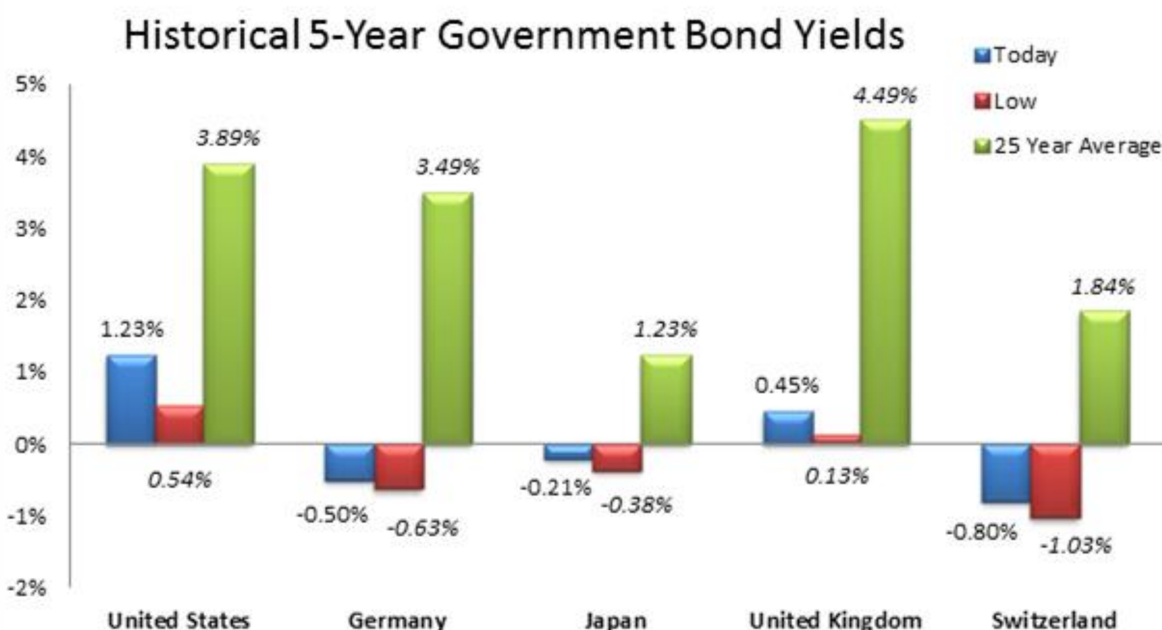
Corporate earnings have declined for the past 5 quarters, while equity valuations have risen. One need only look to artificially low interest rates as the mechanism by which this is happening. By our lights, however, this can't go on forever, and will indeed reverse sometime soon. Either earnings need to increase, or valuations must decline. It's always worked this way.

Diversification has been of little use as international markets have offered meager returns the past few years. Although emerging markets have surged in 2016, we're reluctant to jump on that train just yet. The best of a bad lot continue to be U.S. equities, large caps in particular. However, with declining profit margins, higher energy prices, and little pricing power, companies around the globe will likely continue to struggle to increase profits.

Bonds

The September FOMC meeting could prove to be the turning point in the Fed's 7-year quantitative easing program. We think June's post-Brexit drop in bond yields may indeed mark the end of the 35-year debt super cycle, with gradually rising rates all but inevitable. It is admittedly hard to surmise too much about the future direction of rates given the activist agenda of global central banks. There is, however, a growing backlash gaining steam against central banks, with many seeing quantitative easing as having gone too far, inflating asset prices at the expense of savers and retirees (enriching the 1% while penalizing Main St). Of course, we've argued this for a long time now, and will be thrilled when the Fed finally decides to return control of interest rates to the market.

We continue to favor short to intermediate duration, high quality corporate and municipal bonds in this environment. Investors can earn yields at or above the rate of inflation without taking undue price risk by buying longer-dated debt. Despite deteriorating corporate balance sheets, there remain plenty of high-quality bonds available for those willing to do the research.



Bond investors find themselves in unprecedented times as the chart of negative interest rates above illustrates. Despite these low rates, global growth remains muted, with the latest YoY "growth" rate clocking in at just 1.7%! This tax on savers has been taken to the extreme by foreign central banks. The ECB and BoJ are learning, however, that negative interest rates don't necessarily lead to economic growth. Aside from limiting the ability for banks to make money, they have an extremely deleterious effect on pension schemes. We would anticipate this monetary experiment will be short lived and the legacy of its demise hopefully long remembered.

Alternative Investments

So-called "alt's" have been all the rage over the past decade or two as college endowments and foundations all tried to pursue the “Yale model” of investing. As with any successful endeavor, success breeds imitation, and the number of hedge funds in existence has grown from approximately 500 back in 1995 to over 10,000 today. Subsequently, returns have suffered while fees have remained exorbitant. It's one thing to pay 2% of assets and 20% of profits when the manager is generating consistent double digit returns, but most hedge funds have failed to keep pace with the S&P 500 over the past decade. It's no wonder investors are pulling their money from the space and funds are shutting down.

Commodities

The commodity space is still grappling with the fallout from the slow-down in China, with demand for metals, minerals and agriculture all suffering. Once the darling of diversified investment portfolios for their low correlation to equities, commodities have largely vanished from many policy mixes due to high volatility and poor returns. The sharp rebound in the price of oil seen in 2016 has lifted the fortunes of the broader commodity market, with the CRB Index surging 12.3% through June before trailing off a bit. MLP’s still hold our interest from an income perspective, but our overall exposure to the commodity space remains low.

The Economy

The current U.S. economy has been described by some as a “Goldilocks” economy – not too hot, not too cold. While real GDP growth has been lackluster at ~ +1.5% YoY, it has kept the Fed at bay, ensuring lower interest rates for longer. The challenge has been, how does the economy gain traction when overall aggregate demand is fairly weak? As much as we would all like to see U.S. growth snap back to trend (roughly +3.25% over the past 70 years), this would ensure that the proverbial punch bowl gets taken away and Fed rate hikes would be more the norm than the exception. So, despite the rancor we expressed above, punk growth has had some positive effects if looked at the right way. If you asked most people, however, I think they would gladly trade higher interest rates for stronger growth.

With the Fed out of bullets, it will be up to Congress (scary thought) to enact fiscal stimulus and get our economy moving again. There are plenty of things (infrastructure spending and tax reform for starters) that a bi-partisan Congress could do that would stimulate domestic spending and bring the economy up to speed. The pace with which this happens depends a lot on the outcome of the November elections, which at this point are up in the air. I remain of the belief that a Senate Majority Leader Schumer and a House Speaker Ryan, regardless of the President, will work to enact meaningful legislation. There probably aren’t two more experienced and capable representatives of the people than those two. Fingers crossed.

Fees decline, investors win

Nottingham has employed exchange-traded funds in client portfolios dating back to 2001. We are widely acknowledged as having been early adopters of indexing, building globally oriented portfolios utilizing ETF's. What many of you might not be aware of is that as the ETF landscape has grown from roughly $250 billion in assets back then to over $2.5 trillion today, there has been a behind-the-scenes price war taking place among the ETF providers such as iShares, Vanguard, State Street and Schwab among others.

Recently, iShares announced further price reductions to its ETF lineup, including many funds that are core holdings in our client portfolios. Some of the ETF's we employ cost as little as 0.05% per year, compared to nearly 1.00% on many traditional mutual funds. So essentially, Nottingham's clients are accessing market exposures both domestic and international at some of the cheapest prices ever seen. The less you pay, the more you keep. We like that.

Much of the traction being seen by ETF’s reflects the broader shift taking place away from so-called “active” management towards indexing. Active managers, also known as “stock-pickers” have by and large failed to beat the indexes for much of the past decade, while charging materially higher fees. As I pen this note, the Wall Street Journal is devoting an entire week to articles chronicling this massive shift in dollars, both institutional

and retail, moving from active to passive. ETF's are here to stay thanks to their low costs, purity of style, tax-efficiency, liquidity and diversity. Indeed, more and more investment strategies are being replicated inside the ETF wrapper, which affords Nottingham the opportunity to enhance the value we offer to our clients by building more thoughtful and sophisticated portfolios. We like that too.

Summary

The next 6 to 12 months should be very interesting (by "interesting" I mean VOLATILE) for investors. We certainly think (hope) the Fed will have enough courage to raise interest rates in December. As ironic as it may seem, it's our opinion that modestly higher interest rates will actually be a net benefit to investors and the U.S. economy in general. Although we don't think the path to higher rates will be a smooth one, we're convinced it will be worth it in the end.

As for this aging bull market, well, as Keynes once remarked, “markets can stay irrational longer than one may remain solvent”. So as much as we don't like it, we won't fight it, or look to short it. And, we won't be surprised by a “correction”, or a continued rally. This is the environment the Fed has created and the one in which investors have to live, happily or unhappily. If, as Sir John Templeton once said, bull markets are born in pessimism (2009), grown on skepticism (2010-14), mature on optimism (2015-?) and die on euphoria, we aren't close to the end for we don't see euphoria anywhere. Perhaps that comes with the end of the presidential election when we won't be repeatedly subjected to the nauseating images of two very unpopular and unlikeable people hurling insults at each other for days on end. Whatever the case, when we do detect investors getting excited, you can be certain that we at Nottingham will be getting nervous.

What is for certain in our minds is that as this bull market peters out, returns will mean-revert and investor anxiety will increase. This is usually what happens near the end. Maybe we're in the 7th inning, more likely the 8th. Whether this inning takes a month or a year to play out no one knows. But every end is a new beginning (isn't that a song?), and by keeping one's eyes on the distant horizon, investors can avoid the temptation to make rash or impetuous mistakes so common in investing.

As we enter into this 4th quarter, please let us know if you want to review your tax situation. Well-timed tax-loss swaps can reduce an investor's tax-burden by using losses to offset realized gains. Everyone's situation tends to be a little different in this regard so if you're uncertain where you stand, give us a call. In the meantime, and as something of a public service announcement, did you know that 41 states allow for some form of a write-in candidate for president to be submitted? Just saying...

Happy Halloween,

Larry Whistler, CFA
President/Chief Investment Officer
October 2016

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