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Market Strategy 2016-2017

Capital Markets Outlook

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Recent Gains Mask Long-Term Risks

The recent strong performance of the financial markets in the face of lackluster economic growth and political uncertainties have been impressive. Accommodative monetary policy, which has been the major pillar of support, will be less effective in the future. There may be room for new political leaders to maneuver to a negotiated compromise on select bi-partisan issues. However, we see many risks that could threaten financial asset valuation multiples. Our opinion is that in the medium term (1-3 years) there will be a reckoning in the financial markets for the years of lax monetary policy and subsequent high financial asset valuations. Therefore, we are recommending moderate near-term risk taking (with stock picking emphasis) for our clients, with an eye towards a more conservative, medium- & long-term investment posture.

We Believe the Consensus View Supports:

- **A Stable, But Tepid, World Economic Outlook:** Economies around the globe will post modest results, but will not fall out of bed.
- **Earnings Growth in US:** The 2015-2016 "earnings recession" caused by the strong dollar, weak sales, and declining operating margins will make for easy "earnings beats" in 2016-2017.
- **US Monetary Policy Will Tighten, But Only Incrementally:** US monetary policy is likely to be less accommodative, but it will not change enough to drive valuations lower.
- **Political Legislative Achievement Will Be Low:** Deep, structural problems in the EU will prevent any meaningful political progress abroad, and US politics will remain fragmented and uncompromising.
- **No Threat Big Enough to Derail High Valuation Multiples:** Recent trading suggests that investors believe that capital markets can stomach even major unpleasant shocks, such as Brexit and higher US interest rates.

Our View Differs from Consensus On Politics & Threats

We view a near-term political compromise is possible, which is a major departure from consensus thinking. However, our perception of potential economic threats is worse than market expectations. Therefore, we recommend investors sell into strength, but stay selectively engaged in risk assets.

Potential for Compromise in Next 12-18 Months

At this point, we believe that Hillary Clinton will be the next President of the United States. Despite what may be a decisive win, mutual interest (economic growth) and urgency (saving the troubled Affordable Care Act) will give her political cover to compromise on select bi-partisan goals, such as infrastructure spending and corporate tax reform. This is the basis for a near-term "melt-up" scenario – our most bullish. We would sell into any strength.

There Are Plenty of Risks That Keep Us Up at Night

Declining capital investment, low labor productivity, higher consumer savings rate preferences, and structural budget deficits are all issues that will make the economy feel like it is swimming upstream. More targeted events – such as the Italian financial system, covenant light high yield debt - are examples of issues that have the ability to be a catalyst to worsen market psychology.

Recommendation: Sell & Bar Bell

Our core thesis is that there is a high probability of negative events on the horizon (next 1-3 years) that will depress valuation multiples and warrant a conservative investment strategy. However, we acknowledge the rays of hope that could be temporary boosts to fundamentals (and valuations), which supports select equity exposures.

Sell Into Strength for LT Portfolio Positioning

While there are always select areas of good news and greater possibilities, we believe it will take a major crisis to address a host of substantive structural issues. The current economic environment is not even close to what will be necessary to bring the disparate sides together.

Bar Bell Portfolio Strategy Warranted

However, exiting the equity markets altogether is rash. Therefore, we recommend thoughtful risk exposure towards conservative names in out-of-favor sectors, anticipating the beneficiaries of possible political compromise, and tilting portfolios to be more immune to the risks of higher inflation.

Economy Needs A Jolt

Macroeconomic factors point to just +1.0% GDP growth, well short of what we consider a healthy growth rate. Unless this changes, the future implications will be unpleasant.

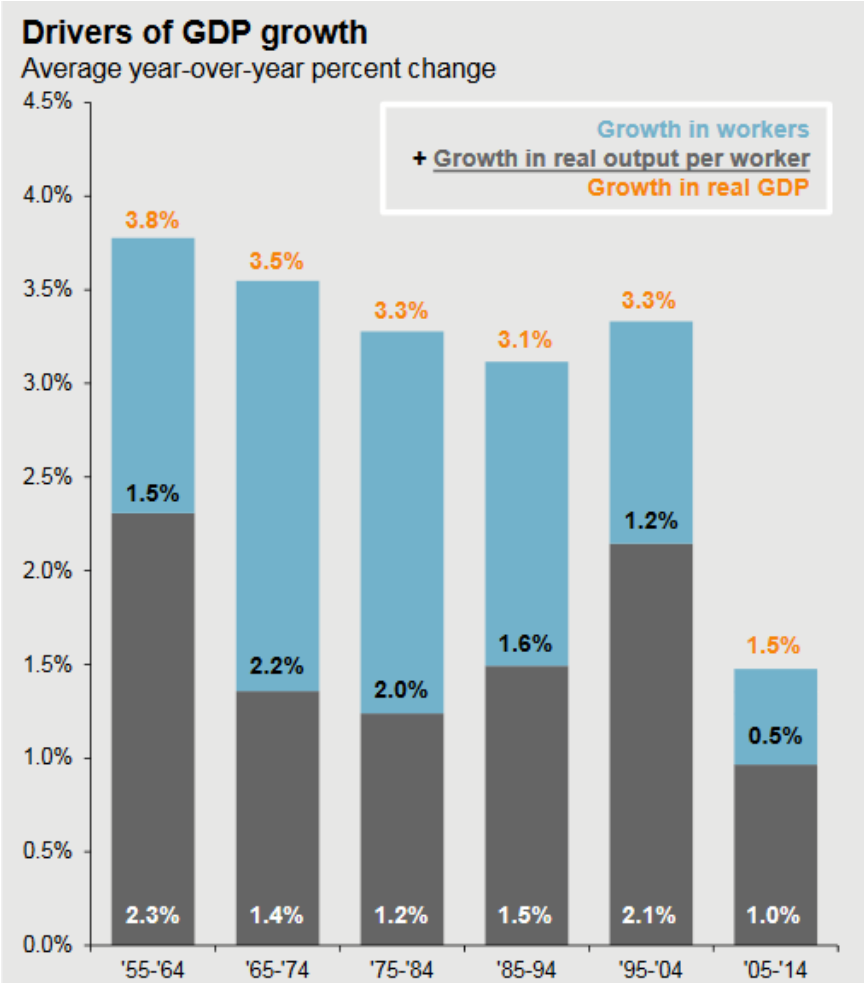
Long-Term US Economic Fundamentals Need a Boost

Low labor productivity, weak corporate investment, fickle consumer spending preferences, stretched government finances and low export growth prospects all combine to offer a lackluster outlook for the economy. Monetary policy measures, from this point on, we believe will have diminishing returns and may in fact encourage poor capital allocation decisions. We see huge potential gains from thoughtful fiscal and tax policy measures that target real income and GDP growth. Upside from first term political compromises would be unexpected and welcome.

Key Components Point to Only +1.0% Long-Term GDP Growth

The productivity of the US workforce is very weak and is a significant long-term problem for the United States. Stanley Fischer, Vice Chairman of the Fed, said: "There are few issues more important for the future our economy, and those of every other country, than the rate of productivity growth."[i] To illustrate Fischer's point, we will use the equation: labor productivity growth + worker growth = GDP growth. In the past 60-70 years, the decade average annual GDP growth has been 3.1-3.8%, comprised of +1.2-2.2% worker growth and 1.0-2.2% productivity growth. Both of these components will likely fall significantly looking forward. We project worker growth at +0.4% and labor productivity at +0.5%, which suggest only +0.9-1.0% long-term GDP growth.

Figure 1: Components of GDP Growth Are Falling

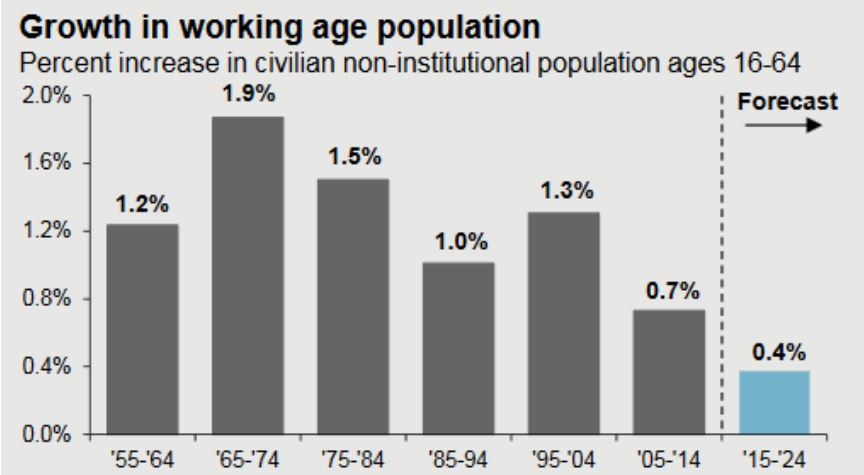


Source: JP Morgan Guide to the Market, Q1 2016, page 20.[ii]

New Workers Growing Just +0.4% in US

JP Morgan forecasts worker growth to be only +0.4% in the United States for the next 10 years, which is a combination of immigration and aging demographics. It is hard to imagine, in the current political environment, passing and implementing immigration policies that are more lenient. Pro-family child support measures may gain political support, but benefits from these policies take decades to bear fruit and are expensive in the near term.

Figure 2: Worker Growth of +0.4% at a 70-Year Low



Source: JP Morgan Guide to the Market, Q1 2016[iii]

Productivity Trends Low, Recently Have Been Negative

The last three quarters of annualized labor productivity have been negative and the six-year average productivity is only +0.5-0.7%. This is well below long-term productivity gains of +1.2-2.3% between 1955-2004. A recent academic work from the Brookings Institution suggests that these trends cannot be dismissed as a measurement problem. [iv]

Table 1: Labor Productivity Trends Slowing, Quarterly Data 2006-2016

Year	Qtr1	Qtr2	Qtr3	Qtr4	Avg.
2006	2.5	-0.3	-1.7	3.1	0.9
2007	0.4	2.6	4.6	1.7	2.3
2008	-4.0	4.0	1.0	-2.5	-0.4
2009	3.1	7.9	6.0	4.8	5.5
2010	2.1	1.5	2.0	1.6	1.8
2011	-3.3	1.3	-0.8	3.1	0.1
2012	0.6	2.3	-0.8	-2.0	0.0
2013	1.3	-0.7	1.7	4.1	1.6
2014	-3.7	2.0	4.2	-1.6	0.2
2015	1.1	1.2	2.0	-2.4	0.5
2016	-0.6	-0.5			-0.6
Since 2010					0.5

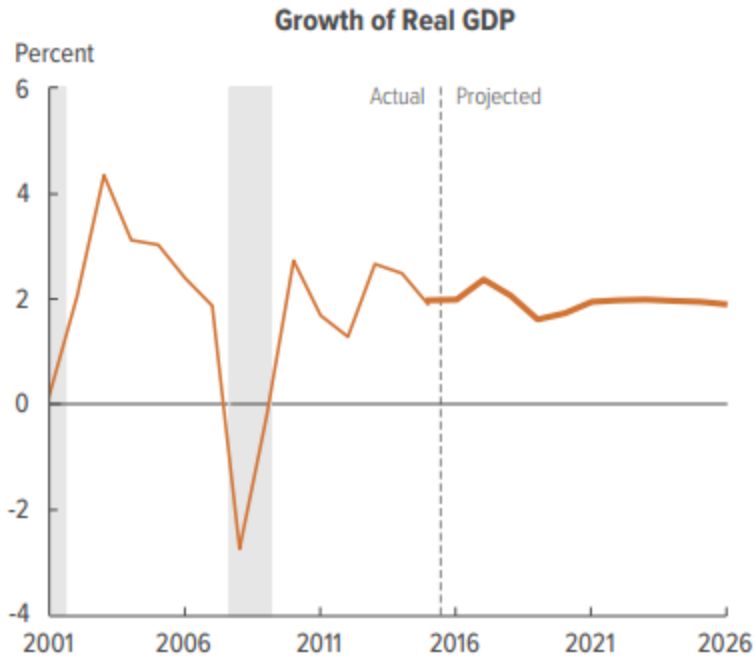
Source: Sapling Wealth Management, Bureau of Labor Statistics[v]

Long Term Congressional Budget Office Forecast Looks Rosy

The CBO is projecting a +2.0% growth in the US economy for the next 10-years. However, relative to the historical labor productivity statistics and demographic

realities, this looks optimistic by 1% (a seemingly small difference). However, looked at a different way, the CBO forecast is nearly 100% higher than our estimate. To put that in perspective, real incomes (which track GDP growth) would take 70 years to double in a 1% growth economy, compared to 35 years in a 2% growth scenario. This has major economic and fiscal policy implications.

Figure 3: CBO Projections for Real GDP Growth Look Optimistic



Source: Congressional Budget Office[vi]

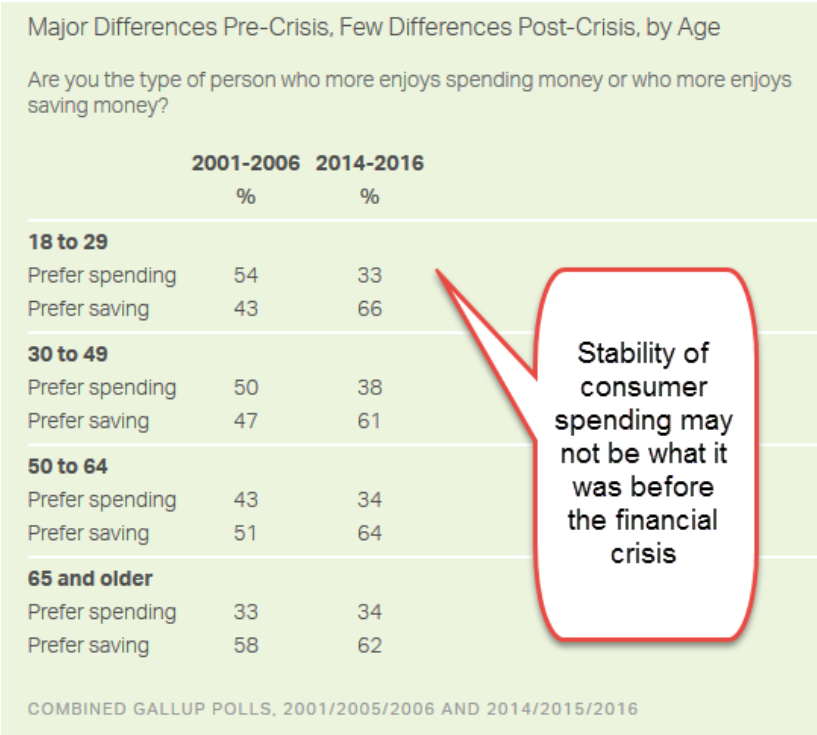
Weak GDP Outlook from Another Angle

If Aggregate Demand = Consumer Spending (68% GDP) + Investment (15% GDP) + Government Spending (18% GDP) + Net Exports (-1% GDP), how are these sectors faring? Not well in our eyes.

Consumer Spending May Be Fickle in Future

Consumer spending (68% of GDP)[vii] – long a stable source of growth in the US - has averaged 1.4% since Q3 2010 and recently accelerated to +2.0% in Q2 2016. However, consumer saving/spending preferences appear to have markedly changed since the 2009 recession. In an analysis by Deutsche Bank & Gallup, many consumers now say they prefer saving over spending. This shift will likely affect how consumers spend money in the future and may indicate less stability than in the past.

Figure 4: Future US Consumer Spending May Be More Fickle



Source: Gallup Poll[viii]

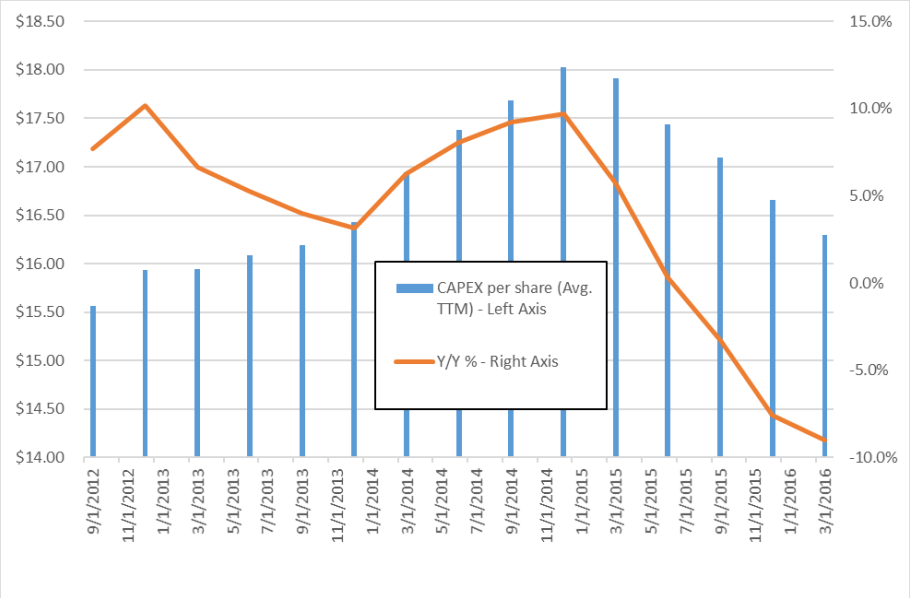
Net Exports Won't Move the Meter

A strong US dollar combined, weak overseas economies and a small net GDP contributor will render this component insignificant to GDP growth. If protectionist fiscal policies were passed and implemented, this segment may detract from GDP growth.

US Corporate CAPEX Is Weak & Getting Worse

Decent residential spending statistics have masked a weakness in non-residential investment. This is important, because cures to the low productivity problems will likely take additional investments of capital. However, that hasn't been a priority for corporations recently, which has seen Y/Y % declines in Capital Spending per Share for the last three quarters. This statistic is even worse when factoring in 1-2% share buy backs. Non-residential private domestic spending represents approximately 12% of the economy.

Figure 5: Y/Y % Trending Negative for S&P 500 CAPEX (per share)

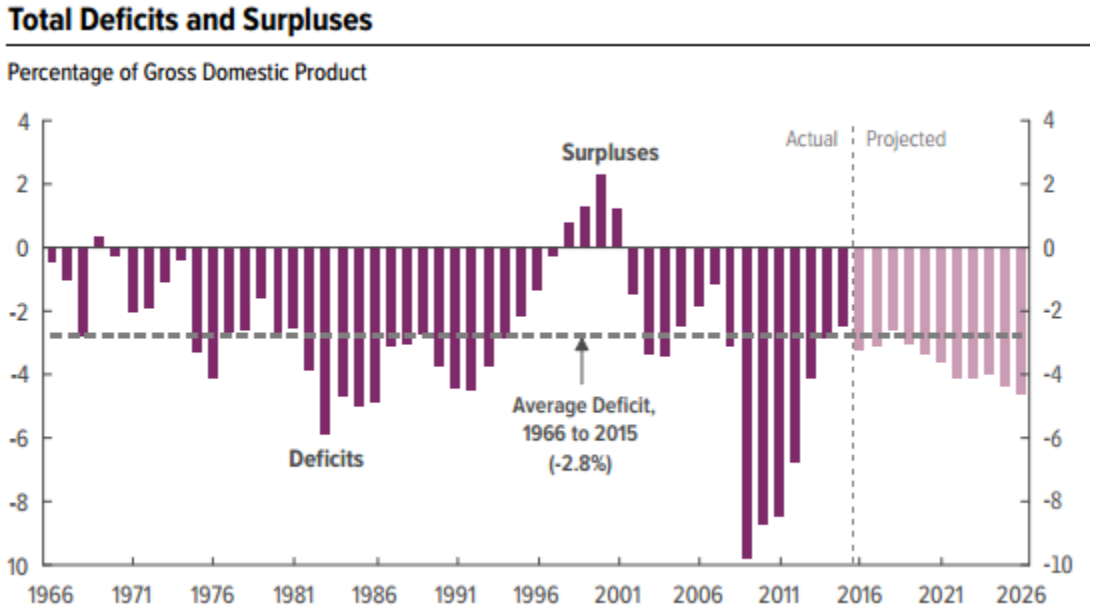


Source: S&P Dow Jones Indices[ix], Sapling Wealth Management

Government Budget Deficits Will Constrain LT Stimulus

In the recent CBO update published this August, US Government deficits are now beginning a gradual acceleration, due to health care and entitlement spending. Near-term boosts to the economy may come sporadically from fiscal measures, however we believe public policies that encourage growth are a more lasting solution in the long term.

Figure 6: US Government Deficit Spending a Constant for Foreseeable Future



Source: Congressional Budget Office, An Update to the Budget and Economic Outlook: 2016 to 2026[x]

Elections Important to Market Valuations

Politics will be particularly important to financial valuations in the next 12-18 months, as we believe the need for thoughtful public policy refinements and changes will be necessary to counter weak economic trends.

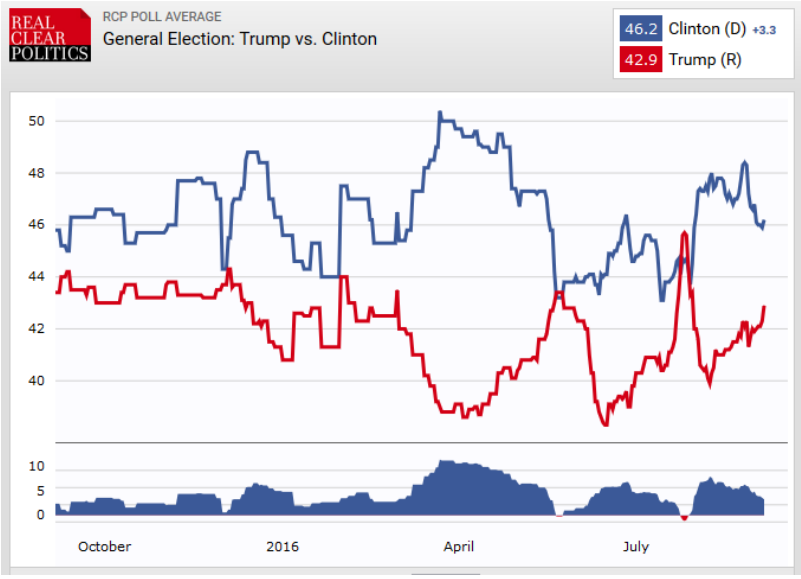
The Next President Will Shape Policies & Compromises

As responsibility shifts from monetary to fiscal policy, the next president will be even more important in passing legislation and forging compromises that affect the US economy. While nearly all of our analysis focuses on a Clinton victory, a Trump victory would likely result in a raft of pro-growth legislation, deregulation and lower taxes (all net positives for the market), which may outweigh Trump's rookie year concerns.

Clinton Won't Be "Trumped" by Anti-Establishment Mood

Post-convention polling results are in and it does not look favorable for the Republican contender, Donald Trump. In recent days, Trump has changed his campaign persona to be more Presidential and moderate some stances on key positions. While we think it is wise not to underestimate Mr. Trump, at this point we don't believe that this strategy change will improve his chances in November. Be prepared for dramatic showmanship (particularly close to Election Day) as Trump tries to increase the number of non-voters to come to the polls and vote in response to his populist message.

Figure 7: Clinton Posts a 4-5% Lead Post Convention



Source: Real Clear Politics[xi]

As of the time of this writing, Clinton leads by more than 1.0% in most key battleground state (FL, OH, MI, PA, VA, NC, NH, WI, NC, NV, OR), with Trump ahead in 3 (GA, MO, AZ) and too close to call in just 1 (IA).

Clinton's Experience and Organization a Force

We believe Hillary Clinton will be the next President of the United States, barring some sort of calamity. A combination of her experience, public policy know-how and strong support from certain constituencies will outweigh her negative ratings (primarily trustworthiness) and general anti-incumbent mood.

Trump's Campaign Strategy Isn't a Winner, in Our Eyes

It is our thesis that the Trump campaign will not succeed in the general election, in large part due to a message that is unappealing to non-whites. While we look forward to the 2016 general election results, Mitt Romney's statistics were (in our eyes) devastating for the GOP. We find it hard to believe that you can win nearly 60% of the largest racial group of voters (White – 72% voters polled) and still lose the election.

Table 2: Obama vs. Romney, 2012 Exit Poll General Election

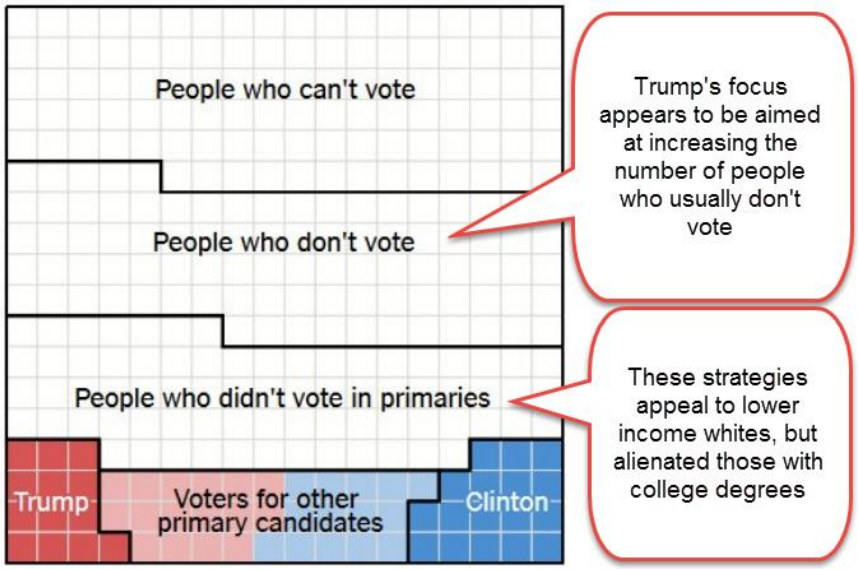
Exit Polls, by Race		% of Those Polled		
	% Polled	Obama	Romney	Comment
White	72%	39%	59%	White voters largely for Romney – 60%-40%
Black	13%	93%	6%	Black voters overwhelmingly for Obama
Latino	10%	71%	27%	Hispanic voters overwhelmingly for Obama
Asian	3%	73%	26%	Asian voters overwhelmingly for Obama
Other	2%	58%	38%	Other voters overwhelmingly for Obama
Total	100%			

Source: CNN Politics[xii], Sapling Wealth Management

Trump's Strategy Aims at Voting & Non-Voting Whites

Trump has been polling +17% vs. Clinton among white voters[xiii] – almost exactly the same as Mitt Romney. In order to win, he must hold the same percent of minorities and do better than Romney with whites. We find Trump's appeal to minorities is unconvincing (at best) and he will be doing well to have the same percentages as Romney. We believe Trump's populist message is squarely aimed at the 27% of US citizens (88 million) who are able to vote, but don't – admittedly a large percent of the voting eligible population. While this may serve to "get out the vote" in the general election in certain groups, we do not believe this strategy will be successful. We expect significant political drama close to Election Day, as Trump seeks to galvanize this population.

Figure 8: US Voting Population, by Voting Status



Source: NY Times[xiv]

Senate Control Will Be Close, But GOP May Hold On

While the Democrats edge Republicans in firm seats (47 vs. 44), the Republicans appear to be winning four of the close elections (AZ, FL, MO, OH). Senate Democrats have the early lead in one state (IN) and four states are a complete toss-up (NH, NV, PA, NC). Past history suggests the winner in the Presidential general election has a positive coattail effect for House and Senate candidates. Our feel is that this year is different and high un-favorability ratings of both Presidential candidates will cause voters to split their ticket to balance power in Washington, D.C. We believe this dynamic favors the GOP maintaining control in a Clinton victory and Democrats regaining control if Trump wins.

House Likely Remain in GOP Hands

Of the 398 House seats up for re-election this year, Real Clear Politics polling suggest that 230 seats are squarely in GOP hands. It is very unlikely the GOP loses control of the House of Representatives this year.

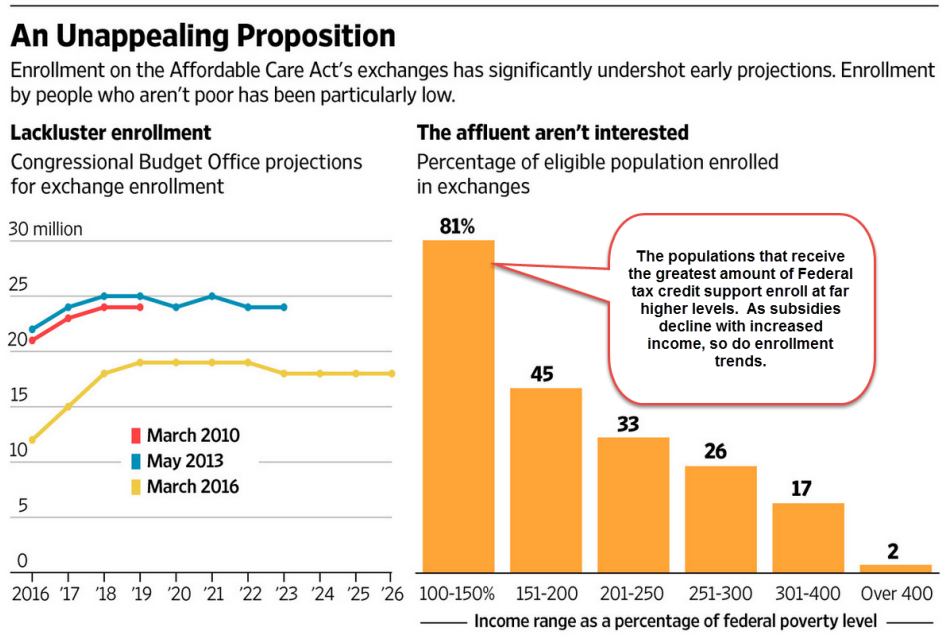
Is The Stage Set for A Compromise? We Think So

The prospects of a weak economy, diminishing monetary policy effectiveness, and political repositioning could add up to some positive legislative achievements in Q1 2017. In order to get substantive legislation through the GOP controlled House, there must be some bargaining. We made a similar call in the past (which was dead wrong), but this year we are hopeful due to the reasons of mutual interest and urgency.

Faltering ACA May Provide a Sense of Urgency

A general election win will put the Democrats in no mood to negotiate on issues important to them, despite Clinton's pragmatic disposition. However, the single biggest legislative victory during the Obama Presidency was the Affordable Care Act, and we believe this effort is in serious trouble. The insurance program has not attracted the enrollment of "healthy" participants and is therefore skewed towards sicker patients. In addition, a greater percentage of low income populations have enrolled than some expected, with 83% of enrollees receiving financial assistance.[xv] This adverse selection is causing pricing to increase and providers to exit markets, due to economic losses. The Kaiser Foundation reported that 38% of counties would see a decline in insurer options in 2016 and 17% will see an increase.[xvi] During 2016, Aetna announced it was withdrawing from 11 of the 15 states where it currently offers plans through exchanges. This followed United Health Care and Humana's plans, which also pulled back significantly. Therefore, we believe 2017 will only look worse from the standpoint of insurer options. With decreased competition will come higher pricing, which will force out the same paying participants that the plan is trying so desperately to attract. We believe this is a slippery downhill slope and, if not addressed quickly, will lead to the program to collapse under its own weight.

Figure 9: ACA's Adverse Enrollment & Demographic Mix Apt to Get Worse



Source: Wall Street Journal[xvii], Sapling Wealth Management

Plenty of Other Areas With Bi-Partisan Interest

Infrastructure spending, tax code changes, and general budgetary refinements are all areas of mutual interest to Democrats and Republicans. At this point, waiting to make decisions in these matters is not serving either parties' interests.

For example, a recent EU decision found that Apple had underpaid its taxes by $14 billion, using an anti-trust legal argument. If successful, this would take away a source of revenue from the US Treasury. The EU move may become a catalyst for US policymakers to act before their counterparts in Europe take these revenue opportunities away from them.

We See Plenty of Risks That Could Rattle the Markets

To balance our contrarian view for bi-partisan legislative achievement are a litany of risks to the financial markets. Any one of these could dramatically affect market psychology and depress valuations. Without the proper response, the potential downshift in risk taking preferences combined with weak economic fundamentals could result in a (50%) downside in the market (our worse case scenario).

Our Top Concerns

US Politics: Waiting for a Crisis

If proactive legislation cannot come out of Washington D.C., we believe the economy will just need to wait 1-3 years until there is a major crisis. Financial markets will anticipate this event and investors will want to be proactive about managing their portfolios ahead of the storm.

Other EU Members Follow the Brexit Lead

Markets have bounced back since the surprise United Kingdom vote to exit the European Union, giving some investors additional confidence in the resilience of equity valuations. If the UK is effective in navigating out of heavy handed EU regulators on issues such as taxes, other EU members could follow. We believe this would be devastating for the EU.

Currency Risks Still Loom Large

Continued strength of the US dollar would put further pressure on commodity prices (such as oil) and hurt foreign borrowers with US dollar denominated debt. Just as we wrote about last year, both areas are highly leveraged and represent material financial risks to the system.

Distractions from Political Adventurism

Economic weakness that shifts resources towards social services and away from military spending could invite political & military adventurism in certain parts of the world (China, Russia, Korea). Distraction from solving economic issues are big negatives, in our eyes.

The Italian Financial System is a World Class Mess

We believe Italy's financial struggles do not receive enough attention from investors. The Economist estimates that nearly $400 Billion - 20% of the

country's GDP – are souring.[xviii] Italian banks have taken reserves for 45% of these troubled loans. Italian retail investors (not institutions) own approximately $220 million in Italian bank bonds. Italy is Europe's 4th largest economy and is the world's 3rd largest bond market (after the US & Japan). This is a world class mess.

Covenant Light High Yield Bonds a Default Recovery Risk

Moody's estimates that 37% of all non-investment grade debt issued was high-yield lite (vs. 28% in 2015).[xix] Moody's defines high-yield lite (HY-lite) as a speculative-grade bond without a restricted payments covenant package (a basic bondholder protection). If the economy dips below the consensus 2% growth rates, defaults will uptick and weak covenant loans will suffer disproportionately.

Decreased Faith in Monetary Measures

A huge amount of faith has been placed in the hands of the world's central banks. However, these policies have risks and recent measures have had decreasing impact on improving economic growth, both in the US and abroad. If this blind faith in monetary policies falter, a significant valuation contraction will likely occur.

Valuations Discouragingly High

We believe S&P 500 earnings will accelerate +7-13% to $122 in 2017, due to lack of a drag from currency translations, higher operating margins in energy/materials sectors, and continued operating efficiency improvements. Our projection is still (7-8%) below current bottoms up S&P 500 EPS consensus of $132.

While EPS Prospects are Decent …

Solid baseline sales growth of 4-5%, limited currency translation drag, and expanding operating margins all add up to sold earnings growth for the S&P 500 in the 2016-2017 period.

Sales Per Share Accelerating, Due to Lack of Currency Drag

We believe the biggest sales disappointment in the 2015-2016 period – a (6.65%) currency translation drag – has largely played out and thus, Y/Y % comparisons will become easier in 2017. The currency translation masked baseline sales growth (ex. foreign currency) of +4-5%.

Table 3: Baseline Sales Solid 2016-2017, Absent Currency Drag

	2013A	2014A	2015A	2016E	2017E
Sales Per Share	$ 1,117	$ 1,163	$ 1,127	$ 1,167	$ 1,240
Baseline Sales Growth	2.19%	3.42%	-4.28%	1.79%	5.00%
Share Reduction	0.10%	0.70%	1.20%	1.73%	1.25%
Total Y/Y % Growth	2.29%	4.12%	-3.08%	3.52%	6.25%
Baseline Sales Growth		3.42%	-4.28%	1.79%	5.00%
Baseline ex. Foreign Currency		4.73%	2.36%	4.00%	5.00%
Foreign Currency		-1.31%	-6.65%	-2.22%	0.00%
% Sales		47.80%	44.30%	44.30%	44.30%
% Change In $/Basket		2.8%	15.0%	5.0%	0.0%

Source: S&P Indices[xx], Sapling Wealth Management

Operating Margins Poised to Recover, But Not to Prior Highs

We believe that operating margins will recover to 9.90% by 2017, up from 8.91% in 2015, as lower commodity prices and business adjustments (primarily in the energy, material and industrial sectors) work through the system. With higher interest rates in the US in 2016-2017, we believe financial service margins also have the potential to improve from here.

Table 4: Operating Margins to Recover in Cyclical Sectors

	Act. Q4:2015	Act. Q1:2015	Est Q2:2016	Est. Chng. 2Q -1Q
Energy	-10.92%	-4.59%	-2.97%	1.62%
Materials	0.81%	3.77%	10.41%	6.64%
Industrials	9.18%	7.89%	9.06%	1.17%
Consumer Discretionary	7.33%	7.32%	7.63%	0.31%
Consumer Staples	6.31%	6.12%	6.73%	0.61%
Health Care	7.63%	8.64%	8.76%	0.12%
Financials	13.46%	14.84%	14.28%	-0.56%
Information Technology	18.32%	15.17%	15.99%	0.83%
Telecommunication Services	11.96%	10.14%	6.99%	-3.14%
Utilities	0.53%	11.45%	9.21%	-2.25%
S&P 500	*7.98%*	*8.75%*	*9.08%*	*0.33%*

Source: S&P Indices[xxi], Sapling Wealth Management

S&P 500 EPS Growth On Track for +7-13% Growth in 2016-2017

Expanding sales growth and margins should put the S&P 500 earnings on track to register $108 in 2016 and $122-123 in 2017, an annual gain of +7-13%. Our estimates are (7-8%) below the notoriously rosy bottoms-up consensus figure of $132-133.

Table 5: Our EPS Growth Still (7-8%) Below Consensus

	2013A	2014A	2015A	2016E	2017E
Sales Per Share	$ 1,117	$ 1,163	$ 1,127	$ 1,167	$ 1,239
Baseline Sales Growth	2.19%	3.42%	-4.28%	1.78%	5.00%
Share Reduction	0.10%	0.70%	1.20%	1.73%	1.25%
Total Y/Y % Growth	2.29%	4.12%	-3.08%	3.50%	6.25%
Operating Margin	9.61%	9.72%	8.91%	9.27%	9.90%
Y/Y % Growth	8.3%	1.2%	-8.3%	4.0%	6.8%
Sapling S&P Earnings Est.	$ 107.29	$ 113.05	$ 100.45	$ 108.14	$ 122.71
Y/Y % Growth	10.8%	5.4%	-11.1%	7.7%	13.5%
S&P 500 Consensus	$ 107.29	$ 113.01	$ 100.45	$ 110.77	$ 132.83
Y/Y %	10.8%	5.3%	-11.1%	10.3%	19.9%
Our Estimate vs. Consensus		0.0%	0.0%	-2.4%	-7.6%

Source: S&P Indices[xxii], Sapling Wealth Management

… Yet Valuations Are Priced for Perfection

The average 25-year forward P/E ratio is 15.9X. Consensus estimates of S&P 500 EPS is $132 in 2017, which would normally suggest a reasonable 16.4X multiple. However, we have a hard time getting to consensus earnings. We believe our 2017 S&P 500 EPS estimate of $122 is more realistic, which indicates that the forward P/E ratio is 17.7X – nearly 11-12% higher than historical norms. While low interest rates argue for a higher than normal P/E ratio, we believe it is hard to justify anything above a 20% premium (about 19.0X), given the potential risks in the economy.

Our Scenario Analysis Indicates Poor Risk Return Profile

The weighted scenario analysis for equity market returns looks like (0-5%) from current trading levels, a losing proposition in our eyes. While our most optimistic scenario indicates a +25-30% upside in equities, it is centered on legislative achievement and economic growth acceleration with modest inflation (25% probability). We handicap a 45% chance that investment returns are negative in 2017.

Table 6: Scenario Analysis for S&P 500 Returns Disappointing

	8/31/16	SWM S&P EPS			P/E Ratio			Trailing 12 Month	Trailing 12 Month
	S&P 500	2015A	2016E	2017E	2015A	2016E	2017E	Yield	Dividends
Prices & Ratios	2,170	$ 100.5	$ 108.2	$ 122.7	21.6	20.1	17.7	2.0%	$43.88
Y/Y %		-11.1%	7.7%	13.5%					

Projected Valuations	Probability	2017 EPS Estimate	2017/ 2016 Y/Y %	% of S&P Estimate	SWM Est P/E Multiple	Chg. '17/ '16 Y/Y %	Target S&P Valuation	% Return S&P	+	% Yield	=	Total Return S&P
Currency & Political Crisis, Recession	10%	$ 85.0	-21.4%	69.3%	12.0	-40.2%	1,020	-53.0%		2.0%		-51.0%
Weak Int'l Economy, Slight US Inflation	35%	$ 105.0	-2.9%	85.6%	16.0	-20.3%	1,680	-22.6%		2.0%		-20.6%
World Tepid, US Moderate Growth	30%	$ 120.0	11.0%	97.8%	19.0	-5.3%	2,280	5.1%		2.0%		7.1%
US Legislative Achievement & Growth	25%	$ 125.0	15.6%	101.9%	22.0	9.6%	2,750	26.7%		2.0%		28.8%
Weighted Average												-3.0%

Source: S&P Indices[xxiii], Sapling Wealth Management

Across the Spectrum, Most Asset Classes Have Low Appeal

In addition, many asset classes have low appeal in multiple scenarios. Emerging markets and international markets do well if the world remains stable and earnings start to grow, but we see additional downside in less rosy economic scenarios. High yield debt markets look decent in three of four scenarios and is the only asset class where we calculate a positive scenario weighted investment return (a modest +0.3%).

Table 7: Returns Across Several Asset Classes Are Underwhelming

		SWM EPS Est.		P/E Ratio		Bond Market		
	S&P 500	2016E	2017E	2016	2017	10 Year	HG Corp	HY Corp
Market Valuations (8/31/2016)	2,170	$108.15	$122.72	20.1X	17.7X	1.58%	2.77%	6.08%

		Equity			Debt		
Scenario	Probability	Int'l	Emerging	S&P 500	10 Yr	HG Corp	HY Corp
Currency & Political Crisis, Recession	10%	-61.0%	-66.0%	-51.0%	7.1%	-3.3%	-33.4%
Weak Int'l Economy, Slight US Inflation	35%	-25.6%	-30.6%	-20.6%	-2.2%	-1.3%	1.3%
World Tepid, US Moderate Growth	30%	12.1%	17.1%	7.1%	0.1%	2.9%	6.7%
US Legislative Achievement & Growth	25%	33.8%	43.8%	28.8%	-10.5%	-7.2%	4.8%
	100%						
Wtd. Average		-3.0%	-1.2%	-3.0%	-2.7%	-1.7%	0.3%

Source: S&P Indices[xxiv], Sapling Wealth Management

Where to Invest?

With the general market offering so little appeal, what does an investor do? We believe that there are select opportunities in certain sectors with reasonable valuation multiples and decent risk adjusted prospects.

Equities

Quality Emerging Markets & International

Emerging markets equities have underperformed dramatically through 2015, but have turned around in 2016. We think only quality names are worth the risk. Individual stocks with high yields carry valuations well below their US peers. We would avoid financial stocks.

Infrastructure & Industrials

Proactive fiscal measures in the US would increase the prospects of infrastructure and industrial names. The industrial sector is selling at an 8-10% discount to historical forward P/E ratios.[xxv] Decent yields and multiple expansion potential could make this a solid sector.

Energy

This beaten up sector will face supply surplus, falling pricing and lackluster demand, but much of these concerns are baked into valuations. Stick with quality names that could purchase distressed assets.

Real Estate

Real estate is the single best performing asset class in the last 15 years, with an average annualized return of approximately +12.0%. Decent yields of 2-4%, acquisition growth, financial leverage, and inflation protection are desirable in the upcoming economic environment.

US Regional Banks

US financial services firms generally are the beneficiary of increasing margins from higher interest rates. Lower exposure to international issues is a plus. Downside of regulations have been baked into the valuations.

Select Healthcare Names

Healthcare companies are trading at 20% discounts to historical forward P/E ratios due to sales and margin uncertainty.[xxvi] We believe value added technologies will continue to support high pricing; however, there many names to avoid due to heavy pricing pressure on undifferentiated products and services.

Fixed Income

High Yield, Non-Energy

Despite covenant lite deals, high yield remains an attractive area. If economy disappoints, this illiquid area has risks.

Emerging Market Bonds

Yields on good credits now approach the US high yield market and could be worth the risk. Expectations and valuations for this area have already improved, but we believe there is further to run.

Municipal Bonds

Increasing tax rates are a high probability, in our eyes. Currently, the yield ratio of municipal bonds to the US Treasury is 1.05 vs. historical average of 0.92. In the period from 1990-2008 municipal bonds were valued at a 0.80 ratio, due to the after-tax advantages of owning these bonds.[xxvii] We think that municipal finances will generally improve, and the tax advantages will drive up relative valuations.

Corporate Credit

In a flattish interest rate environment, corporate credit looks like a relatively good area for solid returns without taking duration risk.

Closed End Bond Funds

CEFs are one of our favorite areas (which we acknowledge is not for everybody due to liquidity reasons). In a reasonably stable interest rate environment, these funds offer significantly higher yields and some are still trading at historically large discounts to NAV.

TIPs

TIPs represent a much better high quality fixed income investment choice than standard US Treasury bonds, due to muted inflation expectations currently baked into TIP valuations.

Preferred Dividend Income

The financial sector dominates this asset class, which we believe will benefit from slightly higher future interest rates. This sector generates higher yields than other assets of comparable risk.

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[xxi] Ibid.

[xxii] Ibid.

[xxiii] Ibid.

[xxiv] Ibid.

[xxv] JP Morgan, "Guide to the Market: Q3 2016", page 10.

[xxvi] Ibid.

[xxvii] JP Morgan, "Guide to the Market: Q3 2016", page 38.