Beacon Trust Quarterly

October 15, 2015

T.I.N.A.'s Tantrum

When we first embraced T.I.N.A. a few years ago, she was compliant, reliable and eager to please. For those who have not had the pleasure, T.I.N.A is an acronym for There Is No Alternative (to equities). Toward the end of last year, T.I.N.A.'s timely elevation allowed us to meet our S&P 500 price target. Similar to the preceding two years, as the Sinatra song states, "It was a very good year". Following a period of relative calm during the first half of this year, T.I.N.A displayed tantrum tendencies during the third quarter, culminating in an S&P 500 market correction, defined as a price decline of 10% or more. During this trying period, we considered being less committed to T.I.N.A. and pondered competing interests, L.I.L. (Lackluster Income Landscape) and A.N.N. (Alternative Non-equity Non-bond). However, the reward from those investments did not seem very compelling. So instead, we decided to analyze probable causes contributing to T.I.N.A.'s somewhat irrational behavior as it relates to economic, financial and market variables. In the process, we hoped to gain perspective as to T.I.N.A.'s performance prospects, recognizing that, as baseball legend Yogi Berra once said, "It's tough to make predictions, especially about the future." Following is a comparison of T.I.N.A.'s perceptions versus our opinion of what we believe to be reality:

US Dollar

Perception: Dollar strength relative to both developed and emerging market currencies would continue, resulting in capital flight, rising inflation, slowing growth, debt defaults, and lower re-pricing of equities.

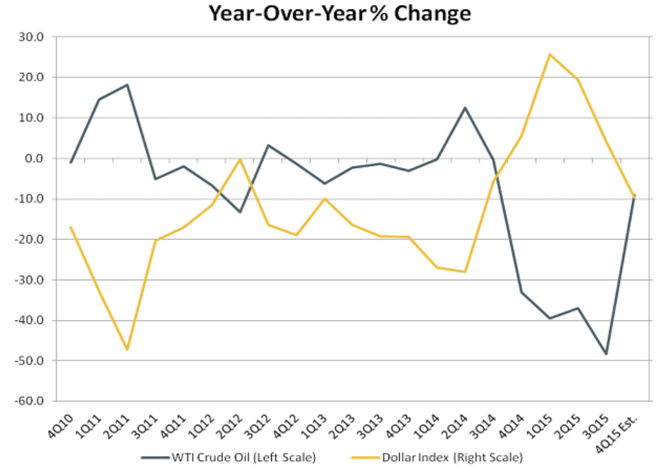
Reality: Our analysis of two key variables influencing the dollar—the budget and trade deficits (twin deficits)—suggested the dollar would be largely stable versus developed market (eurozone, Japan, UK, Canada, etc.) currencies. Admittedly, the more fragile fundamental underpinnings in emerging markets (EM) present greater risk of dollar overshoots in those regions. However, a stable dollar against developed currencies would likely stabilize oil and other commodities priced in dollars. The feedback loop to EM currencies could provide a floor. Historically, EM currencies typically rise during periods of dollar weakness.

Oil & Other Commodities

Perception: Oil and other commodity prices would remain weak due to excess supply and weak demand.

Reality: As stated above, we believe the price of oil, in particular, is influenced by the dollar. Our analysis indicates the dollar is the overwhelming explanatory variable. Since the fourth quarter of 2010, the dollar has explained 89% of the movement in the U. S. Dollar Index (DXY). (Please see accompanying chart.) Stated from a different perspective, supply and demand variables play a minor role in oil price movements. This analysis suggests that West Texas Intermediate (WTI) Crude Oil may have bottomed and is heading for $60 per barrel by the first quarter of 2016 compared with $45 at the end of the third quarter.

WTI Crude Oil and Dollar Index
Year-Over-Year % Change



Source: New York Mercantile Exchange; Exchange Information System
$R^2 = 89\%$

China and Emerging Market Growth

Perception: China's real GDP growth will fall significantly short of the official 7% government target, thereby depressing commodity prices, global trade, and overall emerging market growth.

Reality: China's growth rate is clearly slowing as it transitions to a consumer/services-led economy and relies less on fixed investment and exports. However, the trend in the Manufacturing Purchasing Managers' Index (PMI), as well as our proprietary Alternative GDP Variables, leads us to conclude that 6.8% growth is attainable in the short-run. That said, we acknowledge growth risks associated with commodity exporters and other emerging market countries.

Central Bank Monetary Policies

Perception: Divergent, loose and abnormal central bank policies have several dire consequences including policy and market uncertainty; heightened market volatility; a savings glut; excess capacity; disinflation/deflation; and low interest rates.

Reality: We generally agree with the above assessment and believe the US Federal Reserve will begin its move away from abnormal monetary policy by raising rates this December. This prediction does not come with a high probability, however. It is doubtful that Fed Chair Yellen has achieved Federal Open Market Committee consensus to raise rates. Two Fed governors recently endorsed a wait-and-see posture. The Fed's intransigence could continue to feed market uncertainty and volatility.

Credit Spreads and Credit Default Swaps

Perception: These indicators of financial strength and risk appetite, when elevated, hurt equity and other risk asset prices.

Reality: This is another point of agreement. In fact, high yield credit default swaps have a 64% inverse correlation with the S&P 500 (higher spreads, lower stock market) and lead the S&P by a quarter. Similar to emerging market currencies, this area deserves close monitoring. Recent retrenchment in these measures might endure given projected stability in the dollar, oil and China's growth rate.

Grinding Growth

The global growth landscape is clearly facing headwinds likely to bring the rate close to stall speed. The International Monetary Fund (IMF) recently lowered its global growth forecast for 2015 to 3.1% from 3.5% and raised the risk of global recession, defined as growth below 2%. While recession is not the IMF's base case, we would agree that market stability and policy uncertainty risks have risen. This is important because while economies are not markets (in normal times), recession scenarios often result in negative market re-pricings. The absence of an inverted yield curve and other indicators suggest the US is not headed for a recession during the near-term. The key growth driver remains the US consumer. Despite a recent retails sales report showing disappointing September results and negative revisions to August and July, we continue to forecast Personal Consumption Expenditure (PCE) gains of 3.5 % during the near-term. Personal Income growth remains supportive, and Consumer Comfort was up a strong 14% in the third quarter compared to a year earlier and has increased in each of the last four weeks. Consumer balance sheets are much improved. Government spending should be modestly supportive as sequestration limits unwind and Affordable Care Act spending continues strong. While representing only 13% of GDP, the outlook for Nonresidential Fixed Investment is troubling. We anticipate gains of only 3% during the next few quarters as Policy Uncertainty rises and Nondefense Capital Goods Orders stall. Residential Investment (Housing) growth should be moderate, but this accounts for only 3% of GDP. Overall, the US is likely to be in a real GDP environment closer to 2% than 3%. But this is better than a recession.

Monetary policy is perhaps exhausted. This may be the case both domestically and abroad. As such, fiscal policies and reforms will be needed to increase investment in projects and people. Grassroots rumblings are already apparent in the 2016 election campaign. It remains to be seen if this fosters fundamental change and progress.

US Market Expectations

Our Asset Allocation Strategy continues to favor T.I.NA. (over weight equities). Year-to-date return comparisons between the stock market and the Barclays Aggregate Bond Index (as of 9/30) show the bond market outperforming the S&P 500 by 6.25% (1.00% versus -5.25%). The differential has narrowed to 3.2% (1.6% versus -1.6%) as of mid-October. We recently reduced our upside S&P 500 target to 2,160, representing a 5% gain from the December 2014 average. Our downside target is the same as in January, or 1,870, suggesting lows have been reached for the year. The S&P 500 dividend return is slowing modestly reflecting global growth and earnings concerns. The rate of dividend growth is still nearly 14% as measured year-over-year. Credit spread and default swaps are off their highs and could recede further as economic and financial variables stabilize. The seasonal stock market influence is historically positive from late October to year-end. Bond market returns are expected to remain in low single-digit territory.

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