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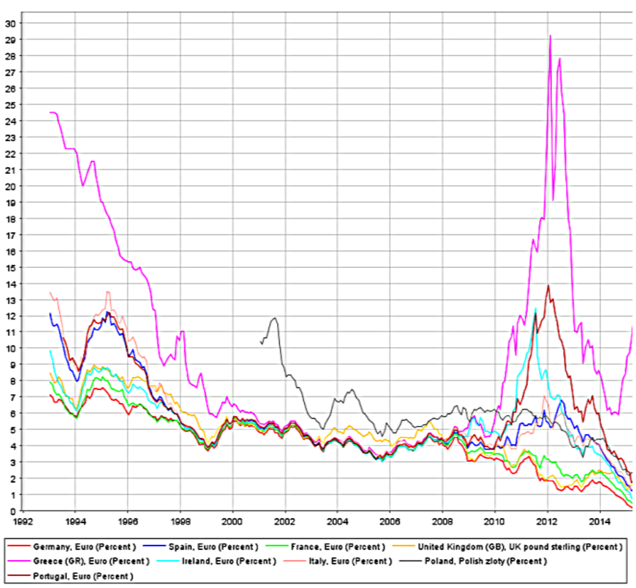
Uncertainty and Its Implications for Asset Values

In the latest International Monetary Fund Global Economic Outlook, measures to sustain growth in the short and longer term continue to be a focus of concern. With the euro area joining in quantitative easing, monetary policy in advanced economies has largely done what it can, leaving the potential for fiscal policy support unevenly distributed among nations. Structural reforms needed for longer-term sustainable growth have embedded challenges that raise the geopolitical and social stakes.



EU Member Monthly 10-year interest rates
(Source: European Central Bank)

During the Cold War, the world experienced a dangerous, yet stable period, followed by an unstable, but not dangerous time, which is now evolving into a dangerous and unstable phase. The levels of danger and instability are unequal around the world. Such concerns as ISIS and elevated levels of refugees around the world, combined with a number of "bubble dependent" economies such as the United States create, at a minimum, heightened uncertainty in expected outcomes.

Given a more fragile and hostile environment, investors must consider the likelihood of higher volatility and greater uncertainty around fair asset valuations. Geopolitics matter on the global macro level; fiscal and monetary policy matter at the national level; gaining a commanding heights competitive position matters at the corporate level; diversified, non-correlated assets matter at the asset allocation level; the sustainability of future cash flows matters increasingly at the asset level; and lastly, demographics matter at the individual level. Further, the uncertainty enables short-term factors to have a heightened disruptive impact.

Based on the Standard and Poor's 500 Index estimated 2015 earnings (S&P Dow Jones Indices) trading at a price to earnings ratio of approximately 18 times, market valuations are trending above average historical levels in a low inflation environment. If we look at 2016 estimated earnings, valuation levels improve, assuming growth in earnings of approximately 15%, but keep in mind that expectations for earnings growth have ratcheted downward the last several years as each year has unfolded. Valuation levels are not nearly as compelling as even just a year ago, and the economic and geopolitical risks have risen. For example, China's Central Bank rate reduction for the third time in the last six months is a stark reminder that in an elevated public debt-to-GDP world, stable, sustainable growth is increasingly challenging to attain. For investors, this means finding undervalued companies with sustainable cash flows is all the more relevant to the risk and reward metrics of a well-diversified and longer-term portfolio that can weather economic cycles increasingly influenced by Central Bank policy.