Titleist

ASSET MANAGEMENT, LTD.

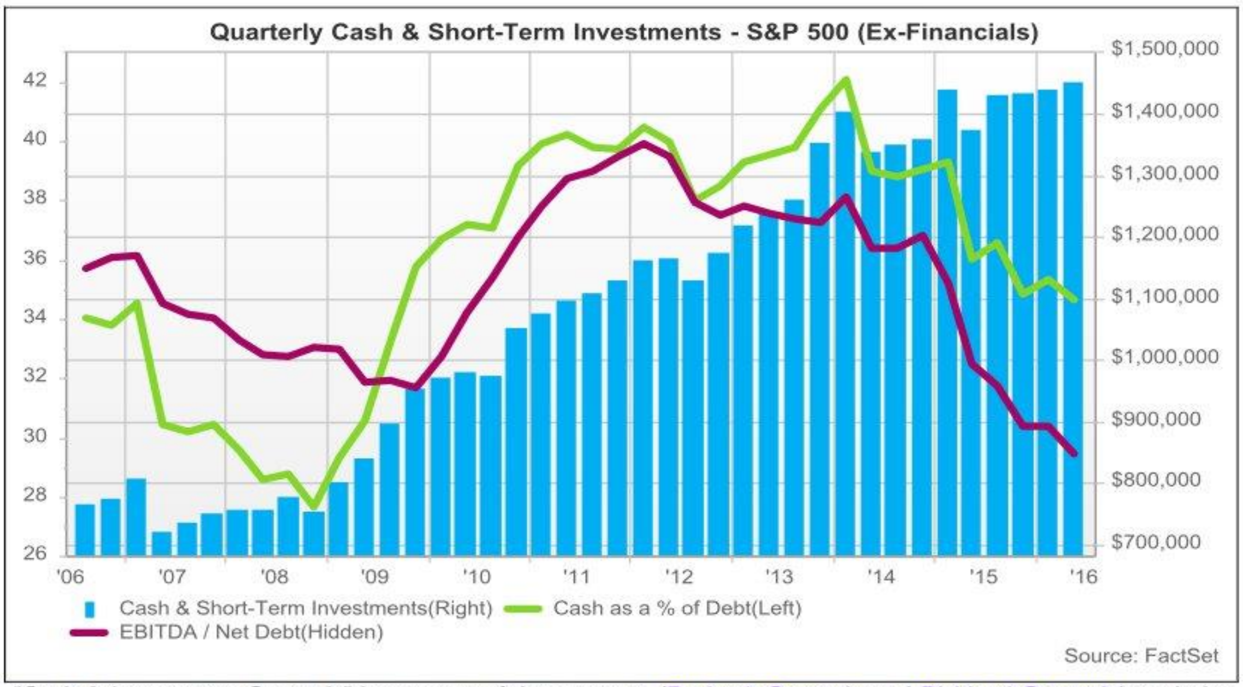
Titleist Asset Management 2016 Q2 Market Commentary

July 6, 2016

The S&P 500 closed out the first half of 2016 with a return of 3.8% while the Russell 2000 posted a meager 2.4%. After one of the longest periods on record without a correction, the major market indices endured two drawdowns exceeding 10% throughout the past 3 quarters.

The S&P 500 looks fairly valued trading at 16.5x forward earnings versus the historical average of 15.5x. One could easily make the case that the multiple should be much higher given low interest rates around the world because the present value future earnings are worth much more in a lower interest rate environment. The S&P 500 has been in an earnings recession for the past 4 quarters with negative year over year growth rates primarily due to the historic losses sustained in the energy sector.

Corporate balance sheets within the S&P 500 ex-financials remain extremely strong with cash and short term investments at all-time highs. Balance sheets within the financial sector are in healthy condition as well with most major financial institutions passing the recent Federal Reserve Stress tests by a wide margin. All of this cash should continue to flow to investors in the form of corporate buybacks and dividend increases. The chart below illustrates current levels of cash and cash equivalents in the S&P ex-financials –



"Cash & Investments Quarterly" is one part of three reports (Buyback Quarterly and Dividend Quarterly) analyzing cash and discretionary spending within the S&P 500.

Central banks around the world remain extremely accommodative. We view negative interest rates by some major foreign central banks as a policy error. The goal of the new policy was to encourage more risk taking however the result so far has been exactly the opposite with flows going into assets that are considered to be risk havens. Unintended consequences to negative interest rate policy include damage to consumer and business confidence, compression of net interest margin and bank profits, and excessive valuations in income generating asset classes such as REITs, Telecom, Consumer Staples, and Utilities.

Even though US Large Cap indices are a few percent shy of their all-time high, they are still trading just 7.24% above where they were two years ago. Well diversified investors with exposure to small cap, mid cap, developed international, and emerging international have not fared as well as returns in these asset classes are down 13-16% from where they were trading two years ago.

Below are the two year returns for the major equity indices. A large part of the decline in the international indices is a result of currency headwinds due to the historically strong dollar.

	(6/30/16)	*(6/30/15 - 6/30/16)*	*(6/30/14 - 6/30/15)*	
Index	**YTD**	**1 year**	**2 year**	**Aggregated 2 year**
Large Cap: S&P 500	3.82%	3.97%	7.24%	11.50%
Mid Cap: S&P 400	7.84%	1.02%	6.09%	7.17%
Small Cap: Russell 2000	2.40%	-6.57%	6.50%	-0.50%
Int'l Developed: MSCI EAFE	-2.98%	-9.48%	-4.65%	-13.70%
Int'l Emerging: MSCI EM	7.58%	-11.20%	-6.34%	-16.90%

Mean reversion – the theory that a given value will return to an average of time, despite fluctuation above and below - is the gravity of finance. It was only 5 years ago all of the major financial publications were issuing headlines about "The Lost Decade." This was the first 10 year period in which the equity markets were flat over a 10 year period in over 40 years. What all of the headlines failed to mention was that small caps returned over 85%, mid-caps 60%, and international emerging over 160%. Interestingly, if you bought the S&P 500 equal weight – each stock comprises 0.20% of the S&P 500 Index – instead of the cap weighted index you would have returned over 66%. It is critical to adjust the weightings of various asset classes within the equity sector but the empirical evidence is overwhelmingly in favor of always having a well-diversified portfolio.

Source: Russell, MSCI Inc., Dow Jones, Standard & Poor's, Barclays Capital

We would encourage investors to look at real returns – nominal minus inflation – when assessing the success of their investments. Risk assets have returned approximately 6% in excess of the risk free rate (10yr Treasury) for the last century. It is likely rates will remain low for an extended period of time and therefore it would be reasonable to expect returns in risk assets to post high single digit returns over the longer term instead of the low double digit returns they have averaged over the past century.

This is not all bad news however. Real returns – nominal minus inflation - are all that matter and as long as one can outpace inflation by the same margin the appreciation in purchasing power remains the same. In other words, if inflation is running at 2% and your portfolio returns 8% that is just as good as inflation running at 4% and your portfolio returning 10%. Investors choosing to remain in cash should consider that a 2% inflation rate will erode the purchasing power of their dollars by over 48% over a 20 year time frame.

We have compiled some data on all recessions post WWII. The reason so many economic data points start at this time is due to the fact that the Depression era preceded the war and there were a lot of safeguards legislated into the financial system during that time.

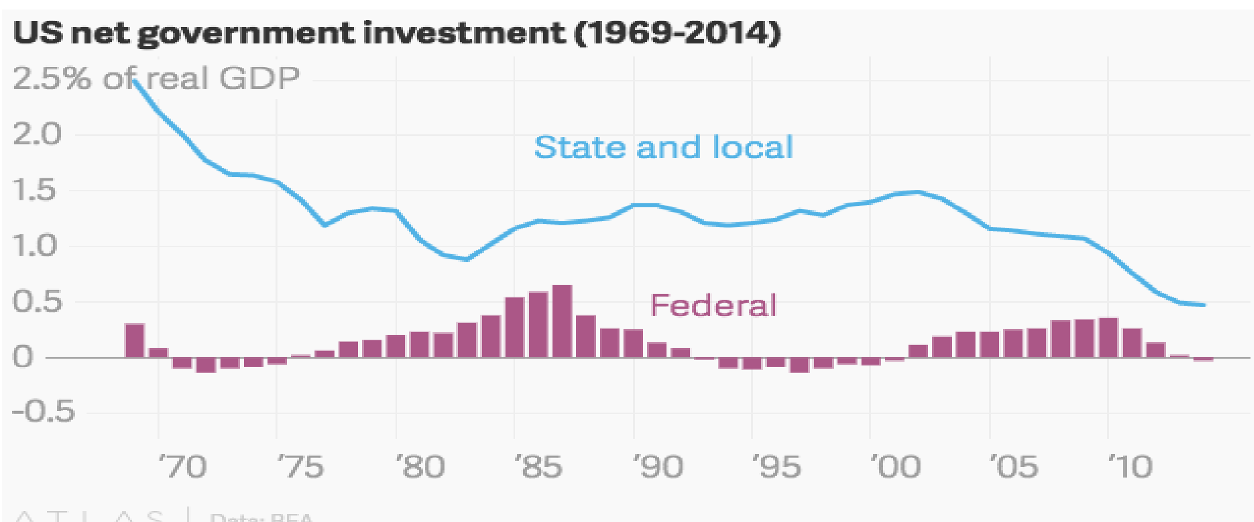
Instead of looking at economic expansions on a calendar basis, we compiled the data below to show total GDP growth in today's dollars and the % growth during each recovery. Looking at this data, it would be reasonable to think we have more room to run since it would take another 50% to achieve the average growth trough to peak. As you can see in the data below, the growth of the economy from trough to current peak is a cumulative 14.6%, well below the average of 23% in the post WWII era.

		Cumulative	*Growth %*
Trough	**Peak**	**Rebased GDP (Bil. Q116)**	**Trough to Peak**
Mar-50	Jun-53	9,159.8	24.4%
Sep-54	Sep-57	9,912.6	12.4%
Sep-58	Jun-60	6,665.9	9.0%
Jun-61	Dec-69	38,568.0	49.2%
Mar-71	Dec-73	17,050.8	13.0%
Jun-75	Mar-80	33,182.9	22.4%
Dec-80	Sep-81	7,287.2	4.2%
Mar-83	Sep-90	68,104.0	36.6%
Jun-91	Mar-01	117,652.7	41.5%
Mar-02	Dec-07	92,425.9	16.9%
Sep-09	TBD	115,326.1*	14.6%**
	Avg.	**40,001.0**	**23.0%**

**Amount accumulated since last trough*
***Growth since last trough*

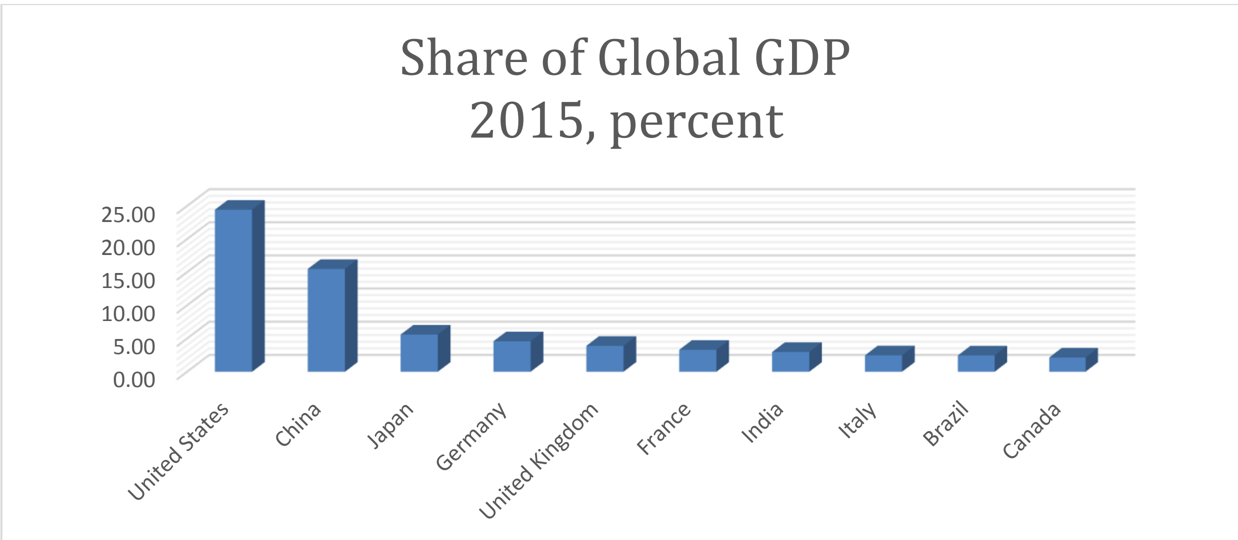
Part of this can be explained by the law of large numbers – it is difficult to continue growing at higher percentages as the denominator increases in value. The cumulative GDP has been adjusted into today's dollars to demonstrate just how much smaller the economy was throughout some of the strongest recoveries. There are several other structural factors such as globalization, demographic headwinds, and large fiscal drag that have played a role in what has been a very tepid, albeit long, recovery.

We are not trying to make a political statement with this data. One could easily argue – and is clearly evidenced by the 2010 mid-terms - that it was time to tighten our belts after municipal, state, and federal debts reached extreme levels. Keynesian arguments would say that had we borrowed more and injected that money into the system that money would have had a multiplier and helped boost the economy to a point where we could pay off that debt easier in the future. As with most things the answer probably lies somewhere in-between and fortunately the electorate gets to decide. It is worth noting that both presidential candidates are running on an economic platform that includes fiscal stimulus beyond tax cuts.



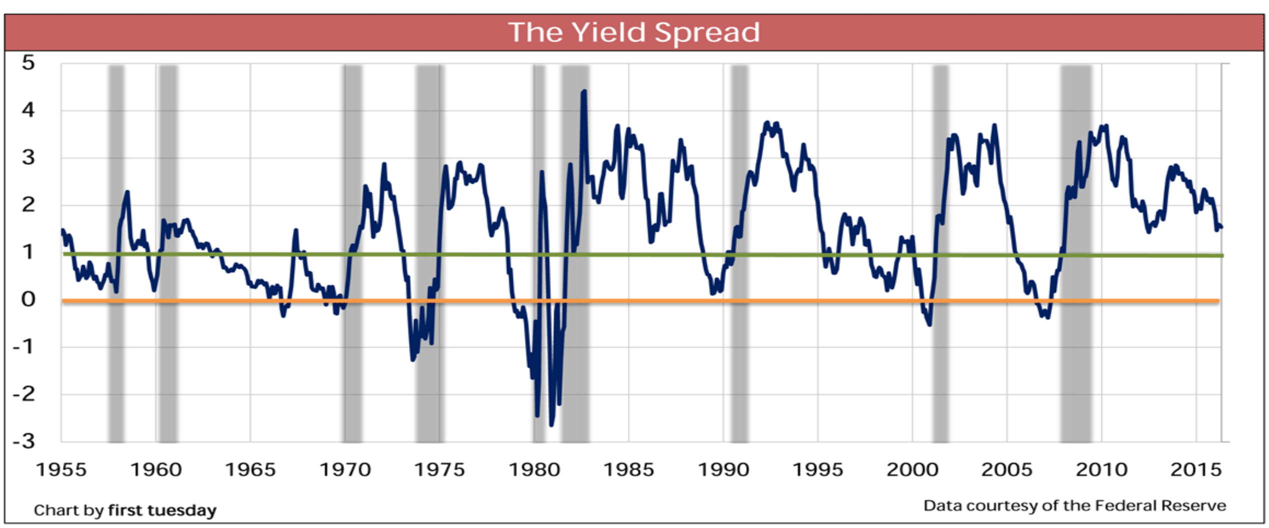
The US economy has held up remarkably well relative to the rest of the world. It is nonsensical to think in this era of globalization that the rest of the world will not have an impact on domestic growth. Almost 50% of all revenues from the largest 500 domestic companies are derived from international sales. Being able to compete in the global market place that includes over 7 billion people is far superior than trying to base all policy on competing domestically with just over 300 million. On a side note, it makes are world much safer because countries that have common economic interest in each other are less likely to go to war.

GDP estimates in developed and emerging markets around the world have been lackluster at best and have definitely contributed to the weak recovery at home. The chart below is a good reminder of just how economically dominant the US is relative to the rest of the world. The US accounts for approximately 25% of global GDP with only 5% of the global population.



Source: IHS Global Insight and Wells Fargo Securities

Our base case – highest probability outcome - is that the economy will continue to plod along at a 2% clip. Absent high valuations in the equity market, it is unlikely that we get a severe pullback unless we fall into a recession. An inverted yield curve – that is when the yields on treasuries with a shorter duration are higher than the yields on treasuries that have a longer duration – has proceeded every recession over the past 7 decades. The chart below shows the yield spread between the 3 month/10yr treasury over the past 60 years. The curve has definitely flattened but we are far from inverting at this point. We will continue to monitor credit spreads globally for any cracks in the ice.



The chart below illustrates the probability of recession based on Yield Curves across the globe.

Historical Percent of Time Economy in Recession within a Year of Different Yield Curves

Indicates yield spread as of 6/27/2016

Yield Spread	U.S.	Eurozone	U.K.	Sweden	Switzerland	Mexico
+200 or more	8%	21%	16%	5%	24%	19%
+200 to +100	25%	23%	7%	1%	18%	16%
+100 to 0	35%	29%	12%	16%	12%	25%
0 to -100	81%	61%	22%	51%	15%	33%
-100 to -200	100%	75%	35%	73%	57%	100%
-200 or less	100%	100%	63%	85%	87%	100%

Historical time period begins: U.S. 1967, Eurozone 1970, UK 1970, Switzerland 1975, Sweden 1970, Mexico 2000.
All yield spreads calculated as 10 year less 3 month except Mexico (5 year less 3 month) and Eurozone (7 year less 2 year)
Source: Charles Schwab, Bloomberg, Macrobond. Data as of 6/27/2016.

The first tenant in our investment philosophy - http://www.tamgmt.com/#/philosophy/ - states "each data point needs to be contextualized for its relevance in the current period." The chart above is a perfect example. While the yield curve should have a heavy weighting in any recession model there are unique characteristics that need to be considered. For example, much of the recent move down in intermediate and long term Treasury rates can be attributed to a flight to quality resulting from Brexit fears, slowing global growth, and negative interest rates in Europe, Switzerland, and Japan. This is evidenced by the Fed Bank of New York's term premium estimates.

Other examples of data points being unique to a current period include the CAPE ratio in 2009-2012 and unemployment throughout the current cycle. It was almost impossible to find anyone advocating equities in the early part of this cycle. We documented this in quarterly letters in 2010 through 2012 with data showing that professionals in endowments, managed accounts, and funds as well as retail investors were overweight cash and safe assets throughout what has been one of the best periods for the stock market on record.

In hindsight the market was about as cheap as it has ever been however people were scared and scarred from the financial crisis and instead of using facts to develop a narrative they did the reverse and found facts to support their narrative. They all would cling to the CAPE ratio which is a rolling 10 year moving average of earnings adjusted for inflation. The problem with this metric was that there were hundreds of billions in bank losses, fines, and write-downs that were unique to that 10 year period.

Another example would be the unemployment data throughout the past cycle. It is typical for markets to peak around full employment of 4-5% as measured by U-3 unemployment. There are unique characteristics to this cycle that would suggest that U-6 unemployment – measure that factors in people that have left the workforce because they do not think they can find work and people with part time jobs that cannot find full time jobs – or at least an average of the two might be a better gauge of where we are in both the economic and market cycle.

Looking ahead, we will continue to monitor global markets and make adjustments if key data points begin to signal vulnerability in the capital markets.

- Byron Fields
Chief Investment Officer