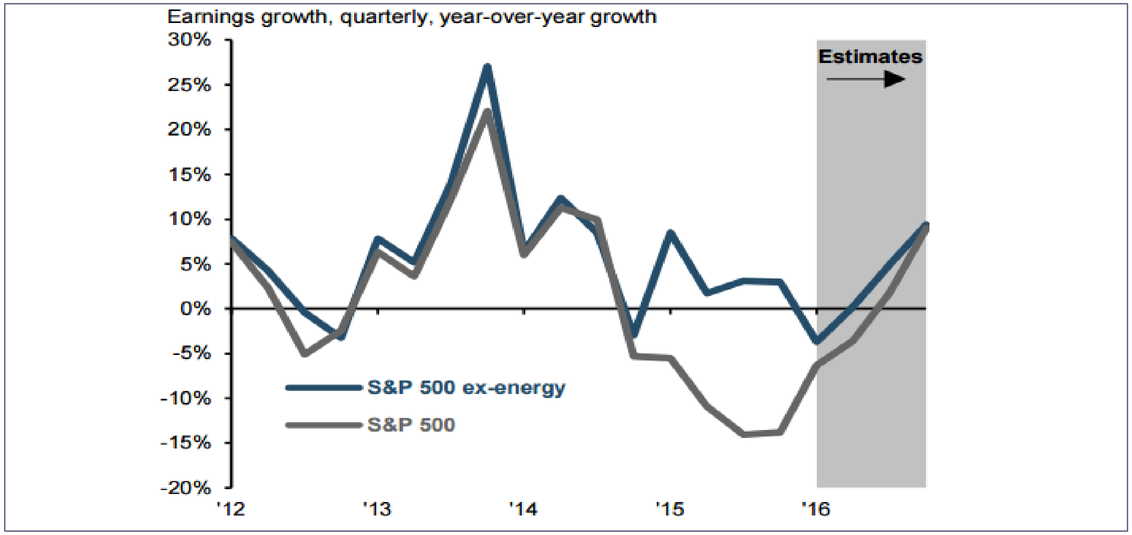
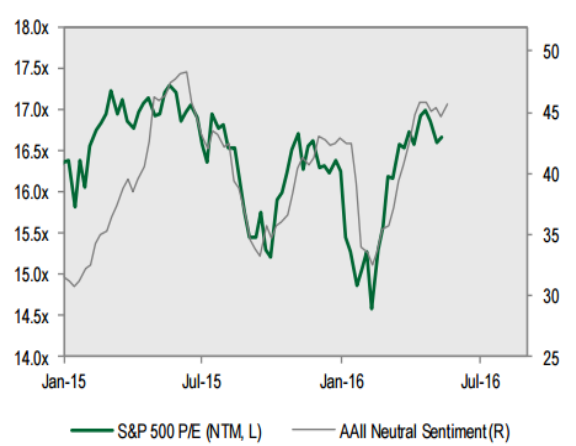
Market Recap

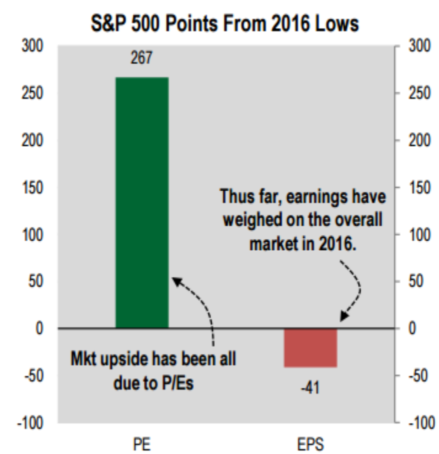
Earnings Growth Should Turn Positive in 2H 2016



Source: JP Morgan

Market Expansion Driven by P/E Growth





Source: Cornerstone Macro

With first quarter company earnings season coming to a close, overall profits were lower versus the same period a year ago. However, some positives arise from what analysts expected to be a fairly weak performance. While EPS growth y/y was -6.3%, that figure improves to -3.7% when energy sector results are eliminated. Oil prices have, at the very least, shown signs of stabilization if not modest recovery, and we can reasonably expect a rebound in y/y energy sector results if the price of oil does not continue to fall precipitously. Revenue growth marked another highlight in Q1, with 44% of companies beating estimates – the highest rate since 2014. This progress was driven in part by an improving foreign exchange landscape, with the dollar's 4.2% decline resulting in a boost to international sales figures. With these macro headwinds expected to abate further, a return to positive revenue and EPS growth may be in the forecast for the second half of 2016.

Historically, in boom or bust markets, equities trade at the mercy of P/E multiples more than earnings. In other words, major structural headwinds (or tailwinds) tend to yield wild swings in investor sentiment as fear (or greed) drive the market through P/E volatility. Today's global investment landscape has been littered with structural and event-driven headwinds (Euro Banks, oil, China, Grexit, etc.) that have been countered by cyclical stimulus (low rates). The uncertainty has manifested itself in increased volatility expressed through the expansion or contraction of P/Es. Over the last 3 years, 97% of the market's movement has been explained by P/Es, rather than earnings growth. The market saw an extension of this trend in Q1, as some of these headwinds resolved themselves, with 118% of the market gain since February's lows attributed to P/E multiples, despite earnings' drag on market valuations to the tune of -18%.

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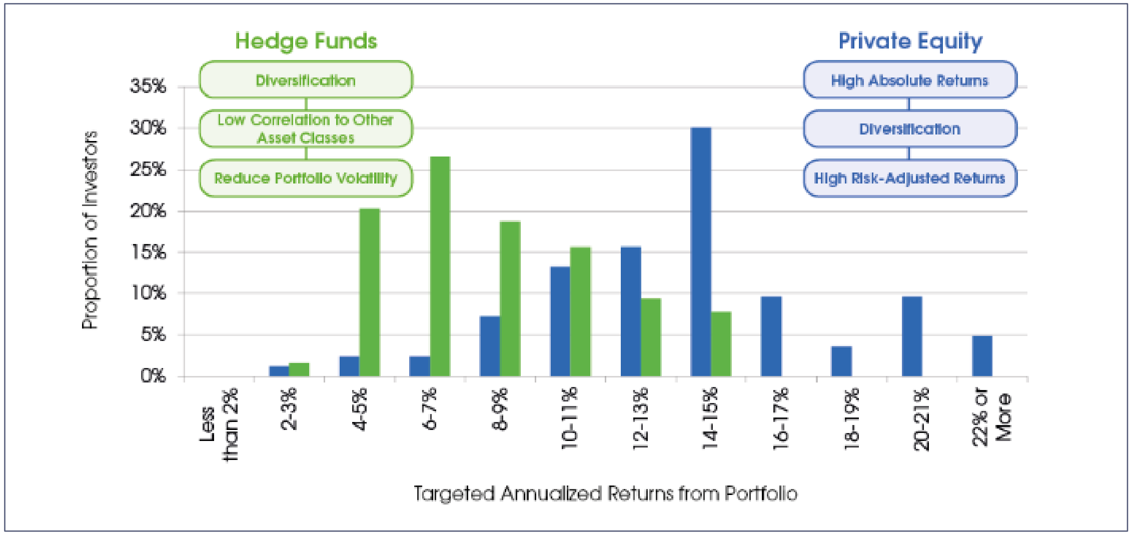
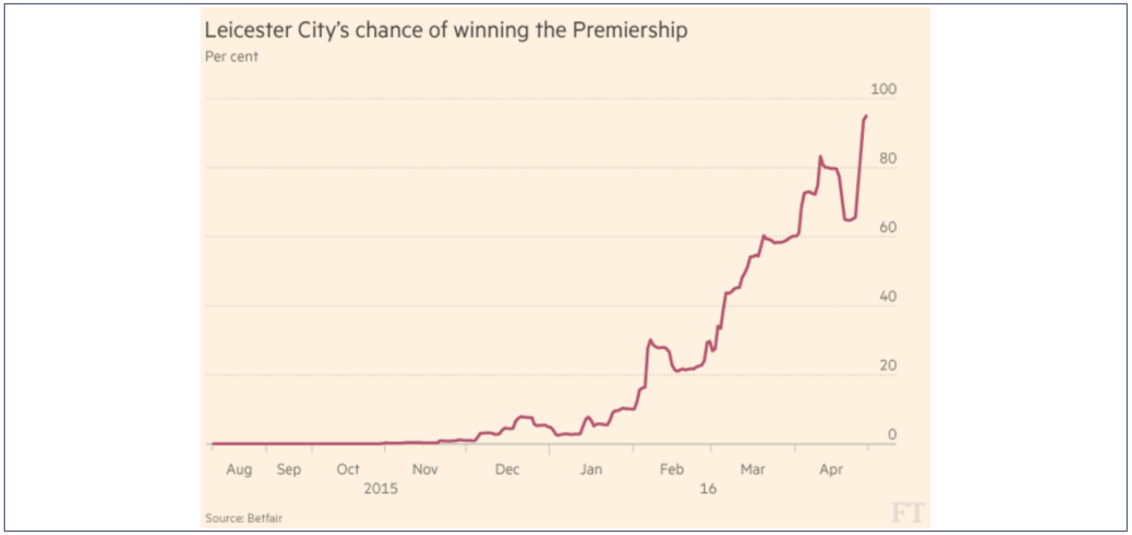
Private Equity vs. Hedge Funds: Divergent Expectations



Source: Preqin Investor Outlook: H2 2015

According to a recent survey by Preqin, investors seeking higher absolute returns have turned to private equity instead of hedge funds. The median target returns for the private equity class ranged from 14-15%, compared to hedge funds at 8-9%. The divergence can be explained by the priorities of the asset owners: hedge fund participants seek diversification, low correlation to other assets, and reduced portfolio volatility, and therefore place a smaller emphasis on absolute returns. Private equity investors instead cite high absolute returns as their top priority, followed by diversification and risk-adjusted returns. The 3-year return for private equity reached 16.2% in 2015, vs. 15.4% on a 5-year basis. Hedge funds fell flat relative to expectations, reporting 4.5% and 4.7% for 3-year and 5-year returns, respectively. However, this disappointment did not deter hedge fund investors, whose average allocation was 13.8% vs. an average target of 14.2%.

Leicester Wins Against All Odds



Source: Financial Times

What are the odds that Elvis is alive? According to the bookmaker William Hill, they're the same odds (5,000-1) as Leicester City winning the Premier League – a feat the team accomplished last week. Other 5,000-1 odds offered by William Hill include the discovery of the Loch Ness monster or the Yeti, and Kim Kardashian becoming President in 2020. While in reality the probability of Leicester's victory was closer to 1,000-1 or 2,000-1, bookmakers inflated the odds in order to attract gamblers – a decision they may regret now, as they face $36 million in payouts, the highest in British sporting history. Still, bookmakers expect to attract five times as many bettors next season, as fans of other underdog teams find hope in Leicester's success. What are the chances of another Cinderella story like Leicester's? Judging by the unpredictability of 2016 thus far, all bets are off.

Contact: If you have any questions or comments, please do not hesitate to contact us at 703.992.6164. For more information about Harbour Capital Advisors, please visit our website at www.harbourcapitaladvisors.com.

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