Year End Review and Outlook

Many of the market outlook articles appearing today in the financial press reflect a sense of foreboding. Much of the unease may be attributed to rich valuations in the market, to lackluster GDP growth, which is hovering near 2% in the U.S., and to the general unease that accompanies the increasing prospects of global conflict in the wake of recent terrorist attacks.

At this point we don't share that pessimism. We expect global growth to be marginally better next year, growth in the U.S. to fall in the neighborhood of 3%, and equity markets to generate mid-to-high single digit returns in 2016.

We expect better global growth in 2016, growth in the U.S. near 3%, and mid-to-high single digit equity returns

In any market, future returns come from current valuations, growth trends, and catalysts. Higher current valuations mean lower future returns, and by many measures, the market today is not cheap. The table below show historical operating performance, valuation, and return statistics for the S&P 500 in aggregate from 2011 through November 2015.

Exhibit 1
S&P 500 Operating Statistics, Valuation, & Returns 2011-2015

	2011	2012	2013	2014	2015 ytd
Operating Cash Flow	1,137,921	945,365	1,224,466	820,920	1,560,073
Capital Expenditures	(580,617)	(682,590)	(1,046,545)	(856,956)	(1,325,257)
Free Cash Flow	557,303	262,775	177,921	(36,036)	234,816
Operating Cash Flow/Revenues	11.6%	9.2%	11.6%	7.5%	14.5%
3-year Annual Revenue Growth	1.4%	7.6%	5.1%	2.9%	1.6%
Revenues/Net Capital	0.57	0.58	0.53	0.55	0.50
EBITDA Leverage	4.1x	3.8x	4.0x	3.8x	4.3x
Return on Equity	14.0%	12.9%	13.7%	13.9%	12.0%
Enterprise Value/Net Capital	1.32x	1.38x	1.53x	1.59x	1.57x
Year-to-date Returns	2.1%	15.9%	32.0%	13.5%	3.0%

Source: Seaport Investment Management, Bloomberg

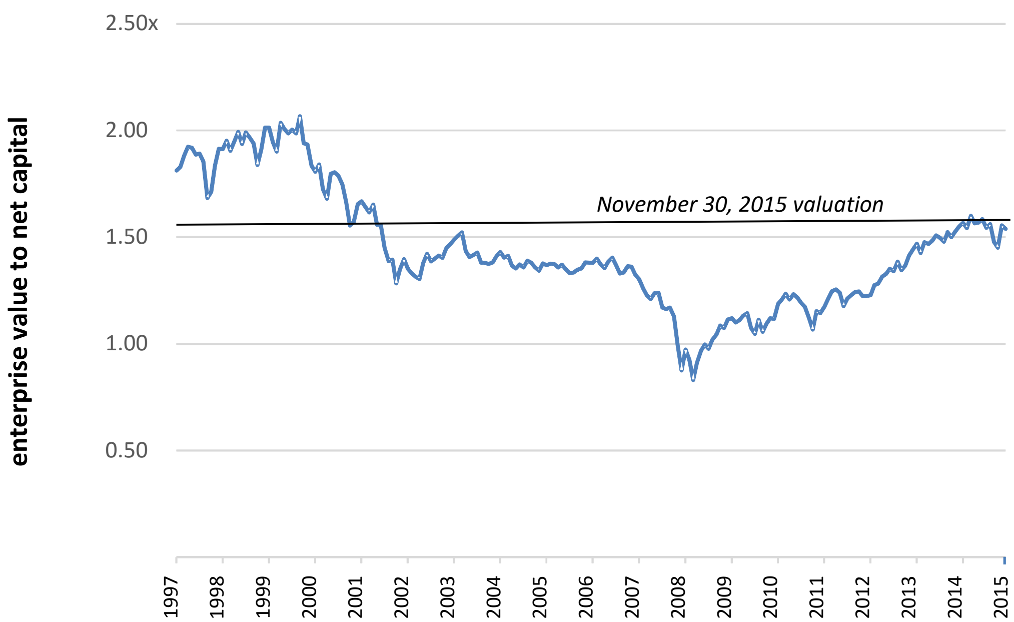
Operating cash flow on the first line is cash flow after net investment in working capital, but before divestitures, dividends, equity issuance, and stock buybacks. It is the gross economic engine of any company before management does anything with the cash. Here, it is the gross economic engine of S&P 500 companies in aggregate. Capital expenditures include cash paid and debt assumed in acquisitions, which have been a significant part of capex in 2015, and free cash flow is what is left after subtracting it from operating cash flow.

There is a lot to be learned from a closer look at these figures by industry, but what is relevant to current market valuation can be found in the enterprise value/net capital statistic. As a basis for valuation, net capital has advantages over net income. It is based on physical assets and liabilities that can be measured precisely, unlike net income, which includes estimates and other arbitrary assumptions. It is a more stable valuation measure since it can be negative only under extremely rare circumstances. Finally, companies do not trade below their net capital for long periods unless there are significant assets of questionable and hard-to-determine value on their balance sheets.

At the end of November, S&P 500 companies closed trading at an enterprise/net capital valuation of 1.56x. In the chart below, which traces this multiple for the S&P 500 from January 1997 through November, this comes close to the top of the range, leaving aside the crazy valuations that accompanied the telecom internet boom of the late 1990's.

Exhibit 2

S&P 500 Enterprise Value to Net Capital 1997-2015



Current valuation of the S&P 500 is close to the top the range where the index has traded from 1997 through November

Source: Seaport Investment Management, Bloomberg

There isn't much room left for valuations in aggregate to expand, particularly when you consider that return on equity and 3-year revenue growth in Exhibit 1 for 2015 are both down from last year.

In the absence of support from valuation, the outlook for global growth takes on added importance for 2016. Three trends matter here. They are (i) the pace of rebalancing in the Chinese economy from export and infrastructure-driven growth to growth in consumption, (ii) the emergence of the Eurozone from recession led by aggressive monetary policies from the European Central Bank (ECB), and (iii) the extent to which growth in household consumption in the U.S offsets a weakening manufacturing sector under pressure from a strong dollar.

China and Global Growth in 2016

Every economy that pursues investment-led and export-driven development, as China has, ultimately faces the problem of how to sustain it. The government policies and programs that promote it are typically financed by a cheap currency and low cost loans at the expense of the household sector with the result that consumption falls far below global norms. The only sustainable, long-term source of growth resides in consumption by the household sector and without its support an economy eventually runs out of steam due to excess debt, uneconomic investments, and rising barriers to exports in foreign markets. History is littered with examples—the U.S. in the 1930's, Russia in the 1970's, Brazil in the 1980's, and Japan in the 1990's.

Any attempt by China to rebalance its economy to favor growth in consumption almost by definition must come at the expense of investment and force growth rates below the current level of 7%. Of greater significance is that it takes the levers of growth away from the government and leaves them subject to the whims of the household sector. The political elite of China has an enormous personal economic stake in the current system despite the rising specter of future shock. That means any change in development policies will encounter resistance and be slow in coming.

The Chinese government has demonstrated with its actions in the stock market earlier this year that it is prepared to do just about anything to ensure 7% annual growth for the immediate future. That target appears a reasonably safe bet for the next 12 months.

China has demonstrated its commitment to do whatever is required to ensure 7% growth in 2016

Longer term, however, we are witnessing the beginning of the end of the industrialization of China. The implications for energy markets and commodities are stark. With the exception of India, there is no other country that has the same scale and capacity as China to absorb anything close to the same level of commodity-intensive investment in infrastructure. It is not clear whether India has the institutions or political will to implement a development program that would replace the inevitable loss in demand from China.

Europe

After China the next major trend that will drive returns in 2016 is the pace of economic recovery in Europe. With a slowdown in global trade putting pressure on exports and on the engine of the Eurozone industrial economy, Germany, the question remains whether aggressive monetary easing by the ECB will be sufficient to accelerate growth in other sectors.

In Europe GDP growth has accelerated from under 1% to 1.6% since the end of 2014 and gains support from the expansion of credit in the region led by the ECB

The economic date provide grounds for guarded optimism. Manufacturing in the region is holding steady in no small part with the help of a cheap euro. Household consumption and domestic demand are growing, and year-over-year GDP growth is inching up from under 1% at the end of 2014 to +1.6% at the end of the third quarter. This slow but steady recovery gains support from an expansion of credit in the economy led by the ECB.

Potential challenges to a recovery, in our view, are primarily political. The Syrian refugee crisis and terrorist attacks in Paris have exacerbated divisions between nations at the periphery and the center and raise the specter of a political fragmentation of the Eurozone. This is a longer-term threat and probably will not become a major factor for investment programs or household consumption in 2016.

Back in the U.S.

As the prospect of a rate hike by the Fed appears more and more likely, the focus in U.S. markets has shifted to the selloff in energy and the knock on effects in emerging markets and high yield. Overlooked in the face of the recent market volatility is the recovery in the construction sector, which has broad implications for the domestic economy as a whole.

Among the major sectors, construction has the highest low-skill labor content in its value-added to the GDP as perhaps the most significant employer of workers in the lower half of the nation's income distribution. These workers typically lack higher education, are often immigrants, frequently are paid in cash, have no savings, and spend everything they earn. Growth of employment in construction invariably accelerates growth in household consumption.

Recovery in U.S construction markets will support growth in household consumption and support a faster pace of domestic economic expansion

While manufacturing has languished domestically, down -0.65% year-to-date through October against an almost 10% rise in the dollar versus the euro, construction spending is up over 15%, contributing to a 5% growth in personal consumption expenditures over the same period.

We expect this trend to continue in 2016. Construction doesn't compete with imports and is seasonal, so the slowdown experienced in October will likely continue through the first quarter.

Any stabilization or weakening of the dollar against the euro would spark a recovery in growth in manufacturing, which gains significant support from the automotive sector. Seasonally-adjusted annual auto sales declined in October, but recent difficulties in gaining approvals for from the United Autoworkers (UAW) union membership in the last round of contract negotiations with the automakers would suggest, at least in the opinion of the UAW, that domestic production capacity relative to demand is tight.

The table below provides return on equity, enterprise value to net capital, and year-to-date returns from 2011 through November 2015 by sector for the S&P 500. Consumer Discretionary was the top performing sector with year-to-date returns of 10.5% and even after one of the worst weeks for the market in 2015 still leads with a year-to-date return as of December 11 of 7.9% versus -0.275% for the index as a whole.

We favor Consumer Discretionary, Healthcare, and Technology in our portfolios for 2016 and underweight Energy

We would advocate a continuing overweight to the sector in 2016. Other sectors we would favor would include Healthcare and Technology, where valuations remain reasonable, operating performance solid, trends favorable, and returns acceptable. Energy may appear attractive by virtue of appearing cheap by comparison with trading levels earlier in the year, but we believe any increase in exposure to the sector at this point to be premature. Reported reserves for energy producers will be released with annual reports in February and at current prices for oil and natural gas one can expect potentially significant negative revisions and bad news for the stocks. The opportunity to increase exposure and reap excess returns will come later.

Energy appears cheap, but with negative reserve revisions expected at year end it's too early to increase exposure now

Exhibit 3

S&P 500 Return of Equity, Valuation, & Returns 2011-2015

sector	category	2011	2012	2013	2014	2015
Consumer Discretionary	Return on Equity	17.9%	18.5%	20.2%	21.2%	21.3%
	Enterprise/Net Capital	2.02x	2.31x	2.75x	2.83x	2.88x
	Year-to-date Returns	6.8%	19.5%	33.6%	10.0%	10.5%
Consumer Staples	Return on Equity	22.9%	21.7%	23.5%	22.2%	19.4%
	Enterprise/Net Capital	2.48x	2.66x	3.09x	3.42x	3.04x
	Year-to-date Returns	14.0%	9.2%	23.7%	18.5%	4.9%
Energy	Return on Equity	17.1%	14.9%	12.8%	10.6%	(2.3%)
	Enterprise/Net Capital	1.71x	1.58x	1.75x	1.54x	1.43x
	Year-to-date Returns	5.6%	5.0%	22.9%	(7.4%)	(12.4%)
Financials	Return on Equity	6.9%	7.3%	8.1%	8.3%	8.9%
	Enterprise/Net Capital	0.97x	1.00x	1.06x	1.06x	1.07x
	Year-to-date Returns	(17.1%)	25.7%	32.9%	11.3%	1.4%
Healthcare	Return on Equity	15.6%	13.9%	17.2%	16.4%	15.6%
	Enterprise/Net Capital	2.29x	2.33x	2.79x	3.51x	2.63x
	Year-to-date Returns	12.0%	16.4%	33.1%	25.0%	4.5%
Industrials	Return on Equity	17.4%	17.3%	16.5%	18.9%	17.4%
	Enterprise/Net Capital	1.74x	1.89x	2.36x	2.51x	2.40x
	Year-to-date Returns	(1.1%)	14.6%	35.4%	7.5%	(1.0%)
Materials	Return on Equity	16.3%	11.1%	12.2%	14.9%	9.7%
	Enterprise/Net Capital	1.73x	1.84x	2.05x	2.27x	2.08x
	Year-to-date Returns	(12.4%)	13.6%	23.1%	8.7%	(6.4%)
Technology	Return on Equity	18.9%	16.4%	18.1%	20.1%	18.5%
	Enterprise/Net Capital	2.80x	3.02x	2.90x	3.67x	2.92x
	Year-to-date Returns	2.0%	13.1%	23.1%	19.4%	7.0%
Utilities	Return on Equity	10.1%	7.0%	6.7%	8.6%	8.4%
	Enterprise/Net Capital	1.23x	1.18x	1.20x	1.34x	1.24x
	Year-to-date Returns	17.6%	1.3%	11.4%	20.3%	(8.0%)

Source: Seaport Investment Management, Bloomberg

Managing a portfolio rests on three decisions: security selection, timing of entry and exit, and position sizing. A well-built portfolio will be the product of an iterative process that starts with a macro framework, assesses how it affects industry valuation, drills down to identify securities that appear cheap relative to the assets of the companies that issued them, and finally evaluates the choice in the context of the macro and industry outlook.

We hope the process we've presented here provides a helpful framework for the year ahead and we thank our investors for their continued trust and confidence in us.

Charles Wyman
Portfolio Manager & Chief Risk Officer
December 14, 2015

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