The Renaissance Report

February 2016

Providing customized financial, estate and investment management solutions.

Renaissance Investment Group , LLC
a subsidiary of Berkshire Bank

25B Main Street
Lenox, MA 01240
(413)445-2481

PRINCIPALS

Thomas E. Malinowski
President &
Managing Director—
Financial Counseling

Trevor M. Forbes
Managing Director—
Investments

ASSOCIATES

Christopher G. King
Senior Portfolio Manager

Paula M. Hilchey
Chief Compliance Officer

Lori J. Killeen
Senior Administrative Officer

Kathleen M. Blair
Administrative Assistant

"Pay heed to the tales of old wives. It may well be that they alone keep in memory what it was once needful for the wise to know."

J.R.R. Tolkien,
The Lord of the Rings

The opening weeks of 2016 have extended the volatility and uncertainty that began in the closing weeks of last year. It appears that much of the selling of stocks has occurred as specific investors have been forced to sell. The large sovereign wealth funds set up mainly by the principal oil producing nations, seem to have become checkbooks for cash strapped governments under severe pressure from the plunge in oil prices. This helps to explain the uncanny correlation that has developed between the fortunes of the oil price and the stock market indices.

In the investment piece this quarter, we examine the disconnect between stocks, bonds and the underlying economy. Our conclusion reflects the importance of an appropriate balance between the major asset classes as a way to control volatility. In his article, Tom discusses the decisions around gifting as well as an update in the main tax rates for 2016.

We recognize that these volatile times are a major concern for our clients, but we do view these as transitory and we expect policy responses to be positive. In the meantime, our focus remains one of balancing the mix of investments to ensure the most appropriate characteristics for the market environment.

Trevor

Enter 2016

submitted by: Trevor Forbes

If the market adage of "so goes January, so goes the rest of the year" is correct, then the auspices for 2016 are not encouraging.

The question in most investors' minds is whether this opening weakness and volatility in equity markets will, indeed, continue. What evidence is there that this could be supported by fundamental economic and corporate developments? Before we examine the principal areas of concern to investors at the current time, we should consider the following statements:

- U.S consumer spending is approximately equivalent to 31% of the value of total world trade.
- U.S. consumer spending is three times the size of the next largest consumer – China.

(continued on page 2)

It's the Gift that Keeps on Giving

submitted by: Tom Malinowski

As we approach another income tax filing season, now may be the time to consider making a gift to your son, daughter, or even grandchild that may benefit them for many years to come. Provided they have earned income, they may be eligible to make a contribution to a traditional or Roth IRA. Teenagers and young adult typically do not have the cash available to make such a contribution or often do not recognize the value since the benefits are many years down the road. You may enable them to do so as well as educate them on the power of compound interest.

The usual IRA rules and limitations apply. Consequently, the child or grandchild must have earned income,

(continued on page 6)

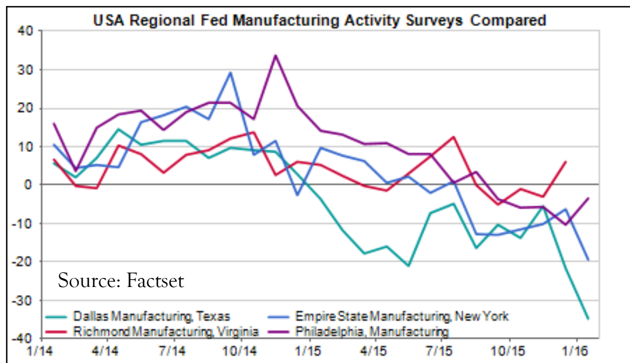
Enter 2016 (continued from page 1)

- For most of the last 100 years, it has been the U.S. consumer that has been one of the principal engines of global growth, helping to stimulate recovery from recession.

As the U.S consumer remains the most powerful source of demand in the world today, it is worth bearing these facts in mind as we look at the issues most concerning investors.

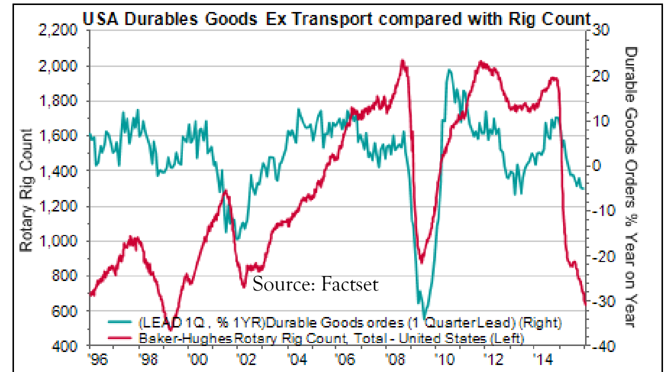
The collapse in oil prices

The impact of declining oil prices on the economies of Texas, Oklahoma and North Dakota has fed concern that this could push the U.S. economy into an early recession. We do, however, view this as unlikely. The sharp fall in manufacturing activity in Texas, as measured by the Dallas Fed Survey, is a clear indication of stress in a state which contributes just 9% of U.S. GDP. The Empire State survey of manufacturing activity in New York also showed a surprisingly sharp fall in January 2016. In contrast, however both the Richmond and Philadelphia Fed manufacturing surveys indicated some improvement:

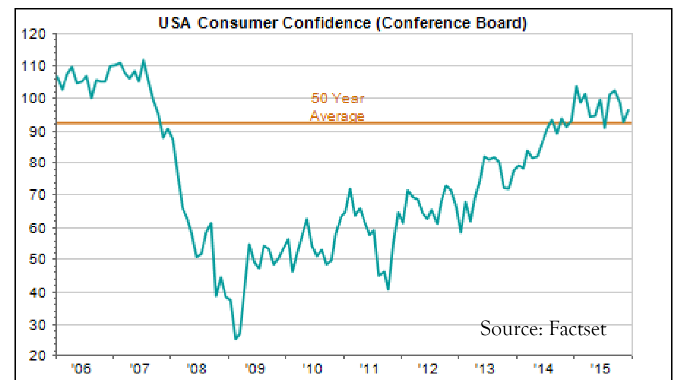


It is also important to recall that manufacturing contributes approximately 18% of the U.S. economy. Contrast this, however, with consumer spending which comprises around two thirds of U.S. economic activity.

Manufacturing demand has been adversely affected by the sharp decline in activity in the energy sector and this can be shown by a comparison between durable goods orders and the number of drilling rigs in operation in the U.S.



The consumer appears to be in a much more robust position. After all, gas prices and household energy costs have declined by approximately 50% over the last two years and this has contributed significantly to disposable income. Measures of consumer confidence show a much healthier picture as a result:



The U.S. consumer benefits from some of the deflationary pressures in the price of goods – especially those that require oil as a raw material.

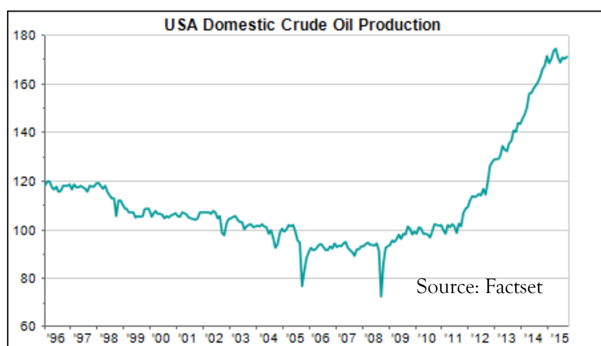
We have been led to understand that at $30 a barrel, most domestic shale oil deposits are uneconomic to operate. The major producers, however, have maintained oil output at near record levels. The reason for this apparent paradox is that domestic producers have worked hard to lower the cost of production and cut their capital spending. In many cases this will be at the expense of future production because a lack of drilling will prejudice production levels as existing wells start to run dry. Companies have been forced to do this through a strong desire to remain solvent at whatever cost.

(continued on page 3)

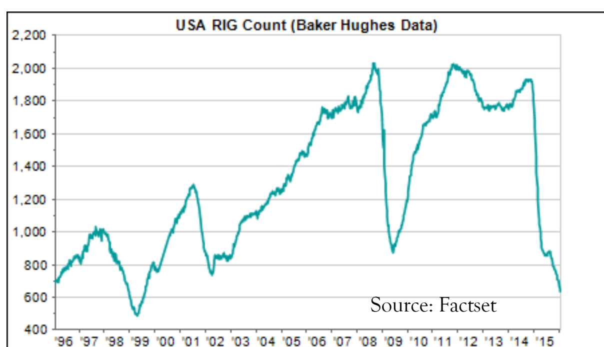
Enter 2016 (continued from page 2)

Meanwhile, a range of industries including chemical manufacturers, industrial gas producers, oil refineries, utilities and transport companies have benefitted as their cost of operation has been reduced significantly. Initially this helps profit margins as many of these companies are reluctant to pass on their gains quickly.

It is not just U.S. oil producers who are affected by the oversupply of crude oil. Many OPEC producers such as Saudi Arabia are being forced to borrow or sell assets in order to balance their bloated government spending budgets. In some cases this becomes an impossible task. OPEC members such as Venezuela and Nigeria, and outside the cartel, Russia and new entrant, Iran, are suffering. Interestingly, despite Saudi Arabia's bold comments that under no circumstance will they sacrifice market share, there are increasing calls for supply discipline across all producers whether or not they are a part of OPEC.



U.S. oil production looks set to fall sharply as the current year progresses. The number of drilling rigs operating domestically has fallen precipitously by 68% from the peak.



At this rate the lack of new wells being drilled means that as shale wells are depleted (typically 2 ½ to 3 years), they will not be replaced. A similar pattern is being seen in other high cost locations such as the Canadian tar sands. Meanwhile all companies have announced significant cuts to their exploration budgets.

As a result, we may be witnessing the first stage of a stabilization for the industry.

The strong U.S. $ and company earnings

- The significant rise in the value of the U.S. dollar has also increased purchasing power for imported items. Consumers gain but so do retailers and manufacturing companies that import goods and materials. The goods they purchase from overseas with a strong dollar can often be sold, at least initially, for a higher margin.

- The other side of this issue is that U.S. manufacturing companies have found it progressively harder to export. A weaker euro and Japanese yen have clearly made it easier for companies in these regions to gain an increasing share of world trade.

- Many investors also view the translation of revenues and profits generated overseas into U.S. dollars as a negative for company earnings. Approximately 35% of company revenues are generated outside the U.S.A. So, the 65% of company revenues that are generated domestically should benefit from a stronger dollar and the greater purchasing power this delivers to the consumer.

China's implications for the U.S. economy

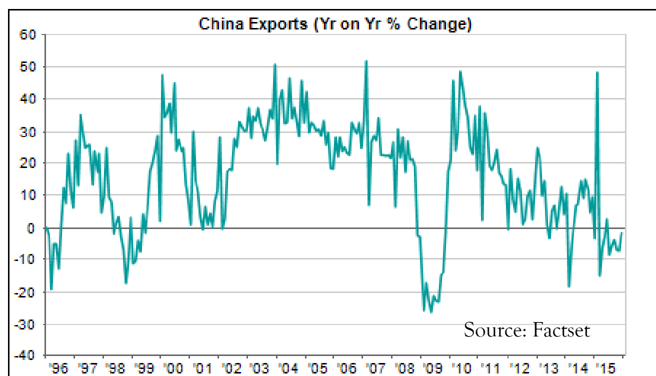
We do not expect China's problems to present a viable threat to the U.S. economic recovery.

There is much disagreement over the precise nature of China's slowdown. The country's emergence from isolation in the late 1990's produced a substaintial demand for capital goods and raw materials. There was significant catch up for an economy that by the end of

(continued on page 4)

Enter 2016 (continued from page 3)

the 1980's was still largely agriculture based and feudal in structure. With the benefit of hindsight, we can now see that much of the enormous capital investment into this manufacturing infrastructure became over-capacity in productive capability as the Chinese currency became stronger. This currency strength together with rising wages has damaged China's international competitiveness such that exports have not grown for the last two years. This is vitally important for a country whose economy relies on exports for close to 40% of Gross Domestic Product (GDP).

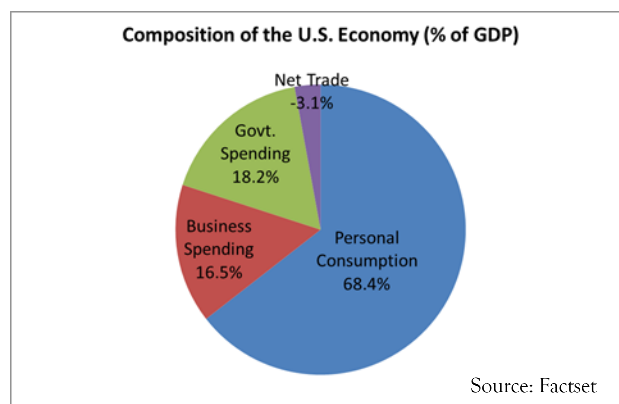


Interestingly, the values of imports have not grown since the end of 2012. This weakness in the data for trade has prompted some observers to question Chinese government official figures that show the economy (GDP) growing by 6.4% during 2015.

Although the Chinese government has recently tried to calm nervous investors' fears by claiming that the data produced is entirely accurate, many doubts remain. Probably the greatest concern is that just as in the U.S and U.K in 2008, the country is wallowing under a vast amount of generally bad lending. These range from the profligate supply of investment funds for basic industries such as steel and cement manufacture, to injudicious debt-fueled real estate investments, and even margin to invest in one of the world's most volatile stock markets – Shanghai.

This does have implications for economies outside China. Dumping of steel and even coal has been highly disruptive to local manufacturers across the world. This has been especially the case in many emerging economies such as Brazil and South Africa but it has also produced calls for protectionism against unfair trading practices in many European countries, such as the UK, and also among North American producers.

China is undergoing a significant transition from a manufacturing to a consumer economy. An understandable concern is that the significant change in wealth distribution that underlies this development is likely to bring social tensions in its wake. These are, however, mainly local issues and although they can be disruptive to world trade, they probably have little bearing on economic developments in the U.S. going forward.

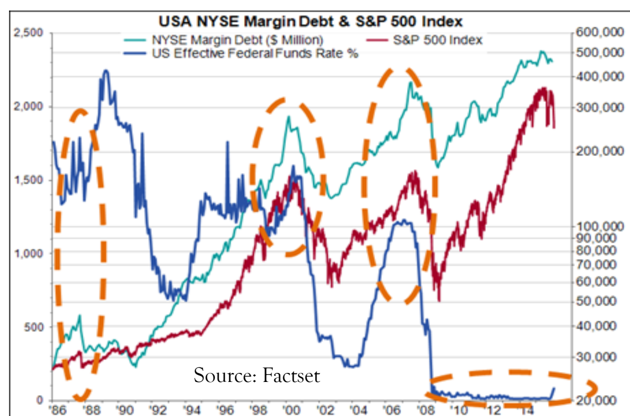


Margin debt and the U.S. stock markets

Many banks and brokers allow investors, professional and individual, to borrow money to invest in the stock market. These borrowings use the value of the underlying portfolio as collateral. If the value of this collateral goes down, the bank or broker will require the borrower to make up the difference by supplying cash into the account. In most cases this will require the investor to sell stock to realize liquidity. The level of margin debt on the New York Stock Exchange (NYSE) has been at record levels. It is thought that the inevitable unwinding of this margin as the market has declined has added to volatility during December and January:

(continued on page 5)

Enter 2016 (continued from page 4)



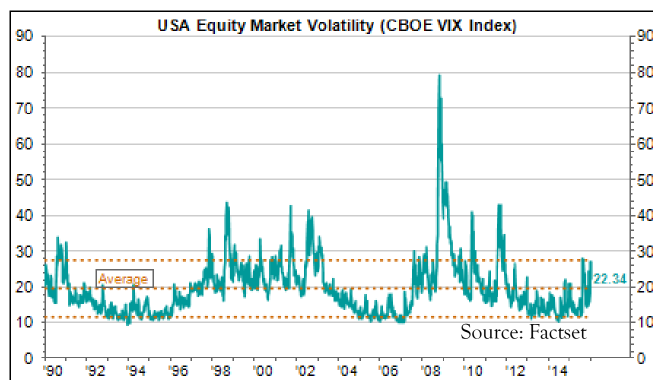
As the chart shows, margin debt has been a feature of the market for many years. Much of this is institutional and reflects the impact of Hedge Funds. The chart also shows a comparison with the Federal Reserve (Fed) Funds Rate. The significance of this is that the cost of borrowing to invest on margin is based on the prevailing interest rates. In mid-1987, late 1990s and again in mid-2007, the cost of borrowing rose significantly causing investors to reduce margin debt and sell equities. By April 2007, the Fed Funds rate at 5.3% required investors to earn significantly more than this going forward to justify the cost of margin.

At the current time, although margin debt is very high, the cost of financing credit remains exceptionally low even after a 0.25% increase in the Fed Funds Rate in December. Only a relatively modest gain in the index will be sufficient for an investor on margin to cover their costs.

As such, we don't see margin debt as a particular problem for the U.S. market going forward. These margin positions do create periodic volatility but they also add to liquidity in the system. Where it is more of an issue is in China where 80% of the Shanghai market is represented by retail investors many of whom are heavily borrowed on margin.

How Renaissance manages volatility

We recognize that market volatility has increased and is likely to remain elevated going forward compared to the last three years. We see this as a return to normality rather than anything exceptional. A balance of assets for most investors remains appropriate in order to help reduce overall portfolio volatility.



For the equity portion of portfolios we balance the majority of holdings we expect to provide good long term growth with some positions included to specifically dampen volatility. We expect this to be achieved through relatively mature products and services and a strong balance sheet. Many of these more defensive positions also provide a much higher than average yield with some dividend growth.

While portfolio balance is important, having the correct amount of cash to take advantage of investment opportunities as they arise can also add value. §§

It's the Gift that Keeps on Giving

(continued from page 1)

the contribution may not exceed the lesser of: $5,500 (in 2015) or 100% of the earned income. If the child (or spouse) is an active participant in an employer plan, he or she may not make a deductible contribution to a traditional IRA if his or her income exceeds certain specified levels. Provided they are not participants in such a plan, he or she may make a tax deductible contribution to an IRA subject to the above dollar limitations.

A non-deductible contribution to a Roth IRA may be made up to $5,500 or 100% of earned income, whichever is less, reduced by any other IRA contributions. The allowable contributions are also phased out depending upon adjusted gross income amounts.

Both traditional IRAs and Roth IRAs grow tax free. As mentioned above, there may be a tax deduction for a traditional IRA contribution but no deduction is allowed for a Roth IRA. However, distributions from Traditional IRAs must begin no later than age 70 ½ and are subject to ordinary income tax, whereas distributions from Roth IRAs are not subject to tax and there is no mandatory age distribution.

For example, if **$5,500** were contributed each of **five years** for a child or grandchild beginning at age 16 through and including age 20, assuming a 6%

annual return, the IRA could be worth **$426,758** at age 65. The same investment earning 8% per year will grow to **$1,029,945** at age 65.

IRA accounts must be established and funded by the original due date of the return, excluding extensions (April 15). We suggest that you speak to your accountant to determine whether a contribution to an IRA may be made on your child's or grandchild's behalf which could benefit them for many years to come. *§§*

This newsletter is limited to the dissemination of general information pertaining to Renaissance's investment advisory services. It is for informational purposes only and should not be construed by a consumer and/or prospective client as a solicitation to effect, or attempt to effect transactions in securities, or the rendering of personalized investment advice for compensation. Renaissance's specific advice is given only within the context of our contractual agreements with each client. Advice may only be rendered after delivery of Form ADV Part 2 and the execution of an agreement by the client and Renaissance.

Banking products are provided by Berkshire Bank: Member FDIC

Investment products are not FDIC-insured, are not a bank deposit, "NOT guaranteed BY THE BANK,,""NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY" and may lose value.