A Bright Future

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Investor Letter
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Surprise, Surprise

Below is an excerpt from a Reuters news article released on November 8th, 2016.

> *"With hours to go before Americans vote, Democrat Hillary Clinton has about a 90 percent chance of defeating Republican Donald Trump in the race for the White House, according to the final Reuters/Ipsos States of the Nation project. Her chances are roughly similar to last week's odds, and any upset by Trump on Tuesday depends on an unlikely combination of turnouts of white, black and Hispanic voters in six or seven states, according to the survey released on Monday."*

A Clinton victory was the consensus expectation, so Trump's win was an upset of presidential proportions. And that wasn't the only surprise. Prior to the election, many believed a Trump victory would cause a financial market sell-off (due to Trump's protectionist rhetoric). Not only has that not transpired, but markets shot into a spectacular "Trump rally." What had been a lackluster year for US markets turned into a strong double digit gain for the S&P 500.

2016 had its share of surprises, and though we'd all like to know what surprises lay ahead, that would be an inherent contradiction. And besides where's the fun in that? The only thing we know for certain is that the market will bring more uncertainty in the year to come. Of course that won't stop me from looking into my foggy crystal ball and trying my hand at fortunetelling in this year's letter -- but I promise I won't spoil all the fun.

Lesson Learned Looking Back

Before we look ahead, let's look back and reflect on last year's fortunetelling. As usual I was both right and wrong, but ended up ahead overall. Although US equity markets started the year off with a scare, I was correct in thinking that 2016 would not bring the next big crash. Of course I also wasn't enamored by US stocks and wrote "*US equities are simply not bargain-priced at present*." I still believe that to be the case (more on that later), but if US equity market returns were the judge, then I was just wrong!

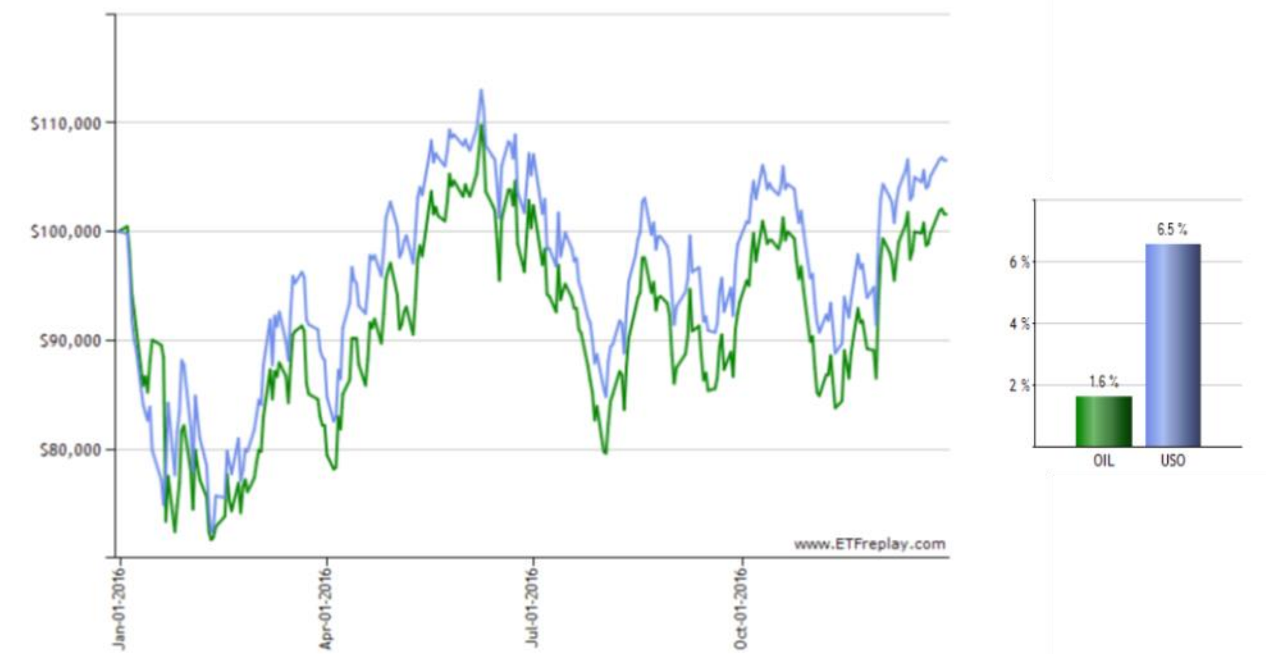
On the other hand, all my "seeking value" calls from 2016 were right on. Specifically I singled out the Russian stock market, oil, and silver. For the year, silver prices advanced 15%, the Russian stock market climbed 47%, and oil prices jumped a whopping 80%! Not bad for a year when the MSCI All Cap World Index (ACWI) returned about 8%. I share this not to pat myself on the back, but to share an important lesson learned.

These investment ideas were actually the primary positions in our Macro Value strategy portfolio. And while we captured the upside in Russian stocks and silver prices, we did not fully participate in oil's runaway returns. This was due to problems I've written about before. Some commodities are difficult to gain exposure to as investments and oil is a perfect example.

The publicly traded financial products designed to provide oil exposure actually do a terrible job of tracking spot prices (or current prices) over time. This is because the products typically invest in futures contracts that track expected oil prices. The difference between spot and future prices (under normal conditions) is known as "contango" (when future prices are higher than spot prices). Long story short, the products basically buy high, sell low, and suffer from time decay as they roll contracts.

The chart below shows the problem clearly. It shows the 2016 prices and total returns for two popular futures-based oil exchange traded products, the iPath S&P GSCI Crude Oil ETN (OIL), and the United States Oil Fund LP (USO). Although spot oil prices were up 80%, OIL and USO returned 1.6% and 6.5%, respectively. In reality the only way to get pure exposure to spot oil prices is to buy and hold physical barrels of crude oil. That's obviously not practical for most investors, and not even for the exchange traded product sponsors.

2016 ETP Prices



Source: etfreplay.com

Having done the research, I was aware of the issues and avoided these products. But I still found myself having to choose from imperfect substitutes for oil exposure, the most practical of which were oil and gas stocks. Digging deeper I ended up favoring oil and gas infrastructure MLPs. There were numerous reasons. MLPs as a group sold off harder compared to larger diversified oil and gas companies. As a result valuations and dividend yields were relatively more attractive. In addition the simple hard assets and toll-based business models of infrastructure MLPs seemed more conservative versus firms that were engaged in everything from exploration to refining.

In the end our MLP position delivered 14.8% in total return for the year. That was much better than what OIL, USO, or even ACWI did. However, it was a far cry from the 80% homerun in oil prices. I'll take the 14%+ and I'm not mad about it. But the lesson is good investments are made of more than just good ideas. They require good implementation as well. When evaluating an investment idea, consideration must be given to whether or not it can be practically executed for profit. Even the best sounding ideas can be worthless if they cannot be made reality.

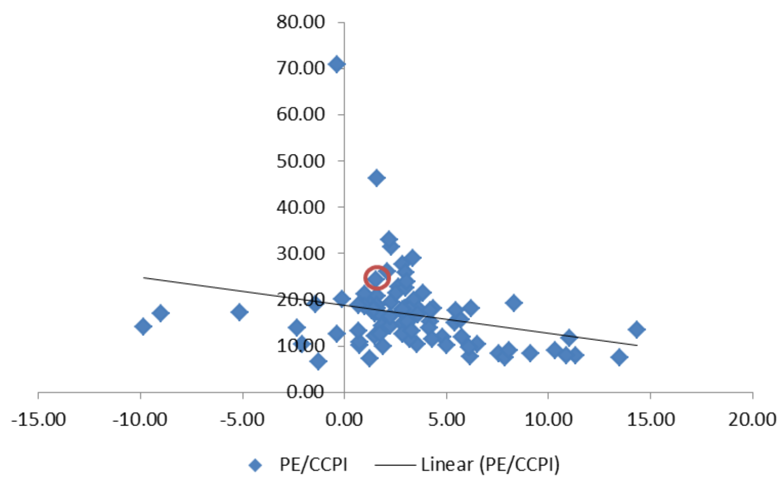
A Valuation Conundrum

The big market story of the year was the dramatic November turnaround in US equites, aka the "Trump rally." Heading into 2016, I thought US stock market valuation was elevated, but also expected a modestly positive, mid-single-digit gain for the S&P. Up until November, that expectation seemed like it would be correct, but how quickly markets change! With a trailing P/E of 26x on the S&P I still think US stocks are expensive. And for those of us expecting some kind of mean-reversion, justifying the elevated valuations has been a conundrum.

But markets don't die of old age and 26x certainly isn't the highest P/E we've ever seen. Besides, there's more to the story than just duration and multiples. There's also the invisible but ubiquitous phenomenon we call inflation. Historically periods of low inflation have coincided with high market valuation levels. Likewise, periods of high inflation have seen low valuations levels.

The two variables don't move in lockstep, but there's negative correlation that doesn't seem totally spurious. And logically, it makes sense. When inflation is high, future earnings (the denominator in the P/E) are worth less and should be valued with a higher discount rate. That results in a lower current price and a lower earnings multiple. And yes, this actually happens in reality. Just consider how higher inflation leads to higher interest rates.

The same logic applies for the US where inflation and interest rates have been very low. A 26x P/E looks high relative to the long-term average of 16x, but it seems less so when considering inflation. In fact the current P/E is near the average among historical values during low inflationary periods. The graph below shows this by plotting annual current P/E over annual core CPI from January 1930 to 2016. The red circle shows where we are now, and the regression line highlights the negative relationship.



Source: US Bureau of Labor Statistics, Robert Shiller Online Data, BCM

Based on the data it looks like P/Es have commonly been above 20x until inflation gets to about 4%. Above 5%, P/Es have rarely been able to stay above 20x. With core inflation reading about 2%, valuations could stay higher for longer. Does that mean US stocks are a bargain? No, even adjusted for inflation they're not cheap. They're just not as expensive as a cursory comparison to historical multiples might imply. The takeaway is the current P/E is high, but in an environment where high P/Es have been supported historically. Valuations could certainly continue to trend higher. But along the way, inflation and interest rates should be watched closely as indicators of when that trend could reverse.

Seeking Value

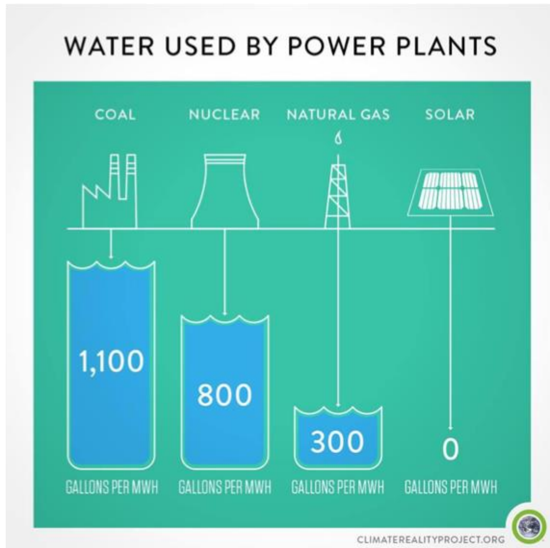
For the risk-seeking investors, I have some new ideas to share this year. These are all positions that we began adding to our Macro Value strategy in 2016, and plan to continue adding to them in 2017. As always these investment ideas are big-picture, high-level (macro-level) opportunities that we believe exhibit attractive valuations and long-term upside potential. Of course they are also speculative and not for the faint of heart, stomach, or risk tolerance.

Looking for Bright Spots

First up is energy. I've been harping on "black gold" for the past two years, but that's actually not what I'm referring to now. I'm looking at the energy sector at large. The sector is unique because it has an absolute need for progress. For example, if technology or healthcare were to never again experience a great leap forward, we'd all we be fine. But that just isn't so with energy.

We require tremendous amounts of energy for just about everything we do, and more so every year. The simple fact is we need more energy than we have fossil fuel. That begs the obvious question – which alternative will become the new global standard? No one knows for sure, but we do have stringent requirements (from being clean to renewable) that reduce the viable alternatives to a short list.

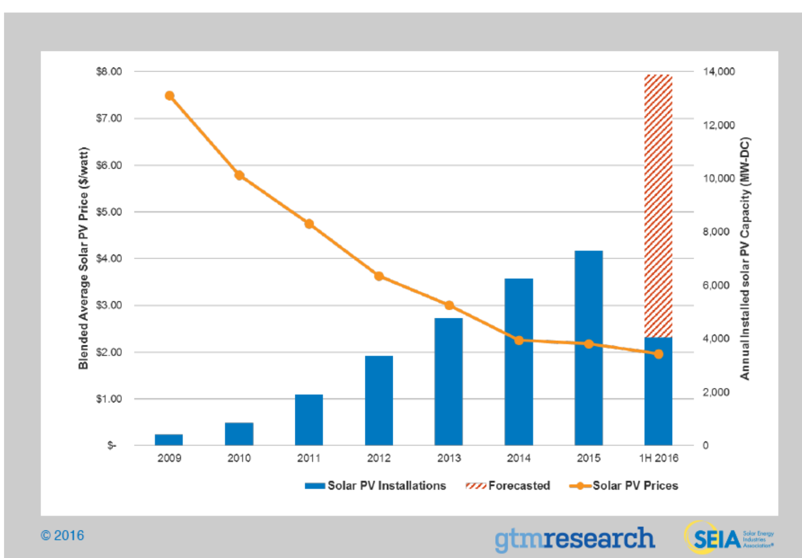
Solar energy is certainly on that list. It's well known as one of the cleanest alternative energy sources available. The generation and use of solar power emits virtually no greenhouse gases. In addition, a less known clean-factoid is solar wastes little to no water. Most other energy generation processes result in large amounts of water pollution.



Source: climaterealityproject.org

Solar energy is also renewable and widely abundant. Yes, the sun will eventually stop burning, but most experts agree it will take somewhere around 5 billion years for that to happen. And unlike fossil fuels that are limited by deposits and combustion, solar energy is available anywhere the sun shines and can power anything from a porch lamp to an entire city. Meanwhile, costs continue to decrease and demand continues to increase, painting a very bright long-term outlook for the solar industry at large.

Solar PV Prices and Installations



Source: Solar Industry Industries Association

And yet it seems like everybody hates solar stocks. From their highs in March 2014, solar stocks are down about 66%. At this point, even if they're not undervalued in absolute terms, they're certainly more attractively priced versus the broader markets. The table below shows price multiples for the S&P 500, Russell 2000, and solar industry stocks (represented by respective ETFs). Even if the broad market didn't look expensive (which it does), solar stocks would still look relatively cheap.

Relative Valuation

MEASURE	SP 500 (SPY)	R2000 (IWM)	SOLAR (TAN)
P/E	19.86	21.47	5.46
P/B	2.73	2.08	0.73
P/S	1.95	1.21	0.48
P/CF	12.23	10.55	4.31

Source: S&P Capital IQ, BCM

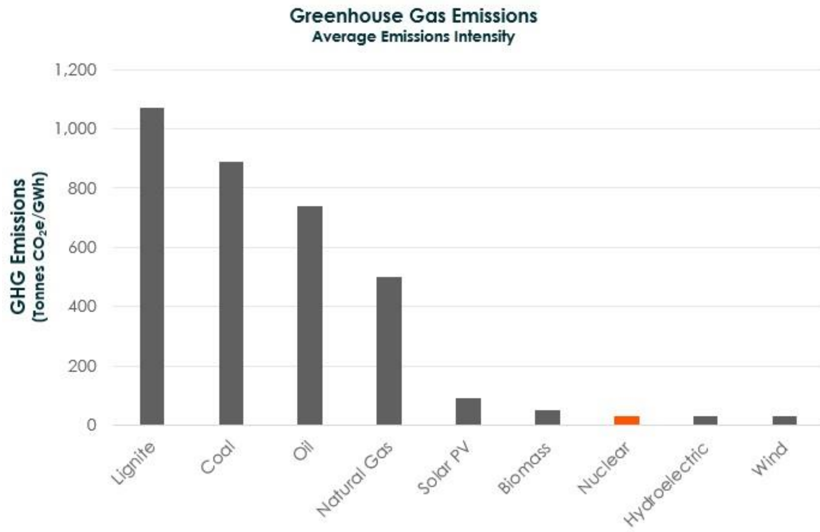
There will be winners and losers, but as I wrote before solar stocks can be complicated and tricky to analyze. It will be difficult to pick out winners without having some special insight to the industry (which I don't). Also, there's no telling if solar stocks have found a bottom. Solar stocks are down for a reason -- sales, earnings, and cash flow have been deteriorating and if they don't improve prices could stay lower for longer. At the same time public policy may have just taken a turn towards the uncertain as president-elect Trump seems to favor oil and gas.

And of course those in the fossil fuel camp will point out solar is far from perfect. Despite claims, solar energy is not completely carbon-free. The manufacturing process for photovoltaic (PV) cells involves the use of toxic materials that actually creates carbon emissions. In addition, despite costs having come down significantly, solar energy still hasn't reached cost parity, at least not universally. This is particularly true when factoring in the infrastructure required. Not just to collect and convert the energy, but also to store the energy since sunlight is limited to daytime (which is yet another issue in of itself).

But ready for prime time or not, I think solar energy is one of the most viable alternatives available today and I'm long-term optimistic on the industry. With current sentiment very negative and valuations already attractive, I think solar stocks are worth a look at current prices or better.

Atomic Opportunity

Next on the alternative energy list, dare I say it, is nuclear power. Some may gasp at the sound of it, but nuclear is actually a very practical alternative energy source. For starters, in terms of greenhouse gases, nuclear energy is actually one of cleanest energy sources available.



Source: World Nuclear Association, Global X Funds

And what may be surprising is the cost of nuclear energy is actually in line with that of traditional fossil fuels, and costs even less than many alternatives (for example, average levelized costs are actually lower for nuclear than some forms of solar and wind power according to the US Energy Information Administration). But what may be most attractive about nuclear power is the level of efficiency at which it produces energy. The amount of energy generated from just 1 kg of enriched uranium is outstanding when compared to other fuels, shown below.

Energy Generation

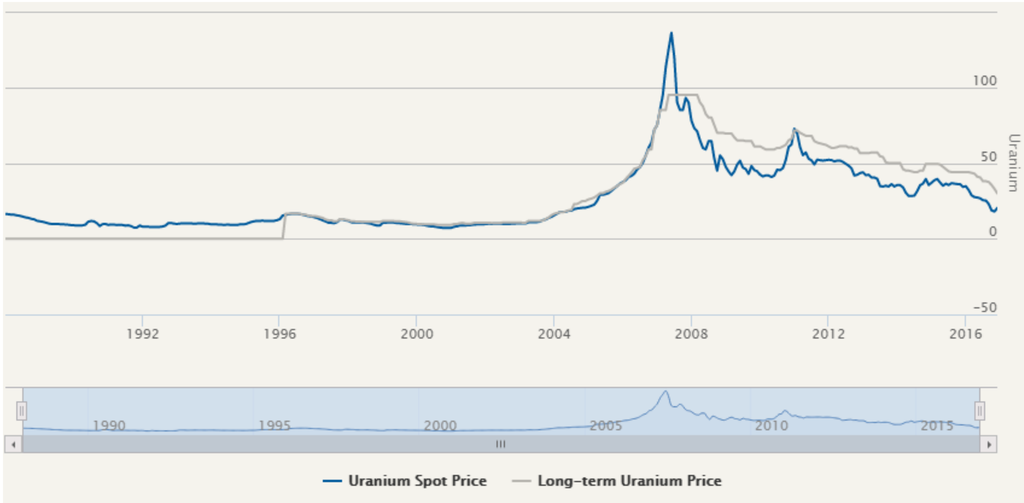
Fuel Type	Heat Values in MJ/Kg (Unless otherwise mentioned)
Brown coal (lignite)	10
Firewood (dry)	16
Black coal (low quality)	13-23
Black coal (hard)	24-30
Natural Gas	38 (MJ/m^3)
Crude Oil	45-46
Natural uranium, in LWR (normal reactor)	500,000
Uranium enriched to 3.5%, in LWR	3,900,000

Source: World Nuclear Association, Global X Funds

According to nuclear advisory firm UX Consulting, global nuclear generation capacity is expected to grow 44% by 2030. Leading the way, not surprisingly, are emerging markets like China. The World Nuclear Association reports China proposes to increase its active nuclear reactors from 34 to over 200. China's plans alone would increase global reactor count by more than 50%, and China only represents 36% of the global pipeline. Other major contributors include India, Russia, and the UAE.

I see uranium, the underlying fuel for nuclear power, as an opportunity to participate in that growth. Uranium prices peaked at around $140 / lb in 2007. With 2016 year-end prices at about $20 / lb, uranium is down by more than 85%.

Uranium Prices



Source: Cameco

Heading into 2007 there was a uranium shortage scare that drove nuclear power providers (the main buyers of uranium) into a buying frenzy. Due to the highly regulated nature of uranium, and the time required to enrich it, nuclear power providers can't allow their reactors to just run out of fuel, so they tend to secure their uranium supplies well in advance. As uranium prices climbed, providers panicked and locked in long-term contracts that only further inflated prices. Then the financial crisis hit and uranium prices plunged. Just as prices began to recover, they were hit again by the Fukushima Daiichi nuclear disaster of 2011. Since then both demand and prices have been weak.

However, many of the contracts signed circa 2007 are now coming due. As those contracts get renegotiated demand should pick up. Significant shortfall isn't expected until 2020 but remember that nuclear power providers secure uranium supplies well in advance. At the same time, uranium producers won't be incentivized to fill the shortfall unless they see about $50 / lb, which is their breakeven price. All these factors combined suggest uranium may have upside potential at current prices or better.

Of course that upside potential is not without risk. Uranium is heavily regulated due to its use in weaponry. There isn't a deep pool of buyers and sellers, so low prices won't necessarily stoke demand as they might for other commodities. Since uranium demand is driven by power producers, there may be a glass ceiling on prices until nuclear power is more widely adopted. Meanwhile, uranium suffers from a lack of liquidity, it only trades thinly in an obscure corner of the commodities market and prices are often negotiated in private, further eroding transparency. These issues make pure exposure to spot uranium prices very difficult. The most practical alternative is indirect exposure through something like stocks tied to uranium production, but of course that introduces separate risks as well.

All things considered, I think the confluence of decade-low prices, increasing demand, and the imminent need for practical energy alternatives make uranium an attractive long-term proposition.

Greek Lightning

My last, but not least, idea for this letter is the Greek stock market. I've had my eyes on Greece for years now, ever since it first started making financial headlines in 2010. If you've followed the news you might think Greek lightning was burning Athens to the ground. While it's true that Greece's finances have been woefully mismanaged (it has the second highest Debt/GDP ratio in the world), in absolute terms things may not be that bad.

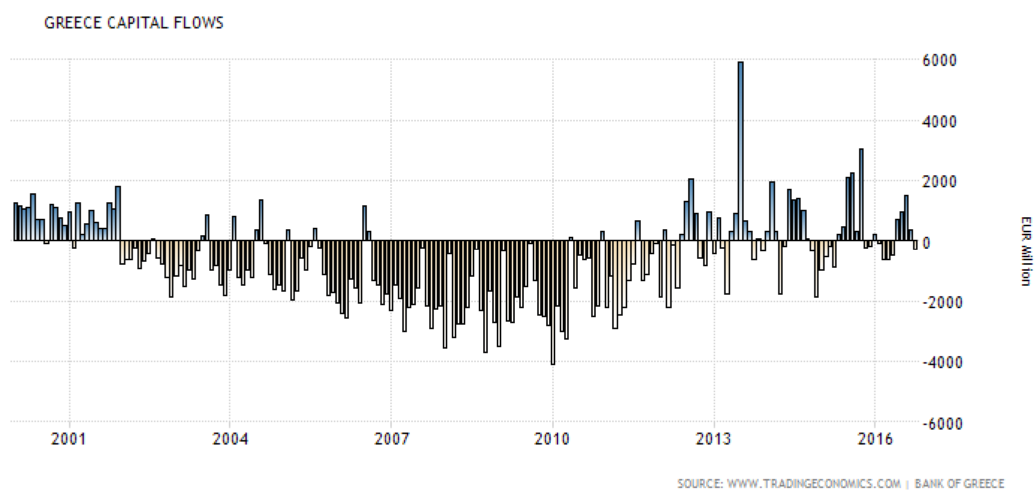
Greek's debt burden is somewhere around $400 billion. Yes that's a lot, but it's relatively small potatoes compared to the trillions in debt carried by countries like the US and Japan. And of course, if push came to shove, Germany (the EU bellwether) could write a giant Euro check to square Greece's problems -- but who could do that for the US or Japan?

The truth is nobody wants Greece to fail. Not the ECB, not the IMF, not the Euro Zone, and certainly not the EU -- which is still reeling from Brexit. Despite much hostile debate, Europe has inflated one bailout buoy after another to keep Greece afloat, showing with action rather than words that it simply will not let Greece go under.

Meanwhile, the market has hated Greece for so long nobody seems to care conditions may actually be improving. For example, despite languishing in recession for the past six years, the worst may actually be behind Greece. On the margin, Greek economic growth has been steadily doing "less bad" year over year. And as Greece makes progress with its debt negotiations, prospects are likely to continue improving.

Source: tradingeconomics.com

The same trend can be seen in capital flows. Following a tremendous flight of outflows, capital is slowly seeping back into Greece, admittedly in choppy fashion.



Source: tradingeconomics.com

But of course everybody still hates Greece. That much is clear just by looking at pricing for the Greek equity market. Greek stocks trade at deep discounts relative to major equity indices (represented by the respective ETFs below).

Relative Valuation

MEASURE	GREECE (GREK)	US (SPY)	EAFE (EFA)	EM (EEM)
P/E	5.30	19.86	16.31	13.95
P/CF	4.06	12.23	8.08	7.62
P/S	0.75	1.95	0.97	1.32
P/B	0.50	2.73	1.57	1.52

Source: S&P Capital IQ, BCM

Though Greek stocks have been languishing for years, it wasn't until last year that valuations finally fell to very compelling levels. Is the current discount justified? Maybe. Is the worst over? Maybe not. Honestly, I don't know the answers to those questions. What I do know is it's highly unlikely the entire Greek equity market will trade indefinitely at 5 times earnings and 0.5 times book value. Timing is always uncertain, but a rebound could happen sooner than expected if conditions continue to improve. Keep in mind I'm not implying Greece needs to stage a miraculous comeback or displace China as the global engine of growth. All it needs to do is perform less badly than expected. As of now pessimism is so pervasive and expectations are so low that it won't take much for Greece to surprise to the upside.

The risks are obvious but should not be overlooked. Greece's finances are clearly a mess and that will continue to be a drag on the economy and sentiment. Whether or not Greece can wrestle favorable terms moving forward will obviously impact its prospects. Geopolitical risks are also a real concern, with respect to both Greece's internal factions and its relationship with Europe. If Greece were to exit the EU or the Euro Zone, Greek lightning could very well strike! And it's not just Greece, the financial troubles of other EU members like Italy could cause enough collateral damage to derail Greece's already shaky trajectory.

That being said, in a world of elevated equity markets Greece appears to be one of very few that are attractively valued at present. Assuming conditions are simply "less bad" than expected, I think Greek stocks should have good long-term upside potential from here.

Summing Up

Despite elevated global equity markets, and record low bond yields, there are still investment opportunities for which the future looks bright. I don't know if solar stocks, uranium prices, or Greek stocks have found their bottoms or not, but I think chances are good that patient, long positions at current prices or better will be rewarding over time. If you take positions, do so slowly and build them incrementally on price weakness. Unless you're keen to what single stocks or industry segments to prefer, I'd stay as wide as possible, maintain broad exposure, and let the markets do the heavy lifting. And of course as with any high-risk value-oriented investment, practice tenacious patience, and don't bite off more than you can chew (afford to lose)!

In closing, I'd like to thank all our clients and those who have supported us for another wonderful year at BCM. We recognize it's no trivial matter to entrust your hard-earned savings to an investment manager and we're honored that you've chosen us. It is your belief in us that keeps us ever striving to improve and deliver the best services possible. Thank you for your business and for always keeping us in mind as a trusted resource and partner for yourselves, your family, and your friends. From all of us at BCM we wish you good health, happiness, and continued success in 2017!

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