Pinnacle Capital Management, LLC

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PCM UPDATE

Equity Strategy

In our July Update we referred to a "sideways pattern" that had continued from the first quarter. After the sell off over the past few months, those first two quarters are beginning to feel like the good ol' days. It's always difficult to attempt to pin movements in the stock markets to something in particular. Sometimes what we think is a cause is merely a trigger or a conincidence while the underlying cause is something different. Nonetheless, we'll try to make some sense of the sequence of events.

For much of the year, the price of oil has been falling. We attribute the decline primarily to the success of drillers aiming to supply the energy needs of both developed and emerging economies. Those energy needs and the concept of "peak oil" led to high prices and a ramping of expenditures for energy exploration. "Peak oil" is a concept under which the world's supply would be in constant decline that became very popular about 2003-4. Those expenditures and a particular technique called horizontal drilling instead led to rapid growth of the oil supply, particularly in the U.S.

Well, as they say, a funny thing happened on the way to the forum. As China's economic growth began to slow and begin the transition to a demand oriented economy, the world was faced with over-production of oil. Then began a negative feedback loop. Weaker than expected Chinese growth resulted in oil prices falling further. Falling oil prices were viewed as a sign that economic growth in China was falling further. A rapidly rising Chinese stock market, fueled by debt, sharply reversed to the downside. The combination of these factors proved too much for the U.S. stock market, and what followed was the decline of the past several months.

Negative psychology in the U.S. began to take on a life of its own. It's just an observation - we don't have the data to back up our assertions - but it has appeared to us that the markets have become increasingly "thematic". By that we mean that if a company is associated with a theme, the stock will move according to that theme irrespective of underlying fundamentals. So a company which supplies the oil industry, even if just a fraction of its business, will be tainted as an oil stock. Many of our industrial holdings, including ITT Corp (ITT), Terex (TEX) and Xylem (XYL), fell as if they were concentrated oil companies. We feel the extent of the sell off was unwarranted.

Oil stocks, and stocks perceived as being related, weren't the only losers. When the Volkswagen scandal hit, the stock price of most auto companies and suppliers fell. Now we did hold Borg Warner (BWA) in many accounts. This company's business was disproportionately weighted towards VW and their growing diesel business. We promptily sold the stock. But we also hold Fiat Chrysler (FCAU) and Tenneco (TEN) in many accounts. TEN's largest businesses are shocks and exhaust / emissions systems. Less than 1% of their business was impacted by the VW scandal, yet the stock fell more than did BWA. Perhaps the use of the term "emissions" frightened investors. Go figure! We continue to hold both TEN and FCAU.

Health care stocks had a rough quarter as well. When Hillary Clinton Tweeted that the prices of drugs were too high (we promise you we'll never Tweet), most health care stocks took a hit. Mylan (MYL), Teva (TEVA), Rite Aid (RAD), and CVS Healthcare (CVS), were all impacted.

The point we do want to get across is that the relationship between the underlying valuation of many of these companies and the actual price of their stocks seems to have been temporarily broken. Why one company would continue to sell at a price to earmings (P/E) multiple of over 30 while a company with similar characteristics trades at a P/E multiple of 10 can most likely be explained by the temporary dominance of traders who ignore fundamentals. The good news is, this is how opportunities are created.

So, we've talked about a very negative situation. What, if anything, worked in client portfolios? Sadly, not enough. Still, we had a few winners. Fidelity National Info Services (FIS) and SAB Miller (SBMRY) performed well. The former announced it was purchasing SunGard Data Systems. This was well received by the markets. The latter was subject to the rumours of a takeover by Anheuser Busch InBev, a rumour since confirmed. Food companies Kellogg (K) and Mondelez (MDLZ) generated positive returns. These were likely perceived to be defensive in nature, and thus in favor. The acquistion of DirecTV (DTV) by AT&T (T) was completed, and now many of our clients hold T in their portfolios.

Though those stocks did perform well, overall we were not happy with portfolio performance. Nothing has changed our view that the stock market still represents an overall good value with many underlying exceptional values. Markets go up and down. Perhaps we've become too accustomed to that not happening often. In the end, it's the long term we're working for. That means we may have to live through several bumpy periods.

Fixed Income Strategy

As we mentioned in our Commentary, we misjudged the Federal Reserve. We had a high degree of conviction that the Fed would raise interest rates at least once this year. So far they haven't. We now doubt that they will, though we wouldn't entirely dismiss the possibility.

How has that changed our thinking? First, it becomes increasingly likely that returns in the fixed income markets will remain less than desireable. It seems the one place where one can get reasonable returns is from the securities of companies with higher credit risk. We see several opportunities, but we have to keep our exposure limited. For the most part, we've gained exposure from the Fidelity Floating Rate High Income Fund (FFRHX) and the SPDR Barclays High Yield Bond ETF (JNK). The former is a mutual fund that invests primarily in below investment grade paper with short maturities. The latter invests in below investment grade bonds with longer maturities. We utilize funds for such investments because they're the most efficient way for individual clients to achieve necessary diversification.

While there haven't been many problems with the underlying securities, the market value of these funds did fall in the quarter. We're not totally surprised as investors tend to run away from these securities when they get nervous. Meanwhile, the funds keep paying their dividends. We don't see increasing our exposure - we know our clients are concerned with safety - but we have no intention of reducing exposure either.

One feature of markets is that we can only take aqdvantage of what is offered. We can't create the returns we like. This is true irrespective of whether we want or need higher returns or whether the current returns are justified. We've discussed time and again as to our belief that wealth is being transferred from investors to borrowers. Frankly, we don't see this coming to an end until the markets force a change. It's now been almost 35 years since interst rates began to fall. At some point that streak will come to an end. Until then, we will continue to navigate the best we can and balance client portfolios in the face of the various risks that can impact portfolios.