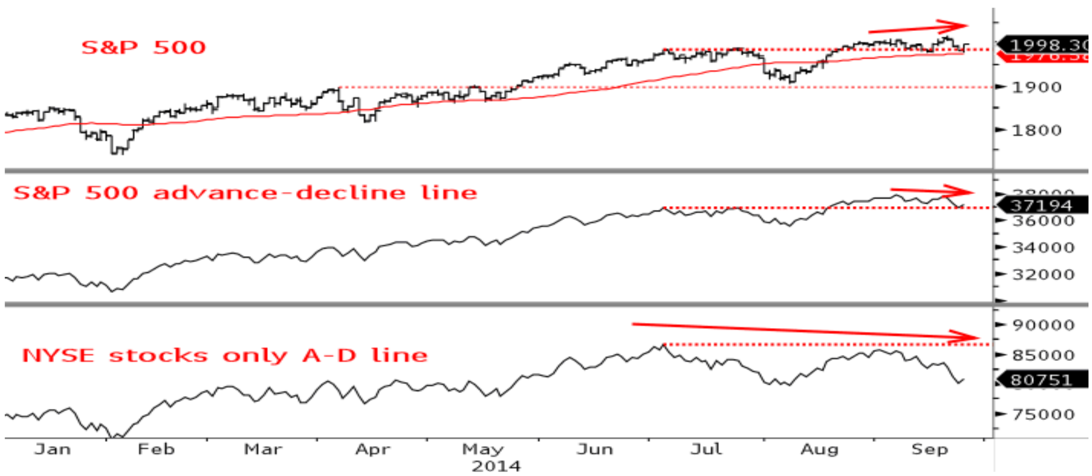
INVESTMENT COMMENTARY

October, 2014

The Stock Market

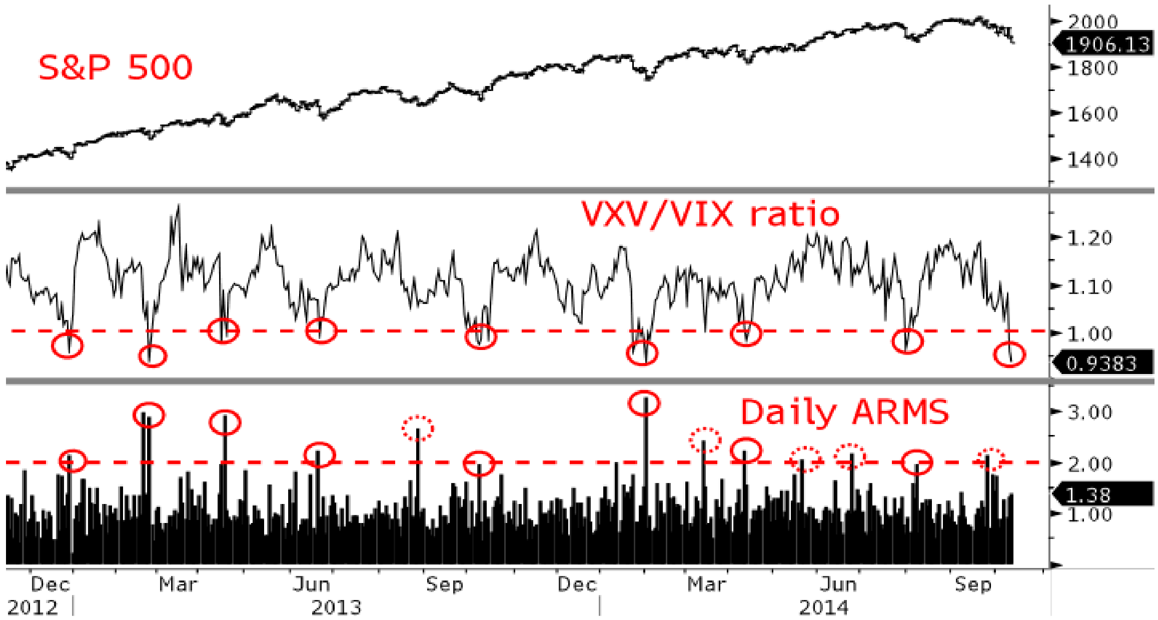
Technically Speaking: Halitosis Market - Bad Breath!

In mid-September, the S&P 500 reached a new Bull market high over 2000, but set up what technical analysts call a "non-confirmation" which means a divergence between the index and the breadth of advance/decline line. Market strength deteriorates as fewer stocks advance or participate in the market climb. These signals usually precede a stock market correction.

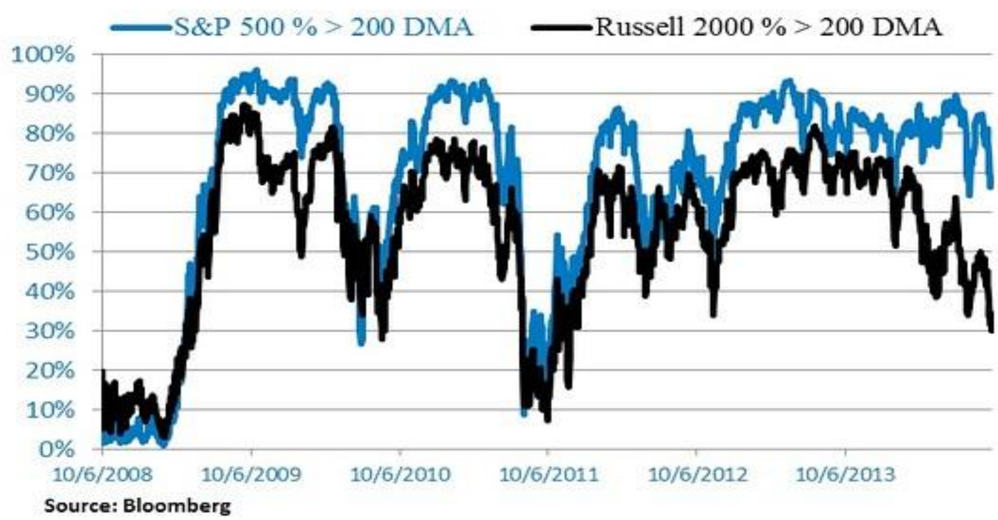


The heightened volatility over the last several weeks has caused about a 5% S&P 500 pullback that now has broken below the lower range of the two-year channel and is testing the 200-Day Moving Average near 1900.

Although the next chart shows that the ratio of the S&P 500 three month Volatility Index to the CBOE Volatility Index has reached a contrarian Bullish reading which has coincided with interim bottoms, a break below the 200 DMA could prompt more downside risk to the low 1800's.

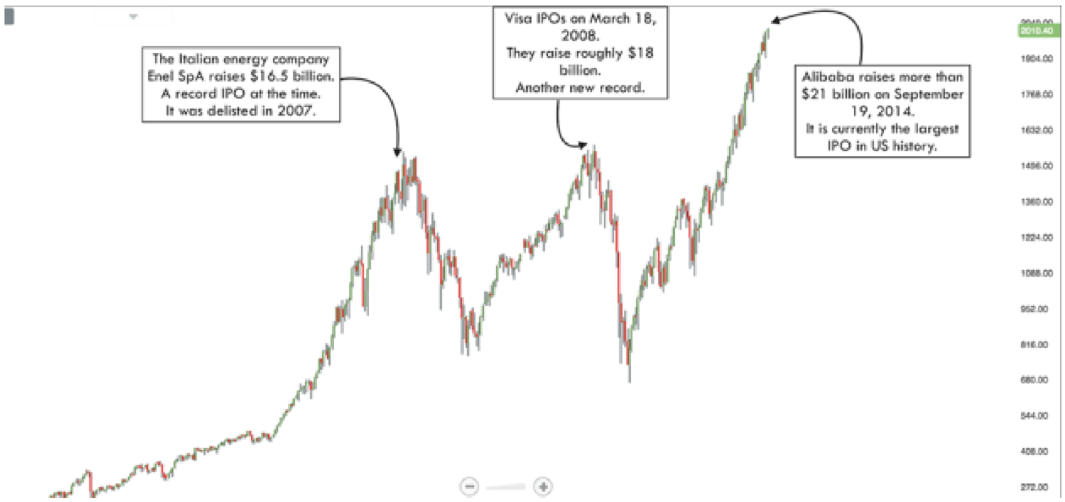


The next graph illustrates how the S&P 500 has recently out-performed the more widely representative Russell 2000. Nearly 70% of the large-cap stocks on the S&P 500 are still above their 200 DMA, while the Russell 2000 has declined to a point where it has only 30% above. Since the performance of both indexes track closely, the conclusion is that there is more downside risk in the S&P 500 than the Russell 2000.



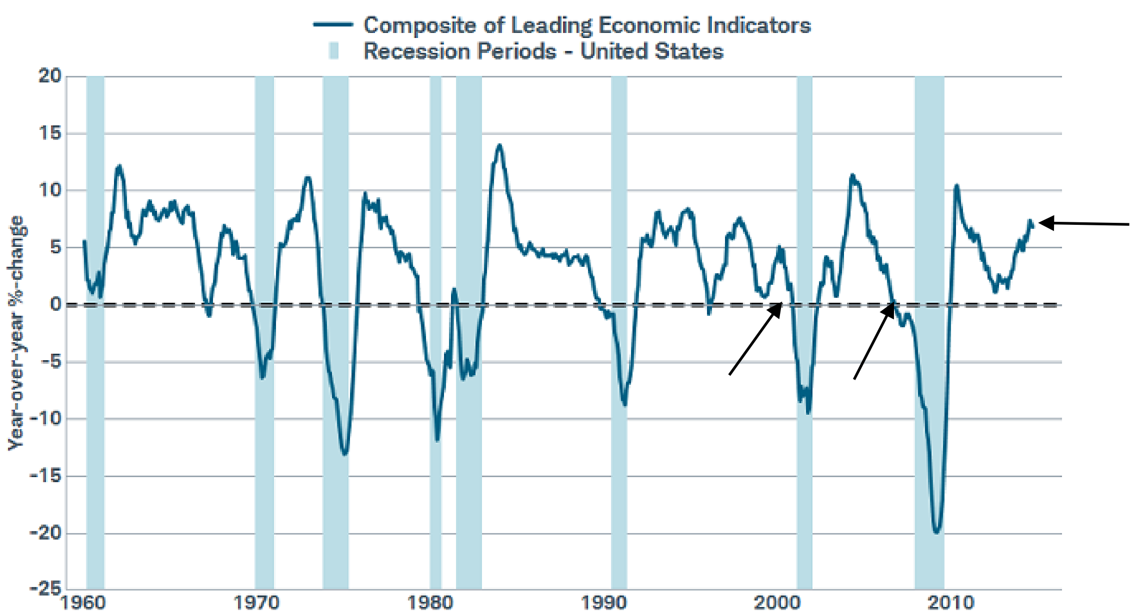
HISTORY REPEAT OR RHYME

It has often been said, "those who forget history are condemned to repeat it." Indeed, one of the most touted possible repeats, the record Alibaba Initial Public Offering of more than $21 billion is a sign of a pending market correction. The previous records were very near the top of the previous Bull market cycles. Is this a warning that the end is near?



To get the answer to this question, we need to closely examine the underlying economic fundamentals and Federal Reserve Policy, then and now.

Recession doesn't appear to be imminent



Historically, the composite of Leading Economic Indicators has turned down and become negative prior to recessions as the preceding chart shows. Note that at the previous IPO records in 1999 and 2008, this index had already weakened and become negative, predicting the forthcoming recession (blue shaded areas). Also note the composite currently has demonstrated continued strength, so economic fundamentals are much stronger than the previous two IPO records.

Another reason for a more likely rhyme than repeat is the historical relationship of the yield curve (i.e. the difference between short term interest rates and longer term) and recessions. Similar to the Leading Economic Indicators, the Federal Reserve Board had raised short term interest rates above longer term rates (inversion) in an effort to rein in excesses within the economy prior to both stock market peaks, recessions and bear markets. Again, note the yield curve is nowhere near inversion as Fed Funds are near 0% and 10-Year Treasury yields are roundly 2.5%.

1 Yield Curve Inversions Mark Stock Market Peaks

Source: LPL Financial Research, Bloomberg data 05/12/14

Red bars indicate when yield curve began to invert.

Shaded areas indicate recession.

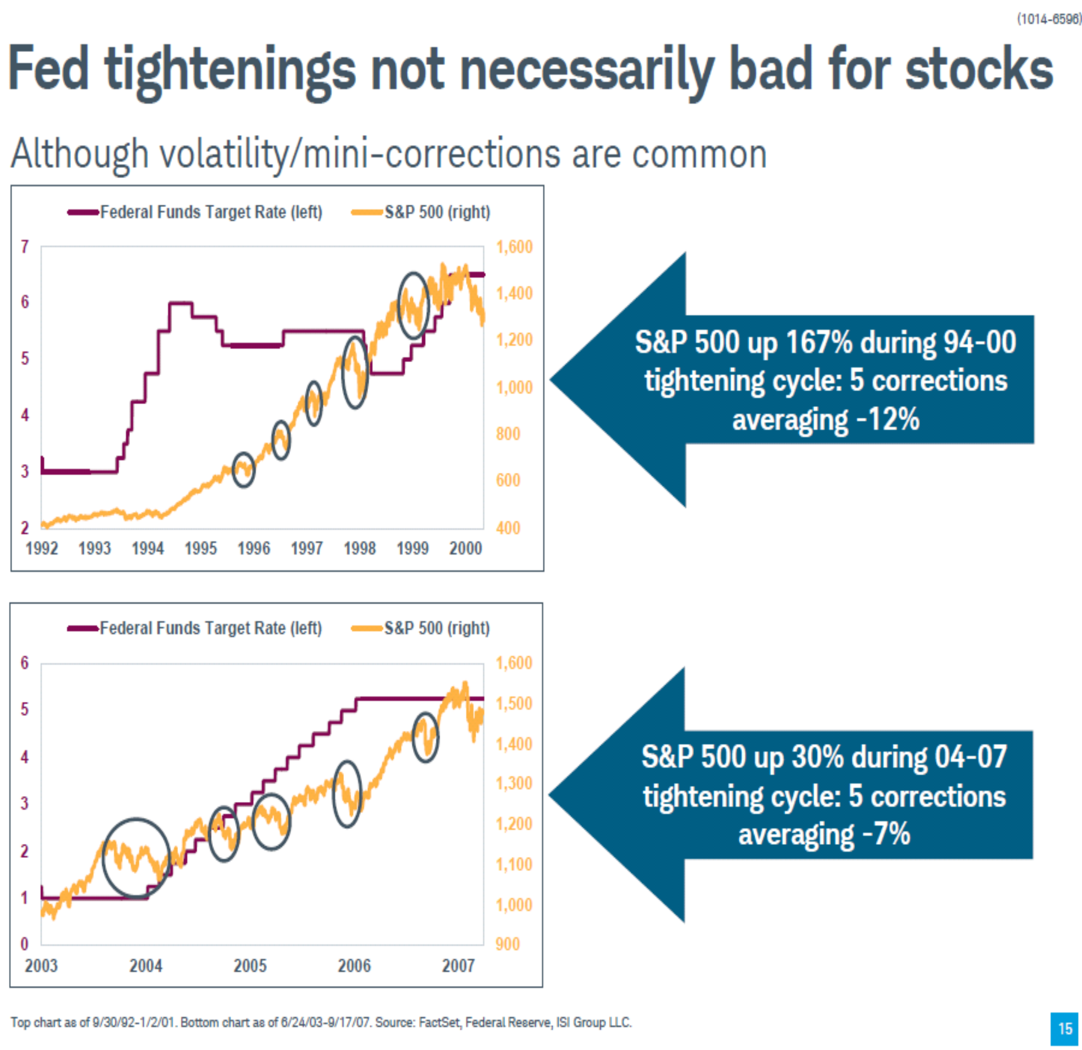
Past performance is no guarantee of future results.

"Every recession over the past 50 years was preceded by the Fed hiking rates enough to invert the yield curve. That is seven out of seven times — a perfect forecasting track record. The yield curve inversion usually takes place about 12 months before the start of the recession, but the lead time ranges from about five to 16 months. The peak in the stock market comes around the time of the yield curve inversion, ahead of the recession and accompanying downturn in corporate profits." (*Jeffrey Kleintop, Chief Market Strategist at LPL Financial*)

While long term economic forecasting may be a fool's errand, what are the projected interest rate increases for the Federal Reserve Board and when is there a possibility that the yield curve could invert?

FED MONETARY POLICY OUTLOOK

Janet Yellin at the recent FOMC meeting said rates would stay low for a "considerable time" after the end of quantitative easing. Although data dependant, the consensus of Fed members project Fed Funds to start increasing mid-2015 going from the current .25% to 1.25%. Rates are projected to be raised five times in 2016 from 1.25% to 2.75% and four times 2017 to 3.75%. Again, fraught with danger, a Macroeconomic outlook published by Merrill Lynch projects Real Gross Domestic Product to grow roundly 3% over the next several years. This underlying economic strength could cause 10-Year Treasuries to gradually rise to 4.50% in 2017. It is not until 2019 that the yield curve actually inverts. We are not suggesting that this Bull market will run that long without a more significant decline. However, we can demonstrate a more realistic shorter time frame by examining how the stock market performed over the last two interest rate tightening cycles.



As you can see, although there are periodic corrections, the primary upward trend in stock prices can continue for several years, before the eventual Bear market.

SUMMARY

We had advised our clients to ***"buckle their seat belts"*** over the short term for the bumpy stock market ride we anticipated. It had been many months since a 10% correction had occurred and our view that such a sell-off, while painful, would be healthy and extend the longevity of the current uptrend. Since the above charts support our longer term optimism with the conclusion that: (1) We are nowhere near a recession; (2) Stocks should do well as Fed policy will raise rates gradually over the next several years as the economy strengthens; (3) The yield curve inversion is possibly many years away. Once current weakness is over, the stage could be set for a dramatic fourth quarter recovery as we enter a seasonally strong time period as the last chart shows.

4Q seasonality bodes well

Especially during lame duck mid-term election years

S&P 500 since 1928		
Q4 performance	**Price change**	**% positive**
Average since 1928	2.6%	72.1%
Median since 1928	4.5%	72.1%
Average when up 10%+ YTD	3.5%	78.8%
Average when up 0-10% YTD	5.6%	87.0%
Average when down 0-10% YTD	-1.8%	41.7%
Average when down 10%+ YTD	0.1%	61.1%
Average during mid-term election years	6.5%	85.7%
Average during mid-term lame duck years	10.5%	100%*

Gray-shaded areas indicate years like 2014

As of 9/14. *Four occurrences. Source: Bespoke Investment Group (B.I.G.).