Observations and Outlook

September 2015

With all eyes and hear highly attuned to whether or not the Fed will attempt to begin to 'normalize' interest rates after a 9 yr. easing cycle, it is easy to get lost in the true consequences of the Fed's past and now, going forward, actions. Most market participants jump to the conclusion that if the Fed raises the target Fed Funds Rate from 0% to 0.25%, this will be negative for equity and bond markets. Conversely if the Fed keeps rates pegged to the zero boundary, this will be positive. However, there are always times when 'good' news is bad for markets, when 'bad' is good; and even when 'good' news is good and 'bad' news bad for markets. This brings up the idea of not what the news will be (to raise or not to raise), but what will the *reaction* be to whichever news shows up.

Is 'good' really bad?

Personally, I believe the Fed will raise rates on September 17. The Fed has talked so much about normalizing rates and the decision as to when, being 'data-dependent'. Given an official unemployment rate of 5.1% and modest inflation, significant increase in asset prices (stocks/bonds/real estate) over the past several years and that we have gone nearly 7 years with 0% rates, it's difficult to imagine what exactly the Fed would need to see if it *doesn't* raise rates. It's really a matter of credibility and the perception of what the Fed's true goals are.

If they raise, the cost of capital will be increased ever so slightly for banks and corporations. It would also signal the Feds belief that the economy is truly getting stronger after 7 years of massive interventions. This could be taken as a positive for stocks in that earnings can continue to grow and tame inflation will allow for some leeway in raising rates very slowly. So a raise will either be seen as 'expenses higher= stock prices lower', or 'economy growing= earnings growth'. In the immediate term stock prices might go either way! If they do not raise rates, it would send the signal that the economy is not that strong, despite a 7 year 'expansion' and still requires zero cost of money in order to muddle through. On the other hand, continued zero cost capital could further seduce speculators and carry-traders into buying more risk assets like stocks, especially the ones that don't pay dividends or have earnings. So the choices are "no raise= continued cheap speculation" and a rise in stock prices; or "no raise due to global economic weakness= lower stock prices due to slowing growth". Either way, it's the reaction to the news that is important, not necessarily the news itself.

The current situation resembles the previous period of excessively low rates, early 2002 to May 2004. At the time 1% seemed extremely low and a 2 year duration has been since criticized as 'too low for too long'. The current period of low rates is without comparison. Last time, Greenspan raised rates through the summer of 2006. Real estate began to drop that year and subprime blew up Spring 2007. Now, rates have never been increased and many signs point to a global recession beginning.

While the outcome of the Fed's decision will be known soon and we can go on to worrying about the next central bank decision, recent market volatility has elicited cries of 'Bargain' from major broker/dealers' offices. "Shopping for bargains", is the claim, after a mere 12% decline in the SP500. Personally when I use the word 'bargain', or 'value', I see a price that has been discounted 30% or more.

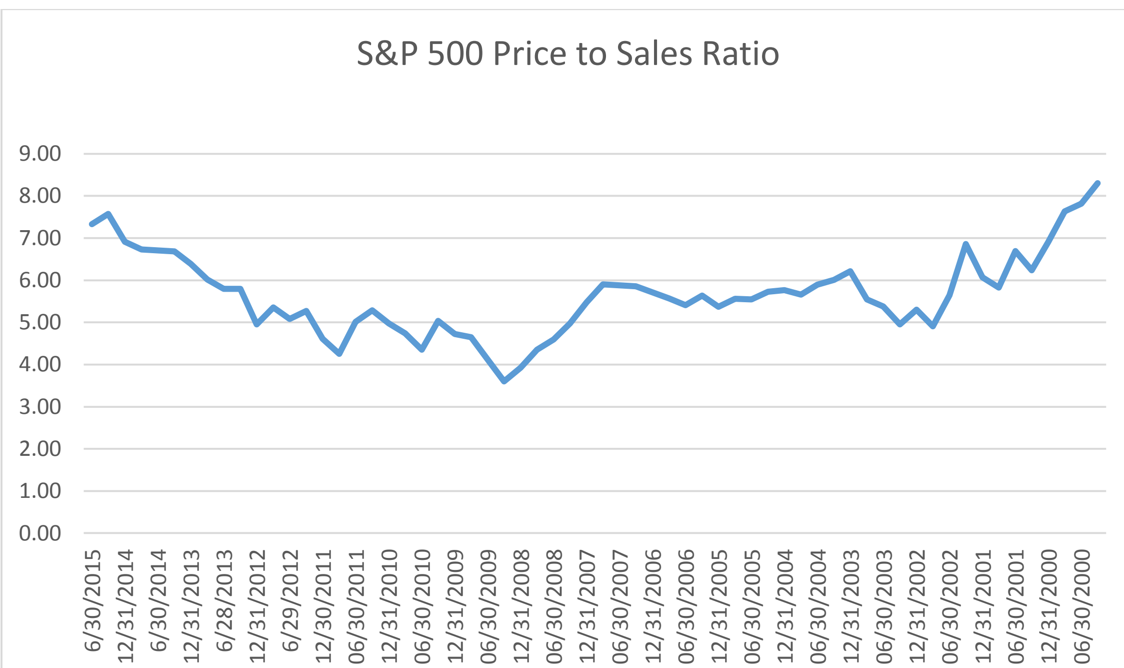
Stocks Continue to Become More Expensive

The fallacy of a cheap market after a mere and brief 12% intraday 'correction'—if that can even be the correct word given the Flash Crash II occurred pre-market when most investors are not active. While Monday 8/24 was quite startling, US indices had been moving down since May 19. Late June saw an acceleration down with issues in Greece coming to the forefront. The Shanghai index topped mid-June and proceeded to jump off a cliff. But this is a closed market barely accessible to US investors. The China story is continuing to evolve as the government there increases its influence (or attempt to influence) the markets, going so far as banning the words "market crash", "equity disaster", and "market rescue" from print media. China is far from an open society or a free market. Large equity bubbles of the past have seen 75% declines and that may be a reasonable target for the Shanghai index.

If commodity prices are any indication of what is truly happening in China there is much to be concerned about. Given China's significant consumption of commodities, and industrial commodity price plunges, one must conclude that China's demand has decreased dramatically. Given China's stimulus the past few years has been to centered around building cities, roads, bridges, trains and all manner of projects to keep the People employed and show GDP growth to meet the Politburo's dictated goals—these all require raw materials and industrial metals---whose prices have declined to multi-year lows. After all, a decline in prices indicates a decline in demand. A slowdown in these primary ingredients use in China's growth model indicates a substantial slowdown in its economy, despite the Central Committee's protestations.

Two Common S&P 500 Valuation Metrics--- Does this look like a bargain to you?

Price to Sales



Price to Earnings

The last time we hit 22.5 trailing P/E, late 2007, earnings were declining and the recession was beginning.

While the near term is unknowable, the longer term is much clearer. Trees don't grow to the moon and stock prices do not go up forever.   3-yr, 5-yr, 7-yr rolling stock market return averages are as high as they were in 2000. In order for these shorter term averages to get back to normal, or average, either markets stay at these levels for a few years, or there is a significant decline in prices sometime in the next year or two.   Investors need to understand their goals, time horizon, and risk tolerance and get portfolios into position BEFORE a market decline.

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