Observations and Outlook

October 2015

The third quarter was very difficult for stocks around the globe as well as all other 'risk assets' like junk bonds and commodities. The ongoing decline in commodity prices, as I've noted before, is a direct result of the declining Chinese economy. A 50% S&P500 and 50% Aggregate Bond Index portfolio would have returned -2.61% in the third quarter and done worse with the addition of small cap and emerging stocks; and better with an overweight of long maturing Treasury bonds.

Selected Index Returns 2015 Recent Quarter and Year to Date

Dow Jones Industrials -7%/ -5.4% S&P 500 -6.44%/-5.29% MSCI Europe -8.7%/-5.2%

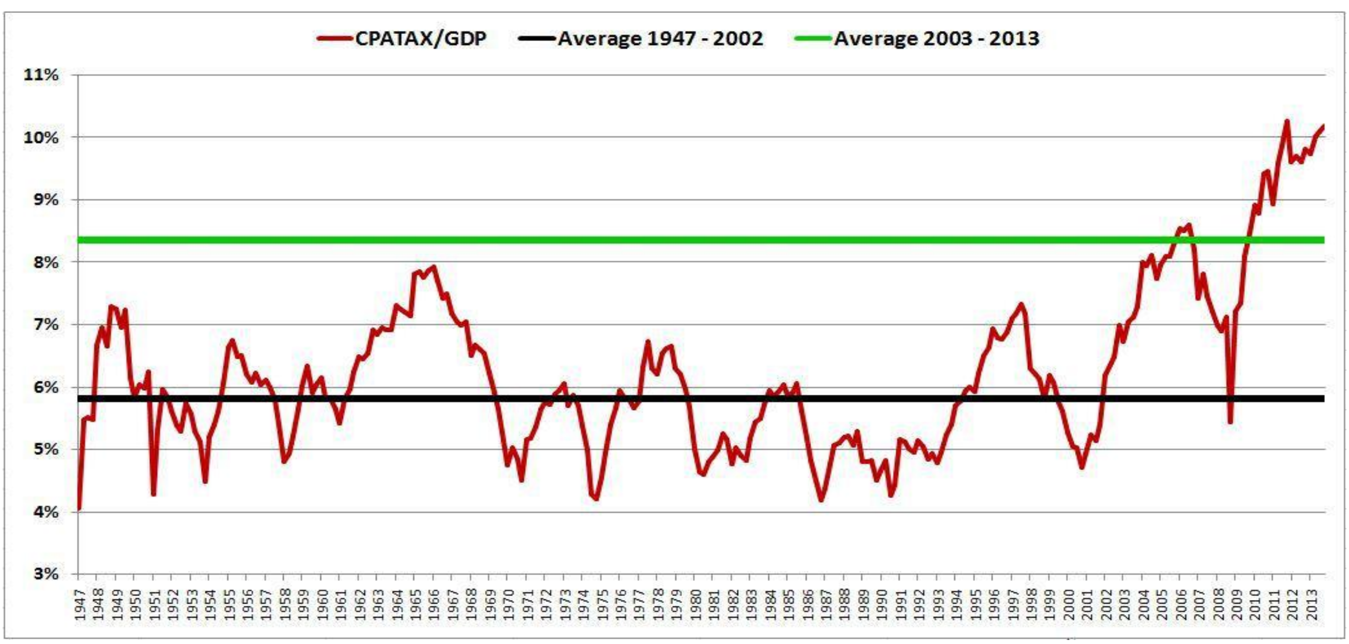
Small Cap (Russell 2000) -11.9%/-7.7% Emerging Mkts -17.9%/-15.5% High Yld Bonds -5.1%/-3.61%

US Aggregate Bond 1.23%/1.13% US Treasury 20+Yr 5.32%/-.21% DJ/UBS Commodity -14.4%/15.80

The End of the Beginning

The recent downtrend in the stock markets has been blamed on many factors. A few are 'global growth worries', 'China', and the ever popular 'unrest in the Middle East'. Attributing these amorphous, subjective and alleged causes to the market action is more likely to overcomplicate the much more basic and direct possible causes that can be traced to the deteriorating fundamentals (and technicals) within the stock market. The decline in revenues, margins, and net income in companies in the SP500 on a year over year basis appears to be well entrenched and perhaps only beginning. Only after a year lower earnings will year over year comparisons begin to look good again. In credit markets, ever widening interest rate spreads on junk bonds, and for the first time ever, 90-day T bills have traded at a negative yield are indicating stress in credit markets. These factors have evolved and persisted now for several months, taken together should indicate more equity market declines punctuated with swift reversals only to decline again, in the coming months. That is unless, the US consumer can decide to spend (or rather borrow and spend) more despite declining real incomes, or companies cease issuing debt to buy back shares and instead invest in research and development and capital investment. The lack of these factors also has persisted now for a few years and doesn't seem about to change.

Corporate Profits as Percentage of GDP (CAPTAX) 1947-2013



Source: www.philosophicaleconomics.com

The chart above shows corporate profits as a percentage of U.S. gdp. From 1947 to 2003 this series had a fairly constant average. Since 2003 and the introduction of 'exceptionally low rates for exceptionally long periods' this percentage has increased dramatically

and today is significantly higher than even this new era's average. Profit margins have decreased from record highs and are expected to decrease further in the coming quarters. A decline to the 2003-2013 average would indicate a decline in profits from current levels of approximately 20%. If profits decline either the market Price to Earnings multiple (P/E) would climb to multi-year highs, in excess of 25x trailing 12 months; or the price level of the S&P 500 would need to decline a similar level. Prior to 2003, profit margins *mean-reverted* on a regular basis. Post 2003 the globe has been awash in very low interest rates and episodes of added 'liquidity'. If or when either of these foundations, below market rates and continually *added* liquidity, are removed margins could revert to levels seen prior to 2003, which would have very dramatic implications on the price level of the SP500.

High Yield Bond Spreads: 'Risk' is Becoming Riskier

The chart above shows the difference between yields on high yield ("junk") bonds and Treasury bonds. One can see the difference bottomed in early 2014, after a spike in late 2011. What occurred in August 2011 was a downgrade in the credit rating of the US on concerns that the debt ceiling would not be raised, and a decline in the SP500 and junk bond prices (which often run in the same direction). September 11, 2011 the third round of Federal Reserve intervention in credit markets, known as Operation Twist was announced. Within 10 days the stock markets began to march up along with a variety of other 'risk assets', including junk bonds which pushed junk yields down and prices up. The last round of QE ended October 2014 and spreads began to widen, and today the discussion is when the Fed will tighten, not about another round of intervention, despite a larger stock market decline than in August 2011. Notice in the chart the spreads were on the rise prior to the 2008 recession. This is a clear indicator of what may be on the horizon.

Classic Sentiment---Where are the Markets?

In The Cycle of Market Emotions (above) we see the ebb and flow of a typical market cycle: The market rises, peaks, declines, bottoms-out and then begins to rise again. In any market cycle, the point of Maximum Financial Risk is at a market peak, when prices are highest. The point of Maximum Financial Opportunity is at a market bottom, when investment prices are lowest. But surprisingly, this is the exact opposite of what investors feel (and consequently how they behave) at these crucial points in every market cycle.

I believe most investors are approaching #5 Anxiety and currently are hoping current high price levels will persist. Common sense and experience tells us that business, economic, and market cycles exist and cannot be permanently mitigated. As such it is incredibly important for investors to know their goals, time horizon, tolerance for volatility and to position portfolios that match these parameters. Unfortunately, most investors do not know how to do this and traditional Wall St. broker/dealers continue to insinuate that stocks are “safe” or valuations are not high.

While still a low probability in the near term, the confluence of decreasing sales/profits/margins and a declining appetite for overly valued ‘story’ stocks may converge to push the S&P500 significantly lower before the Federal Reserve is pressed into action with further QE measures.

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