October 26th, 2015

So much for what the archives say about October…

In a word…Wow. Stocks continued to ramp higher last week with the S&P 500 registering gains for the fourth straight week, rising 2.0%, in what is turning into the most impressive rally we have seen in both breadth and depth this year.

So much for the fabled 'October is the weakest month of the year for stocks' – through Friday the Dow Jones Industrial Average, S&P 500 and Nasdaq are all up more than 8.0% on the month. Leading the averages higher are the hard hit sectors that had been playing the role of the caboose for most of the year: Materials +12.8% on the month (still down 7.3% on the year), Energy +11.5% on the month (down 13.8% on the year), and Industrials up 9.6% for the month (down 3.4% on the year). The risk-on rally has not be relegated to only U.S. equities, with the MSCI All Cap World Index ex USA up 9% on the month, Emerging Markets surging 10.7%, and the MSCI Eurozone index gaining 8.6%.

Last week's rally really started to ramp up on Thursday morning behind comments from ECB Chair Mario Draghi, where he set the table for expanded QE prospects in December. Then on Friday it was China's central bank joining the monetary easing party as they cut the reserve requirement ratio by 50 basis points, the 1-year lending rate by 25 basis points and the 1-year deposit rate by 25 basis points. This was China's sixth interest rate cut since last November which has further elevated the skepticism surrounding their latest 6.9% GDP print.

The WSJ ran with an article titled "China's Growth Numbers Stir Skeptics", where they highlighted statistics like electricity output down 1.3% year-over-year and seaport cargo volumes rising a mere 1.4% in Q3. I'll be the first to admit that I don't have an inside track on the authenticity or accuracy of any data point coming out of China, but attempting to capture the whole of an economy as diverse and complex as China's with any one data point is rather foolish, in my opinion.

One thing that has become clear in the China data is that the economy is going through a radical transformation from an export dependent and infrastructure driven model towards consumer services, whereby metrics that were relevant in measuring the health of China over the last two decades may now be antiquated. Case and point can be found in the most recent GDP report which showed that consumer spending accounted for 58% of GDP growth in Q3 and service sector spending crossed the 50% share mark of the Chinese economy for the first time ever.

So, looking at China with the same lens as the past 10 years is not very helpful, unless you believe that a resurrection in the commodities super-cycle is around the corner. Note that Chinese retail sales, despite the negative wealth effect from the dramatic stock market reversal, increased 10.9% YoY in Q3 – it's been more than 20 years since the U.S. last posted a retail sales figure that strong.

Now don't get me wrong, I'm not a bumbling bull on China as I do believe it has its fair share of challenges with its transformation, namely the elevated and growing debt levels. Winding down the amount of credit in the system too quickly could stall growth, while failure to cut corporate debt levels and deal with bad loans quickly could create a bigger credit crisis in the next couple of years. But I just don't buy into the mainstream chorus that the second largest economy in the world is about to implode.

As for the U.S., the latest round of employment, manufacturing, retail sales, and industrial production numbers confirms that a soft patch is at play right now. It will be interesting to see how this plays into the debate among FOMC officials as they get together this week for one of two Fed meetings remaining on the calendar for the rest of 2015. Expectations are for the Fed to take a pass on raising rates at the conclusion of Wednesday's meeting (futures on the CME peg the odds at a meager 7% probability) and the odds of them starting the rate hiking cycle at the December meeting are at 1 in 3.

The Fed being on hold has shifted the psychology among investors back into an environment where 'bad news is good news' for risk-assets, as it was the disappointing jobs report on October 2nd that catapulted this 179 point rally from the lows in the S&P 500 the morning of the report. Then the ECB and PBoC joined in last week with indications that additional QE may be on the way (in the case of the former) or announcing outright interest rate cuts (in the case of the latter).

However, the pace of the dance between risk-on and risk-off is becoming far more frenetic as the mere prospect of a 25 basis point hike leading up to the September FOMC meeting caused a panic in high-yield bonds as they dropped almost 5%, credit spreads widened 275 basis points, U.S. equities sold-off by more than 10% and emerging market equities tanked by 20%. For sure, much of the destruction that occurred in the markets has been recouped over the last month, but the challenges confronting the Fed and investors remain.

Looking beyond the short-term, of particular concern is the growing dilemma of the Fed being boxed in by its dual mandate, where it is meeting its employment mandate (with the economy showing signs of having reached full employment), but missing on its inflation mandate. Several Fed officials continue to suggest that the weakness on the inflation front is transitory. But acting on this belief (by moving ahead with a rate hike) if these deflationary forces prove not to be transitory could further undermine their ability to meet their inflation objective. With other key developed market central banks easing monetary policy (ECB, BoJ, & PBoC), a rate hike would likely further strengthen the dollar on a relative basis and therefore continue to act as a severe headwind to inflation.

This is what makes today's capital market backdrop so complex. The Fed would like nothing more than to hike rates which would send a message to the markets that the economy is strong enough to handle such a move. However, for the Fed to raise interest rates it would need the dollar to not rally significantly, and that is a rather tall request given the easy money policies from around the world. Many economists have argued that the 17% rise in the dollar since Q3 of last year is already equivalent to 1.00 – 1.50% in Fed tightening.

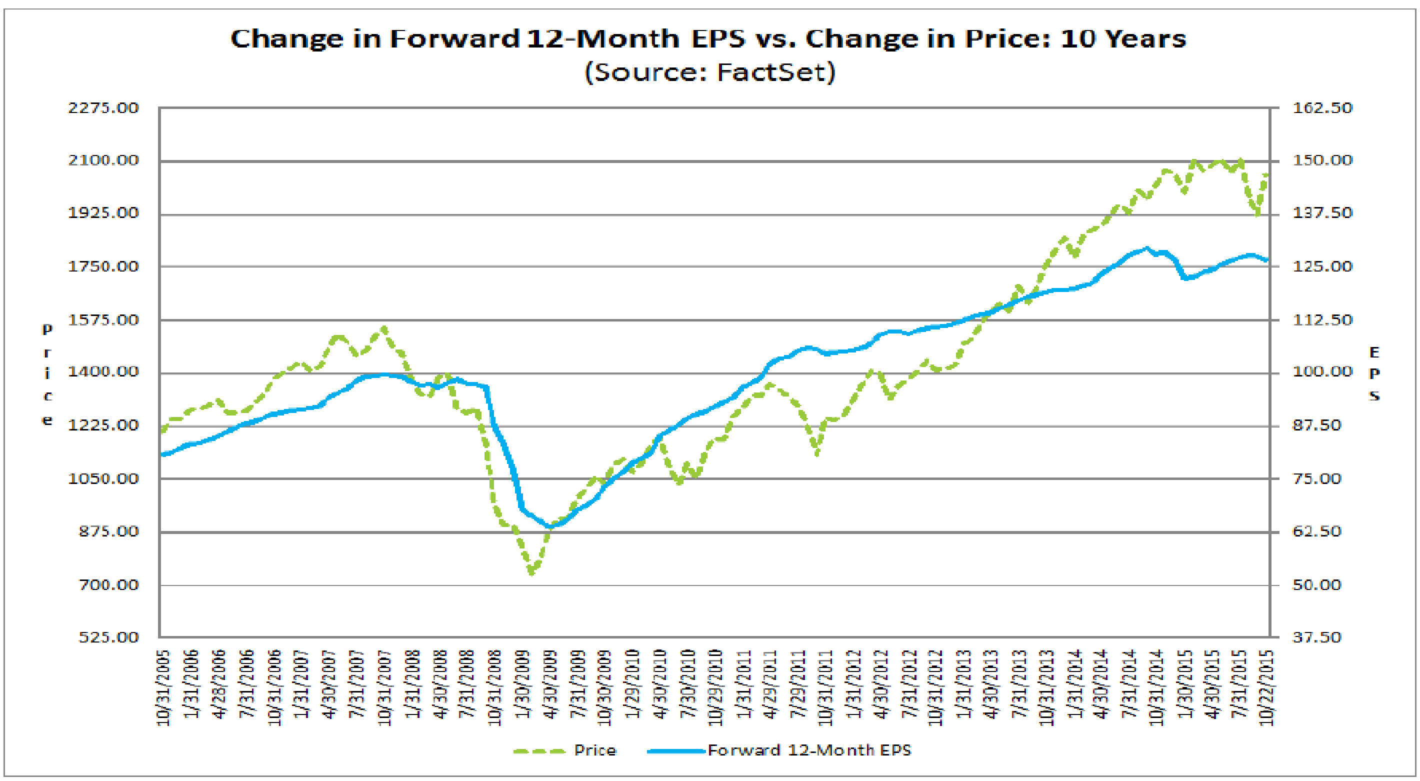
Moreover, the challenge facing investors looking forward is the inevitable change in the landscape that has buoyed asset prices for several years. If easy money led to higher asset prices, in the absence of more robust economic growth, is it reasonable to assume that tighter money in the absence of more robust economic growth will lead to lower asset prices? Has the correction in risk-assets that occurred in August-September simply been delayed until 2016 when expectations for a rate hike resurface?

Corporate earnings season is in full bloom with this week being the busiest of the reporting season as 31% of earnings are expected to be reported. As of the end of last week, according to data from FactSet, 173 companies have reported with 77% beating estimates with earnings on the whole coming in 5.2% above expectations. That all sounds well and good, but keep in mind expectations were dramatically reduced coming into the quarter. The latest estimates for Q3 S&P 500 earnings are for a decline of almost -4.0% (+3.0% excluding the energy sector).

More concerning is what we are seeing on the revenue line with sales for the quarter coming in worse than expected across all sectors except Technology (no sector has had positive sales revisions since the start of reporting on 10/1). Sales growth is expected to decline -3.0% for the quarter which suggests that profit margins are being pressured given that the decline in EPS (-4.0%) is larger than the decline in sales. The main culprits for earnings and revenue misses has been the strong dollar (dollar index +17% YoY), commodity prices (WTI -52% YoY), and weak global growth.

This will likely mark the second consecutive quarter of earnings decline (third consecutive quarter of revenue declines) and the markets are taking notice by differentiating between those companies that deliver and those that don't: companies that beat on both the top and bottom line have seen 1-day performance of +3.2%, while those that missed on both have declined by -3.8%, larger than what we saw this time last quarter (+1.8% / -2.7%).

Undoubtedly the market was bracing for a tough earnings season and that is exactly what we are getting. The fact that equities continue to climb the proverbial wall of worry indicates that investors are putting a lot of stock in the belief that the 2016 earnings backdrop – where tough comps to the significant move in the dollar and the dramatic decline in commodity prices roll off – looks much better. That's all well and good assuming lofty earnings estimates of $127/share on the S&P 500 for next year can be met (let's just say I'm more than a little suspicious of this reality). The divergence between price and earnings is illustrated in the below chart from FactSet, as the S&P 500 has appreciated by more than 8% so far in Q4 while the forward 12-month EPS estimate has decreased by 0.6%.



At this juncture the S&P 500 has repaired a lot of the technical damage that occurred in the recent correction – easily moving above its 200-day moving average last week, which many (including myself) expected to put up a lot more resistance – and is up 10.9% from its August 25th low close (closely resembling the quick snapback rally experienced in October 2014). One major difference in this rally compared to last October is that small caps are not keeping pace. The Russell 2000 is up 7.6% from its September 29th low but has only retraced 82 (37%) of the 218 points (-16.8%) lost during the June-September slide while the S&P 500 Index has retraced 205 (77%) of the 267 points (-12.5%) lost.

All that said, stocks are in a precarious situation, in my opinion, as the refreshing decline in valuation that occurred during the correction has now been removed with the S&P 500 trading back near its peak P/E multiple of 18.5x trailing and 16.75x forward earnings estimates. Global economic data has disappointed on the margin (mind you, not fallen off a cliff), U.S. economic data has weakened (outside of housing and jobless claims), and corporate earnings have been decidedly mixed. But the Fed as well as several other prominent central banks continue to keep their foot on the monetary pedal. So, the game goes on, but now we are in a 'prove it' environment where prices have moved higher in anticipation that central banks have investors' backs as long as the data remains weak. However, at some point, and not in the too distant future, we will have to start seeing a turn in the data for the better, or faith in central banks will dissipate and confidence at large will evaporate.

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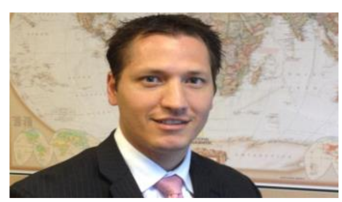

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