September 28th, 2015

Equity prices adjusting to weaker fundamentals…

The risk-off environment continued unabated last week as the bears remain firmly in control, creating a set-up where a retest of the August 24th intraday low of 1,867 on the S&P 500 looks to be in the cards. Of the major U.S. equity averages the Dow held up best as it suffered a modest decline of 0.4% last week while the S&P 500 lost 1.36%, and global equities faired a bit worse with the MSCI Global All-Cap World index giving back 2.02%. The biggest losses came from the most cyclically sensitive segments of the global equity market as Emerging Markets plunged 4.23%, the domestically focused but higher risk small cap Russell 2000 index declined 3.71%, and the tech-heavy Nasdaq sunk 2.91%.

This week is sure to be accompanied with continued volatility as it marks not only the end to a tough September, but also an end to the quarter which sets up to be the worst quarter for stocks in five years:

	Intraday data as of 9/28/15		
Market Index	**MTD% Chg.**	**QTD% Chg.**	**YTD% Chg.**
DOW JONES INDUSTRIAL AVERAGE	-3.08	-9.08	-10.19
S&P 500 INDEX	-4.50	-8.71	-8.64
NASDAQ COMPOSITE	-4.96	-8.97	-4.34
RUSSELL 2000	-6.09	-13.35	-9.75
MSCI ACWI	-5.30	-11.02	-9.71
MSCI EMERGING MARKETS	-6.38	-20.04	-19.45
GOLD	-0.26	-3.41	-4.42
SHORT-TERM TREASURY'S	0.69	1.09	1.41
INTERMEDIATE-TERM TREASURY'S	0.99	2.29	-1.73
LONG-TERM TREASURY'S	1.71	5.14	-2.62
TOTAL BOND MARKET INDEX	0.33	0.55	-0.75

Friday's surprise resignation announcement by Speaker of the House John Boehner perhaps sheds some light on just how divided our legislative body remains as we approach yet another budget showdown with the looming possibility of a government shutdown. However, the common interpretation from the political strategists is that this decision makes a government shutdown less likely with the Speaker able to cross party lines and garner the votes necessary from the Democrats to get a deal done. It's hard to believe that our elected leaders remain so divided and unable to negotiate a compromise for the betterment of the nation without having to oust the majority leader – and I'm not talking strictly about the divide between Democrats and Republicans, but also the bickering within parties (get a grip).

Nevertheless, assuming a deal gets done by the October 1 deadline it's looking likely that this will just be a stop-gap measure that funds the government until mid-December and then they'll be back to the negotiating table talking not only about the budget but also raising the debt-ceiling. Perhaps the Fed was aware of how contentious things were on the hill and took out a little insurance against a possible shutdown by not hiking rates at their last meeting, but they couldn't have known that Senator Boehner would hand in his resignation to avert a government shutdown.

Clearly, investors continue to exhibit an aversion to risk as indecision and confusion continue to retain the upper hand in the global equity markets. Risk appetite actually showed it had a pulse during Friday's trading day following a speech by Fed Chair Yellen the night before at the Philip Gamble Memorial Lecture, "Inflation Dynamics and Monetary Policy" where she reiterated that a move off of zero interest rates was likely before year end, to wit:

> "*Most FOMC participants, including myself, currently anticipate that achieving these conditions will likely entail an initial increase in the federal funds rate later this year, followed by a gradual pace of tightening thereafter".*

Why equity futures were up over 200 points prior to the market's open and rallied as much as 280 points at one point during the trading day is anyone's guess, however, it's how the market closes the day that's important and Friday's close was not a good one. My view is that markets are clamoring for certainty – even if it is accompanied by a rate hike – and following the confusion coming out of the recent Fed meeting it was Chair Yellen's opportunity to provide a bit of clarity. So, for a fleeting moment she was able to calm the markets with her comments, but the Fed's credibility has most certainly been called into question of late.

Judging by the market action since the Fed meeting I'm of the view that stocks could have cared less if the Fed hiked or left rates unchanged, so long as the decision was conveyed with a degree of clarity. The MSCI all-world equity index has declined in five of six trading sessions since the Fed's non-move and the Emerging Market space that Chair Yellen highlighted as a major reason for them to take a pass has declined more than 5%.

And it is this lack of confidence, not only in the Fed and their potentially being backed into a corner, but also the vulnerability of global growth that has markets a bit unhinged at the moment. Since this economic recovery began in late 2009 it has been the Fed that has stepped up during times of turmoil: first in 2010 with the escalating financial stress among European peripheral economies (Bernanke announced QE2 during a speech at Jackson Hole), then in the spring of 2011 we had a catastrophic Japanese tsunami that severely impacted global supply chains which rolled into another chapter of the European Credit Crisis and culminated with a downgrade of U.S. debt in part as a result of the dysfunction in D.C. (Operation Twist was announced), as the end of 2012 approached it was fears of the fiscal cliff and the possibility of a double dip recession (QE3 was announced), and then in 2013 markets revolted in what is now known as the "Taper Tantrum" when Bernanke stated "that it would be appropriate to moderate the monthly pace of purchases later this year" only to assuage the markets later that summer the pace of tapering would be very gradual and done in the context of continued improvement in the economic data.

At each of these junctures over the last five years capital markets reacted in a manner that typifies an adolescent child rebelling against parental discipline. So, no this time is not different in that respect. However, several characteristics do differentiate the current environment from prior episodes of disorder, namely: monetary policy carries a de facto tightening bias and the common perception among investors is that the Fed is out of bullets should it need to step in to thwart a turndown in the economy. The decision by the Fed to leave rates at zero for more than six years and counting attests to the view of how monetary policy has become impotent, where the laws of diminishing marginal returns are on full display.

Moreover, there is a growing divide in the Fed's communication function as the deviation between capital market prices and FOMC guidance expands. For example, Janet Yellen said the following at her September 17th post-meeting press conference:

> *"Now, I do not want to overplay the implications of these recent developments, which have not fundamentally altered our outlook. The economy has been performing well, and we expect it to continue to do so".*

So nothing "altered" their outlook, yet the FOMC made cuts to its outlook on inflation, GDP growth, and fed funds rate forecasts. Hmm, okay, but what's the explanation for the 13 FOMC officials that forecast a rate hike by year end and yet a year ago there was also 13 officials that said we would have had multiple rate hikes by now?

Yes, I adhere to the belief that when the facts change anyone has the right to change their mind, but the inability and/or the unwillingness of the Fed to move off zero interest rates when so many monetary officials are prepping the markets for a move is troublesome. It is this general lack of confidence and growing perception of fragility that is metastasizing in the capital markets as confusion and indecision among investors grows. The escalation in volatility in the equity markets is in part the result of the one central bank that has a semi-decent macroeconomic tailwind not having the confidence to move off zero – this implies that a prolonged period of low growth, low inflation, and low returns is at hand.

As for the capital markets, no doubt the technical picture for equities is weakening as the number of downside 'distribution days' (where volume is higher on down days and light on the rare up days) is growing – a disconcerting signal for the bulls. Additionally, the Nasdaq moving into negative territory on the year last week doesn't help the bull's case as it signals a change in market leadership is afoot – which is usually a near-term concern when sectors that were the leaders do an about-face and become laggards.

This breakdown in the Nasdaq was in part ignited by a tweet from Presidential Candidate Hilary Clinton where she pointed out that she intends to target "price gouging" in the Healthcare space. That tweet went out on Monday and sent the Biotech sector down 4.4% on the day and led to the sector being down every day last week including Friday's bloodbath when it declined another 4.9%. The Healthcare sector, which has been a market leader over the last several years driven largely by the Biotech group, is now trading below its closing low on August 24th. Just to show how weak the Healthcare space has become, according to data from Bespoke, there is not one Healthcare stock trading above its 50-day moving average.

The overall mood of the equity market has clearly soured, but there does remain some semblance of rationality and fundamental distinction within individual securities. The problem is that the good investment opportunities that have not been bid up are becoming few and far between. Nike (NKE) is one of those few as it announced earnings last week beating on both earnings and revenues while sales boomed in China – the stock surged 8% on Friday to all-time highs. On the opposite end of the spectrum was a negative pre-announcement by Caterpillar as the world's biggest mining and construction equipment maker said it would cut up to 10,000 jobs as it faces challenging conditions in key regions and the mining and energy sector.

At least there are two themes that remain intact: the solid job market and financially strong household balance sheets underpin a constructive consumption environment, while the contraction in the energy and mining sector remains unrelenting.

The weakness in the equity market is being confirmed by the debt markets as spreads on investment grade corporate bonds (companies rated BBB- or higher) are on track to increase for the second year in a row according to research from Barclays. This would mark the first time since the '07-'08 financial crisis that spreads widened in two consecutive years – before that, this last occurred during the Asian contagion in '97-'98. The credit spread between investment grade bonds and Treasuries ended 2013 at 1.14%, widened out to 1.31% at the end of 2014, and have expanded out to 1.62% as of last Thursday.

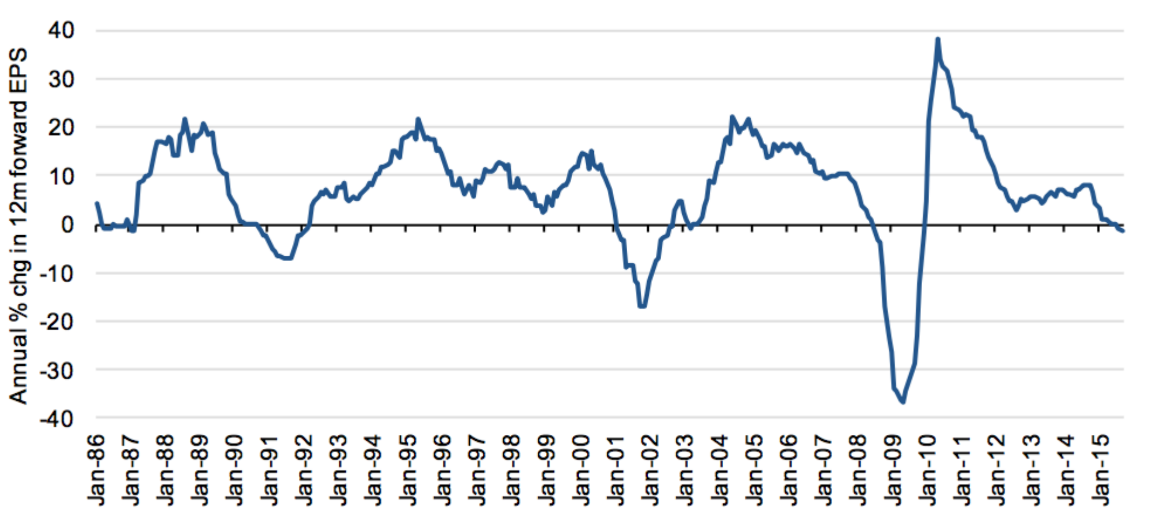
Junk bonds are sending a similar message as the high yield index has declined over 13% since last June, is down six days in a row and 10 of the last 11.

Adding fuel to the current state of discord in the equity markets is the idea that a 'profits recession' is at hand. I have made the argument in the past that investors need not fear the first rate hike by the Fed – it is where the fed funds rate ultimately ends up that matters most. Yes, stocks typically wobble at the onset of a rate hiking cycle, but historically that knee-jerk negative reaction turns out to be just a blip on the radar with the equity market going on to make new highs as the hiking cycle progresses.

However an important element to keep in mind is that earnings growth is typically robust at the onset of the hiking cycle and continues to grow throughout the cycle until monetary policy is tightened to a level that suffocates the expansion, inverts the yield, and a recession commences. As the Fed tightens monetary policy, valuation multiples typically contract in part because the discount rate in valuation models increases and the rate of earnings growth starts to decay. Keep in mind that throughout the tightening cycle the multiple contraction in equities is partly offset by the fact that earnings continue to grow, albeit at a slower rate.

This is not what is occurring today as the annual percentage change in the forward twelve-month EPS expectations recently turned negative for the first time since 2009. This is an ominous sign, given the last two occasions (prior to 2009) that this metric first went below zero (1990 and 2001) the U.S. economy was either in or nearing a recession.

US profit recession?
Annual% change in 12m forward EPS expectation turns negative for the first time since 2009



Source: Thomson Reutrers Datastream using I/B/E/S

The Fed running the risk of being wrong footed by hiking rates at a time when S&P 500 earnings growth is actually negative is a key ingredient for what has now become the stock market's first correction in almost four years.

So what investors have on their hands is slowing global growth – IMF head Christine Lagarde expressed over the weekend that global growth forecasts were likely to be revised downward – a maturing U.S. economic cycle that is not hot (nor is it cold), the Fed threating to hike interest rates, contracting EPS growth, weak technicals, a Chinese 'hard-landing' getting priced in, a meltdown in Emerging Markets (see page 22 of this weekend's Barron's, "Emerging Markets Haven't Hit Bottom Yet"), and the law of diminishing marginal returns taking hold for monetary policy after more than 600 interest rate cuts by central banks since Lehman Brothers went bankrupt.

All of this started coming to a head in early August and went into lift off when China devalued its currency on August 11th. This isn't to say China is to blame – they were more a domino in a chain of events that is culminating at the current time. But whether one is bullish, bearish or agnostic it is clear that investor sentiment has turned bearish and in a very big way – this is perhaps one of the few constructive variables the bulls can point to.

I mean look at the recently released Investors Intelligence poll for the past week which shows the bull camp retreating to 26% from 26.8% as the bear share spiked to 30.2% from 26.8%. The bull-bear spread now stands at -4.2 and is rapidly approaching levels of October 2011 (-11.9) and even March 2009 (-20.9). These were periods of severe market stress but looking back, both of these periods benefited those investors who didn't panic as they provided context for what extreme capitulation could look like when it arrives. And on this front it looks like we are getting close.

The recent results of the BAML fund manager survey showing that fund managers are holding the highest amount of cash (5.5%) since 2008-09 and that their allocation to equities is the lowest in over three years are further indications that a lot of negative news is currently being priced in.

Look, corrections and market pullbacks are never fun and this is the most severe one investors have experienced since 2011. So it goes without saying that the calls for the end of the world carry more weight in the media and grab the headlines at the current time – bears always seem to sound smarter than the optimism permeating from the bulls. I get it, and while I've been sanguine about the prospects for the equity market going back to early this year, I truly do not think we are on the precipice of a recession.

A lot of damage has been done to the market internally and it will take time to work through this as well as the growing chorus of negativity. But retesting the August 24th low on the S&P 500 of 1,867 has always been a distinct possibility and that is likely where we are heading. Heck, we may well be there by the end of week at the rate we're going (it's only 3.3% below Friday's close).

What will be concerning is if we break decisively below these levels and then take out the 1,820 level which marked the low in the S&P 500 during last Fall's equity market pullback. However, keep in mind corrections are par for the course if one is going to own stocks and these episodes are a necessary evil to eliminate the froth that builds up in markets from time to time. It reminds me of the Godfather when Clemenza is talking to Michael as they plot out a plan to take out one of the heads of the other families:

> Michael: "How bad you think it's gonna be?"
>
> Clemenza: "Pretty goddamn bad. Probably all the Families will line up against us. That's alright – these things gotta happen every five years or so – ten years – helps get rid of the bad blood. Been ten years since the last one."

With that being said there is little reason for investors to step up and be a hero. What is happening throughout the trading day is a buyer's strike with few investors willing to step up to buy shares from the predominate share of investors looking to sell. We are now in a decisive downward trend and investors stepping in to buy at the current time in hopes that we've reached a bottom will either be lucky if they are right or more than likely catching a falling knife.

My advice to investors is to step back, take a breath, conduct a thorough evaluation of your portfolio, and decide on what makes the most prudent sense for you. If you can't stomach the losses any longer or they have become too severe then it's likely you have more risk in your portfolio than is appropriate. If you've continued to remain disciplined throughout this cycle and your portfolio is diversified, it's likely you are experiencing declines, but these are the times that remind such investors why they adhere to such a strategy. Lastly, if you're looking for an opportunity to increase your risk exposure and have been waiting patiently for a pullback then you should have your shopping list ready because that moment is upon you.

The most important thing an investor can do in times like these is have a plan, stay disciplined to it, and adjust it if necessary. Now is not the time to panic as the worst is likely behind us, but mind you, investors should rid themselves of any notions that this is going to be a V-shaped snap back in prices like has been the case after each and every correction since this bull market began in 2009. We've been waiting for fundamentals to catch up to prices, but instead patience has run thin and now we are in the process of prices correcting to the fundamentals.

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