Insights: November 2015

Market Overview and Performance

In the words of Mark Twain, "October: This is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August and February." Coming into October, it appeared that few investors were in the mood to speculate this year after having just gone through an 11 percent decline in stocks over the previous two months. However, another well-worn adage about October is that it is the month where bear markets go to die, and just like that, the correction of the third quarter disappeared before Halloween was through.

The S&P 500 Index rose by 8.4 percent in October, the largest monthly gain since October of 2011 and a performance that somewhat surprisingly took the Index within one percent of its all time high reached in May. As we discussed in last month's Insights, we were monitoring a number of indicators like high yield bond spread for signs of deteriorating conditions. What actually transpired was a decrease in potential warnings as several global developments such as a Chinese interest rate cut, further simulative language from the ECB and better than expected earnings here in the U.S. fueled a risk-on rally which we believe has more room to run.

As always, thank you for reading our monthly Insights.

	Month to Date	***Year to Date***
Equity	***Percentage Change (USD$)***	***Percentage Change***
S&P 500 Index	**8.44**	2.70
Russell 2000 Index	5.63	-2.53
MSCI EAFE Index	7.82	2.13
MSCI Emerging Markets Index	7.13	**-9.45**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	0.02	1.14
Barclay's U.S. Credit Index	0.47	0.21
Barclay's Corporate High Yield Index	**2.75**	0.23
Barclay's Municipal Bond Index	0.40	2.17
Macro Measures		
Gold	2.35	-3.61
Crude Oil	3.33	-12.54
CBOE Volatility Index	**-38.49**	-21.51
USD Dollar Index	0.66	7.35

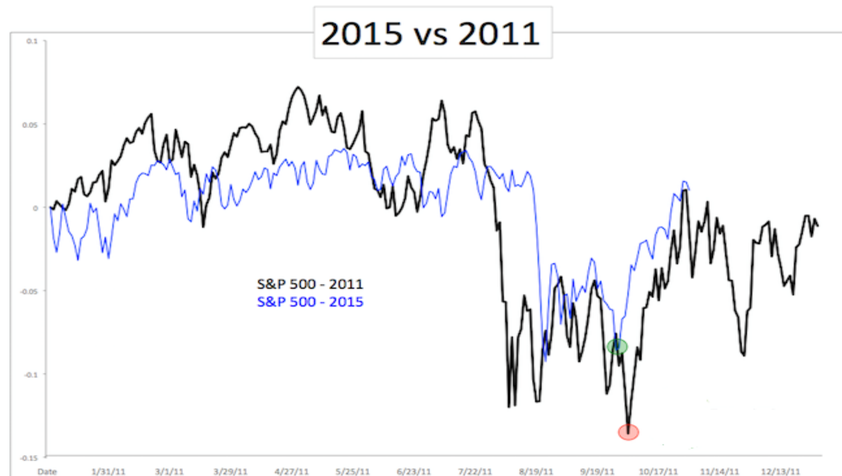
November Themes – Textbook October Recovery After 3Q Correction; Valuation and Seasonal Patterns are Supportive for More Equity Gains; Earnings Surprise to the Upside: Global Economic Conditions Improve; Fed Poised to Raise Rates in December

Market Reversal Following the Playbook

It was almost as if someone put up the "all-clear signal" and rang a bell on September 30th because risk assets in general marched straight upward during the month of October. The rally was surprising not only for its magnitude (S&P 500 +8.4%) but also for its turn-on-a-dime trajectory. After two months of fairly relentless selling in the equity markets, sentiment was extremely poor and there were more than a few who suggested that we had entered a bear market and perhaps even another global financial crisis. But as we said in our October Insights, there really was no basis for this.

Yes, global growth had shown some signs of slowing; however nothing fundamentally had changed other than asset prices. We, like others, were watching indicators that have proven themselves to be worthy guideposts in the past like high yield bond spreads. But nothing materialized that could be viewed as a true change to the growth trend that has been in place, particularly in the U.S.

2015 Has Closely Resembled the 2011 Recovery

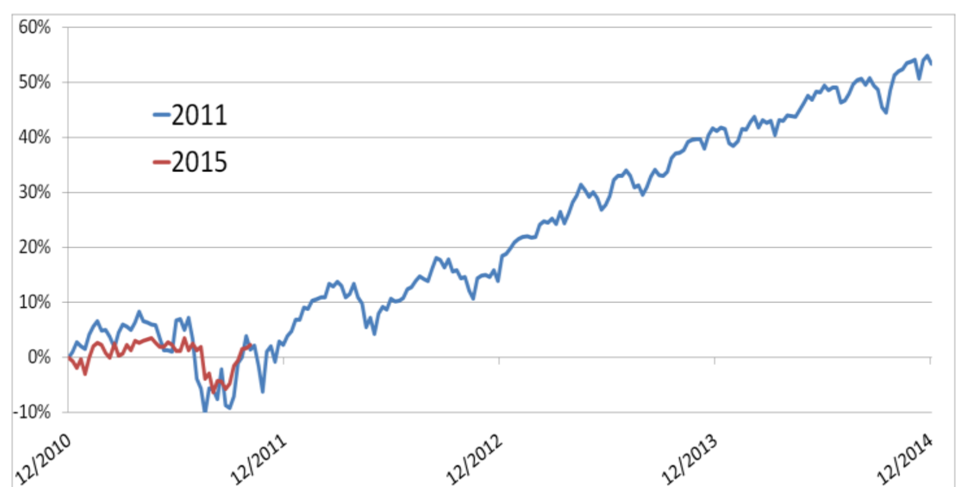


Source: S&P Dow Jones; www.ispyetf.com

As a result, equity markets snapped back sharply as the calendar flipped to October. As seen in the previous chart below, in hindsight, the rally was actually a textbook example when looked at in the context of historical precedents. In last month's Insights, we discussed how the 10 year and 30 year seasonal patterns of the S&P 500 demonstrated a typical Autumn sell-off that bottoms out on October 9th. Additionally, in 2011, 1998 and 1990 the S&P 500 experienced third quarter sell-offs before reversing in early October and moving on to new highs. According to S&P Capital IQ, the typical duration for a recovery after a 10-15 percent correction is 65 days- almost exactly the time it took this year.

Speaking more specifically to 2011, as we wrote about last month, the 2015 chart of the S&P 500 has closely resembled the path taken in 2011. At that time, the market sold off in late summer on the concern that the impact of a slowdown in U.S. growth, resulting in a credit downgrade, combined with a European debt crisis, would produce a global growth deceleration that could even lead to recession. But that didn't happen. Instead, focus returned to improving economic data and better than expected earnings – fundamentals in other words, not hyperbole – and the market quickly rallied 11 percent higher. Not only did it rally in the fourth quarter however, it also set up the market for three straight years of equity gains as seen below.

2011 Recovery Set Up the Market for Years of Gains



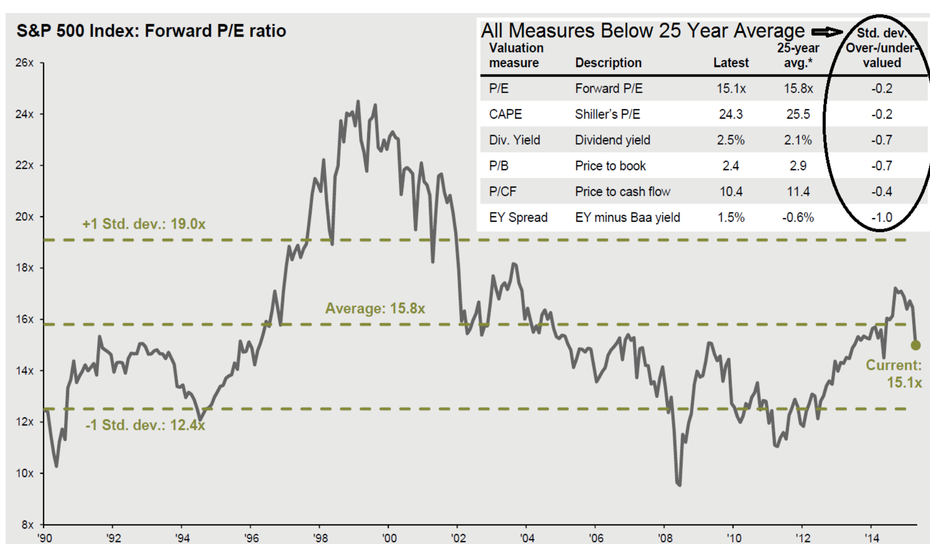
Source: S&P Dow Jones; Thomson One

We are in no way suggesting that simply overlaying similar charts will tell you what the future path will look like. However, there is reason to believe that as in 2011, factors may now be in place that could possibly set the stage for further gains going forward.

Valuation, Earnings, Global Improvement and the Fed

An obvious question would be, "What changed so quickly to reverse the market and to lend credence to the belief that there is room to move higher?" The short answer is "a lot". Broadly speaking though, several developments unfolded in October that provided a good deal more clarity on future events. This was the spark that led to the rally. First, China cut its interest rate and released economic data suggesting that the country is not headed for a "hard landing". Second, U.S. economic data improved. And third, corporate earnings have proven to be largely better than expected. And importantly, several other indicators that are more predictive in nature rather than rear view oriented are now fairly encouraging which we will discuss.

Valuation Levels Now Slightly Below 25 Year Average

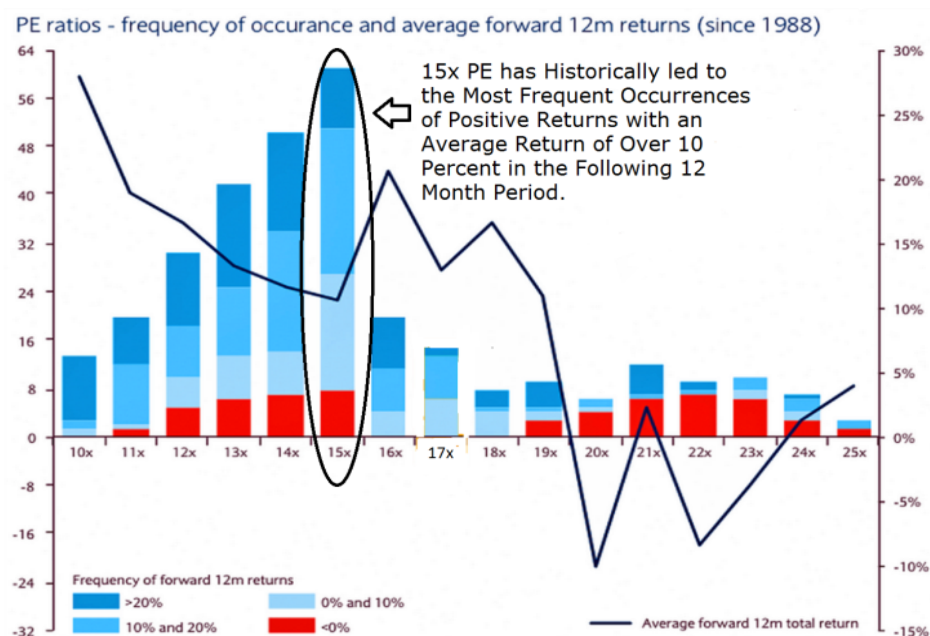


Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-valued
P/E	Forward P/E	15.1x	15.8x	-0.2
CAPE	Shiller's P/E	24.3	25.5	-0.2
Div. Yield	Dividend yield	2.5%	2.1%	-0.7
P/B	Price to book	2.4	2.9	-0.7
P/CF	Price to cash flow	10.4	11.4	-0.4
EY Spread	EY minus Baa yield	1.5%	-0.6%	-1.0

Source: J.P Morgan Asset Management; Factset; Robert Shiller; Standard & Poors

One of the few benefits of a market correction like the one we just experienced is the resulting adjustment to valuation levels. As the chart above illustrates, the recent pullback brought a wide range of valuation metrics down below their 25 year average. In addition to the opportunity to purchase stocks now "on sale" when compared to where they were trading just a few months ago, lower valuations also give investors confidence that the market has not gotten too far ahead of itself. In fact, historically, a roughly 15x forward Price to Earnings level as we have now has been a very good starting point for future returns as the chart below attempts to show.

Current Valuation Levels Have Led to Positive Returns



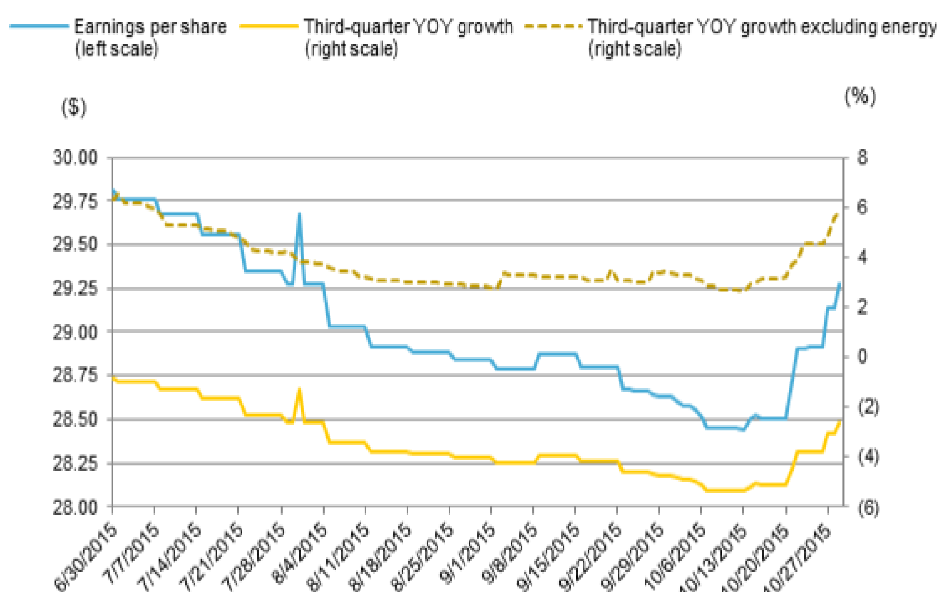
Source: Barclay's Research; Business Insider

The chart highlights the fact that in the past, a 15x forward P/E has led to positive returns in the following twelve months more often than any other starting point with an average return of over 10 percent. Anecdotally, the near record levels of merger and acquisition activity is also a testament to the fact that corporations view current valuations as reasonable.

One of the bigger concerns heading into third quarter earnings season was the possibility that earnings would be declining. Estimated growth bottomed at -5.2 percent as we headed into October.

In addition to signaling a weak business environment, declining earnings also have the negative effect of increasing P/E levels. As we have discussed in prior Insights however, muted growth in earnings or even an earnings decline is massively influenced by the weak energy sector (-66% estimated earnings decline for Q3). With roughly 75 percent of S&P 500 companies having reported by early November, the earnings environment has proven to be much better than anticipated. 70 percent of companies have surprised to the upside, and more importantly, growth outside of the energy sector has been solid with the aggregate level rebounding back to the 6 percent level. The chart below clearly shows the dramatic improvement from the extreme pessimism seen at the start of October.

Q3 EPS Growth Excluding Energy is Almost 6%

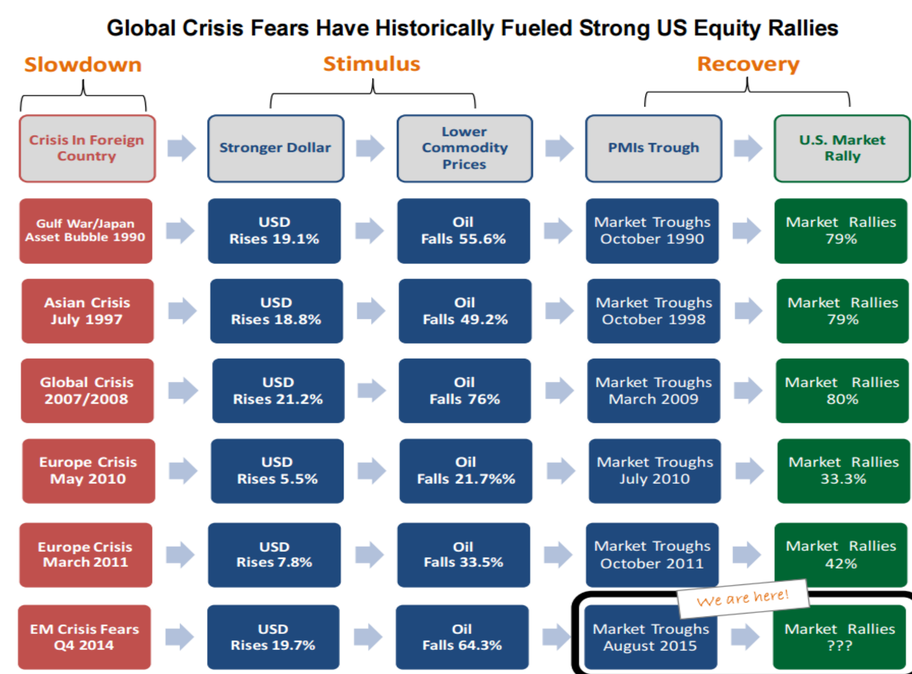


Source: Factset

So with valuation levels looking attractive and actual earnings being "less bad" than many feared, what about the weak global macro environment that dominated sentiment last quarter? Well, the picture has improved there as well. One of the measures we like to look at for various regions is Purchasing Managers Index levels or PMI. Essentially, this is a measure of the robustness of economic activity with a reading over 50 indicating expansion. For example, many market participants were encouraged by the fact that China's PMI improved to 49.8 in October suggesting a rebound from a soft summer and not a "hard landing".

Individual readings are helpful for asset allocation, but when all readings are combined into a global PMI, the measure becomes very useful in gauging market direction. Research firm Cornerstone Macro has done a lot of work in this area and found five prior instances where global crisis fears like we had in August and September have led to future gains.

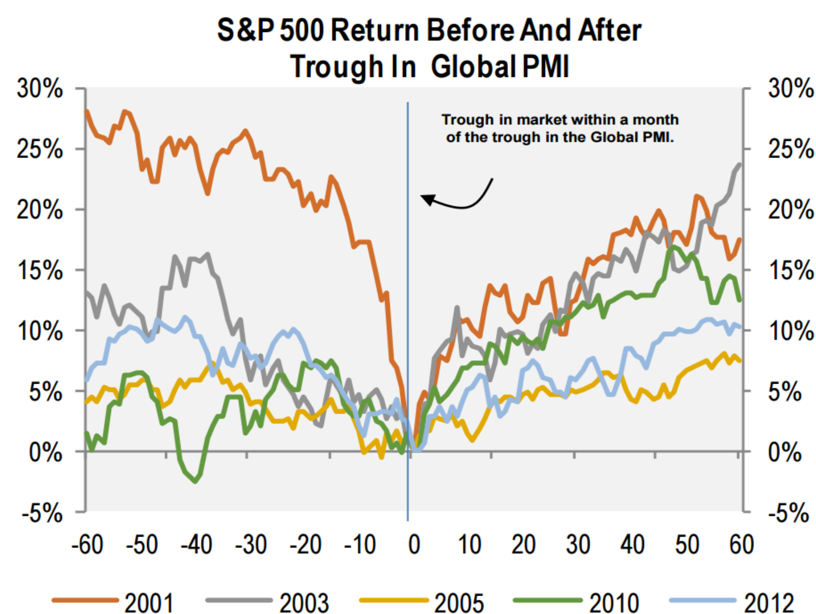
5 Prior Global Crisis Fear Episodes Echo Today – All Led to Future Gains in U.S. Stocks



Source: Cornetstone Macro

Importantly, Cornerstone also points out that we have just gone through a period where equity markets and global PMIs both bottomed at the same time. An inflection point in other words. Below are the resulting future returns.

Notable Coincident Troughs in S&P and Global PMIs



Source: Cornetstone Macro

The turn upward in PMIs is a notable positive development that represents a big change from even just last month. Not only has it been a precursor to higher returns in the past, but it also removes one of the largest uncertainties in the form of a weak Chinese economy. We certainly acknowledge that Chinese growth is slowing from its previous torrid pace, however, what now looks like a "soft landing" would be largely welcomed by investors who Barclay's Research Global Investor Survey claims view China as the biggest risk to the markets over the next 12 months.

The other looming uncertainty that has acted as an anchor on markets is the timing of the Fed's first interest rate hike. During October, the Federal Reserve left rates unchanged as expected, however, they did remove the language from their statement acknowledging "recent global economic and financial developments." This was a reference to China which is seemingly less of a concern to the Fed at this point. The next important development for the "data dependent" Fed was the October jobs report after weak August and September readings.

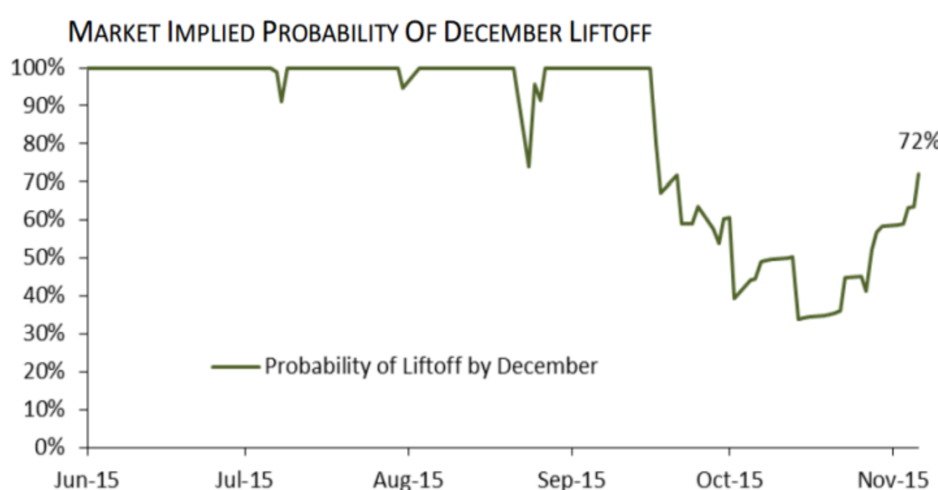
The report did not disappoint with the economy adding 271,000 jobs during the month well ahead of the 180,000 estimate. Additionally, the unemployment rate ticked down to 5 percent. This is a healthy labor market. In fact, the U.S. has now added an average of 206,000 jobs per month in 2015 and is on track to create more than 2 million jobs for the fifth year in a row. The Fed has a "dual mandate" of stewarding both employment and inflation. With a robust employment situation, inflation has been the long-awaited missing piece that would pave the way to rate hikes. October's report indicated that wage pressure is now developing in the economy as well.

Wage Growth Finally Signaling Inflation Pressures

Source: BLS Haver; @MKTWeconomics

As a result, with both the dual mandate items looking solid, the marker reaction was immediate. The probability of a December interest rate hike went from just 30 percent in late October to over 70 percent by the first week of November.

Probability of a December Lift-Off Now Above 70%

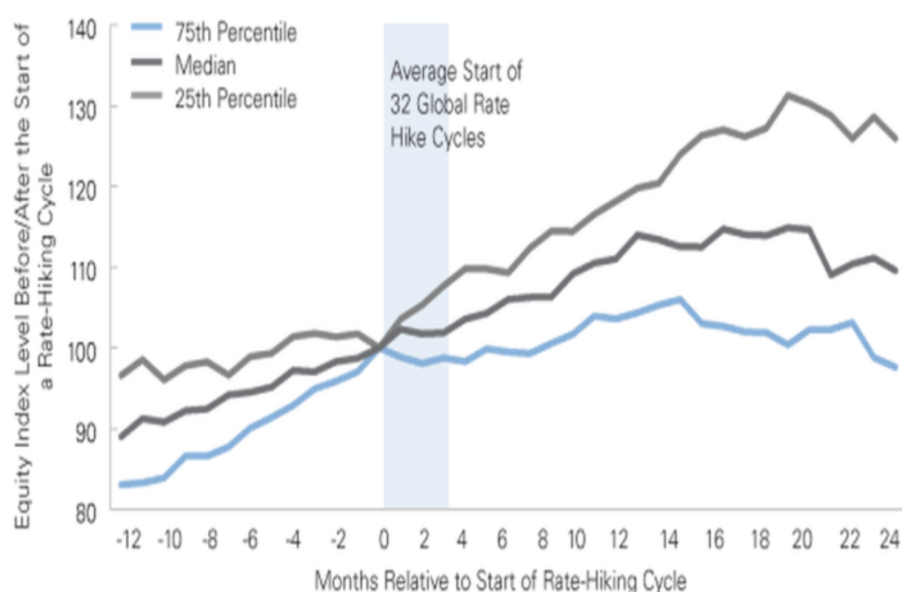


Source: Cornerstone Macro

In other words, the market is ready for rates to move higher and has priced in December as the first initiation of policy changes away from emergency levels. This is all good news. As we have written about previously, the market dislikes uncertainty and within the last 30 days the road into 2016 has become much less murky.

And for those that still side with the view that rising rates will impede equity returns, the chart below from Goldman Sachs suggests that this concern might be misplaced. Looking at 32 global rate hike cycles historically, the following 12 and 24 months returns for equities have on average been quite positive.

Interest Rate Hikes Do Not Always Create Headwinds



Source: Cornerstone Macro

Going Forward

Despite the declines experienced during August and September, we remained confident in the narrative that global fundamentals were sound. This conviction proved beneficial during the October recovery. As we stated last month, we felt that the fall in prices presented an opportunity for good entry points in selected long-term oriented investments. We therefore were putting money to work in equities during the early part of October. Given the recent improvement in the global economy and the seasonal factors that are now coming into play, we remain constructive regarding the potential for further gains as we begin to look to 2016.

Within equities we continue to favor the large cap segment of the U.S. market. We would prefer to achieve our exposure through cyclical areas of the market such as the technology, health care and consumer discretionary sectors which stand to benefit the most from a strong U.S. economy.

In early October, we did add to positions within those sectors as well as initiate new positions in selected securities in the financial and energy sectors. Financials in particular stand to benefit from a rising interest rate environment which appears to be on the horizon.

While we are believers in the strong U.S. growth story, we think that international diversification through allocations to Europe and Japan in particular remain attractive. Both of these global regions are firmly entrenched in a very accommodative policy environment which provides a tailwind for equity markets generally. Additionally, during October both the European Central Bank and the Bank of Japan gave indications of more simulative measures yet to come.

We remain underweight traditional fixed income. With an anticipated increase in the Fed fund rate likely coming by the end of the year, we continue to advocate an emphasis on less interest rate sensitive options available with shorter duration exposures and unconstrained strategies as a focus. Our explicit exposure to the muni markets has also benefitted us thus far this year.

Commodities remain structurally challenged in our view. With regard to oil, the fundamental outlook for the next 12 to 18 months is not likely to improve. However, we believe that high quality names within the sector represent good long term value with the price of oil seemingly having stabilized somewhere in the $40 to $55 range for the time being.

Thank you for taking the time to read our thoughts on the developments within markets this month. We look forward to speaking with you soon.

Litvak Wealth LLC ("Advisor") is a registered investment advisor. Information provided in this letter is for educational purposes only and should not be considered investment advice. Advice may only be provided after entering into an advisory agreement with Advisor. Information is at a period in time and subject to change. Past performance is not a guarantee of future results. Discussions relating to risk and diversification are for illustrative purposes only. Please contact us to discuss your specific allocations and portfolios risks. Indices discussed in this letter, such as Standard & Poor's 500 Index (S&P 500), are unmanaged, do not reflect the deduction of any fees, and cannot be invested into directly.