Insights: October 2015

Market Overview and Performance

Although the mildly negative returns posted in September were less severe than those experienced in August, it certainly didn't feel any more reassuring to many global investors. As Howard Silverblatt of S&P Dow Jones wrote in the opening of his monthly market note, "Anybody here seen my USD 7.35 trillion? Can you tell me where it's gone? I thought I saw it pledged with hedges, commodities and bio-tech. I just looked around and it's gone." By his calculations, that was the amount lost in the quarter by the S&P Global Broad Market Index.

With roughly 1000 days having past since the last 10 percent correction, investors had become unaccustomed to what is actually a fairly common occurrence (they happen every 357 days on average historically according to Deutsche Bank). Although some ground was made up from the lows reached on August 25th, September provided little solace in a quarter that was marked by meaningful global events. Although it seems like a distant memory, the quarter actually began with Greece capitulating to creditors, followed by a Chinese devaluation in August and finally, a lack of action on the part of the Federal Reserve in raising interest rates in September. Seems like enough macro volatility to last an entire year however there could be more to come in the fourth quarter.

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	-1.35	-6.95
Russell 2000 Index	-4.91	-7.73
MSCI EAFE Index	-5.08	-5.28
MSCI Emerging Markets Index	-3.01	**-15.48**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	0.68	1.13
Barclay's U.S. Credit Index	0.46	0.90
Barclay's Corporate High Yield Index	**-2.60**	**-2.45**
Barclay's Municipal Bond Index	0.72	1.77
Macro Measures		
Gold	-1.53	-8.82
Crude Oil	**-8.35**	**-15.36**
CBOE Volatility Index	-13.82	27.60
USD Dollar Index	0.36	6.65

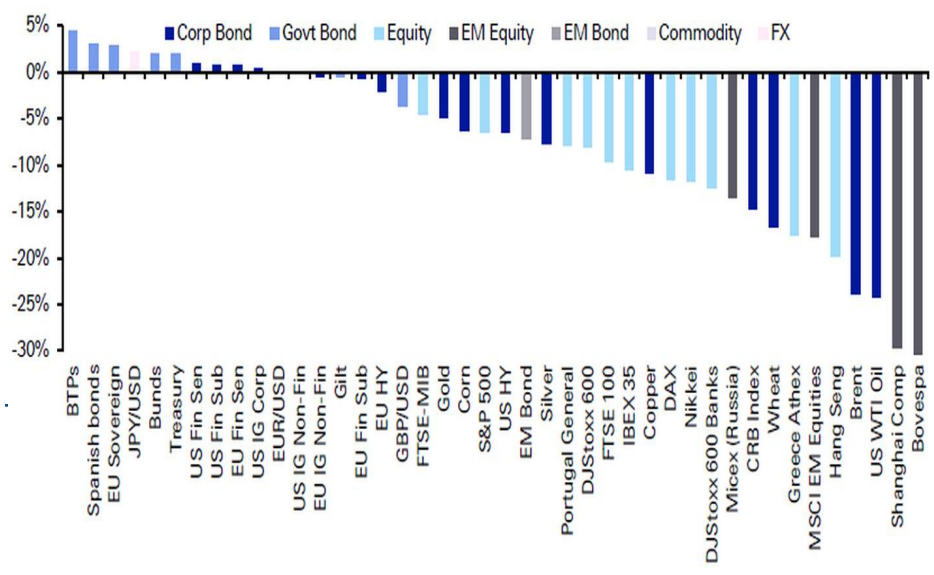
October Themes – Market Pullback Setting up for a Fourth Quarter Recovery? – History Suggests Yes; Earnings Recession? – Not Likely to Lead to an Economic Recession; Global Economic Softness; Macro Risks Elevated in the Middle East

Weak Quarter Leaves Few Places to Hide

Although the month of September itself proved to be somewhat of a sideways period due in part to a decent rally on the very last trading day, the third quarter as a whole was not friendly to investors in all assets classes. Although the drama in Greece initiated the volatility in July and the Chinese Yuan devaluation caused further concerns in August, it was really the Fed's actions, or lack thereof, in September which truly cemented a risk-off posture in the markets. When the Fed chose to not raise rates at their September meeting, markets viewed this lack of movement as a negative sign.

Despite the fact that Fed futures at the time suggested investors were only anticipating a rise in interest rates to be a 30 percent probability, the fact the Janet Yellen cited concerns regarding global growth as part of her reasoning for staying on the sidelines changed the narrative. By suggesting that the global markets have influence over policy decisions, Yellen gave the market the impression that sentiment and not real economic data were actually tipping the scales. This circular logic (the market declines as it worries about the Fed increasing rates causing stress to the system – the Fed holds rates at emergency levels because the markets appear to be in stress) effectively handcuffs the Fed. It also creates a lot of instability and risk aversion. As you can see in the chart at the bottom of the previous column from Deutsche Bank, virtually every global asset class declined during the quarter, some like China and Brazil by as much as 30 percent in US dollar terms. Only government bonds held steady.

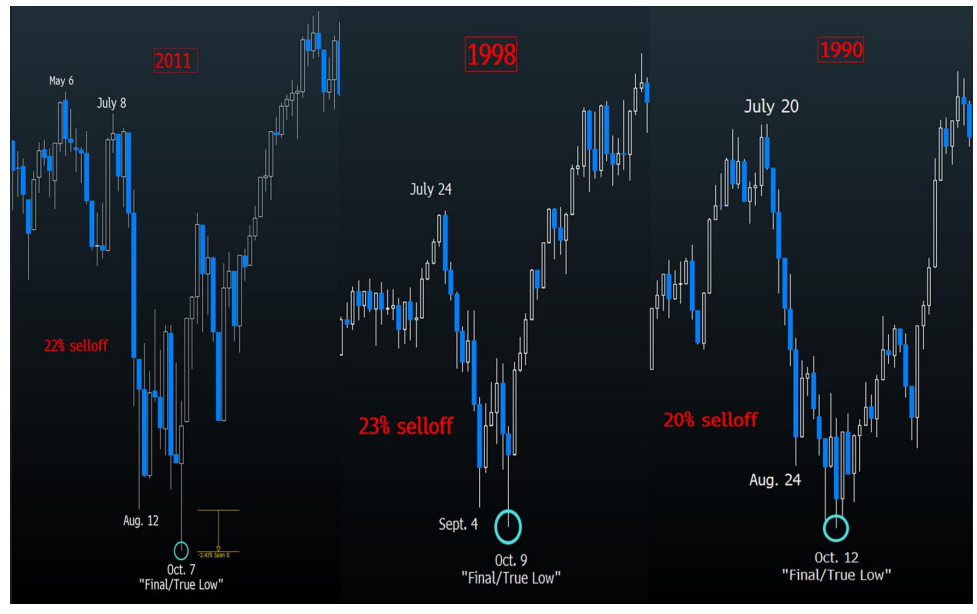
Virtually All Global Asset Classes Declined in Q3



Source: Deutsche Bank

One potential silver lining to the current angst in the market is the fact that we have essentially seen this movie before. In fact, similar seasonal patterns have occurred in the recent past. Looking below you can see that in 1990, 1998 and 2011, the S&P 500 experienced severe sell-offs beginning in July before bottoming in early October and finally rallying to new highs in the following months.

Q3 Sell-offs and Rebounds Have Followed a Similar Trajectory

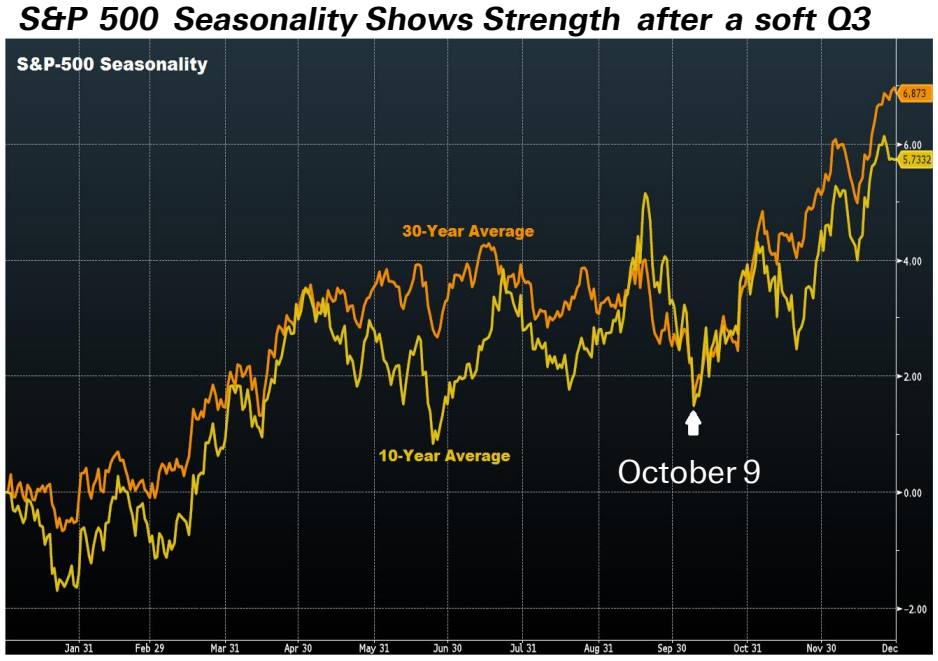


Source: Bloomberg

Interestingly, if you overlay the 2015 chart onto the one from 2011 when the US was facing a summer downgrade of its credit rating and the Eurozone was struggling, it is virtually identical. After bottoming in early October of 2011 the S&P 500 subsequently marched higher for four straight years. Certainly its unrealistic to expect similar outsized performance based on one year alone, however, if one looks back at the 10 year and 30 year seasonal averages of the

Index as seen in the chart below, there is reason to believe that the momentum in the market would be higher as we move into the fourth quarter.

S&P 500 Seasonality Shows Strength after a soft Q3

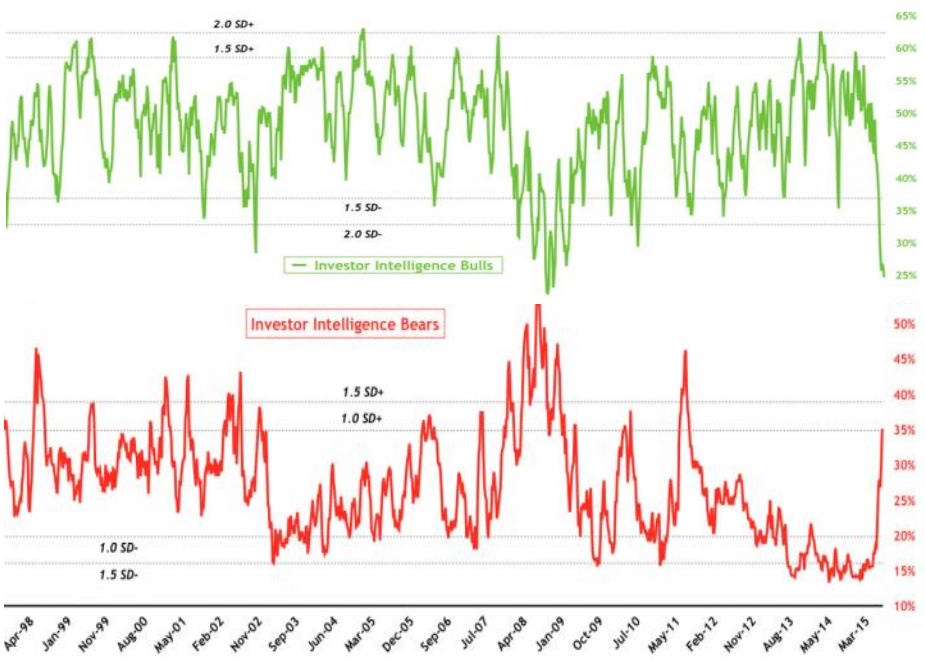


Source: Bloomberg

Sentiment, Earnings and Profits

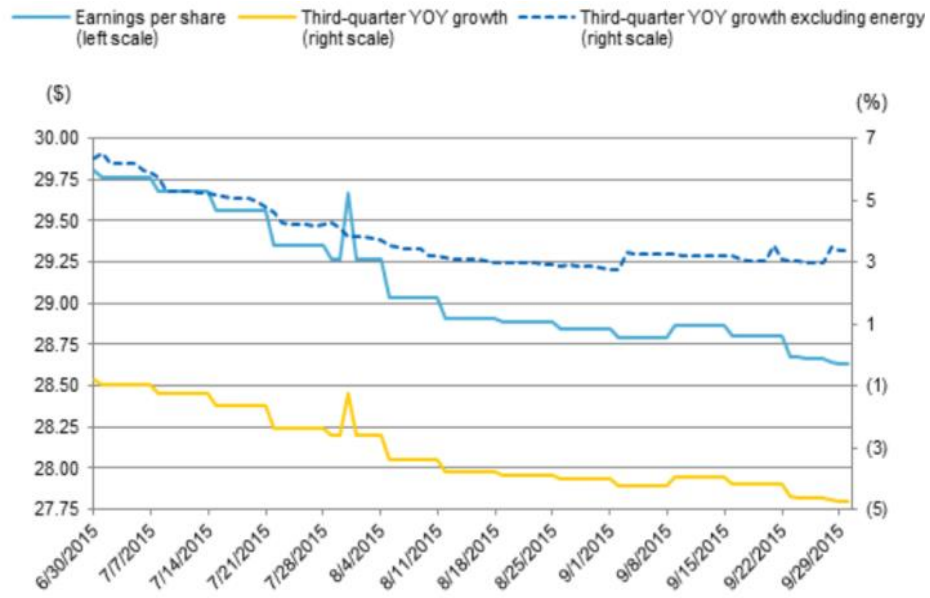
Perhaps one of the harder notions to come to terms with is how can the market turn around and move higher when sentiment is so poor. Sentiment is a contrarian indicator and backward looking in nature, meaning that readings are based off of what has just occurred and essentially the opposite of what is likely to happen in the future. But markets need a catalyst to move higher and as we head into October that catalyst could perhaps be the corporate earnings season. However, there is a high degree of concern heading into this quarter's earnings reporting period. Most of the concerns revolve around the notion that companies faced the combined headwinds of a strong US dollar and declining global growth. Current estimates are for earnings to decline by -5 percent this quarter according to Factset. Certainly weak at first blush and perhaps more importantly, if true, the first back to back quarters of earnings compression since 2009. As we have discussed in the past, the energy sector has a tremendous impact on overall results with anticipated decline of -64 percent (!) for the sector's results. Excluding energy however, earnings growth is projected to be roughly 3.5 percent.

Sentiment is Contrarian – Very Negative at Present



Source: Standard & Poor's; Investor Intelligence; ShortSideofLong

Q3 EPS Estimated to be +3.5 Percent Excluding Energy



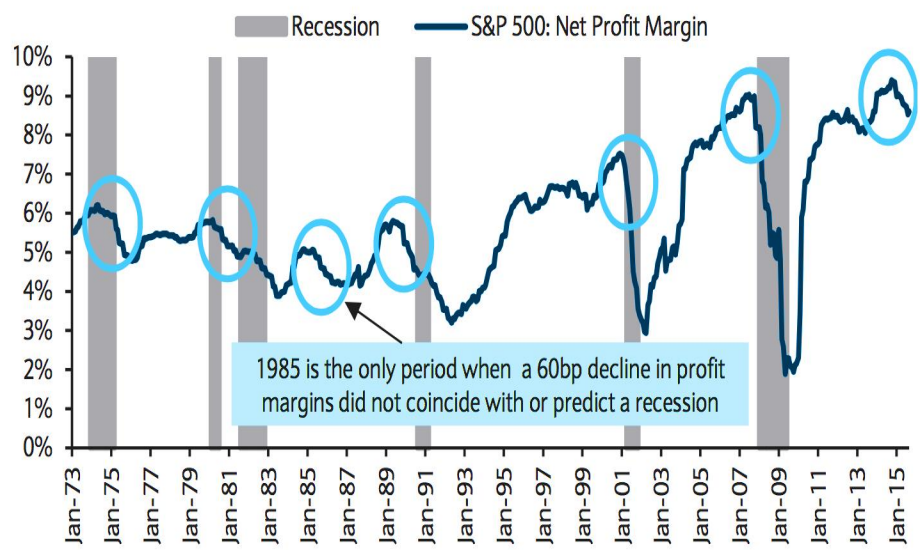
Source: Factset

Three percent growth spread across other sectors is a fairly healthy scenario, however, many pundits are not focused on that side of the equation. Rather, their attention is drawn to the fact that back to back declines in quarterly results would represent an "earnings recession". Historically, this has not been a good sign. In prior periods, earnings recessions have been a harbinger of an actual recession in the US economy. While we readily acknowledge that this earnings season could be a disappointing one at an aggregate level, we do not believe that we are on the cusp of an economic recession. There is simply too much evidence to the contrary. Also keep in mind that public companies have a well established pattern of under-promising and over-delivering which could very well be the case this quarter as well.

That being said, it is worth looking at similar episodes in that past to understand the underlying thinking behind the caution.

Warnings Signs From Declining Profits?- Not Likely

A large decline in profit margins usually leads to or coincides with a recession

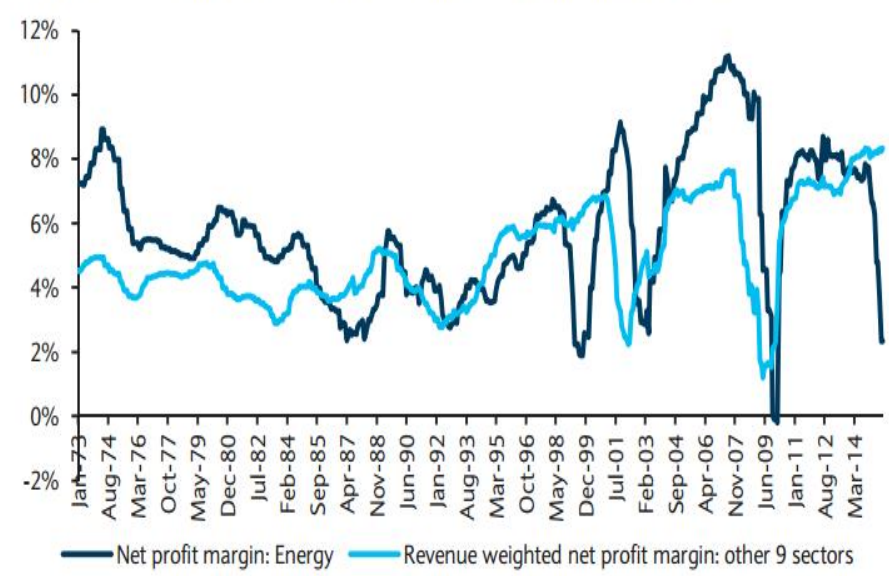


Source: Barclay's Research; Thomson Reuters

As the chart above from Barclay's illustrates, historically, declines in profitability have tended to presage oncoming recessions. This would seemingly be cause for alarm, however as Barclay's highlights in the following chart, in 1985 corporate profits declined due the weakness in the energy sector while all other segments of the market continued to increase their profitability. In fact, in 1985 the S&P 500 actually managed to rally significantly. Given where the market is seasonally, we could see the market react well to potentially "less bad" earnings this quarter as well.

Similarities to 1985 – Energy the Source of Weakness

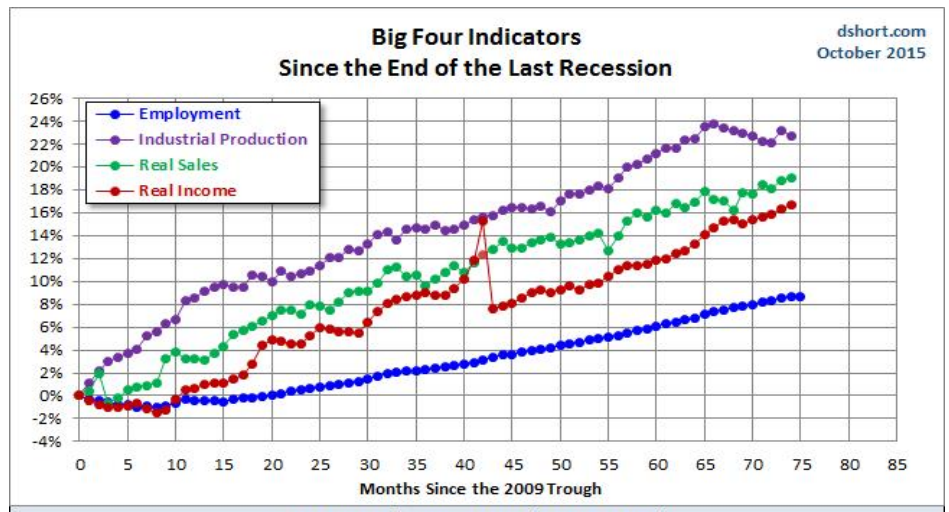
In 1985 profit margins fell because of the energy sector, similar to today



Source:Barclay's Research; Thomson Reuters

As we discussed in several of our previous Insights letters, we believe the US economy, as measured by many indicators, is in very good shape. Consumers think so too, as September's Consumer Confidence reading registered at an eight year high. And as the chart below from Doug Short illustrates with his recession dashboard, many of these indicators continue to trend upward.

Foreign Bank Exposure to China is Limited



Big Four Indicators Month-over-Month

Indicator	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
Employment	0.16%	0.30%	0.23%	0.14%	0.19%	0.08%	0.13%	0.18%	0.17%	0.16%	0.10%	0.10%
Industrial Production	0.16%	0.89%	0.10%	-0.29%	-0.15%	-0.19%	-0.20%	-0.43%	0.00%	0.87%	-0.38%	
Real Sales	0.38%	0.80%	-0.54%	-0.09%	-0.75%	1.30%	-0.07%	0.74%	-0.36%	0.57%	0.26%	
Real Income	0.54%	0.78%	0.51%	0.50%	0.11%	-0.39%	0.40%	0.17%	0.22%	0.38%	0.34%	

Employment is released the first week of the month, Income the last week, Industrial Production and Sales mid-month.

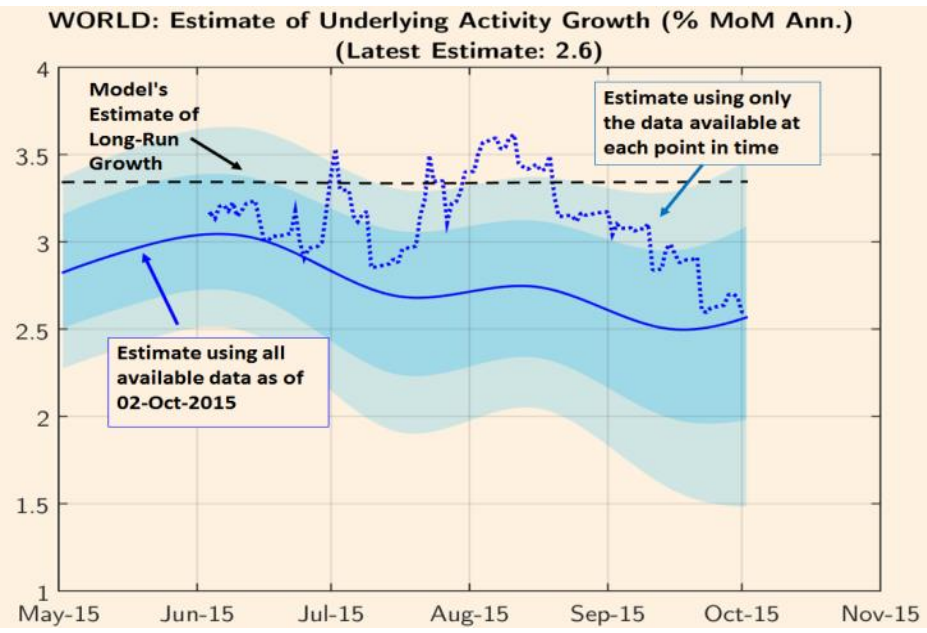
Source: Doug Short

Some Potential Warning Signs on the Horizon

Although we are confident that the US is on strong enough footing to weather financial weakness stemming from overseas markets, there are a number of developments which we feel require attention since they could potentially be warning signs of difficulties ahead.

First, although there are pockets of strength, global growth as a whole is slowing. In the chart below from Fulcrum Asset Management, they estimate that overall global activity has fallen sharply in the last two months. They calculate that the global growth rate has declined from roughly 3.5 percent down to 2.5 percent. This is also below a long-term average of roughly 3.4 percent. Something is clearly hampering activity and most people would point the finger squarely at China.

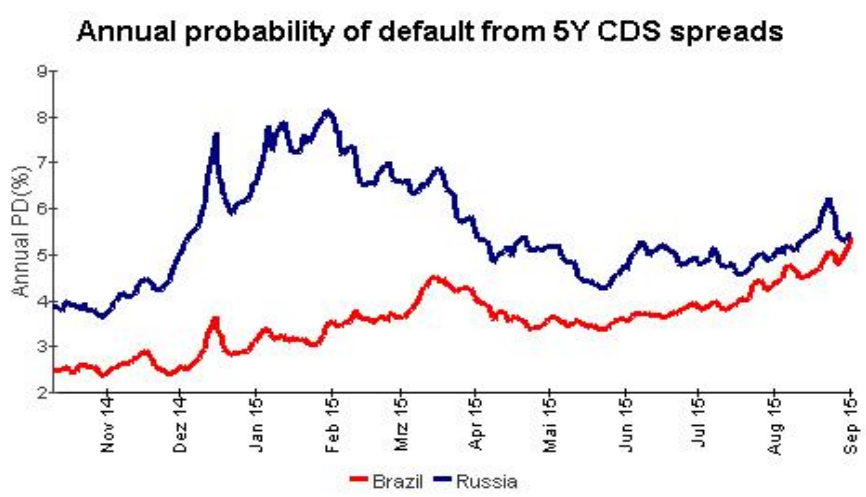
Global Growth Has Slowed in Recent Months



Source: Fulcrum Asset Management

Even though China is slowing as we discussed in detail in last month's Insights, it is still expanding at a rate that is higher than almost every other major economy. The real culprits are Brazil and Russia which have each fallen into recession. In fact, Fulcrum estimated their growth to be -6.9 percent and -3.5 percent respectively. This has not gone unnoticed. As seen in the chart below the market is pricing in a higher likely hood of those countries defaulting on their debt. This is something worth watching closely since credit default swaps often act as a "canary in a coalmine", an early signal of trouble to come.

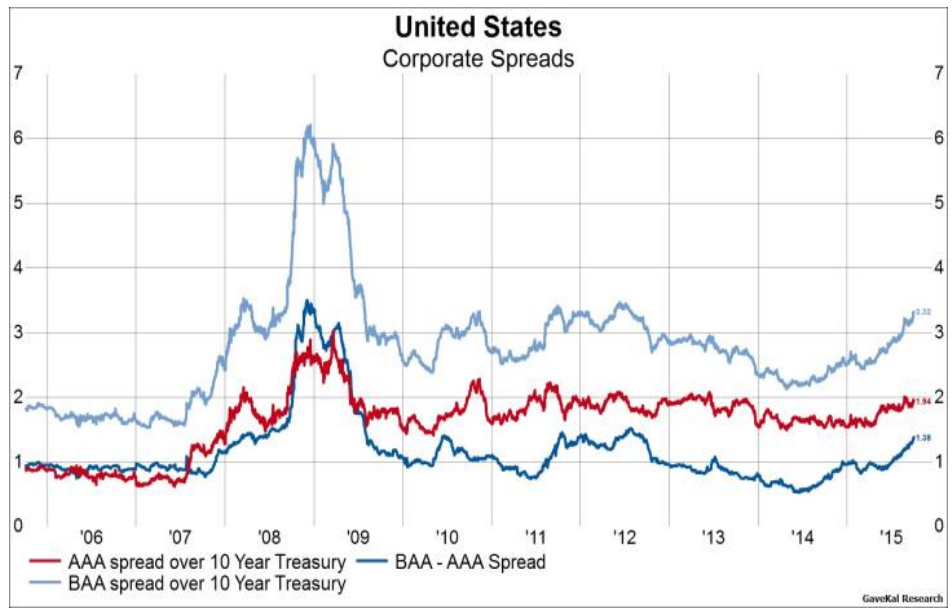
Emerging Markets Seeing Increased Risk of Default



Source: Deutsche Bank

Even within the US, which again, we feel is not under duress, there are some potential signs of strain. As we have discussed in prior Insights, high yield bond spreads have been at elevated levels for much of the year reflecting what investors perceive as greater risk. Like credit default swaps, rising high yield bond spreads can sometimes serve as an early warning system. However, the high yield bond market is disproportionately tilted toward the energy sector whose challenges are well known. What is perhaps more worrisome is the chart below. Bond spreads on higher quality corporate entities have also begun to rise perhaps suggesting an increased degree of risk in the overall market. We will be monitoring this as well.

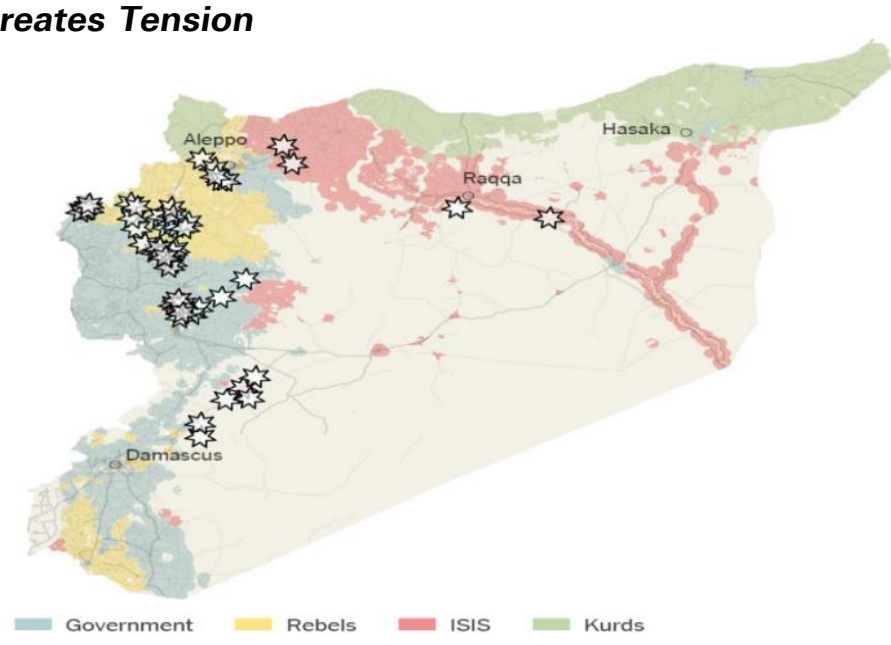
Corporate Bond Spreads Showing Signs of Stress



Source:Gavekal Research

And finally, although global macro risks are always present, Russia's current course of action in Syria is at odds with the rest of the world. Given that Putin has chosen to help strengthen the current ruling powers rather than challenge ISIS, the entire Middle East could see turmoil escalate very quickly. Instability is never good.

Russian Strategy Not Focused on ISIS - Creates Tension



Source: The New York Times

Going Forward

Even though the market has proved turbulent as of late we are still constructive on equities both in the U.S and in developed markets abroad for the remainder of the calendar year. As we stated last month, we believe that current price levels in certain segments represent good long term entry points however we do anticipate further volatility in the near term. What has perhaps altered our thinking somewhat during the month of September is increasing amount of evidence pointing to a global growth slowdown. We remain confident that U.S. economy is on solid footing and is well positioned to weather economic weakness outside of its borders. With that being said, we would suggest that a more cautious tone is merited going forward. Specifically, we will be monitoring the developments in the high yield bond market in the U.S. and credit default swaps for the major emerging market economies for indications of further deterioration globally.

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. The pullback in the market has provided some opportunities to add to positions within those sectors as well as initiate new positions in selected securities in the beaten down financial and energy sectors as well which we began to execute on during the month.

While we are still 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.

We are encouraged by the progress of the recovery in the European Union and believe that Europe represents a good long-term investment opportunity. Additionally, Japan continues to make progress on its structural reforms and has given confirmation of further measures to come.

We remain underweight traditional fixed income. With an anticipated increase in the Fed fund rate sometime in the near future, 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. Additionally, we have been funding our new equity positions in hard hit sectors via gains we have experienced on the fixed income side.

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, high quality names within the sector represent good longer term value and the price of oil appears to have stabilized somewhere in the $45 to $55 range for the time being. Additionally, conflict revolving around Russian military action in the Middle East and the subsequent responses form those in the region could potentially provide a catalyst for a move higher in the near-term, bolstering our conviction in adding to select energy names during the month.

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.