Insights: November 2014

Market Overview and Performance

The month of October is generally not a period that our clients look forward to each calendar year, and 2014 certainly lived up to those broadly anxious expectations. Given the fact that more six-month lows in the equity market have occurred during the month of October than any other by a wide margin, the hesitant mood that takes hold each Autumn is not unwarranted. However, when one reviews the month end returns for this October, not a lot of headway was made in either direction. Despite the hand wringing, U.S. equity markets in fact managed to finish higher with a strong month end push, bonds were modestly higher and volatility was actually down for the month. But beneath those numbers of course, was a torrent of economic, geopolitical, fundamental and even pandemic news that roiled asset prices before the markets generally resumed the trend higher that was established during the earlier parts of the year.

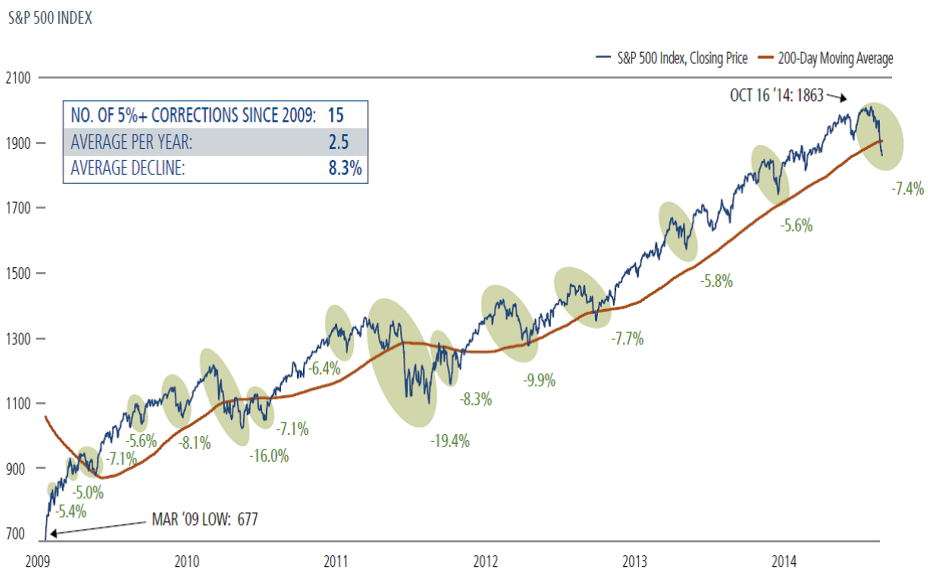
Please enjoy our thoughts and insights regarding both recent events and what we think will shape markets going forward.

	Month to Date	***Year to Date***
Equity	***Percentage Change***	***Percentage Change***
S&P 500 Index	2.16	***6.86***
Russell 2000 Index	***6.59***	1.90
MSCI EAFE Index	-1.45	-2.81
MSCI Emerging Markets Index	1.18	3.63
Fixed Income		
Barclay's U.S. Aggregate Bond Index	0.98	5.12
Barclay's U.S. Credit Index	1.06	6.80
Barclay's Corporate High Yield Index	1.19	4.72
Barclay's Municipal Bond Index	0.69	***8.32***
Macro Measures		
Gold	-3.30	-2.55
Crude Oil	-10.78	***-13.14***
CBOE Volatility Index	***-13.98***	2.26
USD Dollar Index	-0.44	***8.60***

Equities

The S&P 500 Index finished essentially flat for the month of October, but it was a wild ride for large cap U.S. equities, one of our preferred areas of the market. The Index ended September at around the 1970 level, but quickly declined -7.7 percent in the first 11 trading days of the month, hitting 1820 on an intraday basis on October 15th. While many market participants and pundits alike had been clamoring that we were long overdue for a 10 percent correction in equities, there was a high degree of discomfort when the notion appeared be transforming into reality. But in fact, going back to financial crisis low in March of 2009, there have been an average of 2.5 declines of 5 percent or greater per year, yet the trend higher has remained in place. In spite of the October gyrations, we believe our equity portfolios are well positioned to take advantage of what we see as a constructive period for equities between now and the end of the year.

Declines of 5 to 10% Are Not Uncommon in Upward Trending Markets

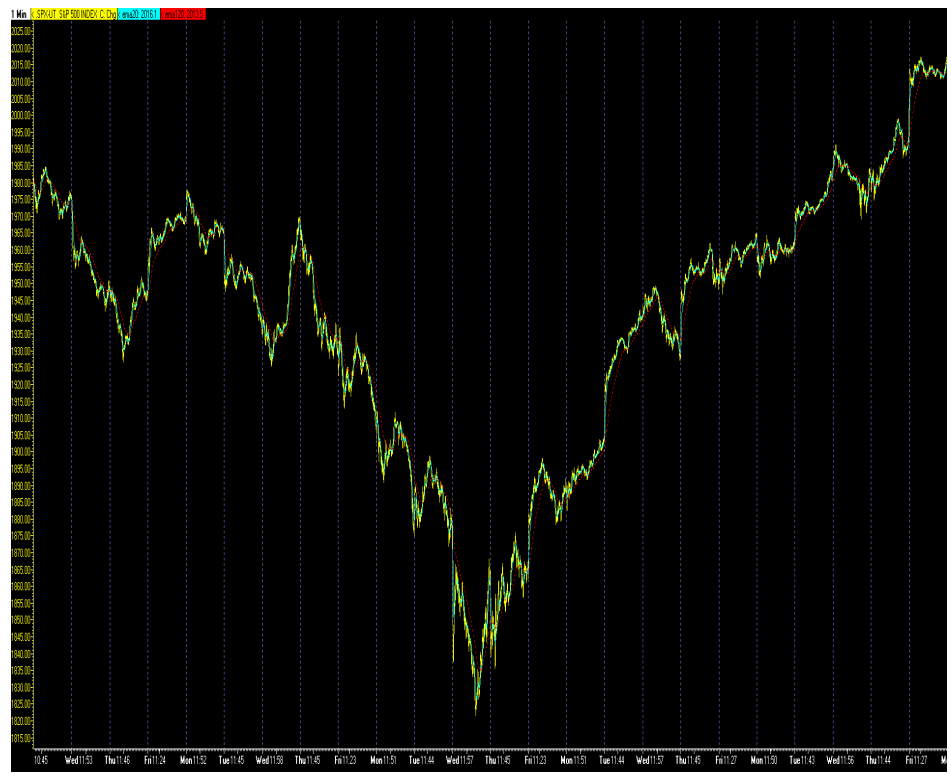


Source: Bloomberg, Calamos Investments LLC.

In what seemed like an impossibility just two weeks earlier, by the time the month came to a close, the S&P 500 had actually surpassed its all-time high levels seen in mid-September, climbing over 10 percent off of the mid-months lows. In fact, the S&P 500 Index, the Dow Jones Industrial Average, the NASADQ Composite and the Russell 2000 Index of small cap stocks all experienced sharp "V" shaped recoveries that left them near trading near all time highs on the 31st.

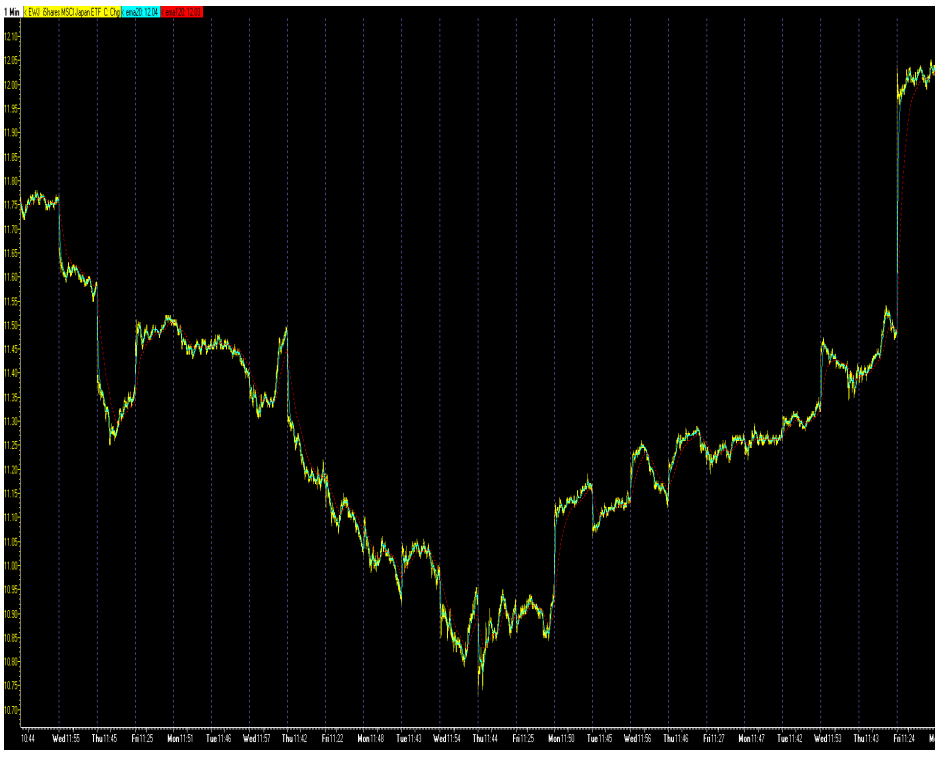
Somewhat unexpectedly, U.S. indices' received an added boost in the final days of the month from Japanese policy makers when they announced a massive increase in quantitative easing and an allocation shift away from bonds toward equities in their Government Pension Investment Fund. The announcement vaulted the MSCI Japan ETF up close to 5 percent on October 31st. We believe that this initiative on the part of the Japanese policy makers to dramatically increase their purchase of assets will support equities in the region for the near term and we are therefore positively disposed to a higherallocation to Japan within our portfolios.

S&P 500 Index 9/30/2014 - 10/31/2014



Source: Thomson Reuters

iShares MSCI Japan ETF 9/30/2014 - 10/31/2014



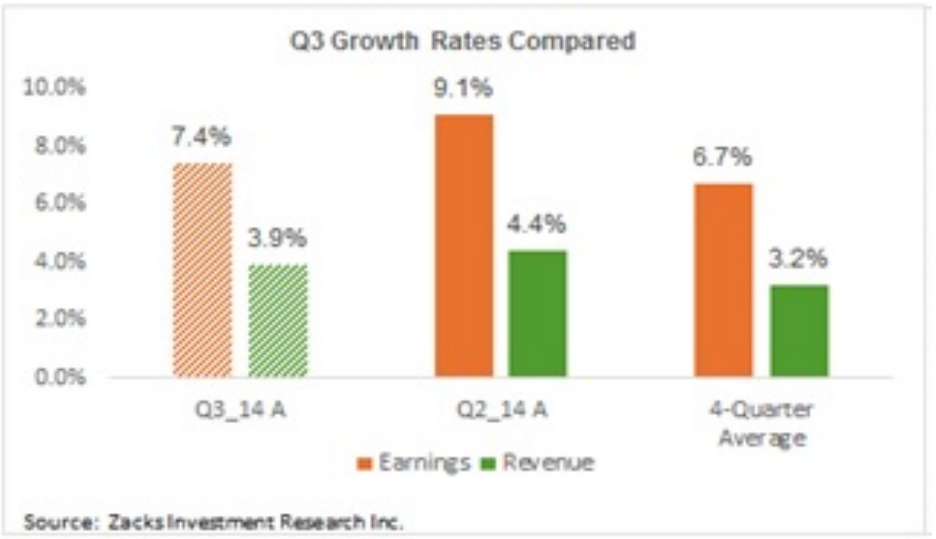
Source: Thomson Reuters

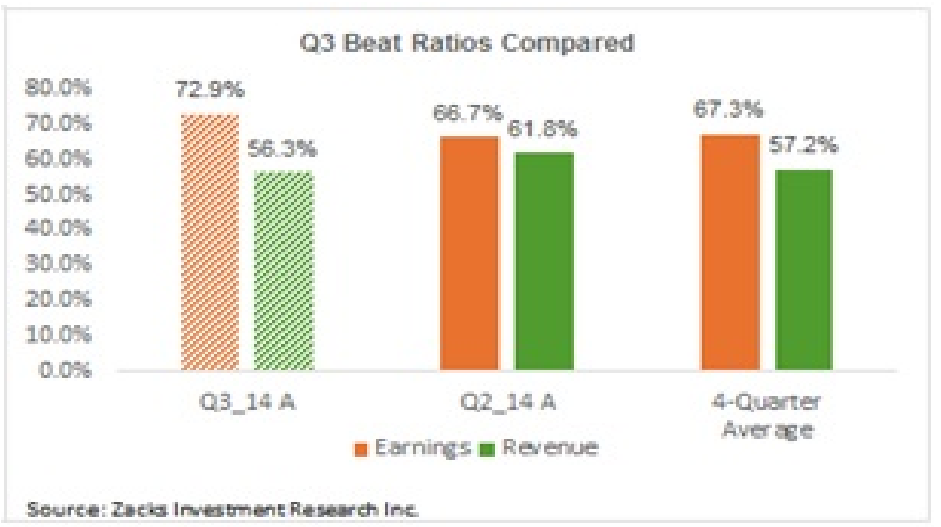
Earnings

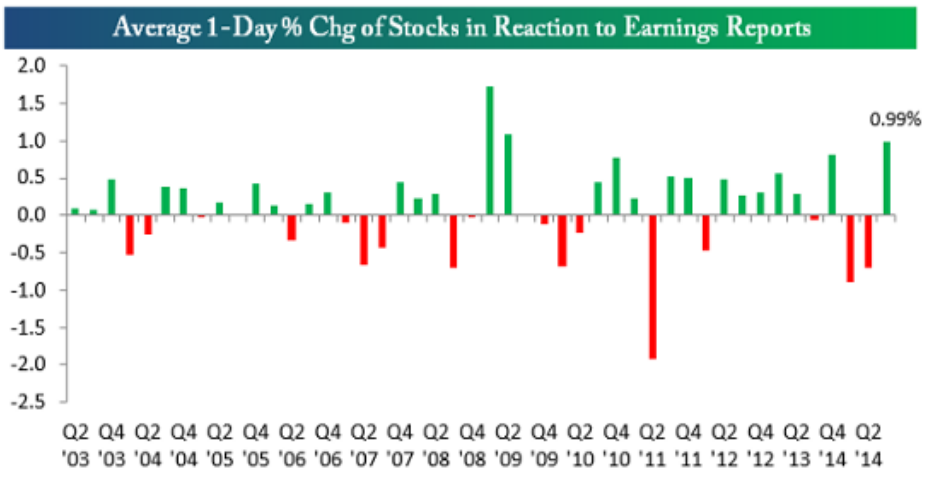
One of the major reasons behind investors' quick change in bias from sellers to buyers came from the corporate fundamentals delivered in the U.S. The solid numbers provided a level of assurance and successfully shifted the focus away from global concerns and toward the belief that the U.S. was in fact in better financial shape than many other areas. By the end of the month, about 73 percent of the S&P 500 companies that reported results beat earnings estimates, while 56 percent surpassed revenue projections, according to data compiled by Zacks Investment Research. Profit for S&P 500 companies rose 7.4 percent in the third quarter and sales increased 3.9 percent. Going into the reporting period, earnings were anticipated to grow by only 4.5 percent according to Factset while revenues growth has been in line with expectations. On the revenue side, it is worth noting that the energy sector is the only area with negative sales growth of over 4 percent due primarily to the falling price of oil.

And perhaps most importantly, given the extreme levels of volatility and macro noise during the month, investors have reacted to the positive fundamental news coming out of corporate America by moving stocks almost 1 percent higher on average after they report. This is the highest average one day reaction since 2009.

Q3 Earning Growth has Surpassed Expectations





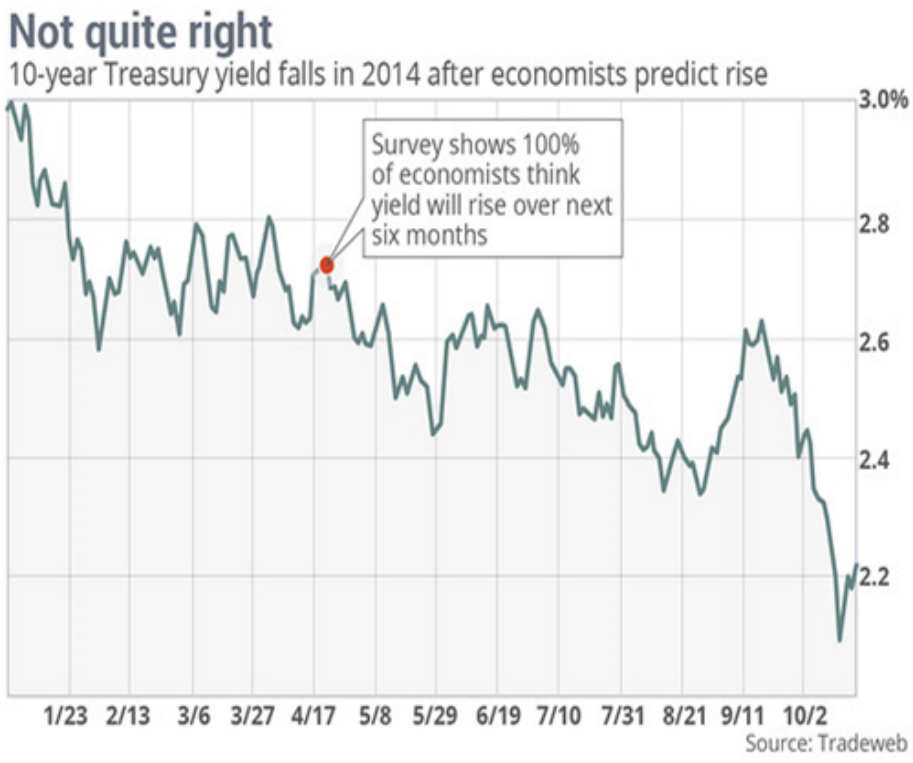


Source: Bespoke Investment Group

Fixed Income

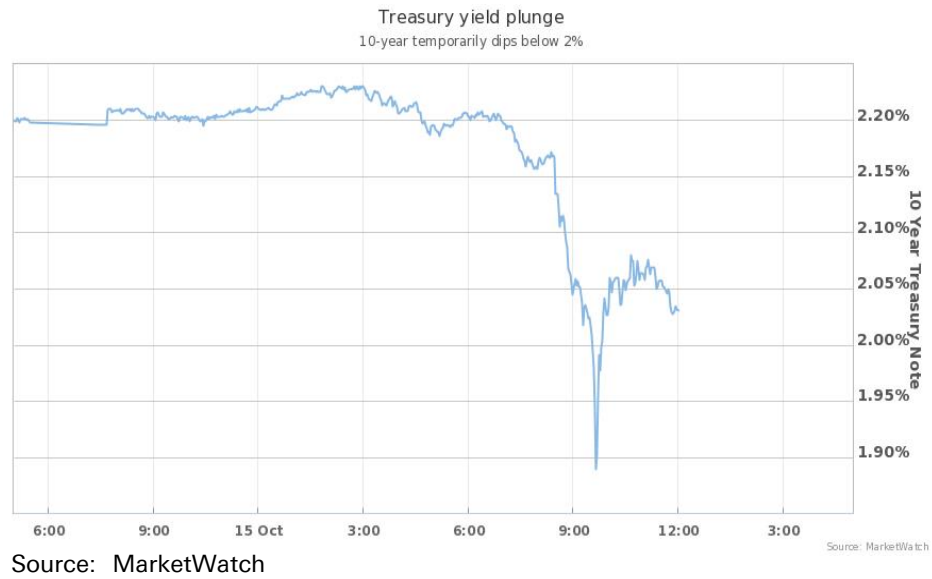
U.S. treasuries rallied significantly during the surprisingly volatile mid part of the month, mainly as a result of increasing concerns that global growth was beginning to falter combined with a series of below expectation readings of economic progress here in the U.S. This bitter cocktail, made more potent with a dash of hysteria over the Ebola virus, incited a flight to quality that pushed treasury yields sharply lower in spite of the fact that the unwavering consensus in the market that yields could fall no further as the Bloomberg Survey below demonstrates. What's clear in hindsight, is that if you have a group of economists universally believing one thing, you should do the opposite.

Market Consensus for Rates to Rise Has Been Unwavering... and Wrong



But fall, it did. The ten year yield moved from 2.63% in mid September to 2.13% by mid-October before recovering, however, during the panic of October 15th, buyers rushed in, pushing the yield brieflly below 2% for the first time since May of 2013. This proved to be a classic example of a capitulation trade, forcing desperate sellers to exit positions at any cost before more patient invetsors waiting on the sidelines began buying at the newly discounted levels.

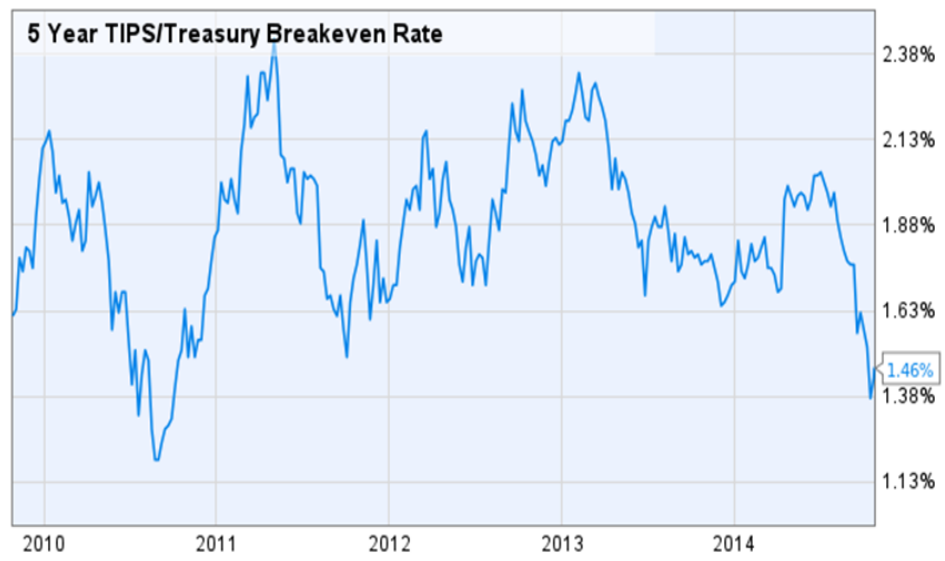
The 10 Year Treasury Yield Briefly Fell Below 2 Percent in a Wave of Frenzied Buying on October 15th



Source: MarketWatch

As the treasury rally intensified and stocks weakened dramatically, Federal Reserve Governor Bullard stepped in to publicly suggest that the Fed may delay the scheduled termination of quantitative easing at the end of October. His comments proved to have a calming effect and opened the door to a potential delay to the anticipated interest rate hikes in 2015. The consequence however, is that the expectations for inflation over the next 5 years moved below the Fed's targeted 2 percent in rapid fashion as the chart below illustrates. The 5-year breakeven inflation rate is the difference between the 5-Year Treasury and the yield on an inflation protected security with 5-years remaining to maturity. The measure is real-time measure of what is priced into the market for inflation over the next 5 years.

Inflation Expectations Have Fallen Rapidly Below the Fed's Target Level of 2 Percent

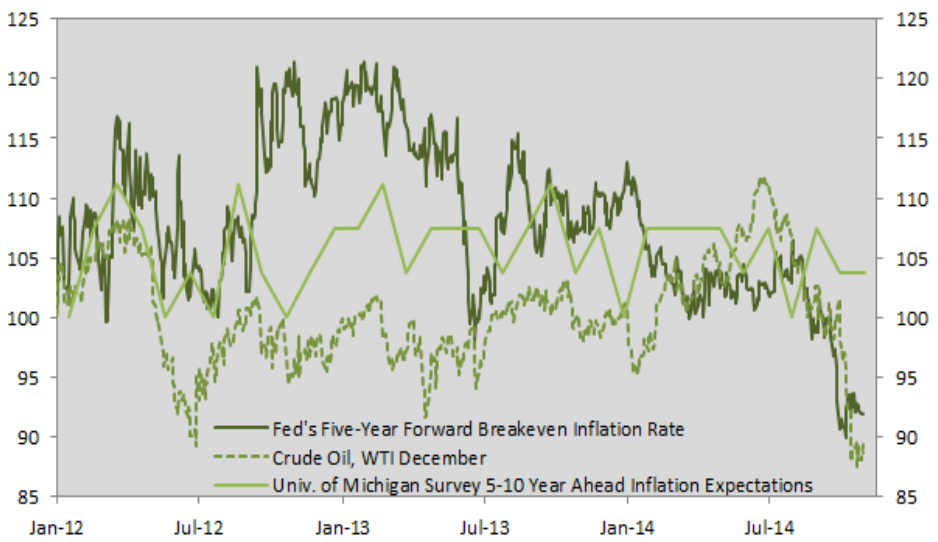


Source: Federal Reserve

In their minutes released on October 29th, the Federal Reserve stated, "The Committee anticipates, based on its current assessment, that it likely will be appropriate to maintain the 0 to 1/4 percent target range for the federal funds rate for a considerable time following the end of its asset purchase program this month, especially if projected inflation continues to run below the Committee's 2 percent longer-run goal, and provided that longer-term inflation expectations remain well anchored." With the global economy potentially softening and wage inflation remaining tepid here in the U.S., we would be inclined to agree with the general market that the Fed is inclined to remain accommodative and data dependent.

But as the team at Cornerstone Macro points out, the breakeven rate is not the only indicator to focus on. While near-term inflation expectations have logically followed energy prices lower, over the medium term horizon, expectations for inflation have remained stable. It's likely then, that a severe deterioration in the medium term inflation outlook would need to occur for the Fed to delay what is believed to be the beginning of rate hikes in June of 2015. Whether the move off of historically low levels comes in June or December, increases will come, and we therefore favor shorter duration instruments that are less sensitive to moves in rates, floating rate securities and diversifying sources of yield via unconstrained strategies that can take advantage of opportunities in the credit space. We prefer to save our risk budget in our portfolios for more attractive risk/reward opportunities outside of the fixed income space.

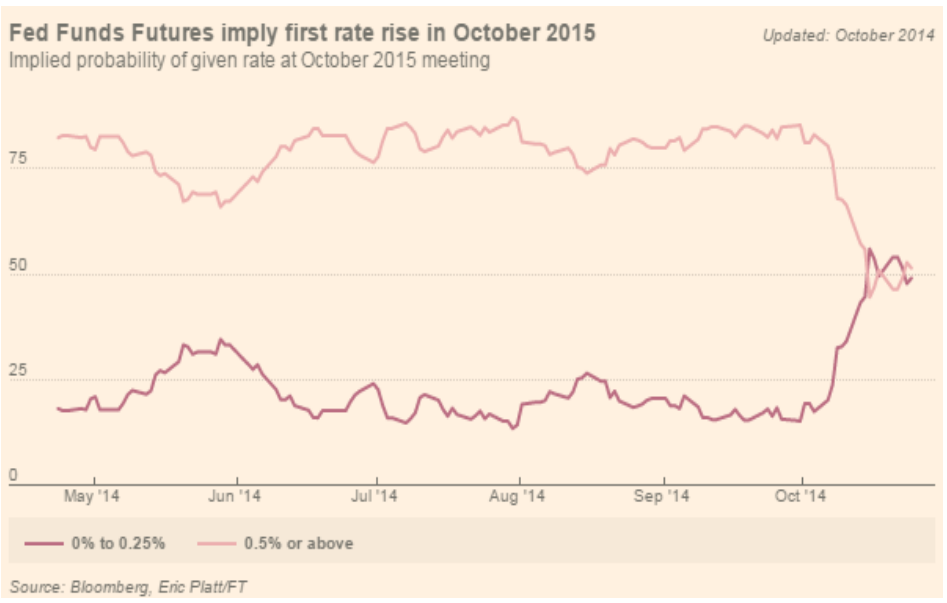
Medium Term Inflation Expectations Have Remained More Stable



Source: Cornerstone Macro

Market participants might beg to differ however. During the tumult of mid-October, traders pushed the probability that rate hikes would be higher one year from now to below 50 percent as illustrated below. We think the prudent course of action however, is not to try to time the movements of the Fed, but rather, to be positioned for what is the most likely path for rates in the near future.

The Once "Sure Thing" of Higher Rates by Next Fall, is Now Assumed to be a 50 Percent Chance



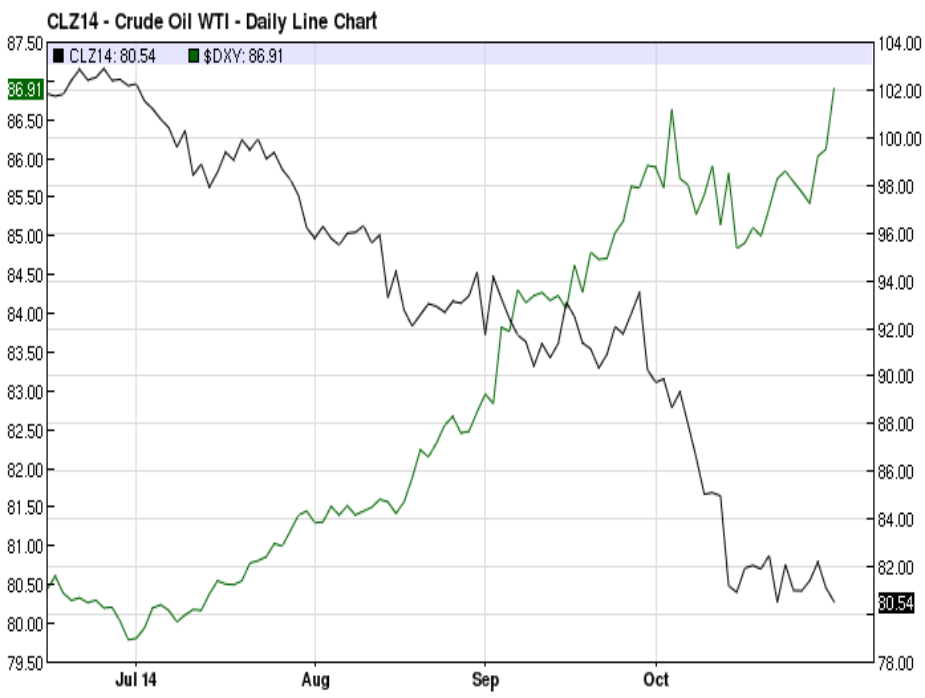
Source: Bloomberg, Eric Platt/FT

Oil, Gold and the Dollar

While many assets were sold across the board in the mid part of the month, oil and gold were hit particularly hard, and in contrast to equities, both commodities only experienced worsening loses as the month wore on. Both the price of gold and oil are closely tied to the strength of the U.S. dollar which has been steadily rising since June of this year, putting downward pressure on each. As the graph of the last four months below clearly demonstrates, when the dollar is ascending, the price of oil is declining. However, there are also other dynamics factoring into the price of oil. It's well documented that the U.S. has been increasing its domestic production of oil, while simultaneously, global demand for oil appears to be softening, keeping prices muted.

Combine those fundamental influences with the fact that Saudi Arabia actually cut its price of oil to the U.S. on November 1st, and it's clear why the price of oil was down 11 percent in October. The surprise Saudi move actually took the price of oil down to $76 dollars on November 4th, a level from which we feel there is compelling value going forward.

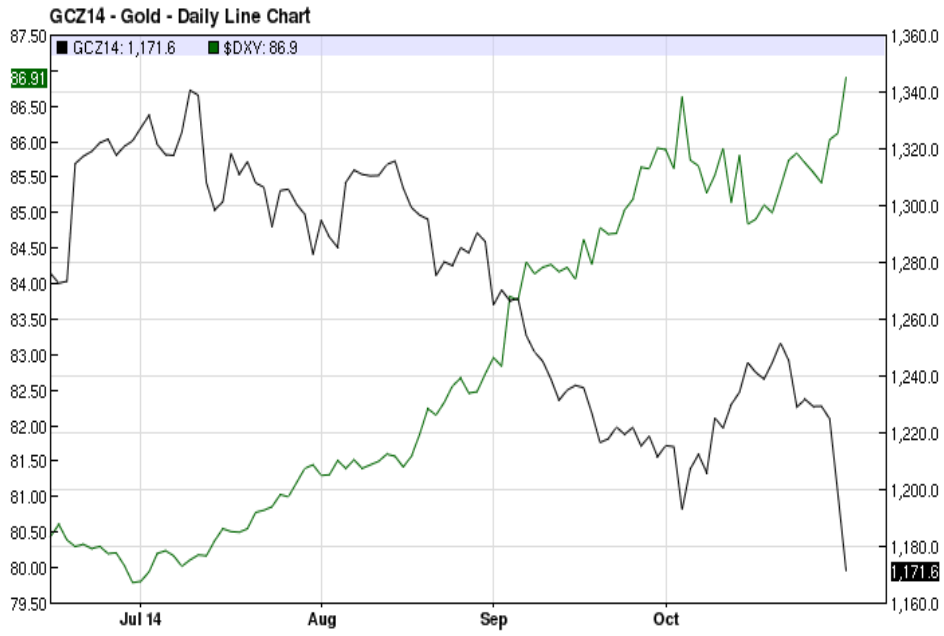
Crude Oil Future (right hand scale) versus Dollar Index (left hand scale)



Source: BarChart.com

While the price of Gold on the other hand, is not dominated by the actions of one large producer, it is heavily shaped by the current macro environment. At present, sentiment towards precious metals and gold in particular is quite negative, given that we have seen strong economic progress here in the U.S., rising equity prices, fairly lackluster physical demand and low inflation prospects going forward. The result was that after a brief bump up from a flight to quality trade, gold met the same fate as oil by the end of the month. We do hold a 5 percent allocation to gold in our portfolios for selected clients, and given the sharp declines, we would be monitoring the commodity before increasing any client allocations with a long-term investment horizon.

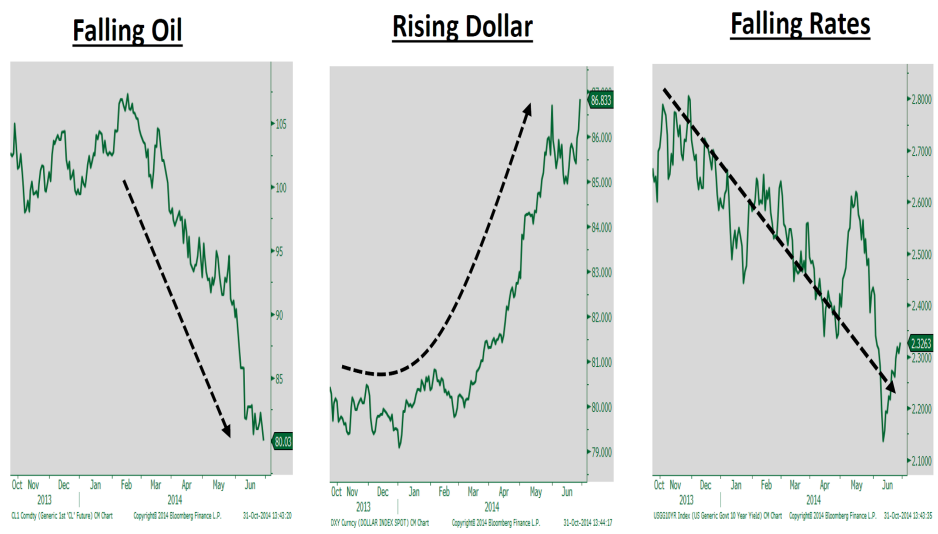
Gold Future (right hand scale) versus Dollar Index (left hand scale)



Source: BarChart.com

One of the benefits of a strong U.S. Dollar is the reduction in import prices and lower commodity inflation. Even though U.S. corporate profit margins are at all time highs, this backdrop of falling imput prices (Oil), a rising dollar and declining interest rate costs creates a a friendly environment for high profits to continue. Additionally, although a stronger dollar can have negative impact on the deficit, the dramatic decline in net imports of energy products has helped to offset the effects of a stronger dollar on the current account side. Projections are for the net import share of total U.S. energy comsumption to continue to fall to a rate of just 4 percent by 2040 according to the U.S. Energy Information Administartion. This is an important tailwind for the U.S. economy.

Notable U.S. Economic Tailwinds



Source: Cornerstone Macro

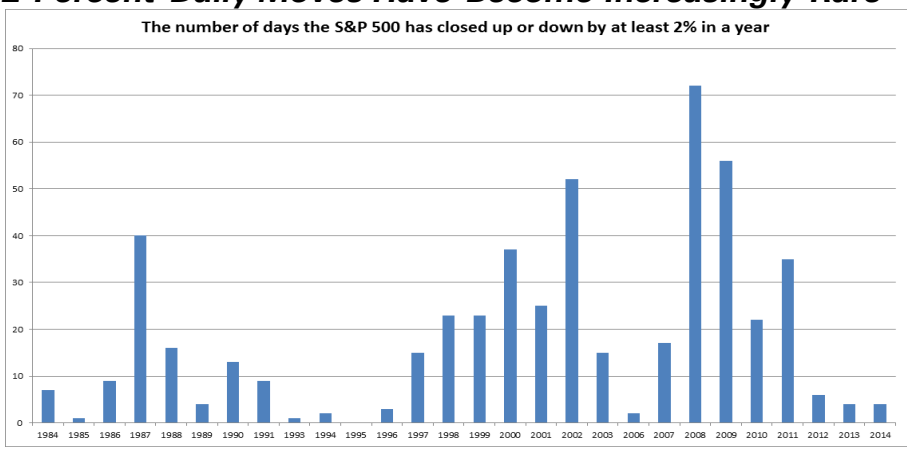
Volatility

The laundry list of worries that came to a head in October forced a spike in volatility as measured by the CBOE Volatility Index (VIX), but by months end, all was seemingly forgotten. The VIX went from roughly 15 on September 30th, to 31 on October 15th and then back down to 14 by Halloween. The Chicago Board of Options Exchange reported record average daily trading volumes on the VIX as the effects of the Ebola, European recession and end of QE dangers reversed themselves completely. Although the absolute level of volatility reflected in the VIX Index during October was not high by historical standards, the increases felt particularly sharp to many because of the dominant low volatility regime that has been in place since 2011. Two percent daily moves in the S&P 500 for example, have been exceeding rare over the last few years despite being fairly commonplace in the market during the last 20 years.

CBOE VIX Index Chart 9/30/2014 - 10/31/2014

Source: Thomson Reuters

2 Percent Daily Moves Have Become Increasingly Rare



Source: S&P Dow Jones

Lurking behind the scenes of the flight to quality that occurred during the heightened volatility was the growing feeling that liquidating assets if required might not be as orderly as one would hope, particularly if you are large industry player. While U.S. stocks serve as a constant source of liquidity, the U.S. bond market on the other hand has proved to be an increasingly difficult trading space as the amount of dollars going into bonds has ballooned asset levels while dealer inventory has decreased sharply. That is a is dangerous combined during times of stress. This issue was forced into the spotlight in an unusual way in October when Bill Gross left the bond management firm he founded, PIMCO. Although the firm had already seen total redemptions of $65 billion over the previous 10 months according to Morningstar, the departure of Gross and resulting portfolio repositioning caused what many believe were trading disruptions during the month. PIMCO in fact, experienced over $27 billion dollars of withdrawals during the month. Even the International Monetary Fund highlighted potential risks of having so many assets concentrated with a few large players and no corresponding liquidity in the market.

Bond Assets Have Risen While Inventory Declines

$27.5 Billion in Pimco Withdrawals had Repercussions

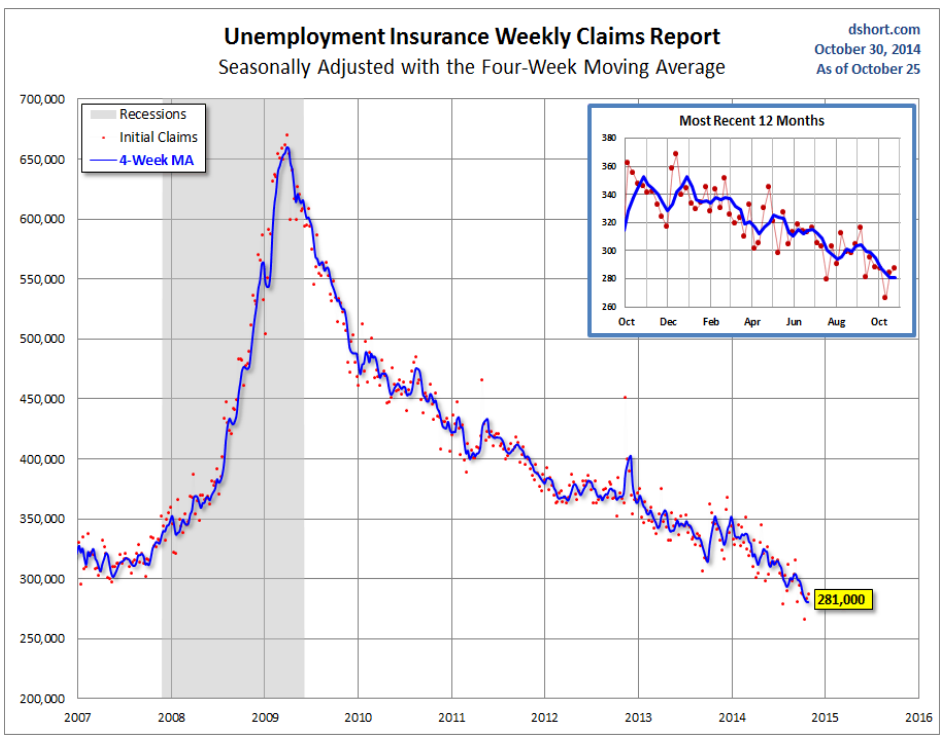
Source: Zero Hedge

Macro Environment

The Macro environment if anything, improved during the month despite some initial soft data. In fact it was the improvement seen in many measures that along with solid corporate earnings, gave investors the confidence to step and buy when the market was close to correction levels.

Jobless claims are now at their lowest levels in 14 years, but even more striking is the fact that claims as a percentage of the population has now matched the record lows set roughly 45 years ago. This suggests that labor market is continuing to improve, and historically, a sustained drop in jobless claims coincides with a pickup in hiring.

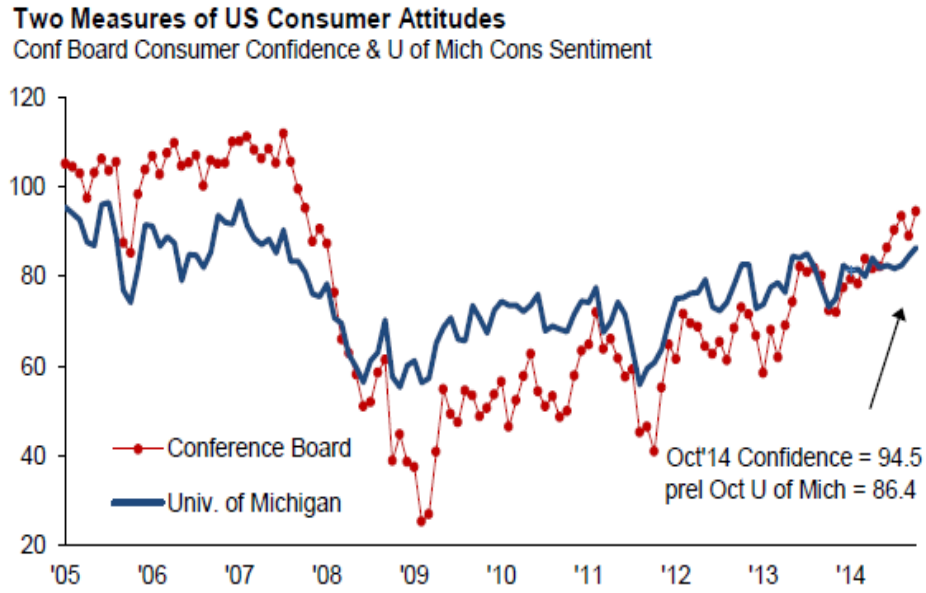
Bond Assets Have Risen While Inventory Declines



Source: Dshort.com

An improving labor market has several follow-on effects. First, a better jobs environment increases the perception that the economy is on solid ground and that prospects are better going forward. This is reflected in consumer surveys. The latest October reading of the both the Conference Board Consumer Confidence survey and the University of Michigan Consumer Sentiment Survey show that confidence is now back to 2008 levels. These measures have also been shown to correlate highly with small business sentiment which is very sensitive to the U.S. economy. Small businesses have in turn been a strong source of job growth over time.

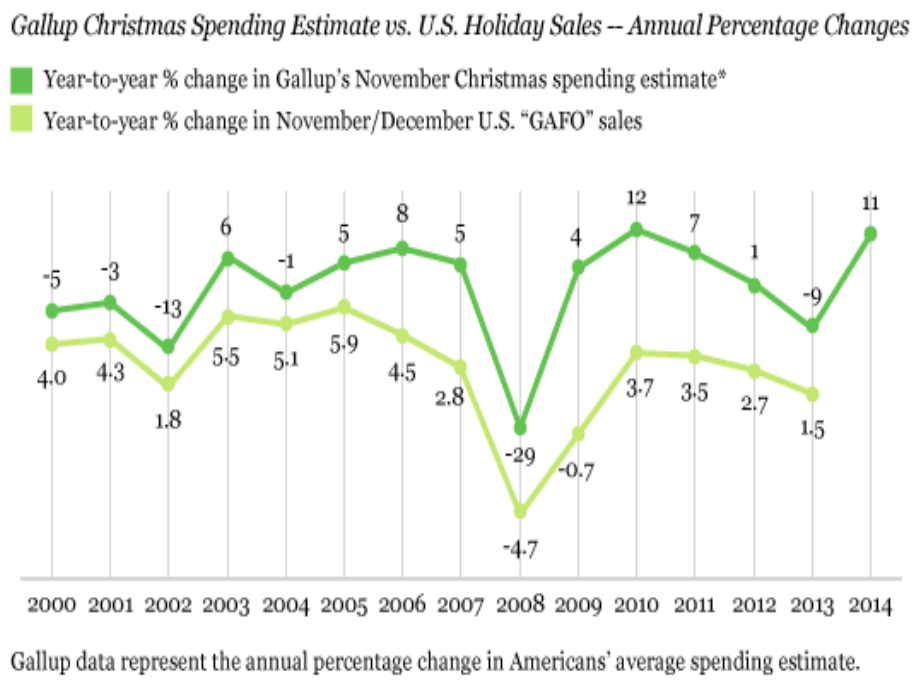
Consumer Confidence has Rebounded to the 2008 Levels



Sources: Thomson Reuters/University of Michigan, Conference Board, Credit Suisse

The Second follow-on effect of an improving labor market is that higher consumer confidence translates into spending as reflected in measures like estimated Christmas spending and durable goods sales. Auto sales for example, were up 6 percent year over year on October and as the chart below illustrates, consumers have felt comfortable enough to bolster their holiday shopping expenditure outlook steadily as the year has progressed.

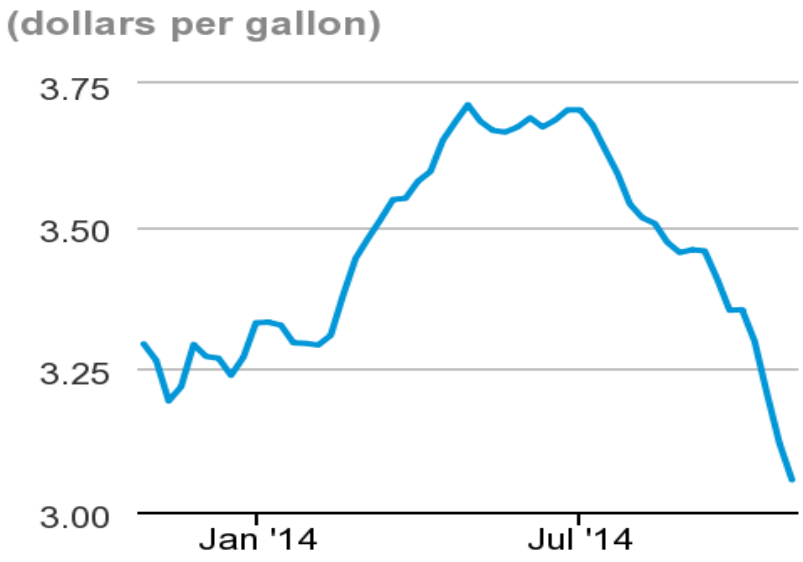
Confidence Fuels Anticipated Spending



Source: Gallup

And finally, another significant tailwind for consumers that is perhaps the most significant driver behind their anticipated increased spending is the "rebate" they are receiving from the dramatic drop in gasoline prices experienced this month. A lower annual gasoline bill, estimated to be down by $720 for the average American family at current price levels, could improve the results of consumer discretionary companies into year end. We are positioning our portfolios to take advantage of these trends via selected opportunities in the consumer discretionary sector, an area that presents both good value and solid growth prospects at present.

Declines in Gasoline Prices Function as a "Rebate"



Source: Gasbuddy.com

Going Forward

By far, the most pertinent question that remains unanswered is, "Can the stock market sustain its path upward now that the Federal Reserve has ended it quantitative easing policy?" Some would suggest that this constant influx of liquidity has been the sole force inflating equities. As the chart below highlights, the S&P 500 has closely tracked the size of the Fed Balance sheet. However, given the Dovish nature of the current Fed, it would seem unlikely that they would choose to end the program without some measure of confidence that the U.S. economy had achieved "escape velocity" and was now able to stand on its own merits.

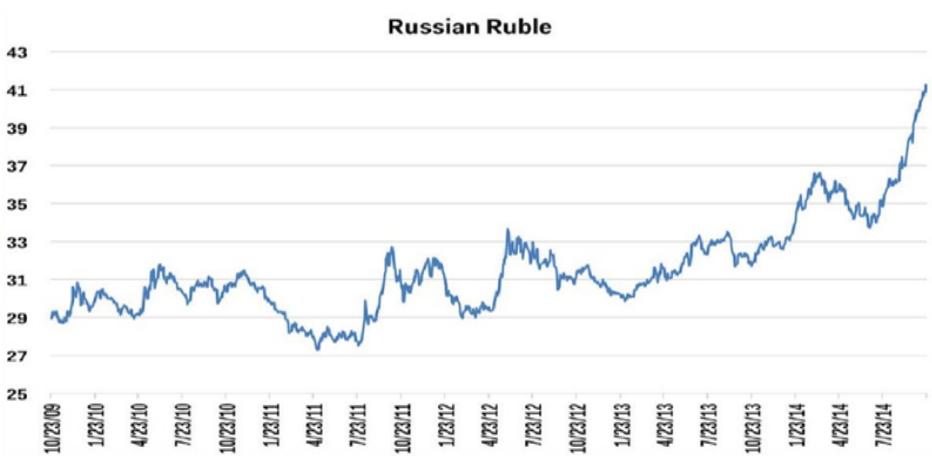
It is worth pointing out that there is a significant difference between "taking your foot off of the gas" and "hitting the brakes" in terms of the action of the Fed. The current policy of low interest rates is still very accommodating, especially in light of the fact that Japan an the Eurozone are just now at the cusp of their quantitative easing efforts which should continue to provide a constructive backdrop for risk assets for some time to come.

Stocks Have Closely Trackled the Fed Balance Sheet

Source: Yardeni.com

From a risk monitoring perspective, one of the biggest wildcards remaining is the future direction of Russia and its effects on the Eurozone. This chart of the Russian Ruble versus the U.S. dollar shows the sharp depreciation since tensions with the Ukraine began. If this weakening continues, Russia will have a difficult time financing themselves with no Fed or ECB or even China to bail them out. Additionally the drop in oil prices only compounds the problem for the commodity driven country. Additionally, it is estimated that over $100 billion in Russian debt is coming due in 2015. This could force Putin's hand and push him further toward aggression and a harsher stance regarding the flow of natural gas into Europe. If not contained, this could potentially derail the already tenuous European economy and send the Eurozone into recession.

Weakening Russian Ruble Could Pose a Threat



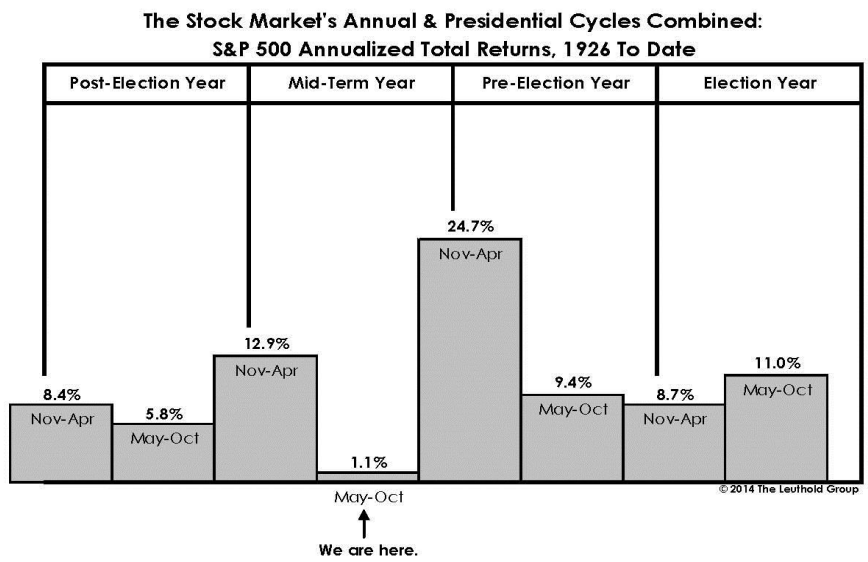
Source: Thomson Reuters

From other side of the globe, another potentially negative scenario could unfold if the trend of weakening Yen exacerbates. Specifically with regard to China, a weaker Yen fuels a further increase in China's already strong exchange rate. This in turn would hamper the growth of the Chinese economy at a time when recent economic data out of China suggests that growth is already on the decline.

Yen Close to Breaking a 30 Year Trend

Source: Datastream

Within the U.S. however, we are monitoring risks to the upside. If one looks at seasonal patterns in the market, historically, during mid-term election years, the period from November through April has produced significantly above average equity returns. This phenomenon, combined with increasingly strong economic data, could point to stocks moving aggressively higher for the next few months. This might seem counterintuitive to some given the rise in equity prices already experienced over the last twelve months. However, at 15.6 times next year's estimated S&P 500 earnings of $129, valuation levels are not stretched, and with low interest rates and high operating leverage on corporate balance sheets, we are positioned for U.S. equity prices to move higher over the coming months.



Source: Leuthold Group

In Closing

As we head closer to 2015, it seems that the spike in volatility that we experienced in October was a signal that very low levels of volatility enjoyed by the market over the past few years have come to end as we enter the new non-Quantitative Easing world. With that mind, we remain vigilant in monitoring and managing our exposures across portfolios.

Our preference is to remain overweight equities, favoring large cap U.S. stocks over their counterparts in Europe and in Emerging markets. That being said we, are cognizant of the sizable relative outperformance of U.S. stocks over all other regions. With valuations elsewhere at historically compelling levels, we will be watching for fundamental improvements outside of the U.S. which would present us with an opportunity to rebalance toward more attractive opportunities.

We also remain underweight traditional fixed income. With the specter of slowly rising yields weighing on returns for the foreseeable future, we prefer to spend our risk budget elsewhere. Within fixed income allocations, we continue to emphasis the less interest rate sensitive options available, leading us to shorter duration exposures and unconstrained strategies.

Traditionally diversifying assets in the commodities area such as oil and gold remain challenged as the combined headwinds of a stronger dollar and rising rates persist. Again, valuations levels in many areas merit close attention for a long-term investment horizon.

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