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TAILWINDS

The 2014 Autumn Fall: *Have the Leaves of Global Growth Changed Color?*

STOCKS FALL

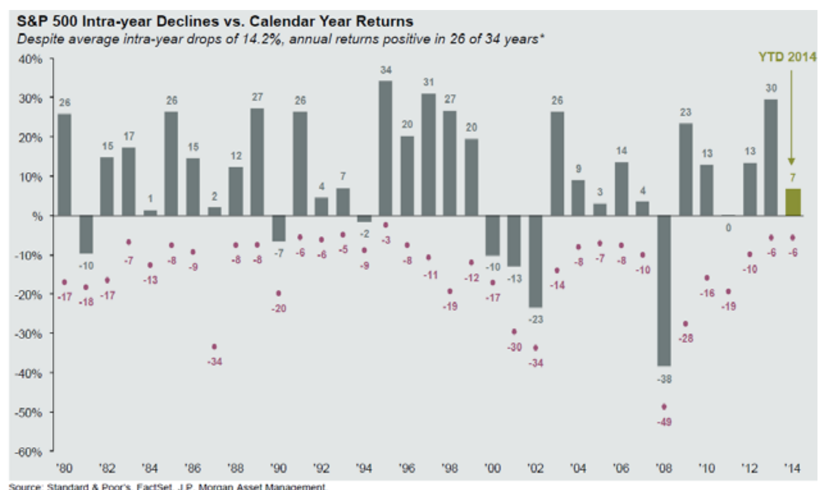
Three weeks ago, the S&P 500 (a measure of U.S. Large Cap stocks) hit a new closing high of 2011.36 (intraday high of 2019 a day later) and was up 10% for the year after returning 32% the year prior. Such fantastic returns over a relatively short period of time prompted the SEIA Investment Committee to mention this past July that investors should "revisit ones asset allocation as the moves over the last 18 months may have left some investors overexposed." But now that the U.S. stock market has backed away from its historical high, investors are now asking whether anything has changed or rather has the change in fall colors coincided with a change in our outlook for economic growth.

THREE STEPS TO REASSESS

In times of market duress, one of the worst mistakes an investor can make is to trade and make decisions based on emotions rather than facts. We believe it is first important to breathe. Then to reassess the markets, we suggest analyzing 1) where we started, 2) where we stand, and 3) where we are likely headed.

Where we started: Less than two years ago in late 2012, stocks (S&P 500) retreated 112 points to 1350 (-8.2%) as some investors sold equities fearing President Obama's reelection. Regardless of political affiliation, those investors were ultimately proven wrong as stocks not only rebounded and reached a new high seven short weeks later, but also subsequently added another 30% throughout the remainder of 2013. Investors that succumbed to emotions and sold at the "Obama bottom" missed out on an ensuing 45% of gains. Why do we consider this the starting point? Prior to yesterday, November 2012 was the last time that stocks traded down 7% from their highs and moved below a major long-term trend line (the 200 day moving average).

Where we stand: As of October 12th, stocks are down 6.8% from their all-time highs. But it is important to remember that pullbacks are normal and necessary. Not only does this pullback mark the fourth time in the last two years that stocks have traded off more than 5% from an all time high, each pullback has been temporary and part of an annual process dating back decades. The chart to the right details an intra-year pullback in every calendar year dating back to 1980. In essence, a pullback is part of the



routine and investors must stomach some volatility for the reward that comes with owning shares in the world's great companies.

In addition, it's important to frame the current position of gains year-to-date. Through Monday, the S&P 500 is still up 3.06% (counting dividends) for the year. To put in context, at the beginning of the year we believed that stocks were near fully valued with a 16x Price/Earnings multiple. However, unlike fixed-rate investments (bonds), we believed that stocks could gain ground while at the same time not become increasingly more expensive. How is that? If the underlying earnings (the E), could grow at the same rate or greater than the price of the stocks (the P), then the overall P/E valuation fraction could remain constant. It's just math—and the beauty of the unfixed earnings component of stocks versus the fixed coupons of bonds. In short, we believed stocks could move north at the same rate of underlying earnings growth which was projected to be in the high single-digit range. Thus, when markets were up 10%, equities were a smidge ahead of themselves (but within the margin of error) and now that markets are "only" up 3%, markets are a tad behind projections. The stock market never moves in a straight diagonal line. The ebb and flow of prices above or below the line is entirely normal and in fact expected.

In this pullback, there has been plenty of blame to go around—there always is. Geopolitical tensions are rising specifically concerning Russia and the Islamic State. New Ebola epidemic fears have increased now that the disease has reached U.S. shores. A slowdown in economic activity in Europe has sparked fears that a third recession (in the last five years) is imminent. And with the Federal Reserve removing Quantitative Easing this month, investors' memories are harkening back to prior (weak) periods when the Fed removed the proverbial punchbowl.

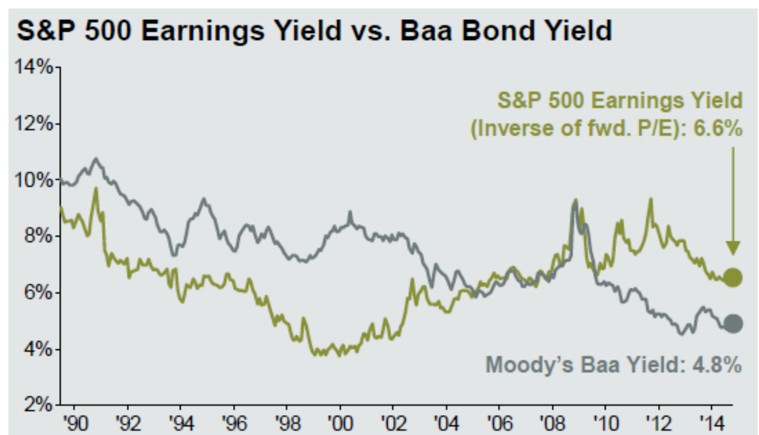
But markets can climb a "wall of worry" and corporate earnings will ultimately drive stock prices. On this front, we have some positive news. Earnings have indeed grown, and now that we are 10 months further along, we can start to look forward to 2015 earnings. Earnings are again projected to grow at a high single-digit range and we believe a 16 P/E multiple is not excessive—especially with low inflation and a dearth of investment alternatives (i.e. low bond yields). Thus, it is rather easy to envision stocks at a reasonable 16x multiple moving north over the next 14 months approaching 2100 or 12-14% higher than current levels. But we are getting ahead of ourselves. How will we get there in the midst of all this bad news?

TEN TAILWINDS

Where we are likely headed: In trying to gauge where we are headed it may be wise to analyze history. **FIRST**, analyzing the calendar can help, as Q4 is typically a strong quarter for the equity markets. According to Bespoke, since 1928 stocks (S&P 500) have been positive in the fourth quarter 72% of the time, with an average gain of 2.59%. Furthermore, when stocks have been up between 0-10% through the first three quarters (23 samples) they have been positive for Q4 87% of the time with an average gain of 5.56%. But wait, 2014 is a mid-term election year—what effects will this have? Historically, during mid-term election years, the S&P has averaged a gain of 6.47% with positive Q4 returns 86% of the time. And in the 4 prior instances where the sitting President was a "lame duck," the S&P averaged a Q4 gain of 10.50% with positive returns every time! So if history holds true, the statistics say that stocks should rise from here.

SECOND, putting aside the calendar, a further analysis of historical selloffs can prove insightful as well. History points to the prospect of a 6-8% decline lasting 4-6 weeks, which translates into an S&P 500 trough between 1850 and 1890. With markets already trading down to 1875, history suggests that not only is further downside limited but the calendar suggests considerable upside could be in store through the last three months of the year. Looking further out some analysts are calling for the S&P 500 to rise by 15% to 2150 in 12 months. While investors continuously hear the negative stories that could drive stock prices lower, there are fundamental positives that could move markets higher through 2015.

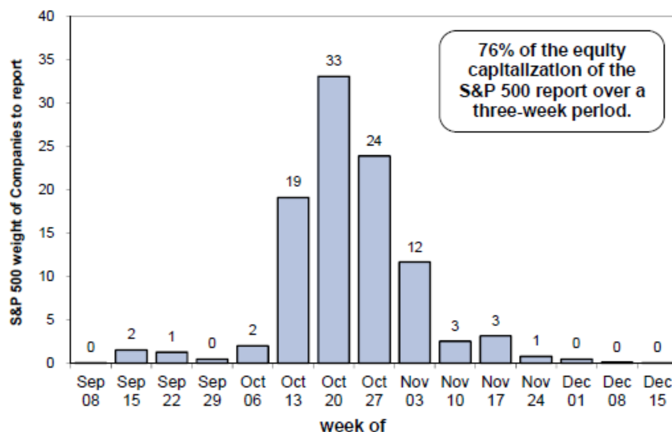
THIRD, bear markets are typically caused by a policy mistake (raising rates/taxes) which then causes a recession. Fortunately, neither is in an investor's time horizon. In fact, the Leading Economic Indicators (LEI) are still showing signs of expansion. And with ample liquidity, improving job market and a steep yield curve, economic growth should continue here stateside.



FOURTH, not only does the U.S. have positive growth but GDP is now expanding at an above-trend pace. Higher sales/earnings consistent with 3%+ GDP growth in lockstep with steady margins (aided in part by low energy prices) could move stocks north.

FIFTH, and this should sound familiar to long-time readers, the prospect of another period of low U.S. interest rates (please see our previous Tailwinds Report on U.S. Interest Rates) should insulate the domestic equity market from a large correction as investors should continually favor stocks over bonds as the relative value "TINA Trade" (There is No Alternative) favors equities (see above chart).

SIXTH, contrary indicators are setting up for a rally. Goldman Sachs's Sentiment Indictor points to an extremely low net positioning in stocks and counter intuitively suggests S&P 500 will rally during the next 4-6 weeks (very low net positions are followed by positive index returns as investors need to buy and very high net positions point to weak performance). Other contrarian indicators are pointing in the same direction. Case in point, the trading volume of Puts vs. Calls reached an extreme 1.4 level in Monday's trading (history suggests any level above 1.10 has marked a bottom in stocks).



Source: Compustat, FirstCall, Bloomberg, Goldman Sachs Global Investment Research.

SEVENTH, corporate buyback activity should resume once earnings season ends (share repurchases are typically prohibited during the five weeks ahead of the earnings release date). Roughly 75% of S&P 500 firms will report 3Q results between Monday, October 13th and

Friday, October 31st (see chart). Investors should expect a surge in buybacks starting in November which will serve as a tailwind for the stock market during the last eight weeks of the year.

EIGHTH, lower energy costs should help consumers in the strong holiday shopping season—providing a tailwind to consumer discretionary stocks.

NINTH, the economic malaise in Europe has now worked its way into the German economy. Why is this good news? Well it's not but in this upside down world we are currently living in, bad news can be good news. Germany controls the European Central Bank (ECB). And with the memories of hyper-inflation post World War I, Germany has been reluctant to back and engage in full blown Quantitative Easing (QE). But now with weakness spreading to Germany and a possible third recession in the last five years, the tight-fisted conservative bankers of the north now have political cover and a change in their position on QE could be forthcoming. What does it all mean? The ECB may come back into play this quarter with another stimulus package to not only help stimulate the economy and stoke inflation but to also provide a safety net to capital markets as well.

While the fundamentals are still pointing towards a continuation of the bull market, investors may not get the spark and liftoff until there is clarity on the Ebola epidemic. While the World Health Organization calls the outbreak "the most severe, acute health emergency seen in modern times" others such as Ian Lipkin (the Director of the Columbia University Center for Infection) states that Ebola "isn't a huge risk" and can be contained due to upcoming vaccines, the fact that it is not easily transmittable, and that "there is 0% chance" that Ebola can mutate into an airborne disease. While the human toll is a horrific tragedy, investors can take solace from analyzing the market's resilience surrounding the SARS outbreak in Hong Kong, Beijing, etc. in 2003. In contrast to Ebola, SARS was an airborne virus that was easy to contract. In addition, SARS took hold in Southeast Asia which is a major traffic center and financial hub (Hong Kong), and one of the larger trading partners to the world (Taiwan, Beijing, etc.). This stands in stark contrast to the limited trading and travel with western Africa. While Asian hotel occupancy and airline travel dropped considerably in the months surrounding the height of the SARS outbreak, what is important to remember is that once the disease was contained, consumers and travelers quickly resumed normal activity. Thus **TENTH**, capital markets don't permanently price in one-off events and rather look ahead at the future streams of growing earnings and income.

In summary, a variety of data points suggest a continuation of the five-year-old expansion. While fear may rule autumn, longer-term investors should be able to reap profits coming out of winter next year. As always, if there are any questions please do not hesitate to contact our office or your local Financial Advisor. Visit us online at seia.com.

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