Fourth Quarter 2015

What, Me Worry?

-- Alfred E. Neuman

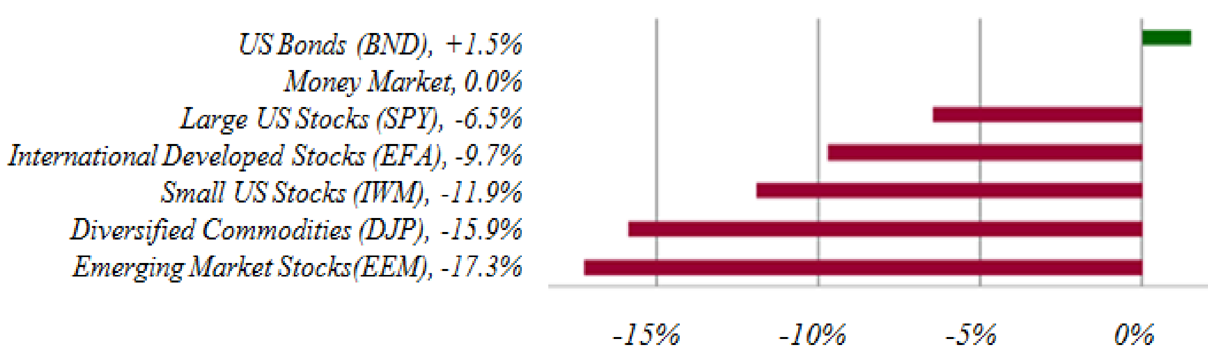
The September sell-off gave investors plenty to worry about. First, it was Greece in the news and then China's slowing economy, then growth globally. I'm a pretty good worrier and can usually find plenty of reasons, or excuses, to worry. But now, there are encouraging signs the stock market "correction" may have run its course. And I am less worried than I have been in some time.

It was a brutal quarter for stocks. As illustrated below, bonds and money market funds were the only safe-havens. The S&P 500 Index and Dow Jones Industrials slid -6.5% and -7.0% respectively *and they were the best of the bunch!* Small caps fell -11.9%. Commodities, which were down -22.5% over the prior year, lost another -15.9% this quarter. Emerging market stocks slid even further, down -17.3%.

Through every stock market downturn, there are bearish analysts calling for the start of a new bear market with further downside risks, while others are more optimistic. I'm siding with the optimists for now.

Among the most prominent worries is the potential for a global economic downturn. This worry is becoming less worrisome. While falling oil prices haven't been kind to oil producers or energy stocks, there is already evidence that low oil prices are boosting global oil demand. And rising oil demand should boost global economic growth. Global oil demand increased 2.0% over the past year. That's the best growth in four years. It reached a new record high in August.

2015 Third Quarter Market Performance



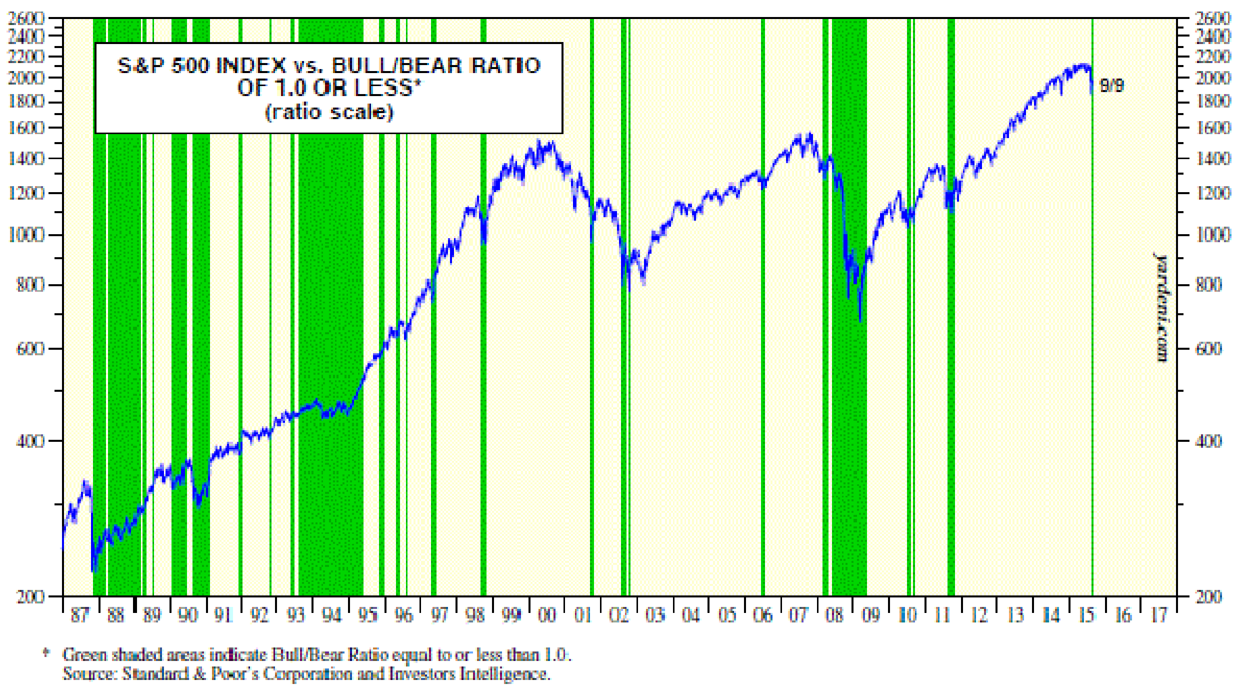
Source: http://finance.yahoo.com

Investors worry that the Federal Reserve will raise short-term interest rates. The Fed postponed raising rates in September, but left the door open for a hike in December. By delaying their first rate hike, Fed officials are signaling that they are cautious. I'm glad the Fed is worried.

What about corporate profits? This is a pretty good worry. A strong U.S. Dollar makes U.S. exports more expensive for foreign buyers. Some exporters are struggling, to be sure. But, there are also many other companies finding ways to grow, despite sluggish global demand. Manufacturers should benefit from low commodity prices. As long as U.S. consumers keep consuming, corporate earnings on balance will most likely keep growing.

Investors are already doing the worrying for us. The correction has depressed the *Investors Intelligence Bull/Bear Ratio*, indicating that investors are more worried than they've been in four years. In the chart below, periods when there are more "bears" than "bulls" among investors are indicated by the green shaded areas. In theory, by the time most investors become bearish and fearful, many have already sold their stocks, which could precede a rally. The chart shows that when the majority of investors surveyed have been bearish during bull markets, it has often been a good time to invest.

More Bears than Bulls



Source: http://blog.yardeni.com/

In my view, stocks are one of the most attractive asset classes for investors seeking growth and income. This is the point that most “bearish” analysts miss. Where else can investors invest? Bonds pay little interest. Many of the world’s central banks, including the Fed, are striving to create inflation. If they are successful, bonds will almost certainly lose value. Diversified commodities funds may finally be close to bottoming, but most commodities are still in down-trends. The real estate market is improving, but this asset class typically lacks liquidity.

The market’s deteriorating internal characteristics that I described last quarter appear to have largely played out. Downside momentum has waned and the stock market’s breadth has improved. Seasonality is now a tailwind in the short run. Another pull-back and more volatility seem likely this month, but the major trend remains up. Fundamentally, stocks are cheaper now than they were earlier this year and the U.S. economy is still the world’s largest and most resilient.

Thank you for your business and continued confidence. Please let us know if we can serve you in any way.

Malcolm M. Trevillian, CFA CMT
October 14, 2015

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