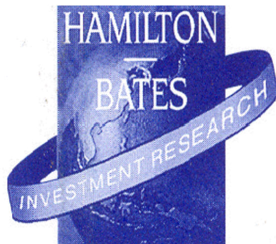

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Market Update *March 11, 2015*

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March 11, 1888—One of the worst blizzards in American history strikes the Northeast, killing more than 400 people and dumping as much as 55 inches of snow in some areas. New York City ground to a near halt in the face of massive snow drifts and hurricane force winds. The stock market was closed for 3 days. At the time, approximately one in every four Americans lived in the area between Washington D.C. and Maine, the area affected by the Great Blizzard of 1888.

Stocks sold off broadly last week, punctuated by Friday's plunge in reaction to the surprisingly strong payroll's report. The terrible news that more people are working was an incentive for investors to take profits, although the trend of weak breadth and a lack of real buying enthusiasm has been in place the last couple of weeks in spite of indexes making new highs during that period.

Economy, Earnings, & Interest Rates

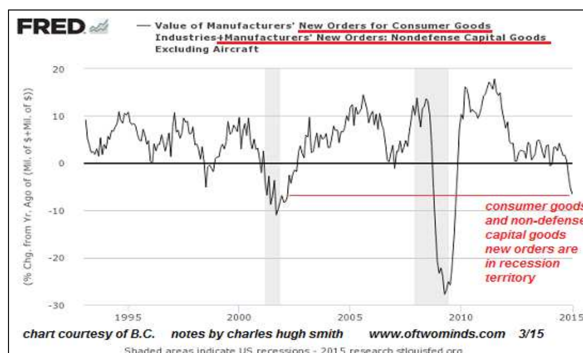
Valuations based on spreads stock and bond yields generally remain favorable—due to the fact that the Fed and other Central Banks continue to peg interest rates so low. The problem is that when/if rates start to normalize, these valuations will quickly skew negative, joining trailing P/E measures; now already at nosebleed levels. When you add into the mix the negative trend of aggregate earnings and revenue growth (largely due to the energy sector), the fundamental case for equities becomes very challenged unless economic growth quickly picks up and stays up. We are not so sure this will happen, as recent economic data other than the jobs reports reflect a general slowdown in growth. The current data suggest GDP growth more like 1% than the 5% of Q3 2014 or the 3%+ rate generally expected later this year.

Adding to the earnings situation is the dollar, which is up over 20 percent from the summer lows. This is now starting to bite into earnings. A stronger dollar makes U.S. goods more expensive abroad and dilutes the value of earnings when American companies bring overseas profits back home. Over 50% of S&P 500 earnings come from overseas, and the dollar's rise decreases the value of the earnings when they are converted to dollars. With aforementioned P/E ratios already extended, it will be difficult for the US market to post gains without earnings growth. After a sharp run the dollar is due for a correction, which could alleviate some of these concerns over the next few months, but if the Fed truly embarks on a rate hike, the dollar could continue to appreciate and in turn crimp earnings.

More Data that Suggest Caution on the Economy

The latest job report was amazingly rosy, with nearly 300K jobs created in February and the unemployment rate down to 5.5%. This adds to what has been some fairly strong jobs number (if you take the data on face value). Unfortunately the unemployment rate continues to be flattered by hundreds of thousands of folks leaving the workforce, and lots of new bartender and waitress jobs being created. There is nothing wrong with those jobs mind you, its just that they are not the high wage jobs lost during the last recession and over the last few months in the energy sector, whose troubles are only beginning to hit the economy.

A data series that has us concerned about the economy is new orders, an estimate of future demand. New Order data is shown below in a chart from oftwominds.com, by Charles Hugh Smith. It is an excellent site for economic analysis. The trend in new orders isn't rosy.



The new orders index has declined sharply, reaching levels over the past 25 years that have only been seen during periods of recession.

New orders have dropped in non-recessionary periods, but the current readings are below other close call dips, and more in line with what has been seen during the last two recessions. This one data point doesn't mean we are heading into recession, just that the economy is not functioning like it would in a normal growth cycle.

Another data point that suggests all is not well with the economy is real (inflation adjusted) household

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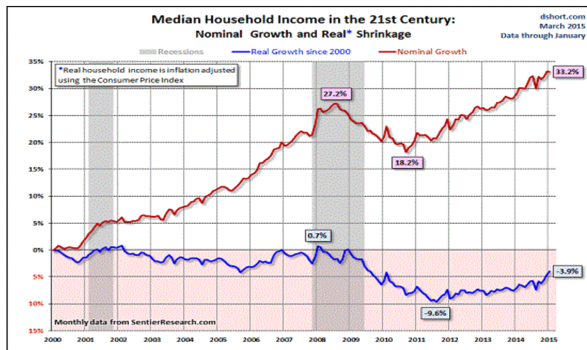
income, shown in another chart from Charles Smith at ofttwominds.com. Income is the main driver of economic growth. Without greater income, households must borrow to consume more, and eventually debt driven consumption leads to households that can no longer afford to borrow. This happened during the housing bubble as folks used houses as ATMs. When it burst and no more debt was coming—the economy cratered.



The chart above shows median household income in nominal terms (red line) and in inflation adjusted terms (blue line). In nominal terms, median household income is up 33% from 2000. But adjusted for inflation (using CPI which understates inflation in our opinion), income has risen only 10% from the recession lows, and is still nearly 4% below 2000 levels. It will take another 4% of real gains just to get back to the level of 15 years ago. This is hardly a sign of robust economic growth.

Market and Investment Outlook

The economy rebounded in 2009 until roughly 2011, when most of our economic modeling tools suggested the economy hit some trouble, since then earnings momentum and economically sensitive commodities have dropped off.

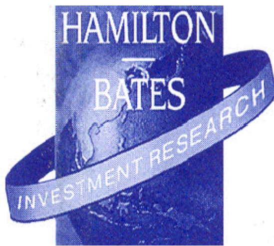
Since 2012 the market has continued higher on the back of Central Bank easing and zero interest rates, with strong correlation between market gains and Central Bank programs. But what the FED has given, they can very swiftly take away, which is why the markets have been very sensitive to any signs of a change in Fed policy.

With a bull market six years old that alone should cause us concern. Eventually the market will have a correction greater than 5-6-7%, and that time is not too far off. But we still believe the Fed will not hike until mid-year at best, giving the market more opportunity to move higher. March has come in like a lion but may go out like a bull. We haven't gotten a major sell signal from our models and the last two weeks of March into April are very strong seasonally. We could see the market dip another 3-4%, but this is not a necessity.

As we head toward quarter end with the market oversold investors and portfolio managers will want to be positioned ahead of that period. Buybacks remain heavy with February the strongest month on record. This is likely to continue and remain a strong support for stocks. In addition, the quantitative easing recently announced by the ECB began this week, and it is a sure bet that some of that liquidity will make its way into the equities markets.

We remain invested in equities with an emphasis on the US, and in the fixed income area an emphasis on corporate bonds. High-yield bonds have come back strong, but to us it is the high grade bonds that have started to look more attractive given their recent decline. Should government bonds decline a bit more even they could become an attractive option for us for the first time in years.

The recent consolidation came quickly on the heels of what looked like a successful breakout of the December-February trading range that the market had been in, catching many investors off-guard and causing many to be quite disappointed. In our view this pullback was needed after the NASDAQ 5000 hoopla, and the relative out-performance by small-caps suggests the decline has nearly run its course and pointed to small-caps as an area of opportunity for gains in 2015. We are buyers of this market weakness.



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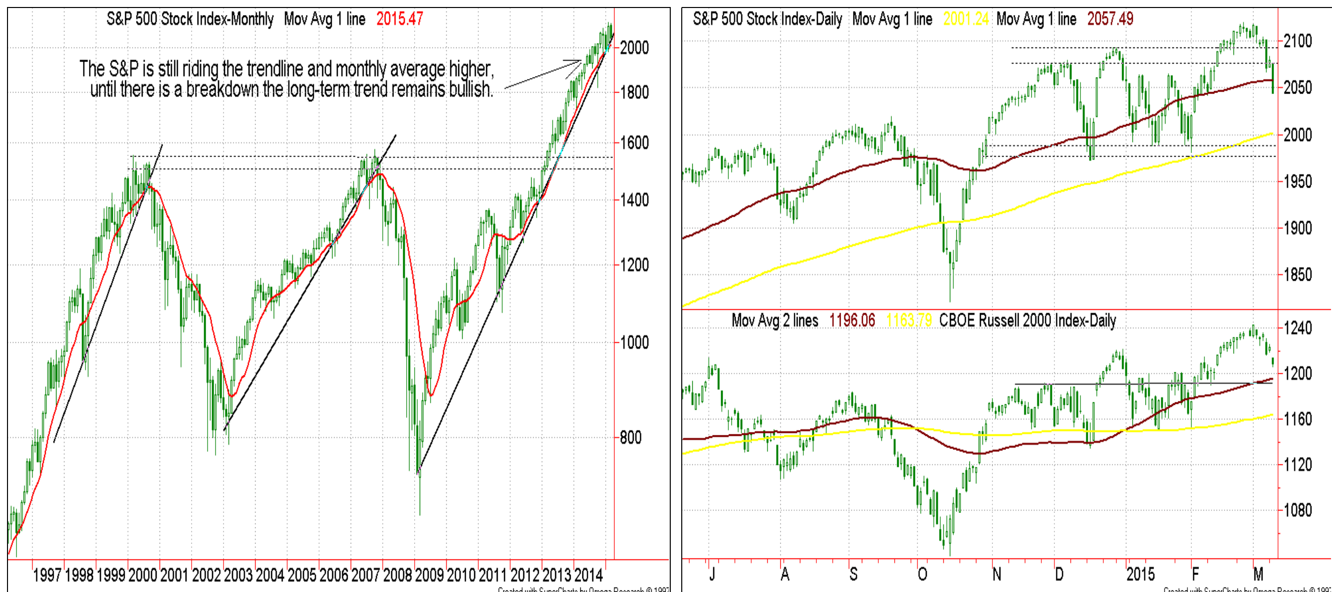
Charts—Long-Term Trend Holding, Short-Term Correction Unfolding



S&P 500 Long-Term (Above Left)
The S&P 500 is still managing to hold above its long-term rising trend-line noted above, along with its long-term monthly moving average (in red).

The from the 2009 lows is now six years old, and has been very persistent, so investors need to be on guard. A break of the long-term trend-line and moving average of any duration should be heeded by investors concerned about the possibility of a large market drawdown.

We now mark key support for the bull market at 2000-2015 on the S&P 500. Possibly giving a little leeway down to 1980. A break of this key 1980-2000 level would be enough to cast doubt on the bull market. Even after the latest weakness the S&P remains 3-4% above this level.

Small-Caps Holding Up Better Than Blue-Chips (Above Right)
After seeming to breakout from the months long consolidation in late February, the financial markets have dropped once again on interest rate concerns and the rising dollar. Small-Caps continue to hold up better than blue-chips, with the Russell 2000 (top panel in chart above) still above the majority of peaks during the late 2014 period. The S&P 500 (bottom panel in above chart) has been weaker due to the strong dollar. Once the current correction runs its course small-caps could be one area of opportunity after their brutal 2014.

Given likely headwinds on multinationals from a strong dollar, the strength in domestic oriented small-caps suggests opportunity there.

Disclosures:
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