TW Advisors

3rd Quarter 2014 Newsletter

Divergent Markets

The theme for this newsletter is volatility. Not only are we seeing volatility in financial prices, but also in economic data and in some indicators we use to gauge the market's risk level.

Recently we wrote that financial markets were eerily calm. Things got a little stormy in the third quarter. Large capitalization stocks in the U.S. managed to eke out a small gain (S&P 500 was up 1.1%) due to money flowing into concept stocks like Twitter (up 22%), but the rest of the equity world struggled. U.S. small capitalization stocks dropped over -7%. U.S. mid-capitalization stocks didn't do much better down around -4%. Emerging market and gold stocks were strong in the second quarter but fell sharply in the third as did developed market international stocks which declined by about -6%.

Most of the world has seen deterioration in economic data lately. The geopolitical situation is hitting Europe hard, and it is bordering on another recession. Recent economic data in China have spooked investors with fears of a slowdown. The lone bright spot is the U.S. where corporate profits are high, monthly job gains are regularly topping 200,000, and household deleveraging seems to have stopped. While improving, the U.S. economy is far from robust. There are still 3.3 million fewer full-time employees than in November 2007, an incredibly dismal statistic so long into the recovery.

Early in the year there was plenty of cautiousness, but **sentiment conditions changed pretty dramatically** as the stock market reached new highs. Margin debt is near all-time highs. A recent Investors Intelligence poll of U.S. investment advisors showed just 13% stock market bears, the fewest since 1987. A big red flag is now waving as a few prominent Wall Street strategists who were cautious all turned positive.

The key factor during this bull market has been the accommodation of the world's central banks. The European Central Bank (ECB) is increasing liquidity by purchasing up to €700 billion of asset-backed securities from countries in the European Union to reverse the shrinkage of its balance sheet which is down 13.6% in the past year. On the other hand the Federal Reserve is moving in the opposite direction which may offset the ECB's activity.

Besides the sentiment data discussed above there are several other warning signs. Reckless lending was the main culprit leading up to the financial crisis and many of the worst practices like covenant-lite leveraged loans are now back. Fixed income investors are chasing yield regardless of risk. Stocks are not cheap and by some measures are quite expensive. The current takeover boom and reliance on share repurchases for growth are classic signs of the final stages of a bull market. Finally, we just saw the largest initial public offering ever, Alibaba. Large IPOs almost always occur near market tops.

Short-term stock market movements are largely random and unpredictable. Ironically longer term predictions are generally more accurate because they are based primarily on starting valuations, which suggests long-term returns will be modest compared to the last five years. So while the recent volatility may not herald a big decline, it at least suggests big returns are not likely. We have been waiting for a change in volatility to signal the time become a bit more active in the portfolios, and recently we have raised some cash. Corporate earnings will be critical in the near term. If earnings season is weak this quarter, we may become more cautious. *Jim Tillar, CFA* *Steve Wenstrup*

OUTSIDE COMMENTARY

Leuthold Group

Inside the Stock Market

If the September 18th S&P 500 high turns out to be a significant intermediate-term (or longer-term) stock market top, there will have been only limited forewarning from internal stock market action. The "granddaddy of all technical indicators"-the NYSE Daily "All Issues" Advance/Decline Line-made a new cycle high only a few days prior to that top, compared with a typical lead time of 2-6 months. Additionally, leading groups like the transportation, bank and brokerage stocks made highs simultaneously with the mid September DJIA and S&P 500 highs.

Instead, our main worry has been the weakness of Mid Cap, and especially Small Cap stocks, in recent months. However, we've noted (see our analysis in the May 2014 Green Book) that bull markets can persist for an extended time in the face of Small Cap underperformance- with the 1995 to 1999 period providing the most memorable example.

It's not just the performance of the Mid and Small Cap indexes themselves. There's been significant underperformance in equal-weighted measures in relation to cap-weighted ones all across the capitalization spectrum-a reason the indexes have suddenly become so difficult for managers to beat. The Mid and Small Cap equal-weighted averages have shown a weakening trend throughout 2014, while the underperformance of the equal-weighted S&P 500 is a newer development. Note the freefall in all three measures during September.

In 2013, about 60% of the issues in the S&P 1500 composite topped the +29.6% gain in the S&P 500. That percentage has been cut in half over the last nine months. The latest reading of 30.2% compares to those recorded in the late 1990s' "bifurcated bull"-an excruciating time for active managers that ultimately ended badly for all involved.

Tillar-Wenstrup Advisors, LLC does not necessarily agree with the opinions of the Outside Commentary.

The information provided in this report should not be considered a recommendation to purchase or sell any particular security. There is no assurance that any securities listed herein will remain in an account's portfolio at the time you receive this report. It should not be assumed that any of the securities holdings listed were or will prove to be profitable, or that the investment recommendations or decisions we make in the future will be profitable. In addition we do necessarily agree with or endorse any outside commentary within this newsletter. If you have received this electronic transmission in error, please notify us by telephone (937) 428-9700 or by electronic mail info@twadvisors.com. Tillar-Wenstrup Advisors LLC does not necessarily agree with outside commentary.