CORRECTED MARKET !

The US stock market finally succumbed to selling pressure that has been affecting financial markets across the globe. For over a year volatility has been a feature of the world's currency, credit and commodity markets. In addition, many world stock markets have been in correction mode, especially emerging markets. Financial markets are interconnected so **as poor economic news piled up last quarter all stock markets headed lower. The S&P 500 fell by -6.44% but that was better than just about any other equity asset class. US small capitalization stocks and most international indices fell by over 10%, while emerging market stocks got clobbered, falling -17.9%.**

The source of most of the trauma during the quarter was emerging market woes. China is clearly slowing, putting pressure on many commodity intensive emerging economies. At the same time the prospect of higher US interest rates (although nothing has yet changed) has sucked capital back to the US. Many emerging economies have issued debt in US dollars so the subsequent rise in the dollar versus emerging market currencies is adding more instability. Financial markets are clearly signaling an economic slowdown and global manufacturing data across the globe have been disappointing. For instance, the September Flash China General Manufacturing PMI™ came in at 47.0, a 78-month low (50 considered neutral). America's jobs market slowed sharply in September. The economy created 142,000 jobs in September, the Labor Department reported, far shy of the 201,000 that economists had forecast. Adding insult to injury, August's jobs tally was revised down from 173,000 to 136,000.

Now that the S&P 500 has entered correction territory (peak to trough fall of 10%) investors want to know if the worst is over. Of course, short-term movements in the market are impossible to predict with certainty but looking at the odds of further weakness is valid. Since last fall we have been warning that financial conditions were fragile and took risk out of the portfolio by raising cash and emphasizing high-quality, mostly dividend-paying stocks. At this time we haven't altered our approach for several reasons. While sentiment has never been overly giddy, neither have we witnessed the kind of panic usually seen at bottoms. Valuations are still full which makes this earnings season critical. Market volatility often precedes profit trouble, warning against rushing back into stocks. Earnings growth has either flattened or started to drop, depending on which measure is used. If it becomes clear that earnings power is at risk, stocks will likely drop from current levels. Finally, bottoms are usually formed when the most hated asset class refuses to fall any further. Emerging markets play that role currently and are still declining.

On the other hand the conditions for a severe bear market of more than 20% don't seem to be in place. While stock valuations are full they are far from bubble territory like we experienced in 1999-2000. Likewise, too much leverage was a key component in the financial crisis. Currently both consumers and financial institutions have significantly reduced debt over the past eight years. Much of this debt has moved to the government's ledger but they are better able to handle it.

On the positive side we are starting to see good value in parts of the equity markets. Growth stocks markedly outperformed value stocks by about 7.5% over the past year. Several high-quality stocks have fallen by 25%-30% and are attractive regardless of what the broader mark may do. Blue chip international stocks are also on our radar given their poor relative performance, attractive valuations and dividend yields. Most foreign central banks are accommodating while our Fed is about to raise rates. The strong dollar should help foreign earnings. Moreover, earnings are closer to the bottom of the cycle overseas versus near the top in the US. US value and blue chip international stocks are priced to provide decent long-term returns and we'd expect to see these groups lead the market out of its correction.

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OUTSIDE COMMENTARY

Blackstone Market Commentary

Byron Wien - October 2015-Excerpt

What hit the stock market in August was the concern that the slowdown in China and the emerging markets (together accounting for 40% of world GDP) would cause recessions in the developed economies of the United States, Europe and Japan. Usually the stock markets top out ahead of recessions, but the current weakness in the developed economies has occurred when the markets were near all-time highs. Before pronouncing that the August decline is predicting a recession in Europe and the United States, a number of reliable developed economic indicators would have to change quickly.

Omega Advisors has prepared a useful list of recession warning signs. Before a recession, inflation is usually increasing, giving the Federal Reserve a reason to raise short-term interest rates. Right now, inflation is stable and below target. In anticipation of a recession, the yield curve would be inverted; it is reasonably steep now. Inventories are above average and increasing in the period prior to a recession; that is not the case now. Employment is declining prior to a recession; it is increasing now. Wages are increasing more than 3.5% annually; the current increase is closer to 2%. Some indicators have started to turn negative, however. A recent University of Michigan survey showed a sharp decline in consumer confidence. Equity markets have been soft recently while industrial production is declining, but most of the warning signs support the view that a recession is not imminent. In spite of its longevity, it looks like the current economic expansion is going to continue for a while. This economic expansion is about 76 months old; the average since 1953 is 60 months, according to Omega Advisors. Since 1949 the stock market has served as a predictor of a coming recession by beginning a major decline an average of 7.4 months before the start of the recession, so the current sell-off would have to be more than a temporary “correction” for a recession to be on the way.

One factor that does worry me somewhat is the cessation of monetary expansion by the Federal Reserve last October. The Fed had expanded its balance sheet from $1 trillion in 2008 to $4.5 trillion in 2014 and stopped buying bonds in the fourth quarter of last year. That is when the broad U.S. stock market began to run into trouble. This raises the question of whether the rise in U.S. equities over the past six years was driven by fundamental earnings improvement or liquidity provided by the central bank. The answer is that both played a role, which is not good news for stocks if Fed accommodation is over.

Without the liquidity driver, the equity market is dependent on earnings, because multiple expansion is less likely. So far this year, according to Bianco Research, earnings for the Standard & Poor’s 500 have been disappointing. For the second quarter, earnings for all companies in the index are expected to be down about 2%. If you exclude the energy sector, earnings would be up 4.5%. The appreciation of the dollar is another factor holding back earnings comparisons. For the full year, earnings are expected to be down about 1% compared with 2014. Excluding energy, they are expected to be up about 7%. Estimates for S&P 500 earnings are about $118 for 2015 and $125 for 2016. At the current level of 1907, the S&P 500 is selling at 16.2 times this year’s earnings and 15.3 times 2016 earnings. The historical median multiple on trailing earnings is 16.3, so while the market may have been somewhat overvalued before the August correction began; it seems more fairly priced now, but still not cheap.