—New Albany—
Investment Management

August 30, 2016

Market Insight: Reading the Road Signs Ahead

Though mid-summer saw a bit of volatility from Brexit, August has been one of quietest months on record. Leading up to the meeting of the Central bankers in Jackson Hole last week, the S&P 500 Index went through 34 trading sessions without a 1% one-day move, up or down, making it the least volatile 30 days in more than 20 years. Similarly, for bonds, the August trading range for the 10-year U.S. Treasury was the tightest for any month in a decade. After plunging oil prices in the beginning of the year sent the global markets reeling, Central-bank innovations of the spring, and the Brexit vote in June, perhaps markets needed some particularly "doggy" days of August to recover. Is the current calm complacency or fatigue? History has shown that periods of unusually low volatility have often preceded bouts of unusually high volatility. So what does the road ahead look like for the markets? Well, some road signs indicate a scenic drive ahead, while other signs are flashing extreme caution. This probably means we are in for an adventurous ride, so fasten your seatbelt! Let's take a look at what the signs are saying.

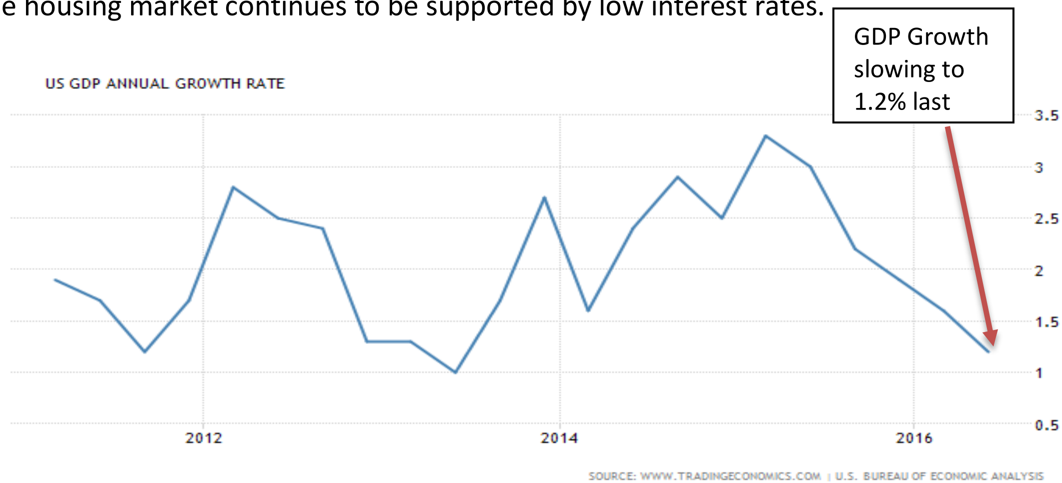
Scenic Drive: A scenic drive sign indicates some beautiful vistas ahead. The current technical picture of the market looks good and is implying further gains

Scenic Sign #1. Market Makes New Highs: After nearly two years of going sideways, the S&P 500 finally broke out of its 15% trading range and has make new highs. History has shown, after long periods of consolidation, a breakout often leads to significant further price movement in the direction of the breakout. In this case, prices should continue to move higher. Below is a weekly chart of the S&P since 2013. Note the 2yr trading range (box) and then break out in July.

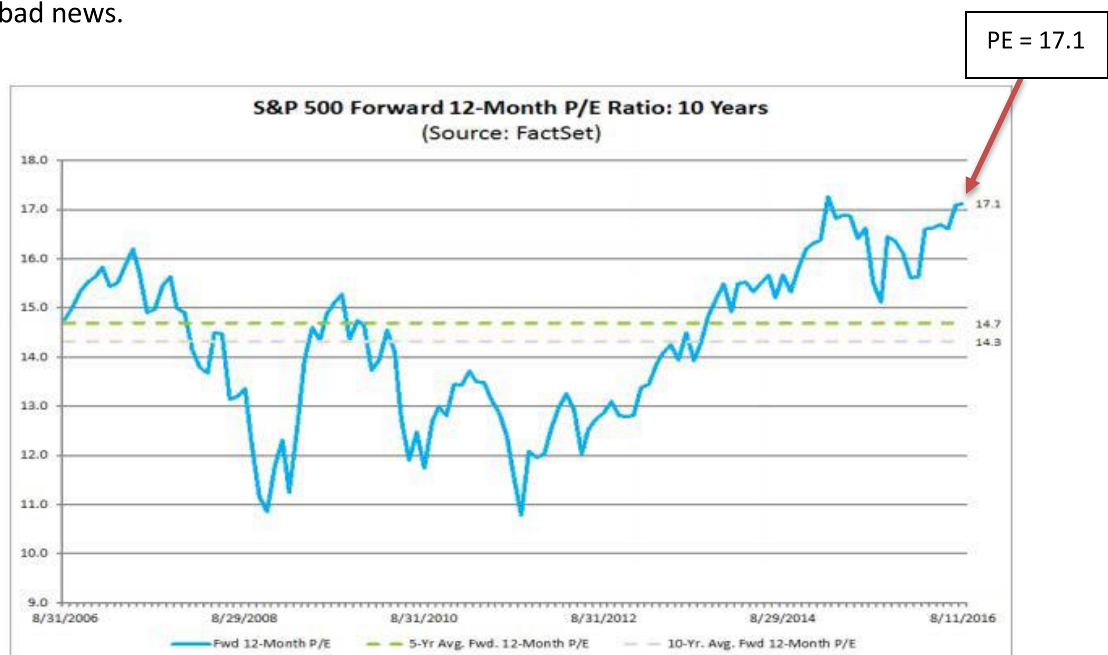
Scenic Sign #2: ‘5 Month-Up’ signal bodes well for future gains. Despite dips along the way, the market has closed higher every single month since March. This five month uptrend is both unusual and tends to foreshadow a very bullish market ahead. Over the past 90 years when the market has been up 5 months in a row, it has been higher one year later nearly 85% of the time. Below is the average return of the S&P 500 since 1927 over various time periods forward after a 5 month- up signal. (Of course past patterns are no guarantee of future returns)

Stats	1Mo	3Mo	6Mo	1Yr
Avg after Signals	1.67%	4.03%	7.41%	11.61%
Average All Periods	0.60%	1.86%	3.66%	7.53%

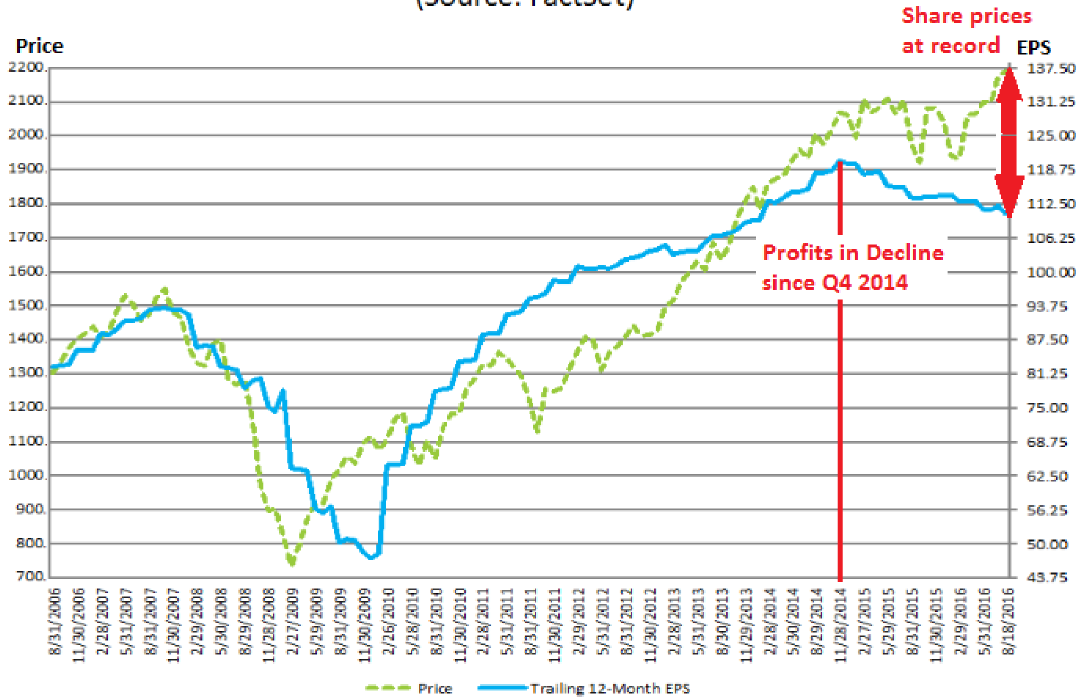
Caution Sign #1: US GDP remains subdued despite low interest rates. The chart below shows US GDP expanded only 1.2% in the second quarter of 2016 over the same quarter of the previous year. This compares to 3.2% average over last 67yrs. Manufacturing remains weak but the consumer is healthy. Unemployment is low and the housing market continues to be supported by low interest rates.



Caution Sign #2: Valuation High The forward P/E Ratio is 17.1, above the 10-Year Average of 14.3. Stocks are expensive by historical comparison, but this alone does not push prices down; it only makes them more vulnerable to bad news.



Caution Sign # 3: Higher Stock Prices are not supported by Higher Earnings: The chart below shows the S&P 500 price keeps rising (green line) despite declining profits (blue line).



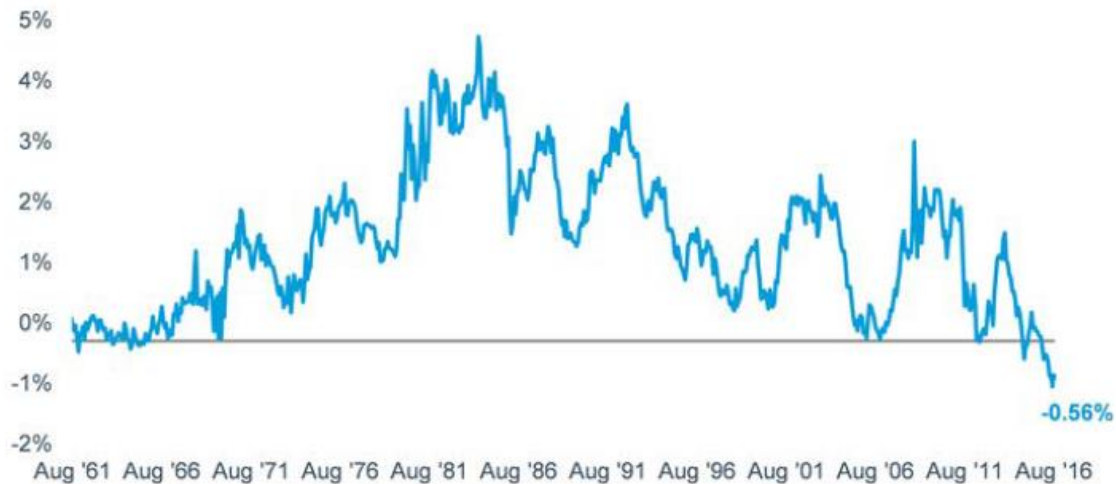
Extreme Danger #1: Global Bond Rates at extreme lows. Thanks to massive intervention by the European Central Bank and Bank of Japan, over more than $13 trillion in global debt now trades at yields below zero. The chart below shows by country, the term and yield of government debt. The Red boxes indicate negative yields; the green boxes indicate positive yields. When 2% inflation is factored in, EVERY developed market GOVERNMENT BOND RETURN IS NEGATIVE FOR 20YRS!

Government Debt in Many Nations Features Below-Zero Yields

Country	1-Yr	2-Yr	3-Yr	4-Yr	5-Yr	6-Yr	7-Yr	8-Yr	9-Yr	10-Yr	15-Yr	20-Yr	30-Yr
Switzerland	-1.15	-1.19	-1.17	-1.10	-1.05	-0.96	-0.89	-0.77	-0.67	-0.61	-0.41	-0.26	-0.11
Japan	-0.33	-0.30	-0.29	-0.31	-0.31	-0.32	-0.32	-0.30	-0.28	-0.22	-0.10	0.07	0.13
Germany	-0.64	-0.66	-0.66	-0.64	-0.57	-0.54	-0.46	-0.38	-0.26	-0.13	-0.08	0.12	0.38
Belgium	-0.58	-0.59	-0.55	-0.51	-0.41	-0.32	-0.23	-0.07	0.09	0.23	0.53	0.60	1.03
Austria	-0.58	-0.55	-0.50	-0.47	-0.37	-0.33	-0.30	-0.25	0.04	0.20	0.16	0.62	0.86
France	-0.55	-0.55	-0.52	-0.45	-0.36	-0.29	-0.20	-0.09	0.05	0.18	0.49	0.73	0.91
Ireland	-0.40	-0.37	-0.27	-0.22		-0.06	0.15	0.29	0.45	0.51	0.81		1.24
Italy	-0.21	-0.11	-0.04	0.07	0.29	0.49	0.67	0.90	1.09	1.26	1.52	1.92	2.27
Spain	-0.24	-0.2	-0.12	0.01	0.18	0.27	0.49	0.84	0.97	1.16	1.48	1.88	2.24
United States	0.45	0.58	0.69		1.00		1.28			1.47		1.86	2.29

Source: Bloomberg and U.S. Treasury Department. Data are as of 06/30/2016. Past performance is no guarantee of future results.
For illustrative purposes only.

Extreme Danger #2: Term Premium for Bonds is Negative. Term premium is the additional yield received for buying a longer maturity bond. The chart below show how the term premium for owning long term bonds has fallen steeply, and now sits at a very perilous negative level. This means there is no income benefit of owing long term bonds.



Technicals forces are in driver seat; Fundamentals are in the rear view mirror. For the moment, the technical or price momentum of the market is in control. We have seen growth scares, currency devaluations, plunging oil prices and a Brexit, but the market was resilient and snapped back. Despite declining capital spending and productivity, subdued growth, virtually no real wage growth and five consecutive quarters of declining year-over-year earnings, many sectors of the stock market have made new highs. **Strength in the face of weak fundamentals means something else is afoot.**

Possible explanations:

1) **Hope for a better road ahead**: Both market Analysists and the Fed are expecting GDP and earnings to accelerate next year. This might sound like good news, however, the catalyst for growth is not based on rising productivity, increased capital spending, or a change in fiscal policy. Improvement is simply based on the hope that the past headwinds of falling energy prices and a rising dollar will no longer be present. Hardly the basis to get very excited about.

2) **TINA: 'There Is No Alternative':** Falling interest rates make other investment alternatives 'appear' more attractive. Extremely low/negative interest rates continues to be the 800 pound gorilla in the room. With bonds offering little to negative return, stocks look pretty darn enticing.

3) **Bonds are as risky as stocks; so buy stocks**: The purpose of owning bonds is for income, price stability and diversification. With today's low/negative yields, it would only take a small rise in rates to see a very large drop in price, wiping out entirely the benefit of owning bonds. Thus, not only do longer term bonds guarantee negative returns after inflation, but are subject to huge price volatility. Thus, depending on the credit quality and maturity, a case can be made that bonds now have as much or more risk than stocks. So why own bonds?

Massive Central Bank intervention around the globe has turned the investment world upside down. The fundamentals of growth, valuation, and productivity, which in the past have been key drivers of stock prices, have taken a back seat to the enormous driving force of excess liquidity. Globally, the Central Banks have injected more than $11 trillion into the financial markets since 2008 through asset purchases of both stocks and bonds. (Bank of Japan is now a top ten shareholder in 90% of the Nikkei 225 stock exchange.) Though this action by Central banks has been reassuring to the financial markets, it has also bred a sense of false security and complacency.

We are on a road that no one has traveled before or knows where it will lead. There is indeed risk ahead, and thus as investors, we must pay attention to the road signs and be prepared for rough patches and detours.

Portfolio Strategy: Neutral Risk position. Stock exposure was rotated out of consumer staples and back to neutral with even allocation to growth and value sectors. Bond exposure remains weighted in short term high yield assets.

As always, please contact me with any questions or concerns.

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