June 7, 2015

Lane Asset Management

Stock Market Commentary

Market Recap for May and Early June 2015

U.S. equities advanced to an all-time high in mid-May, but then retreated as valuation concerns along with rising expectations for a September Fed funds rate increase dampened investor spirits. International stocks lost ground in the month as German industrial production (IP) fell unexpectedly, concerns increased about resolving the Greek government debt issue, and rising dollar expectations battered emerging markets and oil. Investment grade corporate bonds also weakened as the prospects for a Fed funds rate in September gained traction and a sell-off in German bunds along with other countries' government debt raised interest rates in global markets.

U.S. economic data was mixed throughout the month as worker productivity declined (likely attributable to weather and the West Coast dock strike), retail sales were sluggish, U.S. IP fell, and durable goods orders slowed. On the other hand, jobless claims came in at their lowest level in 15 years, the NFIB reported an increase in small business optimism, consumer confidence had a modest increase following April's decline, housing starts jumped to a level not seen since 2007 (though still way down from peak levels) and pending home sales for single family homes surged to a level not seen since 2006.

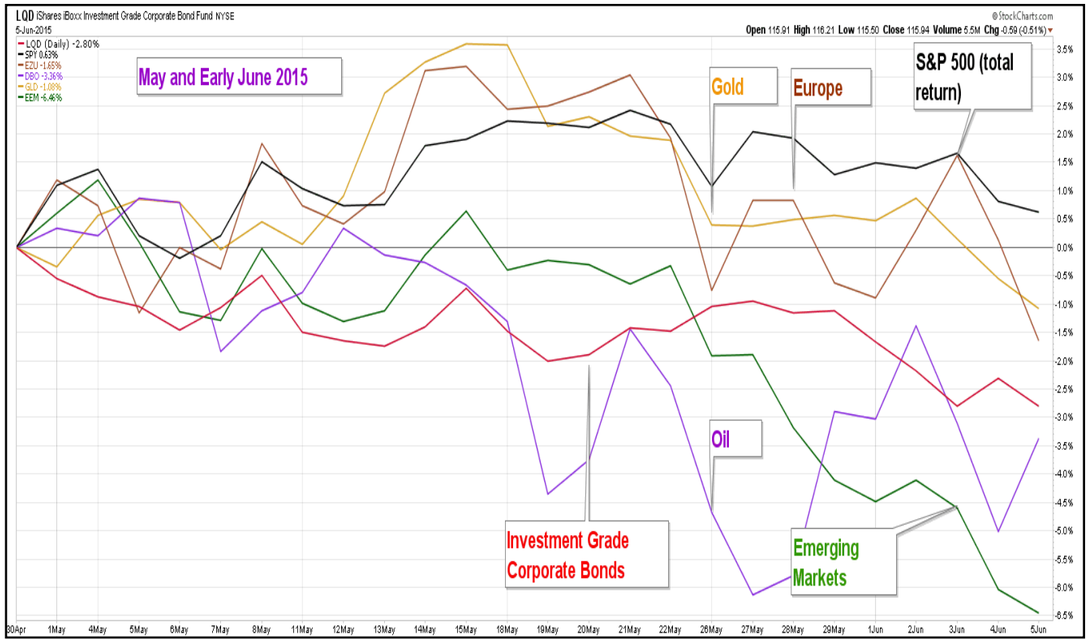
Market Outlook

My market outlook is largely unchanged from last month. The 2015 outlook for the S&P 500, described in my Fearless Forecast from January, was for a total return of 8-10%, lower than 2014's gain of 13.5% based, in part, on my subdued outlook for corporate earnings relative to consensus analyst opinions late last year. With a YTD annualized increase for the S&P 500 through the date of this writing of about 6%, we're running below my estimate. While the second quarter could be another challenging time, I expect the third and fourth quarters to pick up steam — as long as any increase in the Fed funds rate turns out to be less impactful than some folks expect (which I think is the Fed's game plan as the FOMC continues to telegraph its intentions well in advance).

I believe the S&P will continue to be driven by corporate earnings, expectations for adjustments to the Fed funds rate (probably coming later in the year but likely to depress the S&P whenever it comes), and increasing strength in the dollar (driven not only by anticipation of increase in the Fed funds rate, but also by accommodative monetary policy in Europe, Japan and elsewhere).

In any event, as discussed on pages 4 and 5, while we are not, <u>at the moment</u>, on the precipice of a major market decline, we are at a place where it would not take much of an event to present challenging decisions about taking risk off the table.

For international equities, it's looking like the torrid pace so far in 2014 (over 15% annualized for the broad international index) will slow down in the balance of the year (as it did this past month) but still finish well above my single digit 2015 forecast.



The charts on the following pages use mostly exchange-traded funds (ETFs) rather than market indexes since indexes cannot be invested in directly nor do they reflect the total return that comes from reinvested dividends. The ETFs are chosen to be as close as possible to the performance of the indexes while representing a realistic investment opportunity. Prospectuses for these ETFs can be found with an internet search on their symbol. <u>Past performance is no guarantee of future results.</u>

2015 PREDICTIONS (UPDATED)

As the year unfolds, I'll offer updates to my 2015 predictions. Here's where I come out after three months. Revisions/comments are shown in *blue italics*.

U.S. Equities

As I believe the primary drivers of stock market returns in 2015 will be corporate earnings and modest, if any, movement on the federal funds rate, my expectation for the S&P 500 for 2015 is for a total return of 8-10% (measured by SPY) with risk to the downside on account of international considerations. On a sector basis, I expect healthcare, technology, consumer discretionary and small cap stocks to outperform. There may be a rebound in energy, but I'm not prepared to go there now.

The S&P 500 (SPY) gained ground in May but lost a little in early June. As of this writing, total YTD return is now about 2.5%, or about 6% on an annualized basis — below my target for the year.

Zacks reports that for the 463 companies reporting out of 500 (about 93% of the S&P 500 market cap), Q1/2015 EPS increased 2.4% while revenue fell 3.7% compared to Q4/2014, heavily influenced by a large decline for energy companies and an above average increase for financial companies. Overall, earnings have come in above lowered expectations. Notably, earnings forecasts for Q2 are for a decrease of over 6%, setting up the potential for a better-than-expected result.

International Equities

My estimate for total return from international equities, as measured by the Vanguard All-world (ex U.S.) fund, VEU, is 2-3% less than SPY which, given the above estimate, is 5-8% for VEU. I believe the international equity returns will be very region specific with India and China leading the way and commodity-producing regions lagging. Europe is a wild card as the broader economy struggles while the ECB may come to the rescue. I'd keep an eye on Germany as Europe's bellwether country.

VEU caught a cold in May and early June and, as of this writing, stands almost 4 percentage points ahead YTD (7% last month). With VEU up about 6.5% for the year (over 15% annualized), the index appears headed for a better year than expected..

After a surprisingly strong March and April, emerging markets took a dive in May and early June, likely on account of rising U.S. dollar and interest rate expectations which impact their dollar denominated debt. Strength is now showing up in dollar-hedged Japan (as the yen has sunk) and China, especially newly available A-shares. Individual country results are being whipsawed this year on account of interest rate and currency volatility.

Bonds and Other Income Securities:

The 10-year Treasury yield surprised everyone in 2014, especially after its rapid increase in 2013. The yield currently rests at about 2% and I believe it will end the year near 2.5%. Total return for 7-15 year U.S. government bond funds in 2014 was a bit over 9% while investment grade corporate (IGC) bonds funds returned a bit over 8%. For 2015, I expect total return for IGC bonds between 6% and 8%, still better than current yield. I believe the best opportunities for income investing will come from preferred stocks, REITs and established, long term dividend paying common stocks.

The 10-year Treasury yield rose further in May and early June to 2.41%, up from 2.16% last month, and up about 24 b.p. for the year so far. Investment grade corporate bonds (LQD) weakened further with the strengthening in Treasury yields and now sit with a nearly 1.6% decline YTD, about 4% below the S&P and well below my 2015 forecast. Preferred stocks (PFF) added strength in May relative to bonds as did dividend-paying corporate stocks. REITs followed LQD during the month.

I continue to believe that the FOMC will go slow with any Fed funds rate increase. Current betting seems to be on a September increase, and that could turn out to be the case if the next few employment reports meet or beat expectations. With the second reading for Q1 GDP being –0.7%, corporate earnings being not particularly stellar, core PCE dropping back slightly to 1.24% vs. the Fed's target of 2%, and no real growth showing in hours worked or the average hourly wage, we'll need to see solid improvement in the coming months before the Fed decides to pull the trigger.

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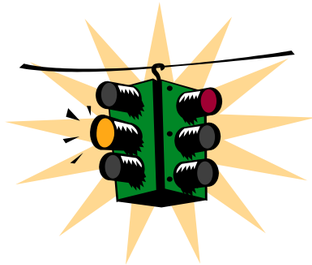
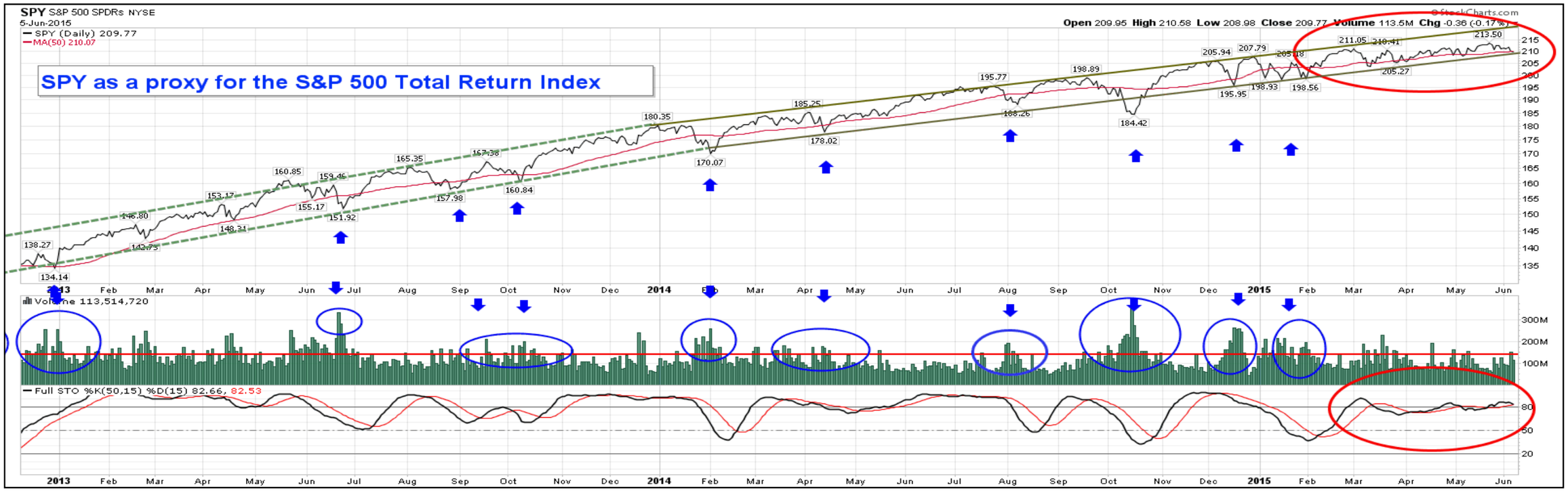
S&P 500 Total Return



SPY rode a rollercoaster in May and early June as the price eeked out a small gain over the period. The 50-day moving average trend weakened while momentum drifted. A modest April jobs report and lowered expectations for a policy rate move by the Fed brought the S&P 500 to an all-time high mid-month. Fed Chair Yellen's comment that stocks were "generally quite high" took some wind out of the sails as SPY drifted lower in the balance of the month. Despite the expected (and discounted) downward revision to the Q1 GDP report to -0.7%, the May jobs report exceeded expectations, raising expectations for a September Fed funds rate adjustment. As of this writing, the YTD total return of the S&P 500 index proxy SPY is about 2.5%., or about 6% on an annualized basis and a lower trajectory than the 10% gain over the last 12 months (these percentages are volatile and highly dependent on the starting and ending points).

Speaking strictly from the technical perspective shown in the chart below, the large cap domestic index is barely within the trend begun in early 2014 with some modest risk to the downside and ambivalent momentum hovering near the top of its range. Meanwhile, the analysis of margin debt on the next page illustrates additional risk inherent in the market today. Accordingly, I don't believe this would be a good time to go beyond one's strategic long term allocation to equities, and having some cash in reserve may be appropriate for those with limited risk tolerance.



SPY is an exchange-traded fund designed to match the experience of the S&P 500 index adjusted for dividend reinvestment. Its prospectus can be found online. **Past performance is no guarantee of future results.**

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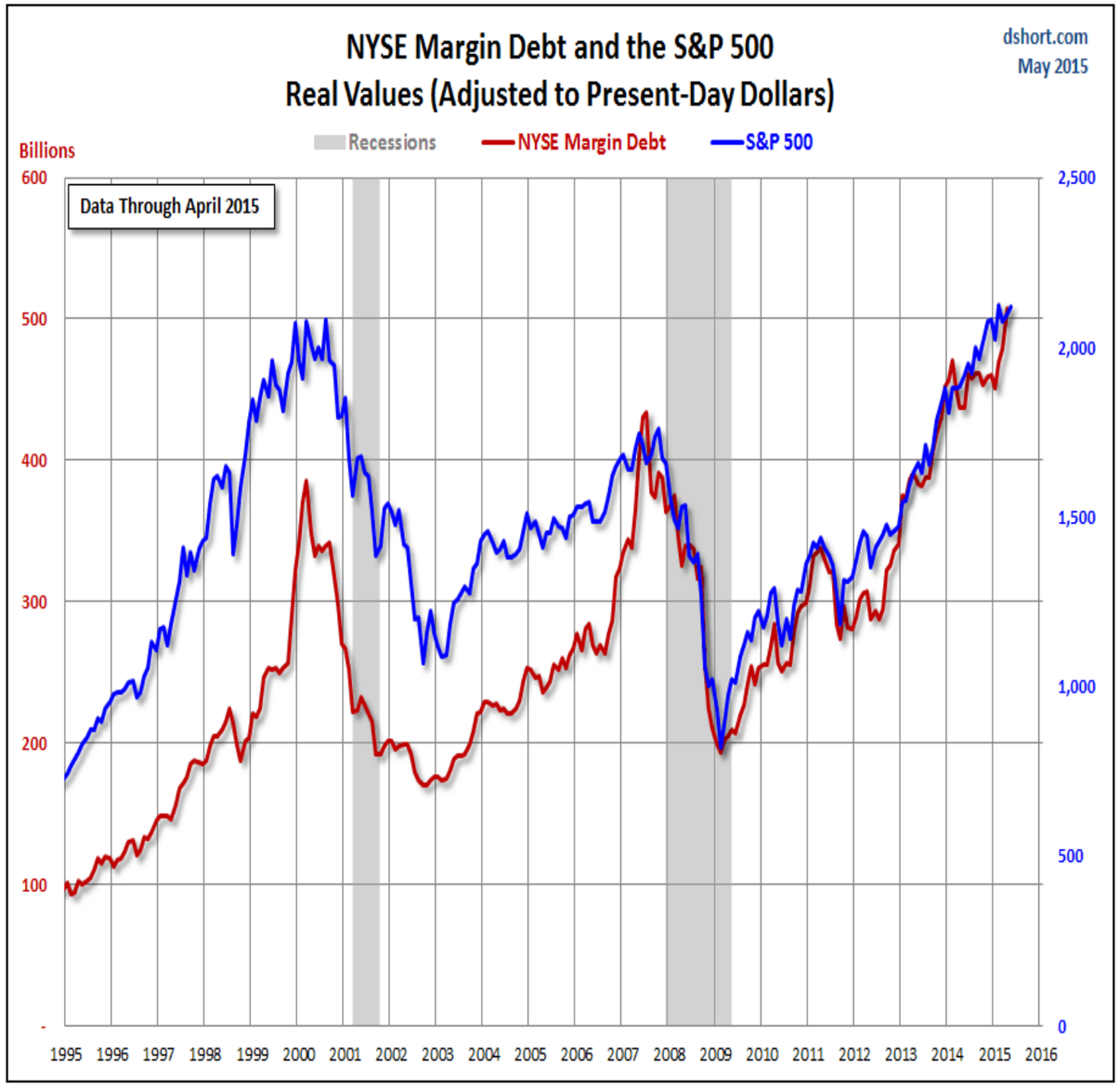
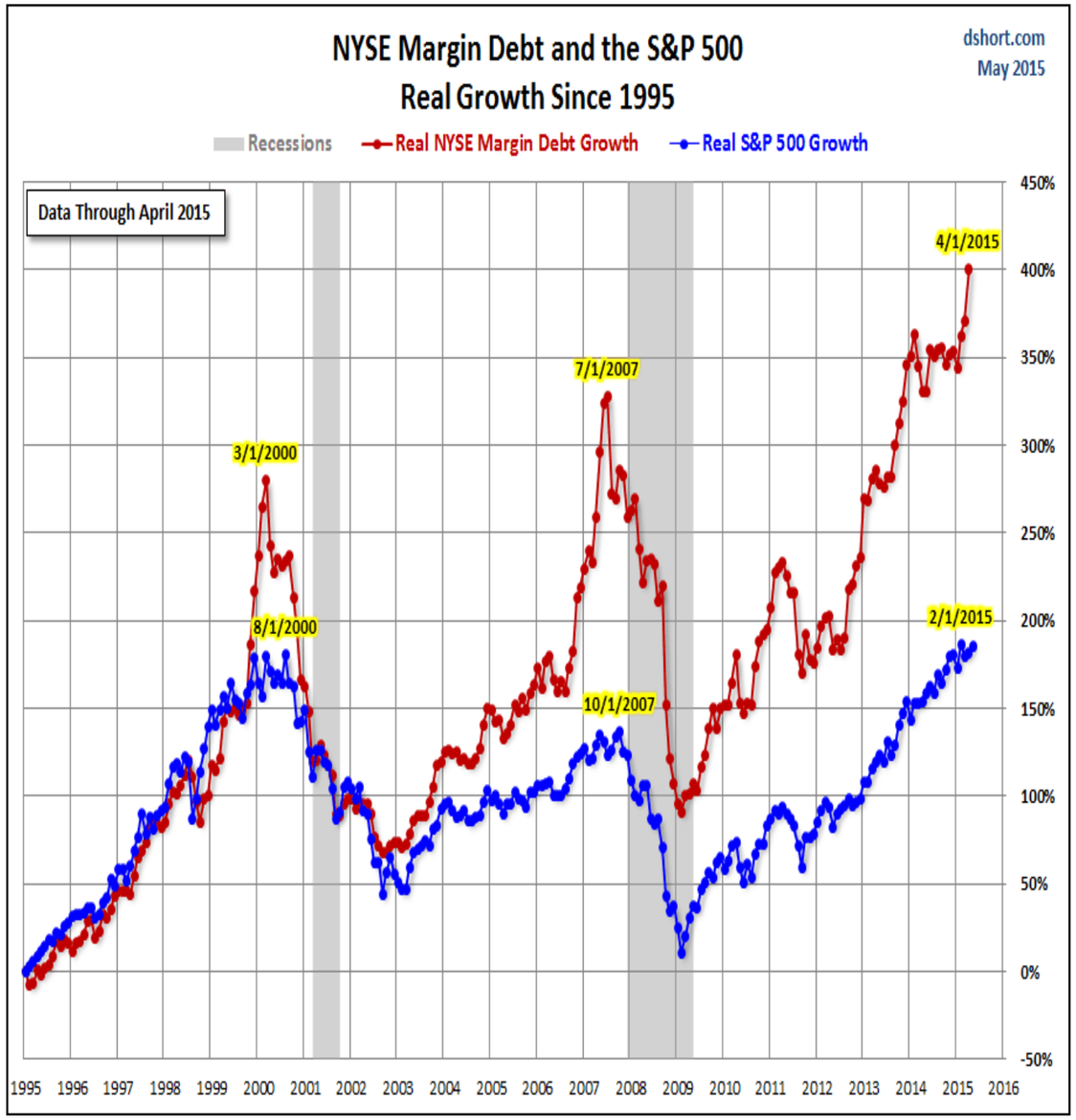
Margin Debt

Margin debt has reached an all-time high. I'm not sure if the absolute level means much OTHER THAN the implication that at a very high level, a mild correction in the S&P could trigger margin calls and a flood of selling, exacerbating a downturn in the market. On the basis of the charts below, while we are in the territory where there's added risk of a self-reinforcing correction, the potential for that correction to be very large needs to be accompanied by an emerging recession. On that question, while few say a recession is imminent, the potential is raised by weak S&P 500 revenues and GDP in Q1, and weakening retail sales, durable goods orders, export growth and growing budget gaps at the state level. On the bright side (if you call it that), if this analysis is correct, the Fed may be that much more reticent to increase the Fed funds rate.





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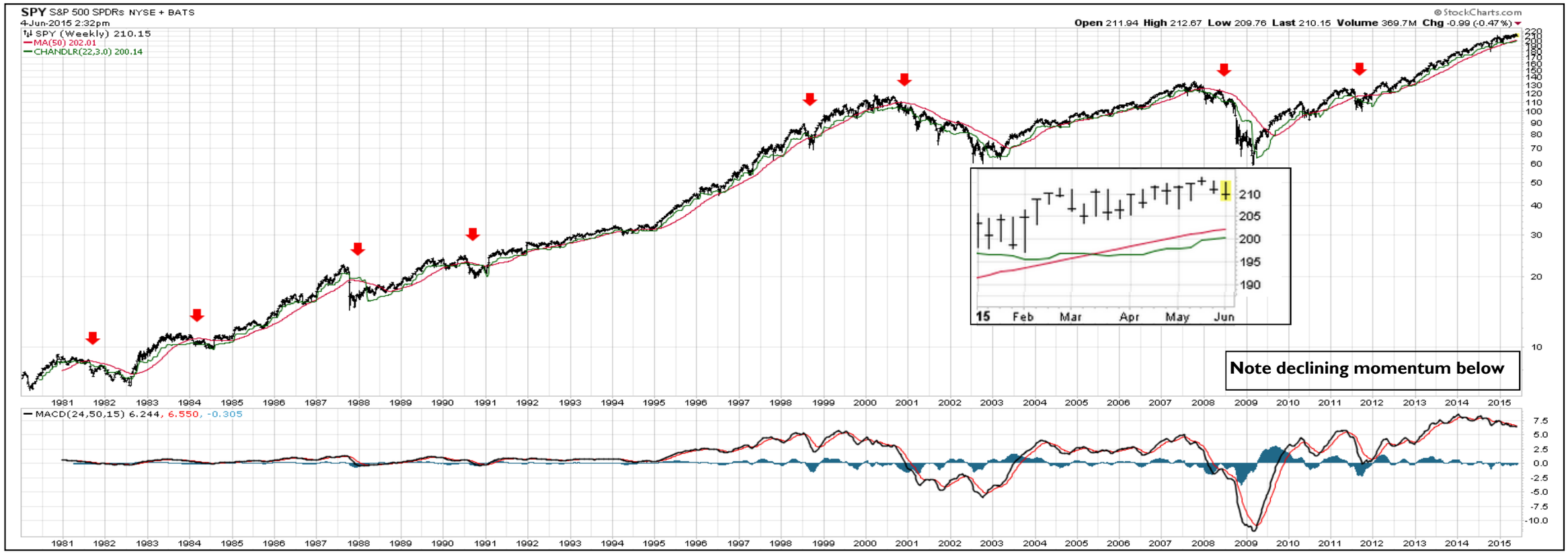
Portfolio Protection

This chart has been prepared to assist investors in making a decision about portfolio protection, in particular, protecting against a major market sell-off such as occurred in 2000 and 2008. The chart shows, since January 1980, the weekly value of SPY (the ETF proxy for the S&P 500 index on a total return basis). The red line is a 50-week moving average (50WMA) and the green line, called a "Chandelier Exit," is a form of a trailing stop-loss. The red arrows show when the weekly price has fallen below the 50 WMA. This is often accompanied by the Chandelier Exit falling below the 50 WMA.

To me, events such as these would be an important signal that it would be timely to reduce equity exposure, perhaps significantly so if the 50WMA also had an inflection point and began a downward slope. In the last 36+ years, this has happened 8 times; 6 if you exclude 1998 and 2011 when the 50WMA did not turn negative. Since it's the major negative market sell-offs that are to be avoided (and reversals to be taken take advantage of), this is the kind of evidence I would be looking for to protect the equity portion of a portfolio. While it's true there can be false or short-lived signals, as there were in 1984, 1990, and, if you like, in early 1998 and 2011, taking steps to protect assets at the "wrong" moment is, I believe, a small price to pay, especially since we don't know how "wrong" the moment is at the time it occurs.

The point I want to make at this time is that for the S&P 500 to have another "red arrow event" of the type that occurred in 2000 and 2008 (as some thoughtful analysts believe is likely in the not too distant future), the current price would need to fall about 5% (see the magnified insert for 2015). I'm not expecting or predicting this will happen, even though market momentum has been fading since January 2014. While this analysis would not necessarily work for other securities, the action of the S&P 500 would be enough for me to react across the board. Also, if such an event were to happen, I'd probably go to cash rather than, say, the investment grade bonds or preferred stocks, depending on the interest rate outlook at the time.



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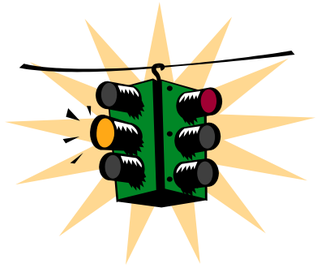
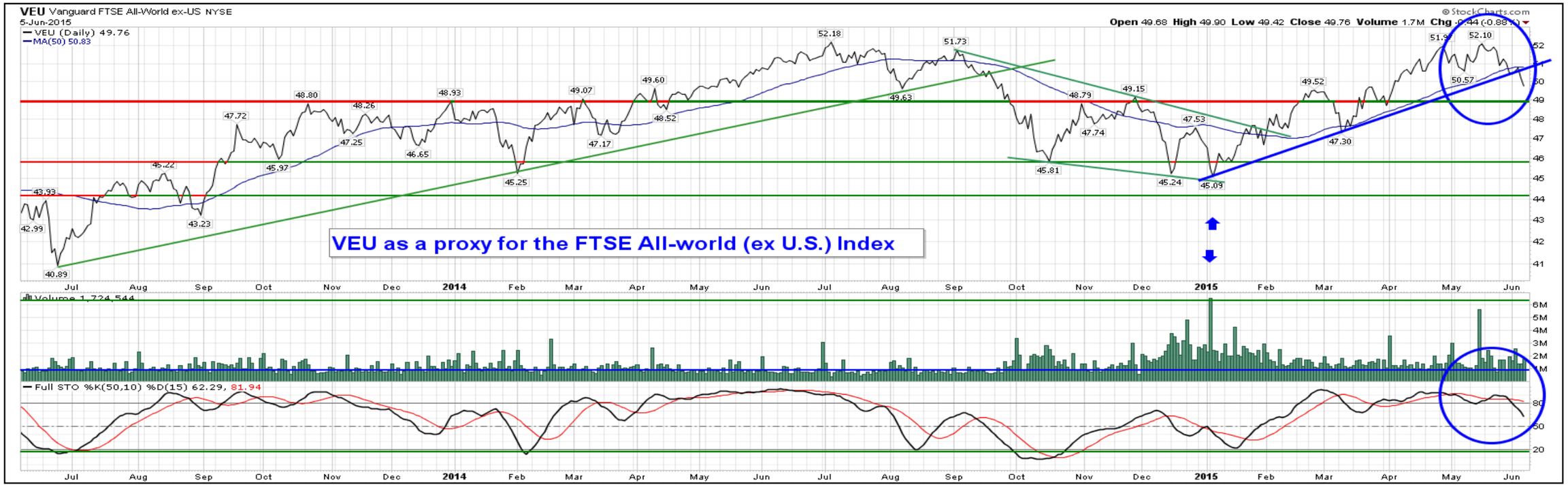
All-world (ex U.S.)



International equities, represented here by VEU, experienced a volatile month owing to wavering negotiations on Greek debt repayment and rising interest rates that pummeled emerging market equities. By the end of the first week in June, both trend and momentum had reversed to the downside.

In recent months, I've been partial to selected countries, especially on a hedged basis, rather than the broad index. Looking back over this year, I've found a lot more volatility among the individual countries, whether or not dollar-hedged, than I am comfortable with. There's also been a fair amount of shifting among countries for leadership in performance while the aggregate index had continued to perform well. Consequently, for the most part, I will be focusing more on the broad index than individual countries. Looking at that index below, the picture is giving a very different outlook than we had just a month ago. While it may be a little early to jump ship, I would avoid adding exposure to the broad index until we have a little more evidence on direction.

On an individual country basis, certain Asian countries have heated up, especially Japan (best hedged on account of the sinking yen), selected India, and China (especially the relatively recent access to so-called A-shares). Be careful in country and fund selection, however, as not all Asian countries are having the same positive experience.



VEU is a Vanguard exchange-traded fund designed to match the experience of the FTSE All-world (ex U.S.) Index. Its prospectus can be found online. As of 12/31/14, VEU was allocated as follows: approximately 19% Emerging Markets, 46% Europe, 28% Pacific and about 7% Canada. **Past performance is no guarantee of future results.**

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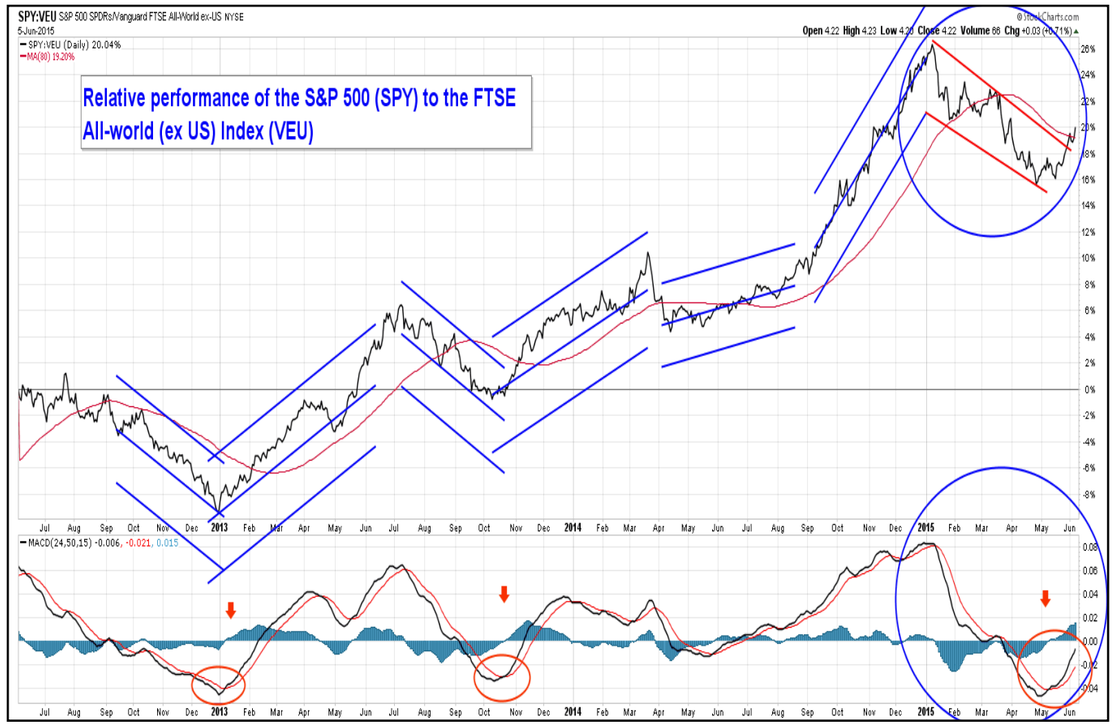
Asset Allocation and Relative Performance

Asset allocation is the mechanism investors use to enhance gains and reduce volatility over the long term. One useful tool I've found for establishing and revising asset allocation comes from observing the relative performance of major asset sectors (and within sectors, as well). The charts below show the relative performance of the S&P 500 (SPY) to an investment grade corporate bond index (LQD) on the left, and to the Vanguard All-world (ex U.S.) index fund (VEU) on the right.

On the left, the relative strength of U.S. equities over investment grade corporate bonds regained ground in April that was extended in May with a further improvement in both trend and momentum. Importantly, the broad trend of relative outperformance of equities remained in the channel established at the beginning of 2014, albeit with a fair amount of volatility. I expect this relationship to continue.

On the right, the outperformance of international equities deteriorated in May with a net YTD difference of about 4%, down from 7.4% last month. As I suggested last month might happen, the longest sustained period of outperformance by VEU relative to SPY in the last 8 years wore itself out as first seen by reversing momentum and now seen by reversing trend. Of course, there are sound fundamental reasons for the reversal, like the impact of increasing interest rates on emerging market equities, so I wouldn't say this was necessarily <u>sure</u> to happen. My point, though, is that the technical analysis gave a helpful indication that it was likely to happen, just as it did in January and November 2013.



SPY, VEU, and LQD are exchange-traded funds designed to match the experience of the S&P 500, (with dividends), the FTSE All-world (ex US) index, and the iBoxx Investment Grade Corporate Bond Index, respectively. Their prospectuses can be found online. **Past performance is no guarantee of future results.**

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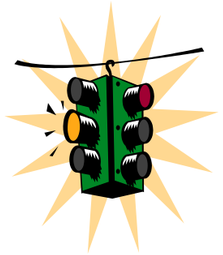
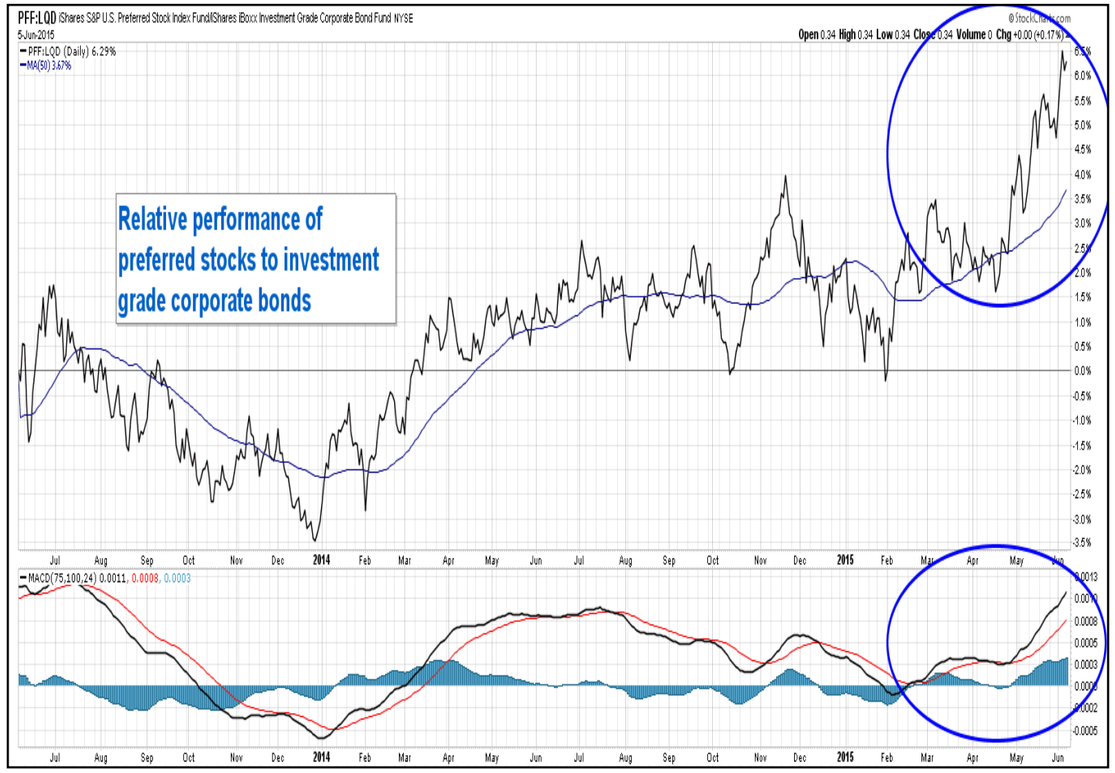
Income Investing

Investment grade corporate bonds (LQD) weakened further in May, and now are underwater by about 1.6% for the year. On a technical basis, the trend extended its decline after becoming negative for the first time in about 2 years. While the April employment and payroll report was taken as dovish, rising global interest rates capped by a better-than-expected May employment report in early June, raised investor expectations for a September Fed funds increase and helped push the yield on the 10-year Treasury bond up by almost 30 basis points in two days. Despite the technical weakness for bonds, I'd like to see a little more deterioration before "pulling the plug" completely.



While we wait to see how the bond picture unfolds, preferred stocks further extended their outperformance in May (the variations are smaller than they appear because of the scale of the chart). With increasingly positive trend and momentum, I expect this relationship to continue as the preferreds have a higher current yield and, for the most part, lower volatility. While PFF outperformed LQD in a one-, three– and five-year look-back periods, there can be no guarantee this will continue. A pullback from the recent sharp increase would not be a surprise.

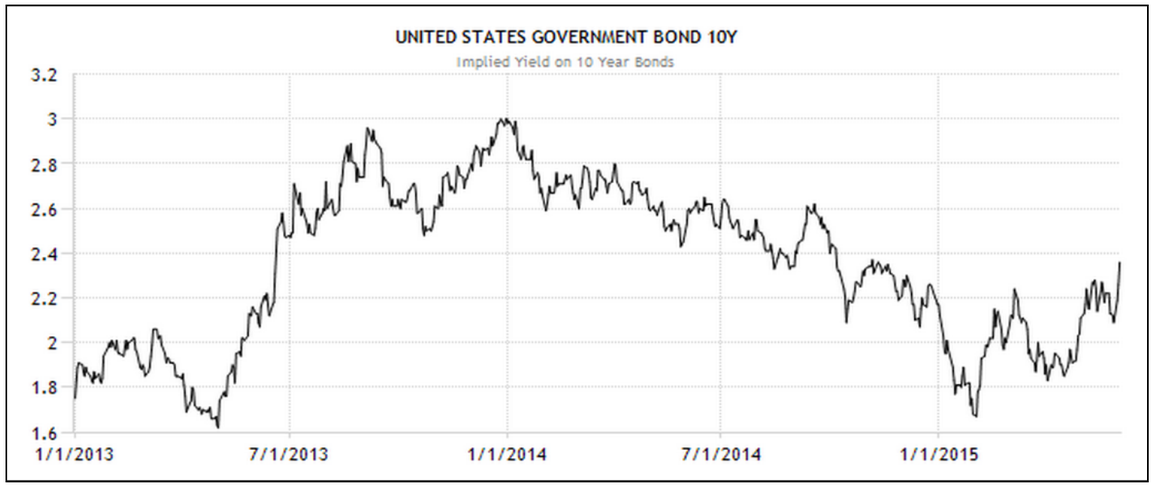


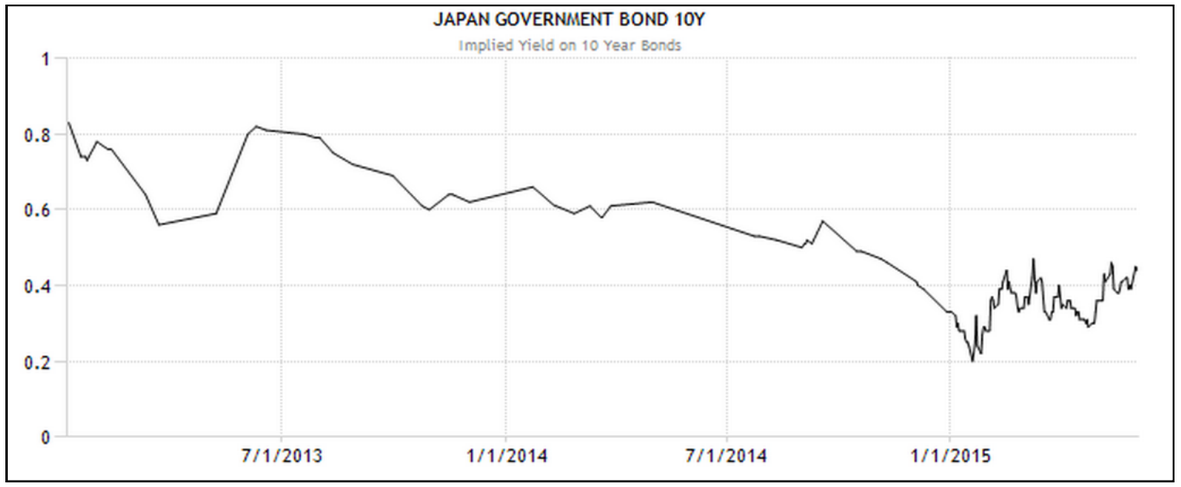
LQD is an ETF designed to match the experience of the iBoxx Investment Grade Corporate Bond Index. Prospectuses can be found online. TLT seeks to track the investment results of an index composed of U.S. Treasury bonds with remaining maturities greater than twenty years. PFF seeks to track the investment results of the S&P U.S. Preferred Stock Index (TM) which measures the performance of a select group of preferred stocks. **Past performance is no guarantee of future results.**

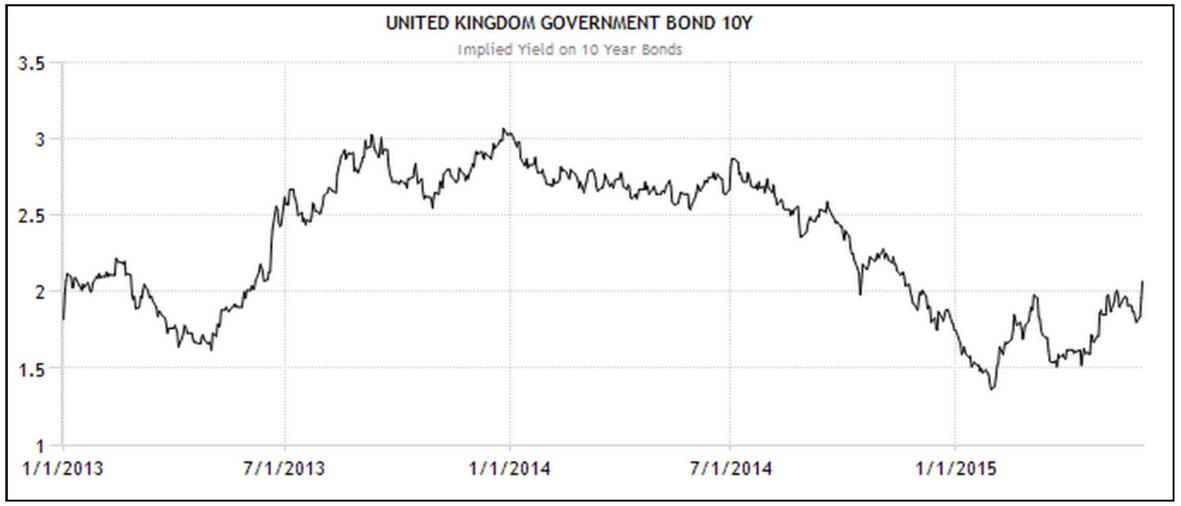
Interest Rates

Shown below are 10-year government bond rates for the U.S., Germany, Japan, and the U.K. As you can see, there's been a reversal in the last couple of months. The U.S. 10-year Treasury rate is now about 2.4% (at this writing and very near my year-end forecast of 2.5%), its highest level since last October and up 50 basis points from about 1.9% at the beginning of April. A number of factors are driving interest rates here and abroad, including anticipation of an increase in the U.S. Fed funds rate as well as an unwinding of short bond positions, especially for Germany bunds which Bill Gross and Jeffrey Gundlach called "the short of the century." The co-movement of these rates is no accident as government bond traders react to rate differentials and inflation expectations.

While the increase in global rates has been quite pronounced the last couple of months, with subdued global growth and inflation, I'm not expecting the year will end with rates much higher than they are today.







Disclosures

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Investing involves risk including loss of principal. Investing in international and emerging markets may entail additional risks such as currency fluctuation and political instability. Investing in small-cap stocks includes specific risks such as greater volatility and potentially less liquidity. Small-cap stocks may be subject to higher degree of risk than more established companies' securities. The illiquidity of the small-cap market may adversely affect the value of these investments.

Investors should consider the investment objectives, risks, and charges and expenses of mutual funds and exchange-traded funds carefully for a full background on the possibility that a more suitable securities transaction may exist. The prospectus contains this and other information. A prospectus for all funds is available from Lane Asset Management or your financial advisor and should be read carefully before investing.

Note that indexes cannot be invested in directly and their performance may or may not correspond to securities intended to represent these sectors.

Investors should carefully review their financial situation, making sure their cash flow needs for the next 3-5 years are secure with a margin for error. Beyond that, the degree of risk taken in a portfolio should be commensurate with one's overall risk tolerance and financial objectives.

The charts and comments are only the author's view of market activity and aren't recommendations to buy or sell any security. Market sectors and related exchanged-traded and closed-end funds are selected based on his opinion as to their usefulness in providing the viewer a comprehensive summary of market conditions for the featured period. Chart annotations aren't predictive of any future market action rather they only demonstrate the author's opinion as to a range of possibilities going forward. All material presented herein is believed to be reliable but its accuracy cannot be guaranteed. The information contained herein (including historical prices or values) has been obtained from sources that Lane Asset Management (LAM) considers to be reliable; however, LAM makes no representation as to, or accepts any responsibility or liability for, the accuracy or completeness of the information contained herein or any decision made or action taken by you or any third party in reliance upon the data. Some results are derived using historical estimations from available data. Investment recommendations may change without notice and readers are urged to check with tax advisors before making any investment decisions. Opinions expressed in these reports may change without prior notice. This memorandum is based on information available to the public. No representation is made that it is accurate or complete. This memorandum is not an offer to buy or sell or a solicitation of an offer to buy or sell the securities mentioned. The investments discussed or recommended in this report may be unsuitable for investors depending on their specific investment objectives and financial position. The price or value of the investments to which this report relates, either directly or indirectly, may fall or rise against the interest of investors. All prices and yields contained in this report are subject to change without notice. This information is intended for illustrative purposes only. **PAST PERFORMANCE DOES NOT GUARANTEE FUTURE RESULTS.**

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