Lane Asset Management

Stock Market Commentary

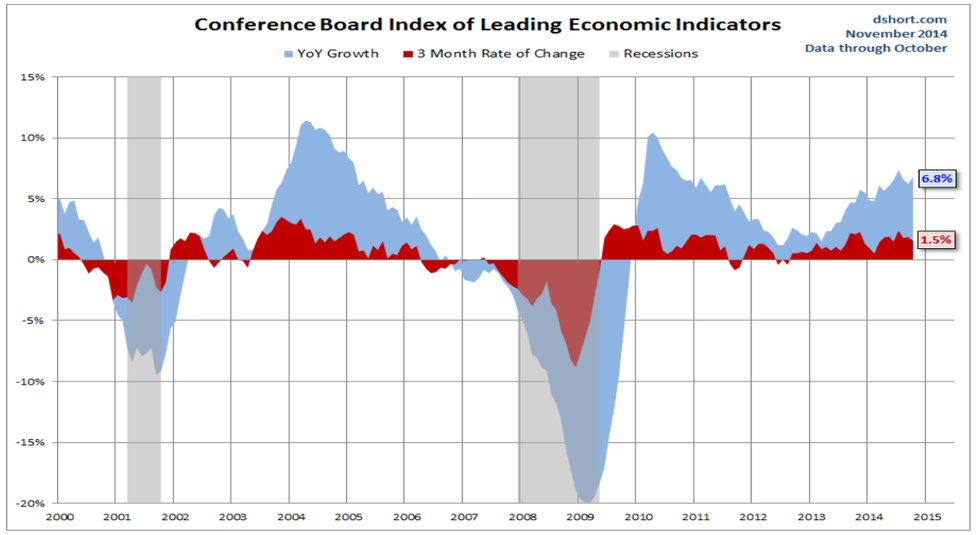
December 6, 2014

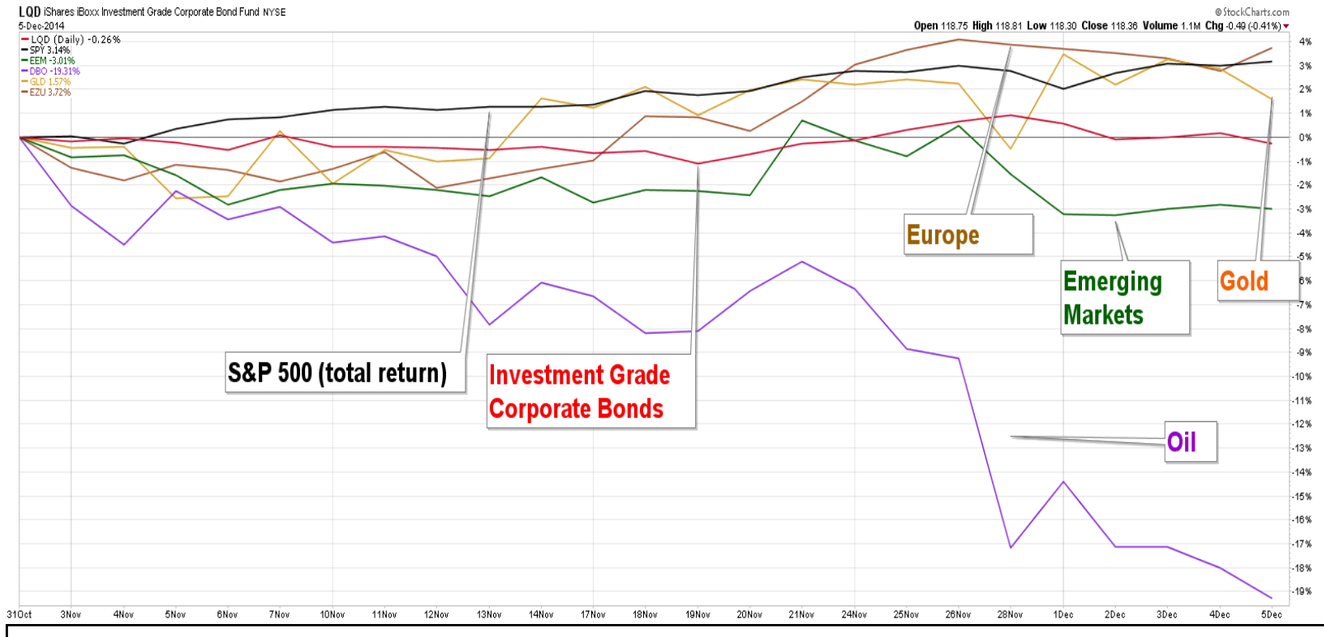
Market Recap for November 2014

November was a good month for U.S. and EuroZone equities and not so much for emerging markets or the broader international equity index (see page 3).

The U.S. economy is on good footing: Nonfarm employment is strong with the November figure of 321,000 being the largest increase since January 2012 while the unemployment rate remained steady at 5.8%, its lowest reading since July 2008. Prior months have been revised upwards. Even better is that the latest job gains were widespread across industries. In addition, both manufacturing and nonmanufacturing indexes from the Institute of Supply Management remain strongly expansionary, U/Michigan consumer confidence remains at a post-recession high and the Conference Board's Index of Leading Economic indicators was at its highest level since July 2007.

Oil is the big story for the month as Saudi Arabia decided to maintain production levels, thereby supporting lower prices, in an apparent attempt to drive out lower cost producers (some of whom could be higher cost producers in the U.S.). While this amounts to a tax holiday for consuming nations, the problem with this strategy is that a number of producing countries, including Russia, depend greatly on higher oil prices, so the geopolitical fallout may bring unintended consequences.





Investment Outlook

As stated last month, the outlook for U.S. equity investments is "fair to good" with the greatest concern being whether (when?) and to what extent the economic challenges outside the U.S. will impact the domestic economy. The nearly 14% total return performance of the S&P 500 this year has exceeded most expectations, including mine. While it's hard for me to believe this pace can be maintained in light of global headwinds and current market valuations, it does appear that the relative strength of U.S. equities will continue.

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. Past performance is no guarantee of future results.

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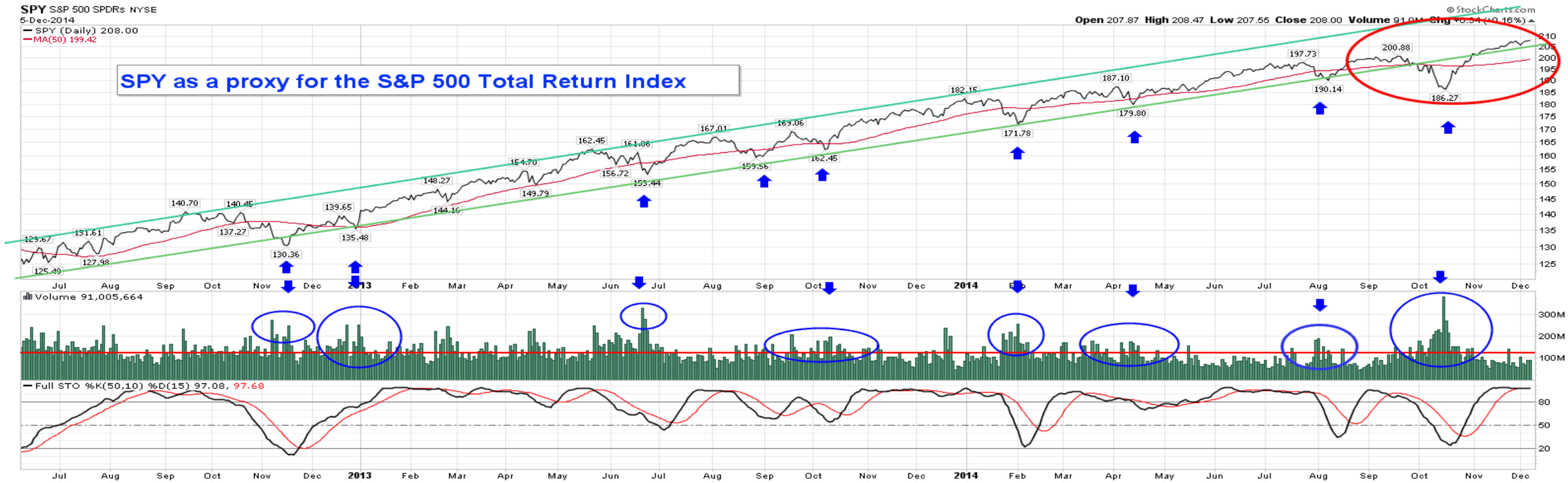
S&P 500 Total Return

Last month, I commented that despite not having fully recovered to the longer term price channel, there did not seem to be any apparent technical or fundamental weakness that would undermine the market. That said, I cautioned against going beyond a strategic (long term) allocation to equities. As it turned out, with a 2.7% gain in the S&P 500 (SPY), the caution turned out not to be warranted. I also pointed out that opportunities may have been present in energy, health care and mid-cap stocks. As it turned out, energy was recovering well for the first 3 weeks — that is, until the Saudis decided to not cut production and energy prices plummeted. Mid-cap stocks did well until the last two days of the month when they, too, got pummeled (though they have since come back strong). Health care had a very strong month.

Going forward, the technical and fundamental outlook is, if anything, looking better for large cap U.S. equities represented by the S&P 500. The 50-day moving average trend has turned positive again and momentum remains strong. And, as discussed on page 1, the U.S. economy also appears to be in good shape. Of course, a hiccup is always a possibility, but a larger correction does not appear to be on the foreseeable horizon. As for individual sectors, the Saudi action moved me away from energy for the time being, but I still favor mid (and small) cap stocks (both of which remain oversold on a relative basis) and health care. And, I'm adding technology to my overweight list.



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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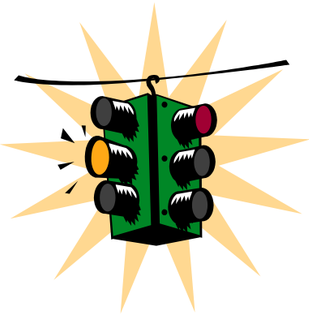
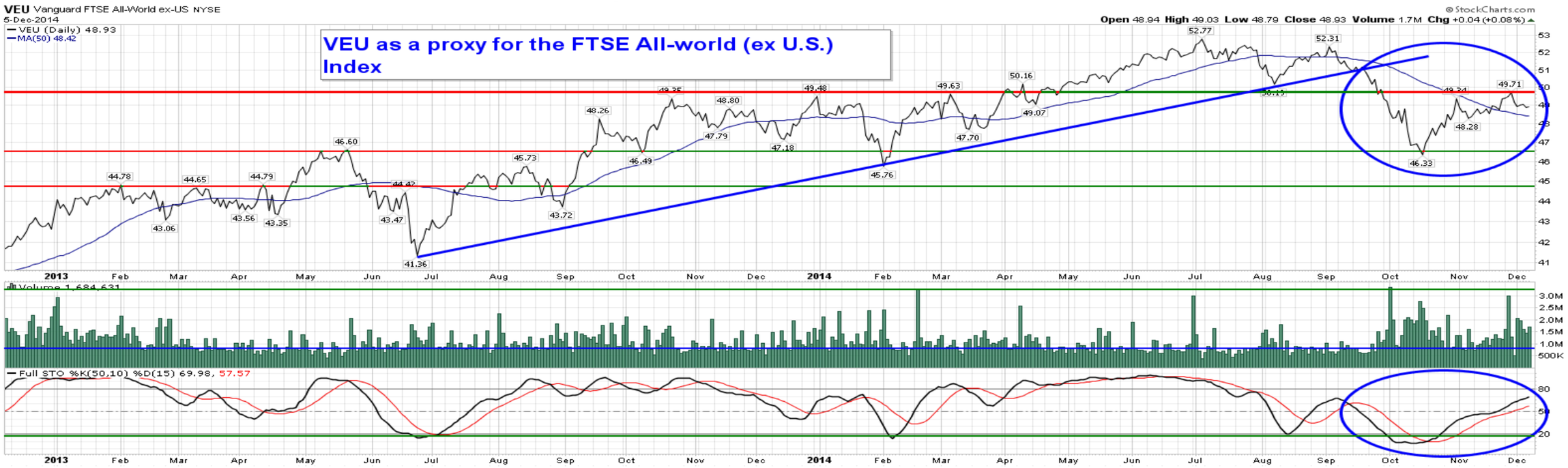
All-world (ex U.S.) Equities



International equities, represented here by Vanguard's ETF, VEU, came in just below even in November despite the positive momentum as shown below. The month was best characterized as bimodal with the best performances coming from countries in Continental Europe despite the economic challenges and near recession, perhaps reflecting a perceived oversold situation, while the worst performances came from Latin America, Canada, Australia and so-called Frontier Markets where dependency on income from commodities, especially oil, plays a major role in the local economy. In fact, although the broad international index underperformed the S&P 500, the EZ, pulled forward by Germany (spotted last month as a potential opportunity to "buy low"), actually outperformed the S&P index, as did India.

From a technical perspective, the broad index is still having trouble getting past the line of resistance at about $49 and has diverging signals from a declining trend on the one hand with improving momentum and heavier volume on the other. The oil situation is complex and its impact over the next few months is uncertain with the potential to help some and hurt others in a significant way.

At this stage, as I think a safer bet rests with the U.S., I would continue to minimize broad international exposure while considering taking a measured position in selected countries such as Germany and India.



VEU is an exchange-traded fund designed to match the experience of the FTSE All-world (ex U.S.) Index. Its prospectus can be found online. **Past performance is no guarantee of future results.**

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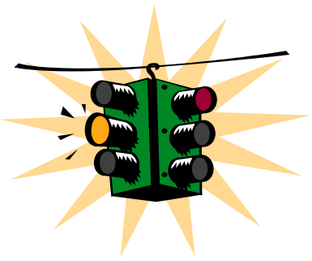
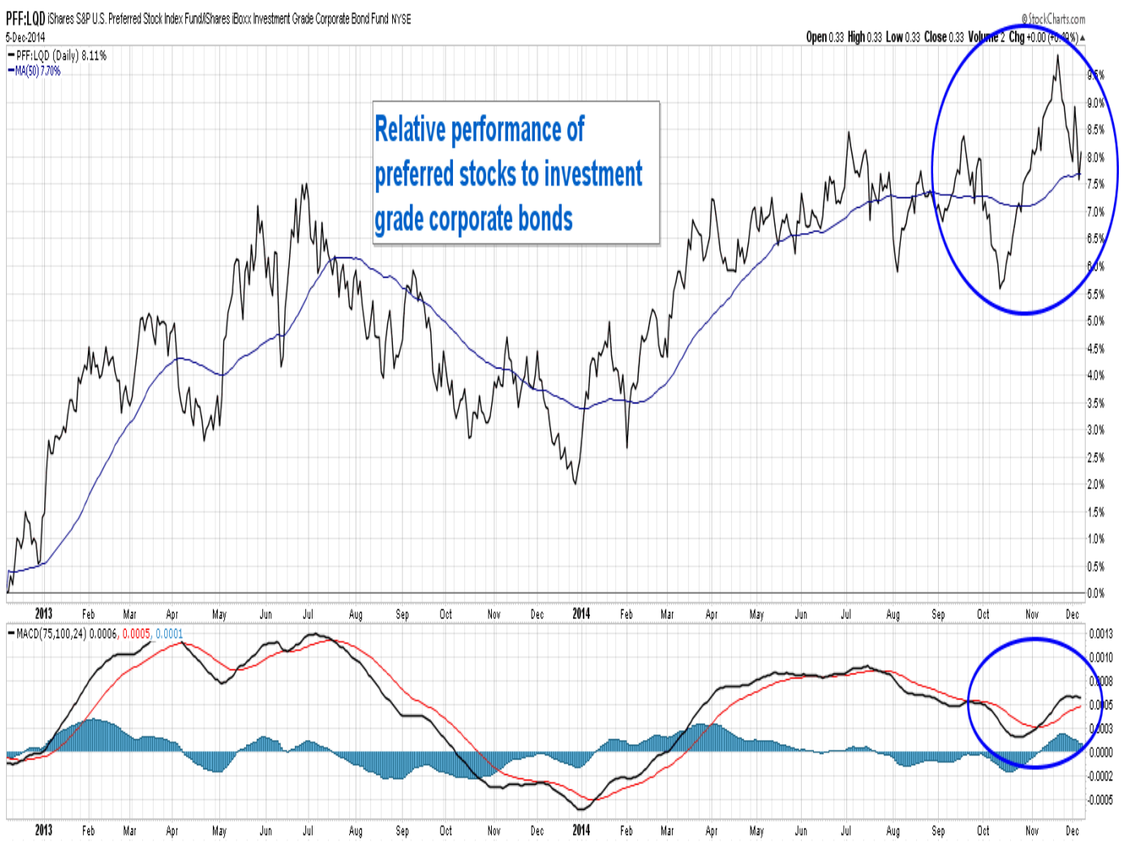
Income Investing

As I mentioned last month, investment grade corporate bonds are going through a testing period characterized by unusual volatility as in the middle of 2013. As seen on page 6, short term interest rates are edging up while the 10-year (and longer) rates are continuing to fall as they have throughout the year, surprising many. Although the trend for LQD remains positive, the implication of the narrowing channel for the popular bond index is unclear.



Shown on the right below is the relative performance of the preferred stock index fund, PFF, compared to investment grade corporate bonds on a total return basis. Even though PFF's relative outperformance lost momentum from July through October, this appears to have been regained in November. I believe the higher yield relative to investment grade corporate bonds represented by LQD (currently about 6.9% vs. 3.4%) and the lower volatility (especially among selected individual bank preferred stocks) will continue to attract investors and, in any event, provide balance and diversification to the income portion of an asset allocation.



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 . LQD is an ETF designed to match the experience of the iBoxx Investment Grade Corporate Bond Index. Prospectuses can be found online. **Past performance is no guarantee of future results.**

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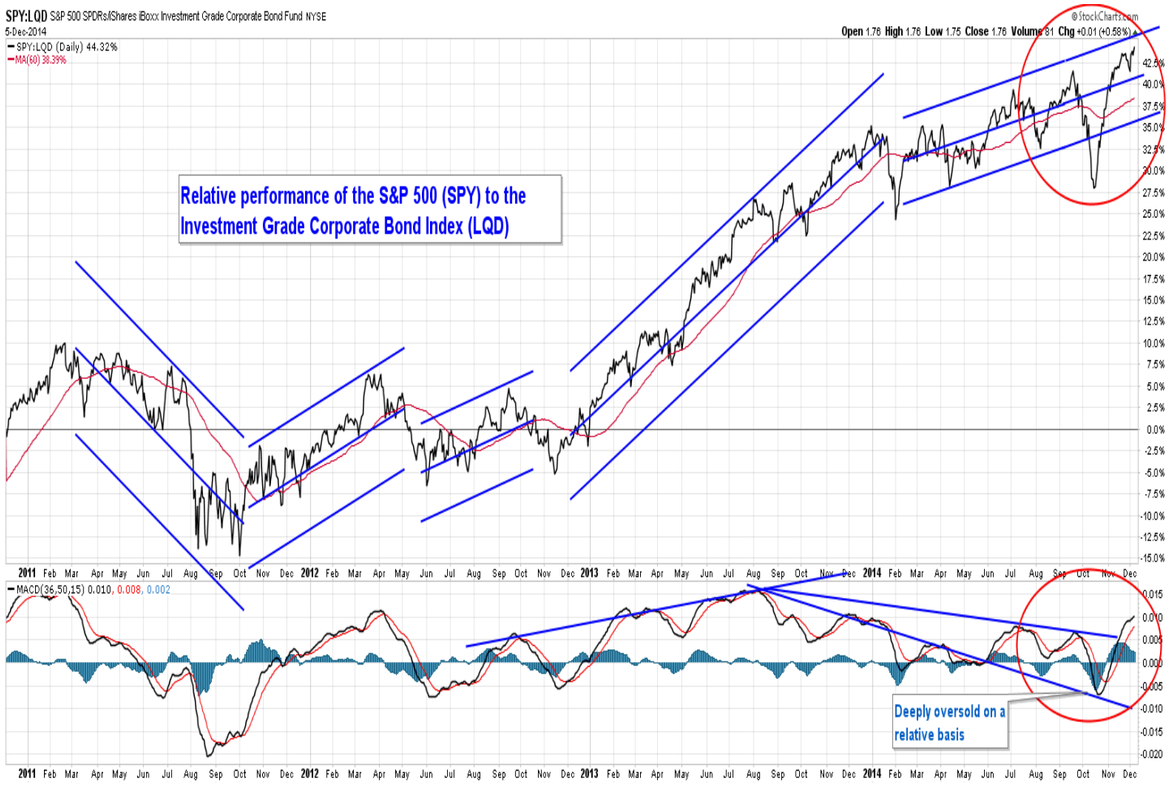
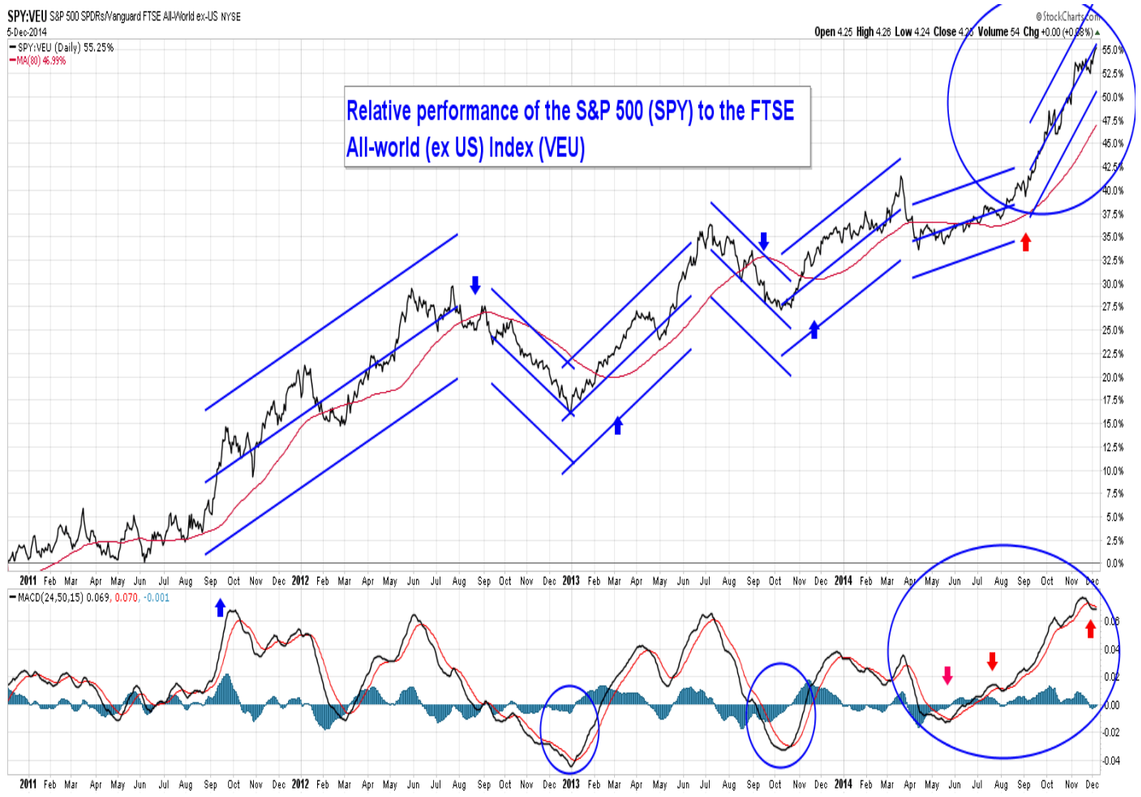
Asset Allocation and Relative Performance

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 equities has reasserted itself in both trend and momentum. The weakened momentum of equities took a sharp turn in October as equities regained the trend of outperformance that has been in place for over three years. Reflecting the uncertain direction for investment grade corporate bonds shown on the prior page, I expect the trend going forward, while not without volatility, will continue to favor domestic equities and, for that reason, would begin to overweight equities relative to a long term strategic allocation.

On the right, in light of global economic weakness exacerbated by the situation with oil prices, U.S. equities are shown to be trouncing the broad international index. Be aware, though, that a turnaround is beginning to occur with the EuroZone and selected other countries. Unlike the U.S., where few sectors dominate for long, individual countries can show a longer trend worth paying attention to.





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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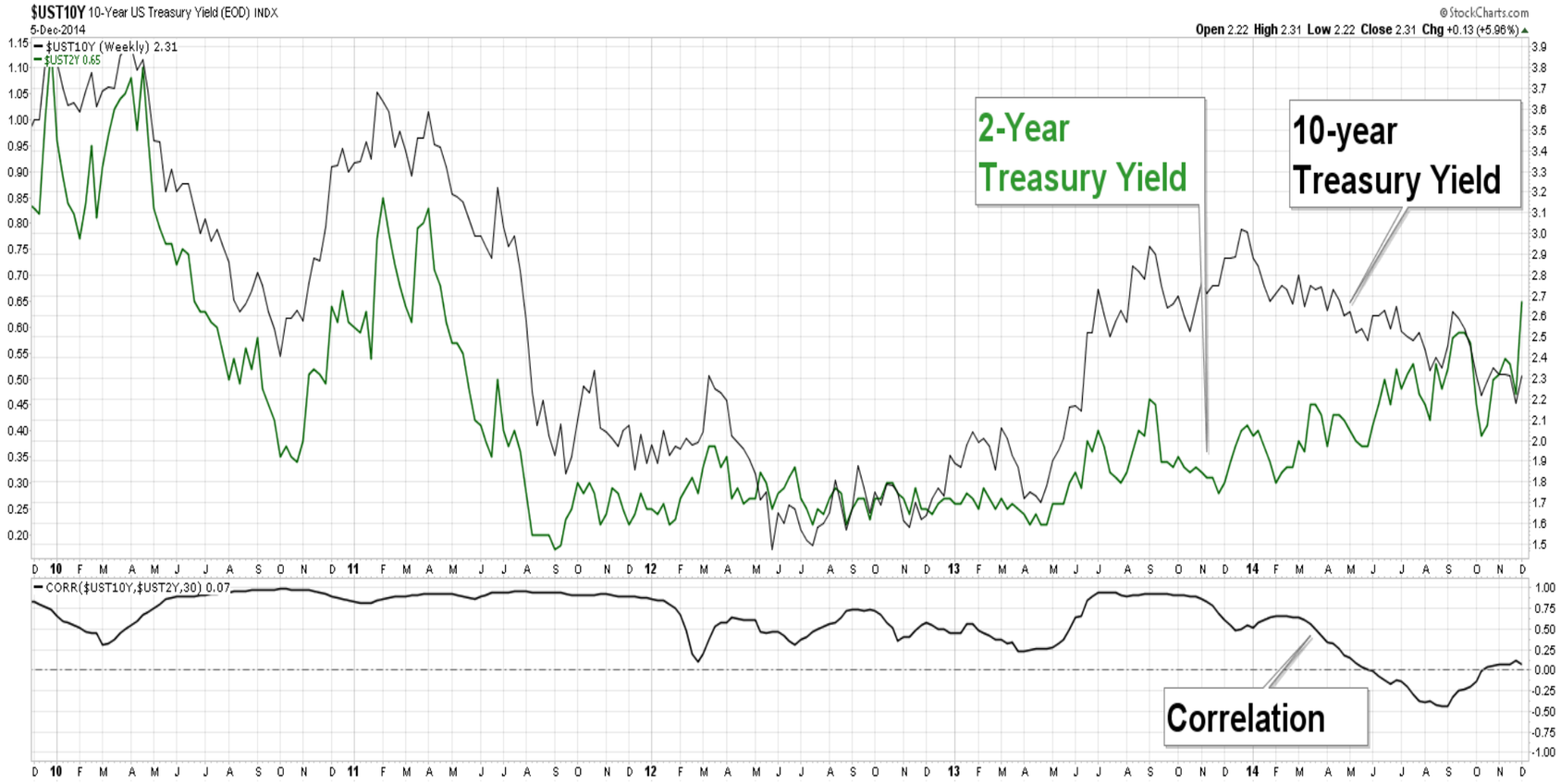
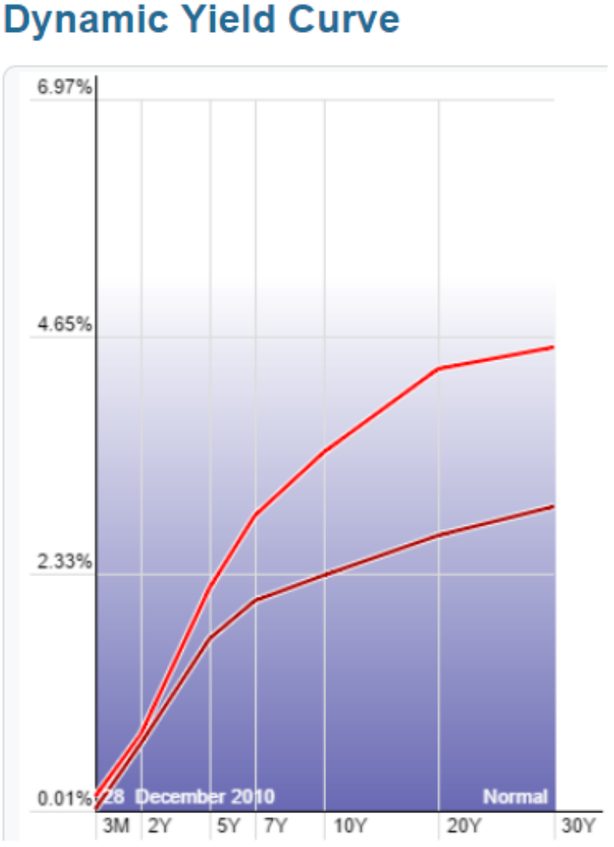
Interest Rates and the Yield Curve

Shown on the left below is a 5-year comparison of the 10-year Treasury yield to the 2-Year Treasury yield. What's interesting about the chart this month is the growing strength at the short end of the yield curve with more weakness at the longer, signaling further flattening of the yield curve. Typically, the flattening of the yield curve suggests slower economic growth and that's very much like the economic mood today (not recession-like, but slower still).

The higher short rate seems to be reflecting growing anticipation of a Fed Funds rate increase, perhaps on account of the continuing improvement in the U.S. economy. On the other hand, the lower long rate, I think, has a more complex explanation that includes lower expected economic growth abroad and dollar strength as U.S. rates remain relatively high among developed economies. The decline in the longer rate provides ballast for bonds — as long as it lasts.

On the right is a snapshot of the yield curves at the beginning of 2011 (red top curve) and today (purple bottom curve). As a flat yield curve is associated with a recession, the flattening of the curve since 2011 (continuing this past month) provides some level of concern though we have a long way to go before we reach the flatness typical of recent recessions.





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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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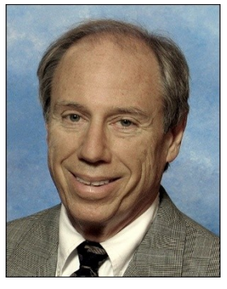
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