Lane Asset Management

Stock Market Commentary

October 11, 2015

Market Recap for September and Early October 2015

U.S. equities fell over 2.5% in September but recovered strongly in the beginning of October for a net change of about +2.4% for the combined period. The market was relatively stable through the first 3 weeks of September until the Fed, postponing its anticipated rate increase citing concerns over global growth and low inflation, began a slide. This was then reinforced by a sell-off in health care following a speech by Hillary Clinton to "stop price gouging" by drug companies. Immediately thereafter:

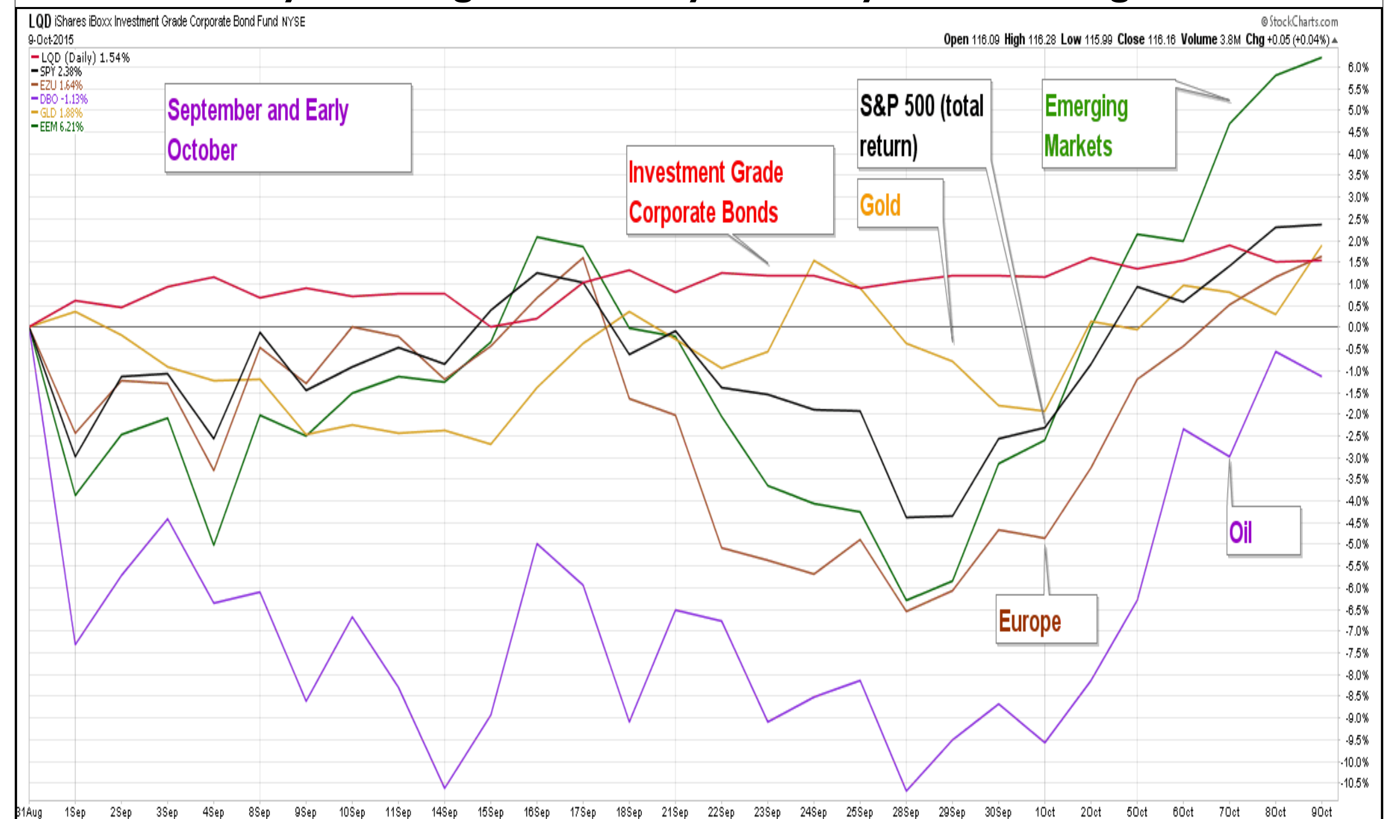
- Bellwether Caterpillar slashed its revenue forecast for 2015 and cut up to 10,000 jobs,
- The third estimate of Q2 GDP was reported with a 3.9% annualized gain, as expected much better than Q1, but below the 4.3% gain from Q2/2014,
- The U.S. trade deficit widened sharply on dollar strength,
- The highest inventory to sales ratio since 2009 was reported which may lead to future GDP weakness as inventories are sold off,
- Business optimism was reported by Markit to be at one of its lowest levels since the beginning of the financial crisis, and
- China's manufacturing index was reported at its lowest level since March 2009.

Perhaps sensing that bad news was good news in that the Fed would be less likely to raise the Fed funds rate in 2015 despite Chair Yellen's more recent speech indicating her preference for a 2015 hike, the market began a recovery late in the month. Progress on, and then completion of, the agreement on the Trans-Pacific Partnership added to market optimism which was then followed by a manic reaction to the disappointing September jobs report that at first saw bad news as bad, then reversed to see this as reinforcing a possible delay in the Fed funds rate hike.

Market Outlook

As the charts that follow show, we are in a period of high volatility with no established trend in place. My sense on the fundamentals is that U.S. corporate earnings will be modest, at best, and that the global economy is indeed slowing. The U.S. elections are gearing up to be contentious, as always, with the potential for a government shutdown in December. As a result, central banks, including the Fed, are going to remain accommodative longer than was thought just a few months ago — although I think this will have limited impact without an accompanying, but unfortunately unlikely, assist from fiscal policy.

All things considered, I expect equity markets will remain volatile and, once they find their footing, advancing on a reduced trajectory with risk to the downside. As for benchmark interest rates, I see no driving force to cause them to be very much higher than they are today in the coming months.



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.

2015 PREDICTIONS (UPDATED)

As the year unfolds, I'll offer updates to my 2015 predictions. Here's where I come out as of October 11. 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.

Although the S&P 500 (SPY) had declined almost 5.5% YTD by the end of September, a recovery spike late in the month and in early October on the heels of a delay in an expected increase in the Fed funds rate and an agreement reached on the Trans-Pacific Partnership brought the index back to nearly par (-0.6%) for the year as of this writing. While small stocks lag the S&P, healthcare and technology (despite their recent beating) and consumer discretionary are still ahead of the S&P YTD. Energy , having gained considerably in recent days, still lags YTD.

While the next major test will come with 3rd quarter earnings reports, global economic weakness, a potential government shutdown, challenges to prescription drug pricing, persistent low inflation, and concerns about a potential Fed rate hike by the end of the year will be headwinds to improvement in equity prices. While my forecast of 8-10% for the S&P now seems optimistic, it seems I was right about the downside risk due to international considerations.

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.

While VEU fell over 4% in September, it bounced back strongly in early October on account of agreement being reached on the Trans-Pacific Partnership (see page 5). As of this writing, VEU is down only 0.7% for the year, a substantial improvement from last month's report and nearly the same standing as the S&P 500. While India remains ahead of the broad index, few other major countries are, exceptions being Italy, France and Belgium.

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 remained fairly stable since my last report, currently sitting at 2.12%, essentially where it began the year. My year-end forecast of about 2.5% is looking optimistic. Investment grade corporate bonds (LQD) gained ground since last month's report and are now down only 0.25% YTD, well below my 2015 forecast and, unexpectedly, ahead of the S&P 500.

While the preferred stock index (PFF) retains a positive return for the year (up over 2%), dividend-paying stocks and REITs have been weak.

With the Fed holding off its expected move in September with a rationale of persistent low inflation and global economic weakness, with the added potential of a government shutdown in December, I am not expecting an increase in the Fed funds rate this year.

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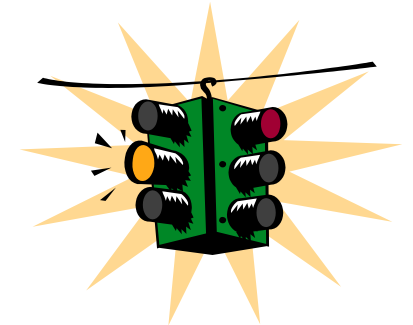
S&P 500 Total Return

While September proved to be a challenging month with the S&P 500 down over 2.5%, the first week of October has seen a significant reversal with the index gaining over 5% so far this month, this past week being the best in 2015. Since the world hasn't changed a great deal in the past week, we are left wondering whether the recovery is a statement by investors that the recent correction was overblown and nothing more than a release of pressure to be followed by a resumption of advancing trend or a technical "dead cat bounce," sometimes called a "bear trap," with further deterioration to come.



On the fundamental front, I remain concerned that the slowdown in global growth hasn't fully played out while, on the other hand, despite mixed messages, I am not expecting the Fed to raise the Fed funds rate this year or, if they do, for it not to have a great impact on the market.

With price having risen above the 50-day moving average trend line, with the trend line turning up (visible on close inspection), with the bottoming momentum looking for a reversal, and with the surge in volume, on the whole, it's possible that the worst may be behind us. I would add exposure at this point, but pace my commitment on the continuation of the current trend.

SPY S&P 500 SPDRs NYSE
9-Oct-2015
SPY (Daily) 201.33
EMA(50) 198.41
SPY as a proxy for the S&P 500 Total Return Index
Open 201.38 High 201.90 Low 200.58 Close 201.33 Volume 107.1M Chg +0.12 (+0.06%)
Full STO %K(50,15) %D(15) 45.36, 43.63
Volume 107,069,240

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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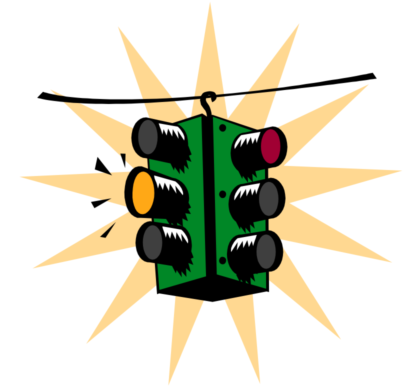
Portfolio Protection

Reflecting the concerns of most investors, this analysis chart has been prepared to assist 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 the weekly value of SPY (the ETF proxy for the S&P 500 index on a total return basis) for the last 3 years. The red line is a 50-week exponential moving average (50EMA) and the green line is a 25-week exponential moving average (25EMA). When the weekly price has fallen below the 50EMA, the 25EMA has crossed over the 50EMA, and the 50EMA has turned negative. these three critical criteria would be an important signal to me that it would be timely to reduce equity exposure, perhaps significantly so depending on the current state of the economy and market valuation. This has happened only twice in the last 20 years, though it has come close on 3 other occasions, including this past month. While it's true there can be false or short-lived signals, as may have just occurred , 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.

As shown below, following several weeks where 2 out of my 3 criteria have been triggered and the third was very close, the market staged a strong comeback in the last couple of weeks. Along with improving momentum, this has given us a little breathing room and offers a chance to put some cash that had been taken off the table as the conditions deteriorated, back to work. While I'm aware of the potential that this could be a "trap" as occurred in early September, with an expectation of continued Fed easing and modest but acceptable corporate earnings reports for the 3rd quarter, I'm prepared to be a little more constructive on the market. That said, we are truly in a period of high volatility reflecting the uncertainty of market conditions, so caution is advised.

Past performance is no guarantee of future results.

All-world (ex U.S.) Equity Index



No sooner had international equities fallen over 4% in September in a follow-through of last month's technical outlook, the first full week of October seemed to respond to the anticipated market capitulation with an advance of over 7%. The big winners for the period were many of the Trans-Pacific Partnership (TPP) countries (Viet Nam, Malaysia, Singapore, Australia, Canada, South Korea, Mexico) plus India and China. With the exception of India, all these countries were and remain laggards against the broader international index for the year, some substantially so. Therefore, it's hard to tell whether this was a technical correction of deeply oversold positions motivated by the agreed commitment for the TPP reached on October 5th, or something that can be sustained. On account of the fact that it will take some months for the respective countries to approve the agreement and on account of concerns over global growth that might have not fully played out, I would lean on the side of caution by limiting exposure to these countries and would do so on a very selective basis.

From a purely technical perspective, the recent action certainly looks promising, but we'll need more time to see if the trend actually reverses. We're now just above the support/resistance price of $45 that has been so meaningful in the past. Perhaps we'll know more by the end of October. Meanwhile, a measured allocation to selected countries in Asia looks like it could be worth the risk.

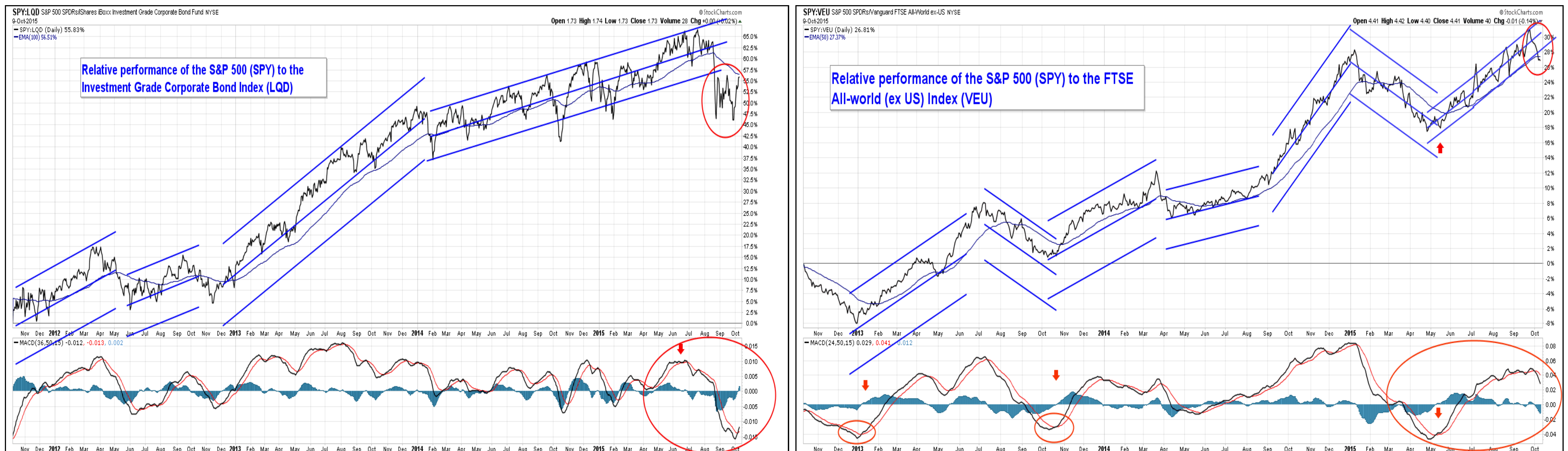
VEU is a Vanguard exchange-traded fund designed to match the experience of the FTSE All-world (ex U.S.) Index. Its prospectus can be found online. As of 12/31/14, VEU was allocated as follows: approximately 19% Emerging Markets, 46% Europe, 28% Pacific and about 7% Canada. **Past performance is no guarantee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

Asset Allocation and Relative Performance

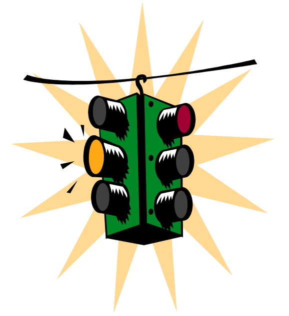
Asset allocation is the mechanism investors use to enhance gains and reduce volatility over the long term. One useful tool I've found for establishing and revising asset allocation comes from observing the relative performance of major asset sectors (and within sectors, as well). The charts below show 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, we have a highly volatile picture with equities taking the lead in the first week of October. Even though the trend has not yet reflected the recent surge in equity outperformance, momentum appears more than ready to swing in favor of equities. Potentially working against the continuing equity strength would be continued weakness in benchmark interest rates (which would keep the value of LQD rising) and also, if it should happen, unexpected weakness in 3rd quarter corporate earnings. This is where we will keep a watchful eye this month and next.

On the right, the outperformance of domestic equities over international may be coming to an end if, as suggested last month, the oversold condition of emerging market equities, boosted by the impact of the recent agreement on the Trans-Pacific Partnership, is sustained. Certainly the weakness in the momentum would suggest at least a short period of outperformance for international equities, especially those affected by the TPP. That said, while I'm prepared to have some exposure to selected international markets, I would limit my exposure until we know more.

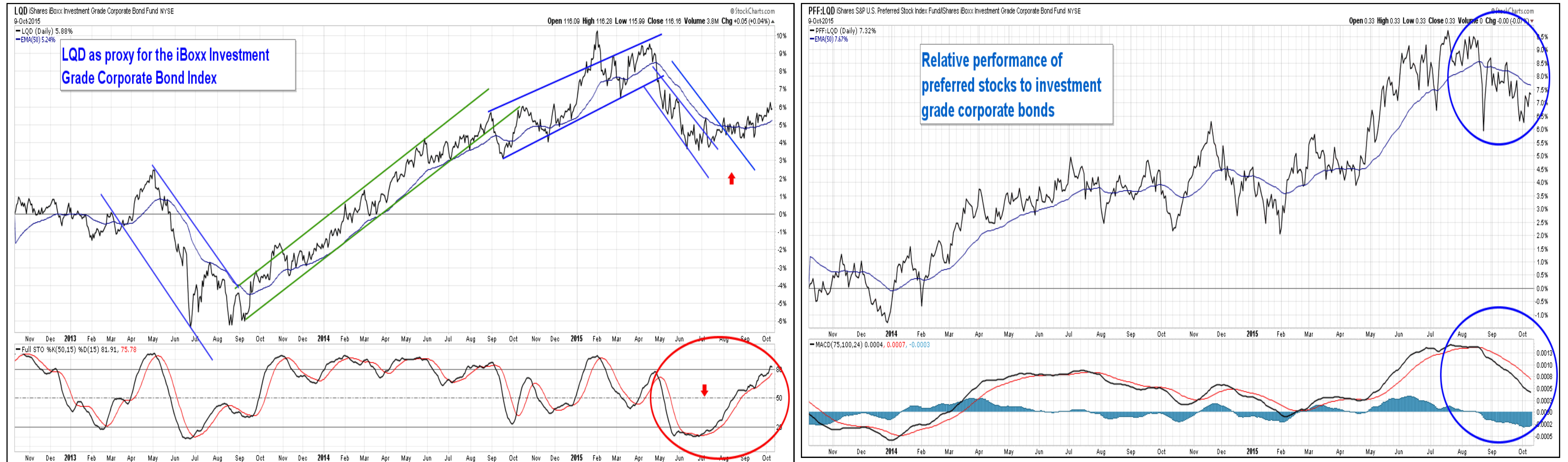


SPY, VEU, and LQD are exchange-traded funds designed to match the experience of the S&P 500, (with dividends), the FTSE All-world (ex US) index, and the iBoxx Investment Grade Corporate Bond Index, respectively. Their prospectuses can be found online. **Past performance is no guarantee of future results.**



Although it makes a technical analyst like myself feel good when a trend reversal follows through and is confirmed by momentum, I had expected the benchmark 10-year U.S. Treasury to slowly rise as the Fed came closer to increasing the Fed funds rate, thereby lowering investment grade corporate bonds (LQD). While it looked like that might have happened in September, once the Fed took a pass and left some doubt whether it would take action this year, LQD pushed higher. Judging by both the trend and the momentum, it looks like we can continue to expect further improvement in LQD for now, though this will come to an end once the 10-year yield begins to rise. We just don't know when that will be.

This was another weak month for the preferred stock index (PFF) relative to LQD, not so much on account of weakness in PFF itself, but on account of the stronger move by LQD. This was anticipated by the weakening momentum first spotted in July that extended into August and now September. Query: did the market really see the Fed deferral coming? It certainly looks that way. In any event, though PFF is weakening against LQD, selected preferred stock issues continue to match LQD's performance or do better. Accordingly, I'm still favoring preferred stocks, especially selected individual issues.



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.**

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Interest Rates

Shown below are the 2-year and 10-year U.S. Treasury yields for the last two years. The 2-year yield might be taken as a proxy for the market's opinion about what will ensue for the Fed funds rate. The 10-year yield is a reflection of not only domestic attitudes about changes in the Fed funds rate, but also the global interest rate environment and developing strength or weakness in the U.S. dollar.

As you can see, both the 2-year and the 10-year rose during September as the expected date for the Fed to increase the Fed funds rate approached, then fell back sharply when the Fed deferred action. The bounce back in early October may be only a technical re-action — time will tell.

The most interesting feature of the chart, I believe, is the continued downward move in the 10-year yield that began around mid-year and now rests at 2.12%, exactly where it started the year. I dare say this is a surprise to many analysts at this point, including me, where the rate was ex-pected to move higher through the year (and may still). However, with comparable government bonds yielding even lower for virtually all other major developed economies, it would take a major selloff of the U.S. benchmark bond or a serious spike in inflation before we would see much of an increase from here. Despite recent dumping by China and a few other countries, I'm not expecting either to occur.

Disclosures

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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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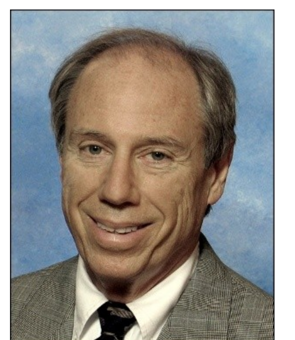

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