

Lane Asset Management

Stock Market Commentary

September 6, 2015

Market Recap for August and Early September 2015

U.S. equities suffered their worst weekly decline in over 4 years in August as the relatively modest but thrice executed devaluation of the Chinese yuan signaled a global economic slowdown too investors. One measure of Chinese manufacturing activity fell to a 6 1/2 year low, and into contractionary territory. Equity markets around the world have also been brought low with all major regions, save Japan, in negative territory for the year. Emerging markets, being dependent on oil and other commodity exports to China and elsewhere, are down over 17% for the year, matching the move in oil.

The second revision (of 3) in the Q2 U.S. GDP rose an annualized 3.7% . While sounding good, this may be nothing more than a catch-up following a 0.6% increase in Q1. The Bureau of Economic Analysis reports U.S. corporate profits rose \$47 billion in Q2 compared to losing \$123 billion in Q1. There's still some catching up to do.

Global macroeconomic issues are driving the markets. Here are some quotes reported by the WSJ from Christine Lagarde, Managing Director of the IMF, from last week's meeting with top finance officials from the Group of 20 largest economies:

"Downside risks to the outlook have increased, particularly for emerging market economies. Against this backdrop, policy priorities have taken on even more urgency since we last met in April." ... "A concerted policy effort is needed to address these challenges, including continued accommodative monetary policy in advanced economies; growth-friendly fiscal policies; and structural reforms to boost potential output and productivity."

Among the things Lagarde is arguing for is a delay in the increase to the U.S. Fed funds rate as it may lead to a stronger dollar which, in turn, will hamper repayment for emerging market dollar-denominated debt.

Market Outlook

Robert Shiller, Nobel prize winning economist from Yale, stated in a New York Times article on August 27th (parentheticals mine):

"It is entirely plausible that the shaking of investor complacency in recent days will, despite intermittent rebounds, take the market down significantly and within a year or two restore CAPE (cyclically adjusted PE) ratios to historical averages. This would put the S.&P. closer to 1,300 from around 1,900 on Wednesday (the 26th), and the Dow at 11,000 from around 16,000. They could also fall further; the historical average is not a floor.

Or maybe this could be another 1998 (when the market fell 20% in 2 months and then rebounded completely over the following 2 months). We have no statistical proof. **We are in a rare and anxious "just don't know" situation, where the stock market is inherently risky because of unstable investor psychology."**

Here's what I think about the emerging economic environment:

Oversimplifying greatly, the U.S. and, by extension, the world economy, has been supported by out-sized debt accumulation since at least the year 2000, first by factors that led to the global financial crisis in 2008 and then, with overlap, by Chinese infrastructure development that has led to their debt-to-GDP ratio being about 300%, over 3 times that of the U.S.

We are seeing now, and some saw earlier, that this debt-driven growth is looking more and more unsustainable, especially as it produces relatively little tangible foundation for future economic growth (Google "Chinese ghost cities," for example, or consider the lack of infrastructure development in the U.S. or the expenditures on the military as desirable as they may have been for other reasons). As debt levels are unwound, this will lead inevitably to a period of slower growth, at best, relative to what we've become accustomed

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to in recent years, all other things being equal. Meet the real “new normal.”

As Christine Lagarde suggests, escape from this new normal will require investment in infrastructure improvement (not the Chinese method), education, research, and health care – those things that will improve the lives of the middle and lower classes around the world that will, in turn, build up the consumer base, the ultimate source of economic growth.

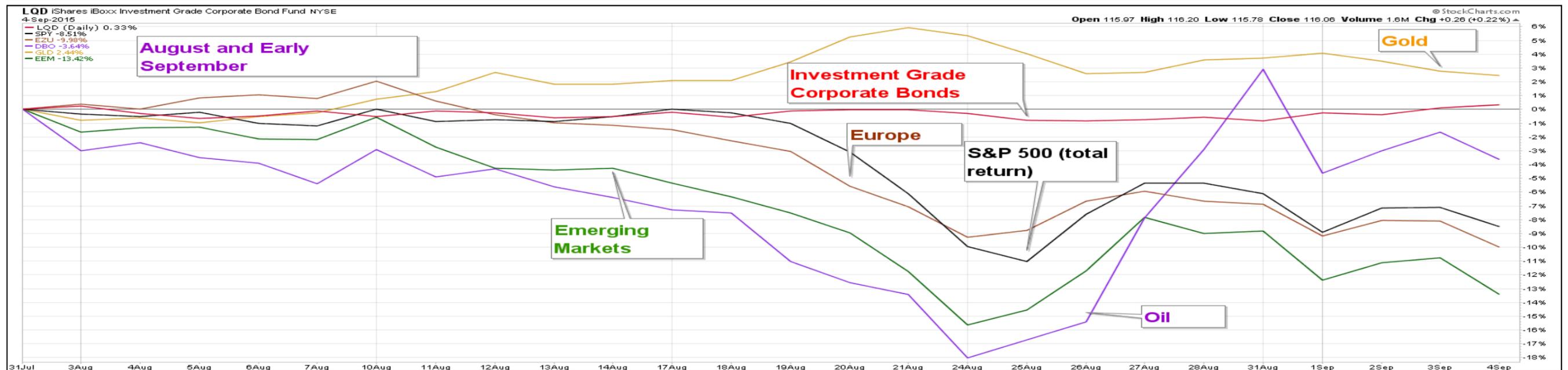
While the investment need not come from new debt, the timing wouldn't be all that bad given current interest rates. Nevertheless, as it stands now, political forces cannot agree on how this investment should come about and the situation basically continues to deteriorate.

As the timing for a political consensus is indeterminate and likely some time off, my suspicion is that equity markets, once the current correction has played out, will advance on a new lower annual trend of maybe 5%, more or less, and certainly well below what we've seen since the bottom of the current recession, with greater volatility and risk to the downside.

Opinions differ, however, even among the most well-regarded economists and investment analysts. This is just my view and, while it informs my investment decisions, I rely more heavily on the technical outlook (what investors are actually doing) for major moves in my portfolio management, especially when it comes to portfolio protection.

As for interest rates, U.S. Treasuries look to remain a relative safe haven and the dollar appears likely to remain among the strongest currencies, especially if other countries begin a round of devaluation to follow the Yuan. Therefore, notwithstanding the eventual increase in the Fed funds rate, I suspect the market-driven U.S. 10-year Treasury bond benchmark rate will remain close to its current range of 2% to 2.75% for a lot longer than most people thought likely at the beginning of the year (my estimate was 2.5%), with both upside and downside risk given the nature of emerging global developments.

As you will read on the following pages, long term trends have been broken. And, as a result, Shiller's words ring true to me. Caution is advised.



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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) entered a full blown correction with a collapse of over 12% from the high reached in July. With the index down about 5.4% YTD as of this writing, departure from its long term daily trend (see next page) and a developing breakdown from a long term monthly trend (not shown), a projection for how the index will end up by year-end would be, frankly, a guess lacking technical support.

With all but one company reporting, Zacks reports Q2 EPS for the S&P 500 were down 2.3% (up 5% excluding oil) and revenues are down about 3.5% (up 1.2% ex oil). But here's the kicker: Zacks reports earnings estimates for Q3 are -5.5% (-8.8% excluding finance and +1.6% excluding oil). If this estimate turns out to be accurate, equities could be in store for a difficult year-end.

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 fell nearly 8% in August and is now down over 7% YTD, 1.6% below SPY (similar to my estimated differential for the year though the absolute value is way off). The thesis that has come into focus for me this year is one of declining global growth with China as the harbinger of bad news—not so much on account of their modest devaluation of the Yuan, but more so on account of weakening economic readings. When I said China and India would lead the way this year, I didn't mean down though that's what has happened. While Germany has followed the rest of the index down, some countries in Europe, like Italy and Belgium, are actually holding onto a positive return so far this year, as has Japan.

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 2.13%, roughly where it began the year and I'm sticking with my year-end forecast of about 2.5%. Investment grade corporate bonds (LQD) lost a little ground since last month's report and are now down 1.8% YTD, well below my 2015 forecast and, unexpectedly, ahead of the S&P 500.

While preferred stocks (PFF) retain a positive return for the year (up over 2%), dividend-paying stocks and REITs were punished in August, both of which are now below even the S&P 500 for the year.

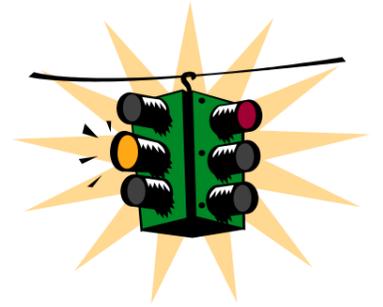
While I still believe the economic backdrop is not strong enough to warrant raising the Fed funds rate, especially if we are in the middle of global economic slowdown as I suspect, an increase in September may still come about if the Fed feels it needs to get one increase under its belt to keep markets "honest."

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S&P 500 Total Return

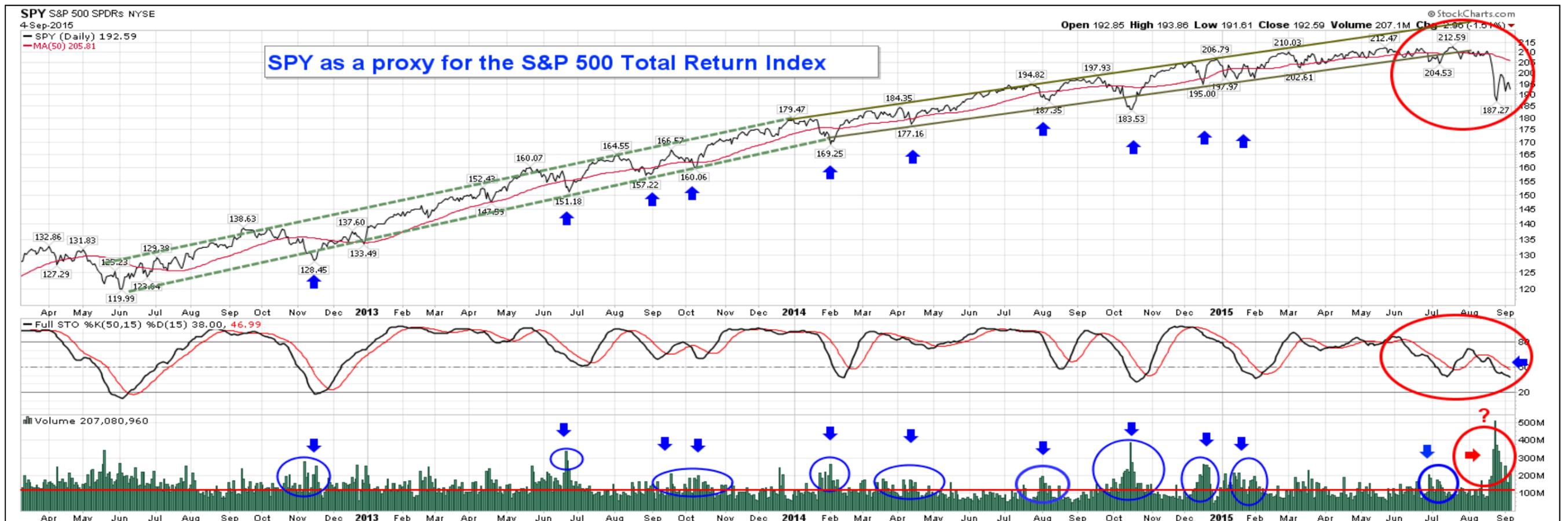


Having observed emerging weakness for months and warning about not going beyond a strategic allocation to equities, the S&P 500 (SPY) finally rolled over in August as I have been expecting, though much more aggressively than I had imagined. Whether the sell-off was due to concerns about slowing global demand on account of weakness in China or if news from China was only a catalyst for investors to adjust for market overvaluation, the bottom line is the same. As of this writing, the YTD total return of the S&P 500 index (SPY) is a negative 5.4%, and a negative 1.9% for the last 12 months (these percentages are volatile and highly dependent on the starting and ending points).



While I am not expecting a full-on collapse of the market, it's too early for me to speculate how long the current correction will persist. Certainly, on the basis of trend and momentum in the technical picture below, the near term outlook is negative. About the only potential bright spot is the volume spike which could be an indication of capitulation and a near term recovery based on prior experience. We'll know soon.

Some might see the current picture as a buying opportunity as it turned out to be over the last several years. For me, I would prefer to wait until we see reversal in trend or momentum. While this will mean missing the bottom, there's no guarantee that's what we are seeing today.



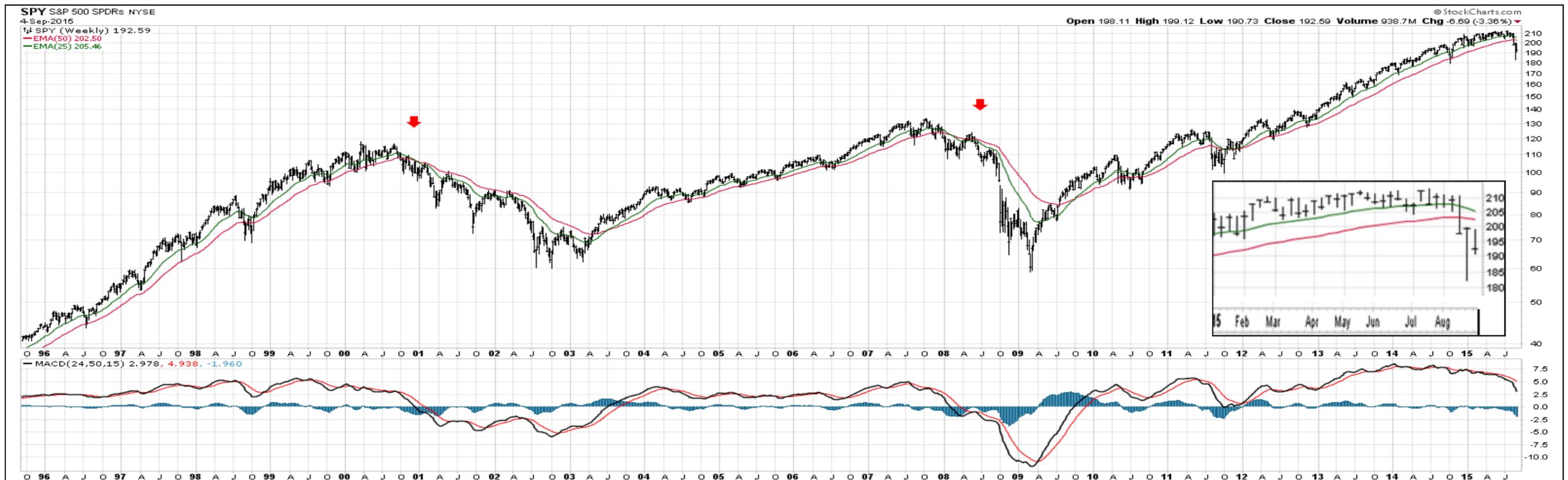
SPY is an exchange-traded fund designed to match the experience of the S&P 500 index adjusted for dividend reinvestment. Its prospectus can be found online. **Past performance is no guarantee of future results.**

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Portfolio Protection

Reflecting the concerns of most investors, this 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, for the last 20 years, 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 exponential moving average (50EMA) and the green line is a 25-week exponential moving average (25EMA). (I previously used a “Chandelier Exit” and simple moving averages, but the EMAs are smoother and more sensitive to recent data.) The red arrows show when the weekly price has fallen below the 50EMA, the 25EMA has crossed over the 50EMA, and the 50EMA has turned negative. Taken together, these three criteria would be an important signal that it would be timely to reduce equity exposure, perhaps significantly so depending on the current state of the economy and market valuation. 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, 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 the inset shows, as of the date of this writing, only two of my three criteria have been “triggered” though the 25WMA is headed toward crossing over the 50WMA. While I don’t believe this situation is strong enough yet to completely pull the plug on equities, given the macroeconomic concerns about a slowing global economy and the fullness of the market valuation that preceded the current sell-off, I have been in the mode of reducing equity exposure on a dollar-averaging basis, that is, slowly, since the middle of August. Additional reductions will depend on developments in the next couple of weeks, especially if the 50EMA trend turns negative.



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



International equities were swept up in the same maelstrom that affected the S&P 500, even more so. Asia and emerging markets were especially hard hit in August, Canada and Belgium, not so much. After retesting the line of resistance just above \$48 several times, the index succumbed to the deteriorating trend and momentum by falling past one line of support to the next just below \$44. On a technical basis, while both trend and momentum offer nothing positive, the huge spike in volume could be an indication of capitulation in the market and a harbinger of a reversal. To me, going after the broad index looks a lot like trying to catch a falling knife.



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If the weakness is due to slower global growth overall, emerging markets and commodity producers will be the most vulnerable. Investors looking for international exposure should concentrate on the developed markets in Europe and Asia. For me, especially in light of the relative performance shown on the next page, I would keep international exposure to a minimum until a reliable pattern of performance emerges. Eventually, places like emerging markets that are down over 50% from their peak relative to the S&P 500, will offer attractive returns, but I don't believe that time has come yet.



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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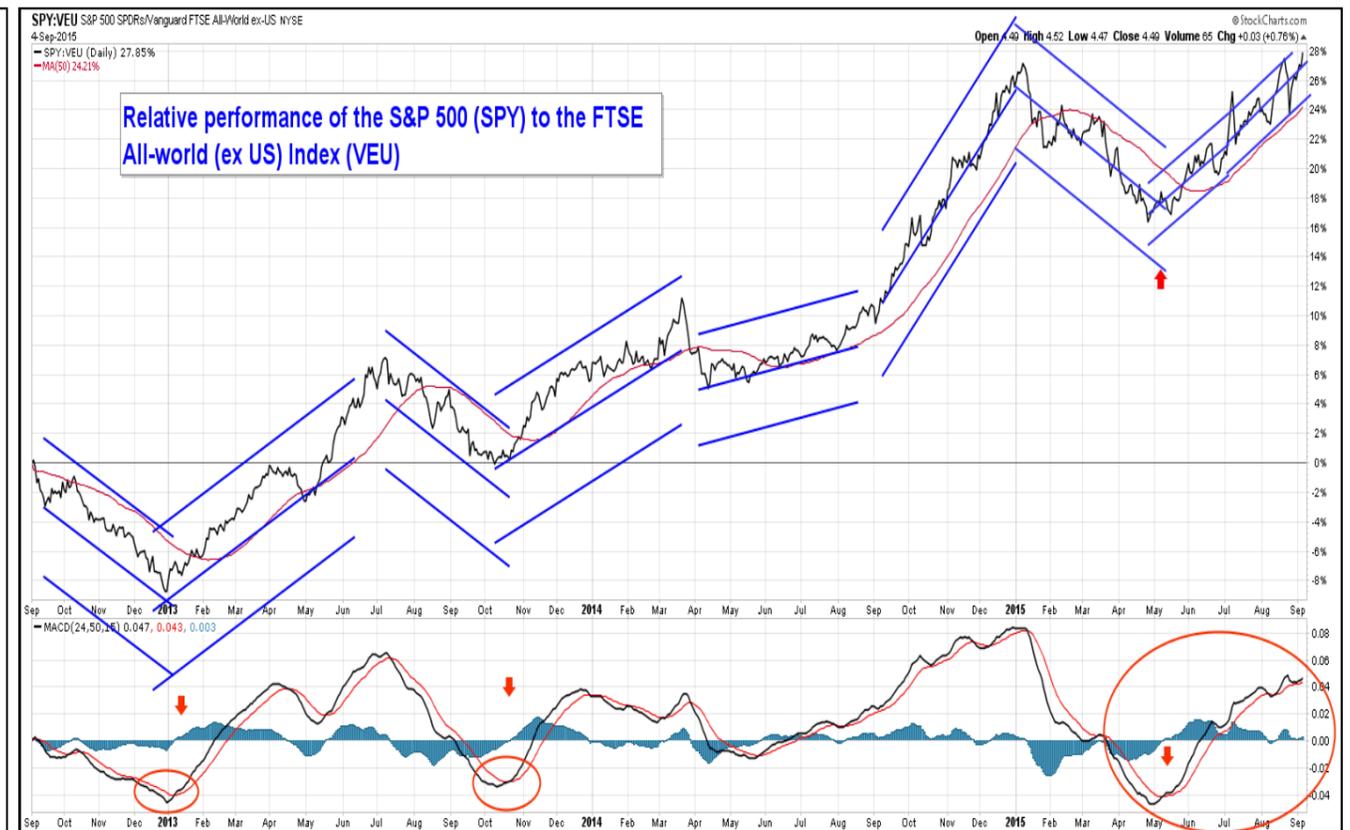
Asset Allocation and Relative Performance

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 weakening momentum for equities over investment grade bonds that I identified last month materialized into a full blown rout in August. While the trend has turned negative and the momentum is bottoming, despite the current technical picture, I believe the current pattern will be temporary on account of rising interest rates, once they emerge, and stabilization in equities. In other words, I would balance bond holdings with cash.

On the right, the outperformance of domestic equities over international came about on account of the significant weakness in emerging and commodity producing markets which has now extended to virtually all regions. While all technical measures favor domestic equities at the moment, the continuing losses among the emerging markets may potentially be seen as overdone, resulting a relative setback for the domestic equities at some point soon. If so, I'm not expecting it to last very long. I continue to underweight the broad international index.



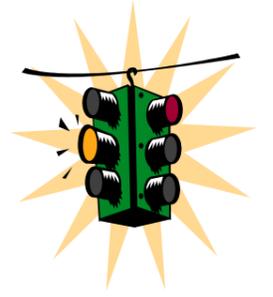
SPY, VEU, and LQD are exchange-traded funds designed to match the experience of the S&P 500, (with dividends), the FTSE All-world (ex US) index, and the iBoxx Investment Grade Corporate Bond Index, respectively. Their prospectuses can be found online. **Past performance is no guarantee of future results.**

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Income Investing



Last month, I spotted the reversing trend in investment grade corporate bonds (LQD) and suggested that it might not last if the 10-year Treasury yield began to rise, as I thought it might. Well, that did not turn out to be the case this past month as the yield on the 10-year fell slightly during the month. LQD remained basically flat in August and gained a bit in early September. But, I'm going to stick to my forecast and say again: if the 10-year Treasury yield is close to bottoming, as I think it may be, I'm not expecting much follow-through on the positive technical shift for LQD we're seeing at the moment.



This wasn't such a good month for the preferred stock index as it followed equities in direction though not nearly so in magnitude. This might have been indicated by the weakening momentum I spotted last month but, if so, it escaped me. Now, however, while momentum is clearly favoring relative improvement in investment grade bonds over preferred stocks, I'm not yet ready to abandon my preference for overweighting preferreds, especially selected 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.**

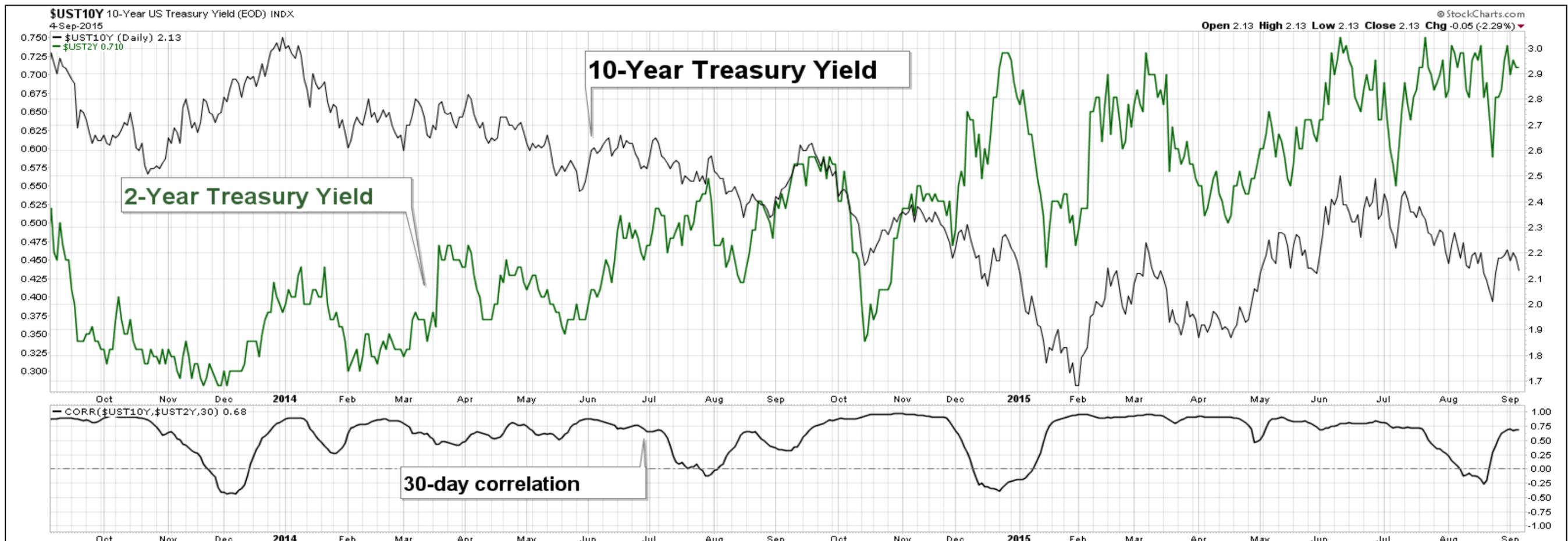
Interest Rates



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 the developing strength or weakness in the U.S. dollar. The correlation between the two is high over longer periods with periodic hiccups such as occurred in late July and early August.

As you can see, the 2-year yield fell sharply in August but then recovered just as sharply reflecting changing views regarding the revision in the Fed funds rate. By the beginning of September, following the August jobs report, the net view seemed to be a slight reduction in expectations for an increase in September.

On the other hand, the 10-year yield fell slightly to 2.13% as of the end of the first week in September, down from 2.2% reported last month. This is a continuation of a downward trend that began in July and the longer trend that goes back to at least January 2014, and reflects falling rates globally. Considering the market-driven nature of the 10-year Treasury yield and weak yields globally, I expect little movement as a result of U.S. Fed funds rate tightening, whenever that occurs.



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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

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