November 9, 2015

Lane Asset Management

Stock Market Commentary

Market Recap for October and Early November 2015

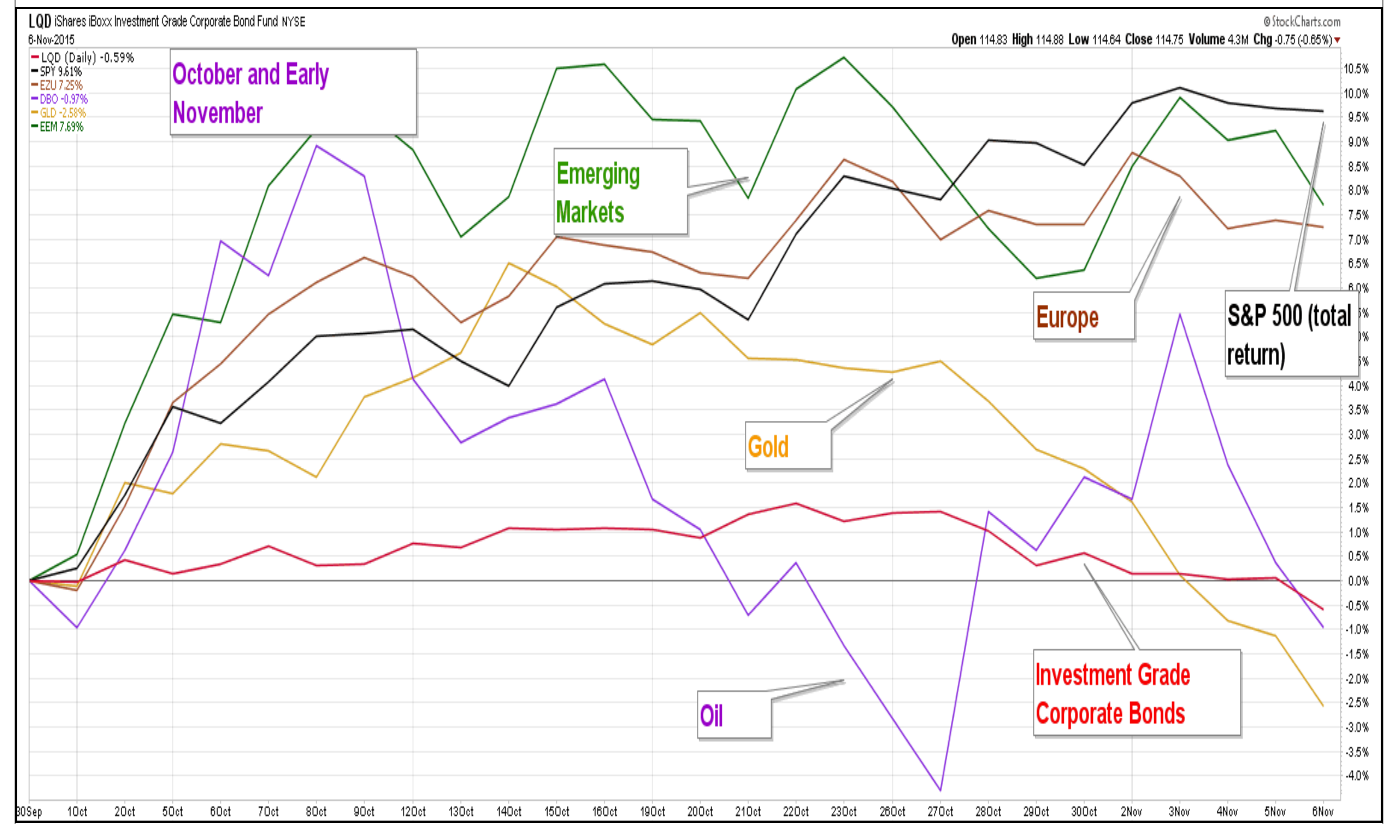
U.S. equities gained over 8.5% in October, the best month in over 4 years, and another 1.1% in the first week of November. And after all that, has risen just 3.7% year-to-date.

The month was a mixture of good and bad news. Here are some highlights:

- **October opened with a much weaker-than-expected jobs report for September, interpreted immediately as a sign that the Fed would be postponing the long-awaited rate hike until 2016.**
- **This was followed by a downbeat ISM Factory index report for September with the lowest reading in 2 years.**
- **A few days later, the ISM nonmanufacturing index report came out below expectations, though still holding onto an average for the 3rd quarter that was the highest in 10 years. The nonmanufacturing report is especially noteworthy since nonmanufacturing activity accounts for about 85% of all U.S. employment.**
- **As the month wore on, 3rd quarter corporate earnings continued to be reported. Despite losses from IBM and other noteworthy names, the overall reported earnings increase — excluding energy — was a very respectable 4.5%, and over 10% for companies whose operations are primarily domestic, according to FactSet.**
- **On October 27th, Congress and the President reached a budget deal that will take us past the national elections and should forestall a government shutdown in that period.**
- **On October 29th, the advance (first) estimate of 3rd quarter GDP was reported with an annualized gain of 1.5% but this was dragged down by inventory depletion while consumer spending and durable goods orders came in at very healthy rates.**
- **On November 4th, Chair Yellen called December a "live possibility" for a rate hike. The market took it in stride.**
- **And on November 6th, the October nonfarm payroll report came out with a much better-than-expected jobs gain along with another tick down in the unemployment rate (to 5%), likely cementing a December rate hike.**

Market Outlook

As I indicated last month, my sense on the fundamentals continues to be that the U.S. and global economies are slowing. That said, growth is continuing, inflation is low, interest rates will still be low after any rate hike, and there's no recession in sight. I think we have a modestly growing equity market in store for the foreseeable future while bonds will be challenged. Risk to equities, if there is some, is probably still to the downside, but not enough to cause great concern as we sit today.



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.

With the extraordinary recovery of the S&P 500 in October, its best monthly performance in over 4 years, the index is now about 3.7% higher for the year at this writing. All my sectors have performed as well or better than the S&P 500 with the best relative performance coming from the technology and consumer discretionary sectors. While energy has made a strong recovery from its low earlier in the year, it still lags the S&P 500 by a considerable margin.

While overall S&P 500 Q3 earnings have been a weak –2.2% (according to FactSet) based on over 80% reporting companies, the picture is brighter when energy companies are excluded reversing the negative to a +4.5%. Supporting my concern about international considerations, companies (ex-energy) with over 50% of sales coming from outside the U.S. reported a blended earnings decline of 2.1% compared to companies with over 50% of sales coming from inside the U.S. reporting earnings growth of 10.1%! Of course, the strengthening dollar has a lot to do with that.

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 bounced back in October along with the S&P 500, but has drifted back since the beginning of the last week in the month. As of this writing, VEU is down 1.2% for the year, a slight weakening from last month's report. Few countries have outperformed the broad index, exceptions being Japan. Italy, France and Belgium. Stronger international results from select countries are reflected in currency-hedged funds.

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 moved up about 20 basis points since my last report, currently sitting at 2.34%. My year-end forecast of about 2.5% is looking good at the moment. Investment grade corporate bonds (LQD) lost a little ground since last month's report with the increasing 10-year yield, and are now down about 1.2% YTD, well below my 2015 forecast, about the expected differential relative to the S&P 500 total return.

While the preferred stock index (PFF) retains a positive return for the year (up about 3.4%), dividend-paying stocks and REITs have been weak, performing in line with LQD YTD..

While I previously felt we would not see a Fed funds rate hike this year, it appears Janet Yellen is ready to pull the trigger in December with support from an improving U.S. economy despite weakness abroad.

Lane Asset Management

S&P 500 Total Return

The emerging technical reversal spotted last month followed through with the best month for the S&P 500 in over 4 years and a nearly full recovery from the recent 12.5% correction from the prior high. We actually had four mutually confirming technical signals of recovery since the first bottoming in late August: the coincident volume spike (although it took time for this to play out), the double bottom test at about $186, the momentum reversal in early October and, finally, the reversal in the moving average trend in mid-October.

While nothing is guaranteed in this world, on the strength of the technical improvement in the charts and continuing improvement in the U.S. economy, even if it's slower than we would like, I'm prepared to move to a green light on the S&P 500 and support an equity allocation of at least as good as an investor's strategic (long term) outlook. That said, as I still believe global growth will be sub par, I am looking for a lower trajectory in the next phase of the developing trend. Looking at the chart below, it could be argued that a new, lower trend actually began some months ago with an overlap of the trend that was broken in August. <u>IF</u> this is the new trend, it's a little disconcerting since the channel is horizontal with no projected growth at all. Therefore, that's what I will be looking for in the coming months, namely, whether or not we can get and stay above recent highs of about $211 that have been tested several times this year without a break-through.

SPY S&P 500 SPDRs NYSE
6-Nov-2015
— SPY (Daily) 210.04
— EMA(50) 203.00
Open 209.74 High 210.32 Low 208.46 Close 210.04 Volume 110.5M Chg -0.11 (-0.05%)
©StockCharts.com

SPY as a proxy for the S&P 500 Total Return Index

Volume 110,471,472

MACD(50,75,20) 0.252, -0.597, 0.849

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.**

Lane Asset Management

Portfolio Protection

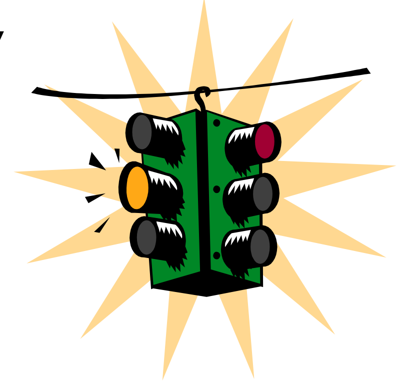
Reflecting the concerns of most investors, this analysis chart has been prepared to assist in making a decision about portfolio protection, in particular, protecting against a major market sell-off such as occurred in 2000 and 2008. The chart shows the weekly value of SPY (the ETF proxy for the S&P 500 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 anticipated last month, the improving momentum followed through and has moved the S&P 500 comfortably above both EMAs, taking us out of the danger zone for now. Given how quickly the market deteriorated in August, another correction (or worse) can't be ruled out. However, I don't see any cause for concern today as the market appears to have discounted a near-term Fed rate hike and a slowdown in global growth.

Past performance is no guarantee of future results.

Lane Asset Management

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



International equities followed the S&P 500 higher in October, breaking through resistance at $45 early in October and now poised to retest that price as support. The good nes is that positive price trend and momentum has returned to the index. More challenging but perhaps providing some opportunity is the volatility and dispersion among the various countries and regions. Among the best performing regions were those in Asia (including China (especially A-shares), South Korea, Singapore and Viet Nam). By far, the best performing opportunities were found in currency-hedged funds that benefit from a relatively rising dollar, including Japan and Germany, among others (note that these are not reflected in VEU).

Despite the improvement in VEU, I am still not comfortable making a major commitment to the broad index (see the next page) and prefer a more focused and tactical approach that is country-specific and takes into account macro considerations such as local central bank policy.

VEU Vanguard FTSE All-World ex-US NYSE
6-Nov-2015
Open 45.32 High 45.40 Low 45.08 Close 45.38 Volume 3.3M Chg -0.30 (-0.66%)
VEU (Daily) 45.38
MA(50) 44.48
VEU as a proxy for the FTSE All-world (ex U.S.) Index
Volume 3,303,204
MACD(50,70,25) -0.230, -0.388, 0.157
©StockCharts.com

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.**

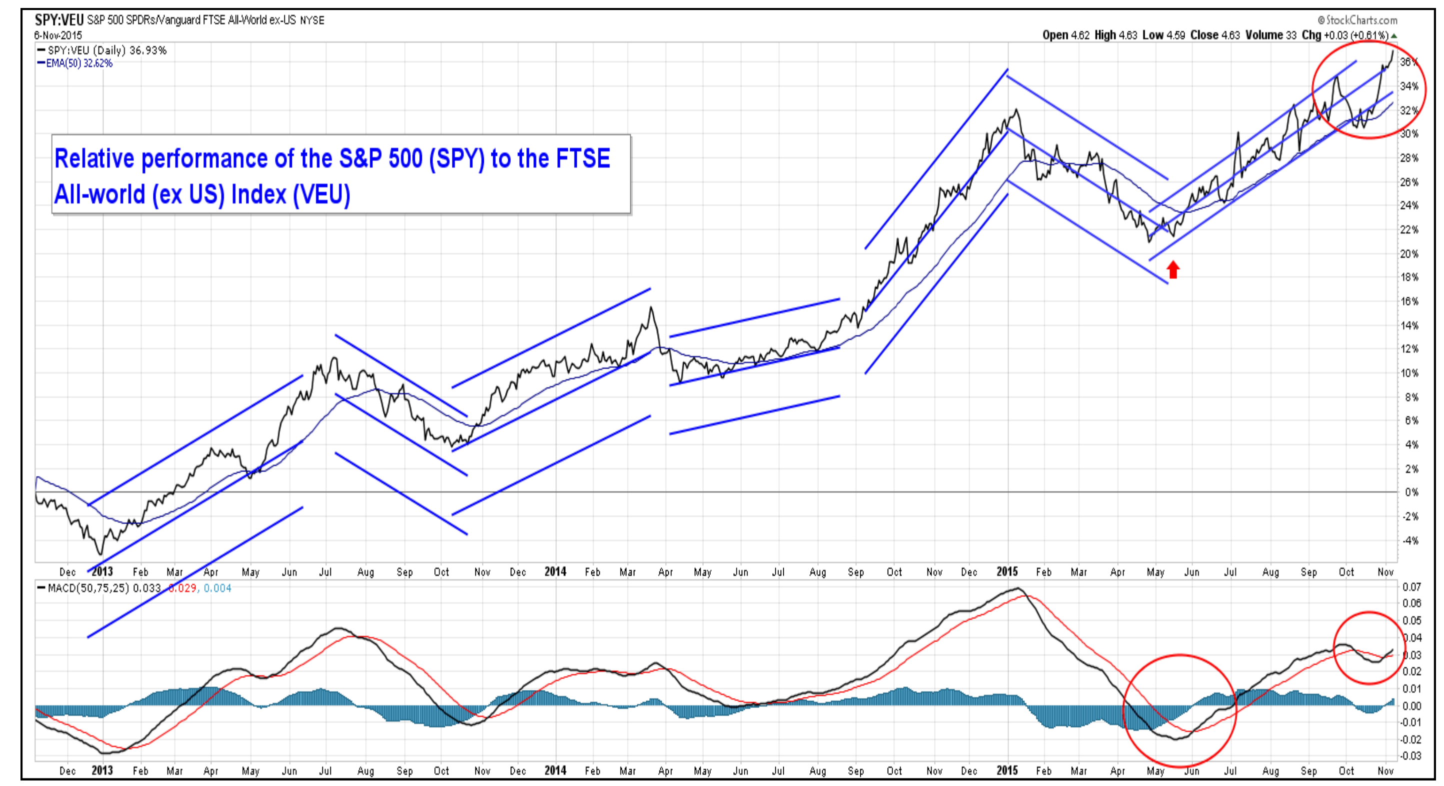
Lane Asset Management

Asset Allocation and Relative Performance

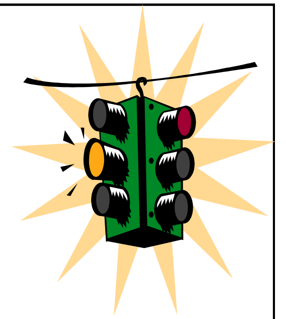
Asset allocation is the mechanism investors use to enhance gains and reduce volatility over the long term. One useful tool I've found for establishing and revising asset allocation comes from observing the relative performance of major asset sectors (and within sectors, as well). The charts below show 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 the extended recovery of equities over bonds that began in early October reflecting the double whammy of the sharp recovery of equities occurring at the same time that anticipation of a Fed rate hike in December pushed short and long term rates to higher levels (see page 8), depressing LQD. With the relative performance of equities back into the channel that began in early 2014, I expect it will remain there for quite a while to come — not so much on account of outstanding equity performance — which I don't anticipate — but on account of slowly rising interest rates that will hold back bond performance, particularly for LQD

On the right, the outperformance of domestic equities over international did not come to an end as I thought it might last month while my recommendation to limit exposure to the broad index turned out to be the right move regardless. And, although such a sharp relative price movement as we had in October is often followed by a reversal, even if one should occur, I continue to favor U.S. equities, many of which in the S&P 500 have significant international exposure in any event. That said, the strength in the dollar masks investment opportunities in selected countries on a currency hedged basis. Germany and Japan provide two examples where current and YTD performance has exceeded the S&P 500.

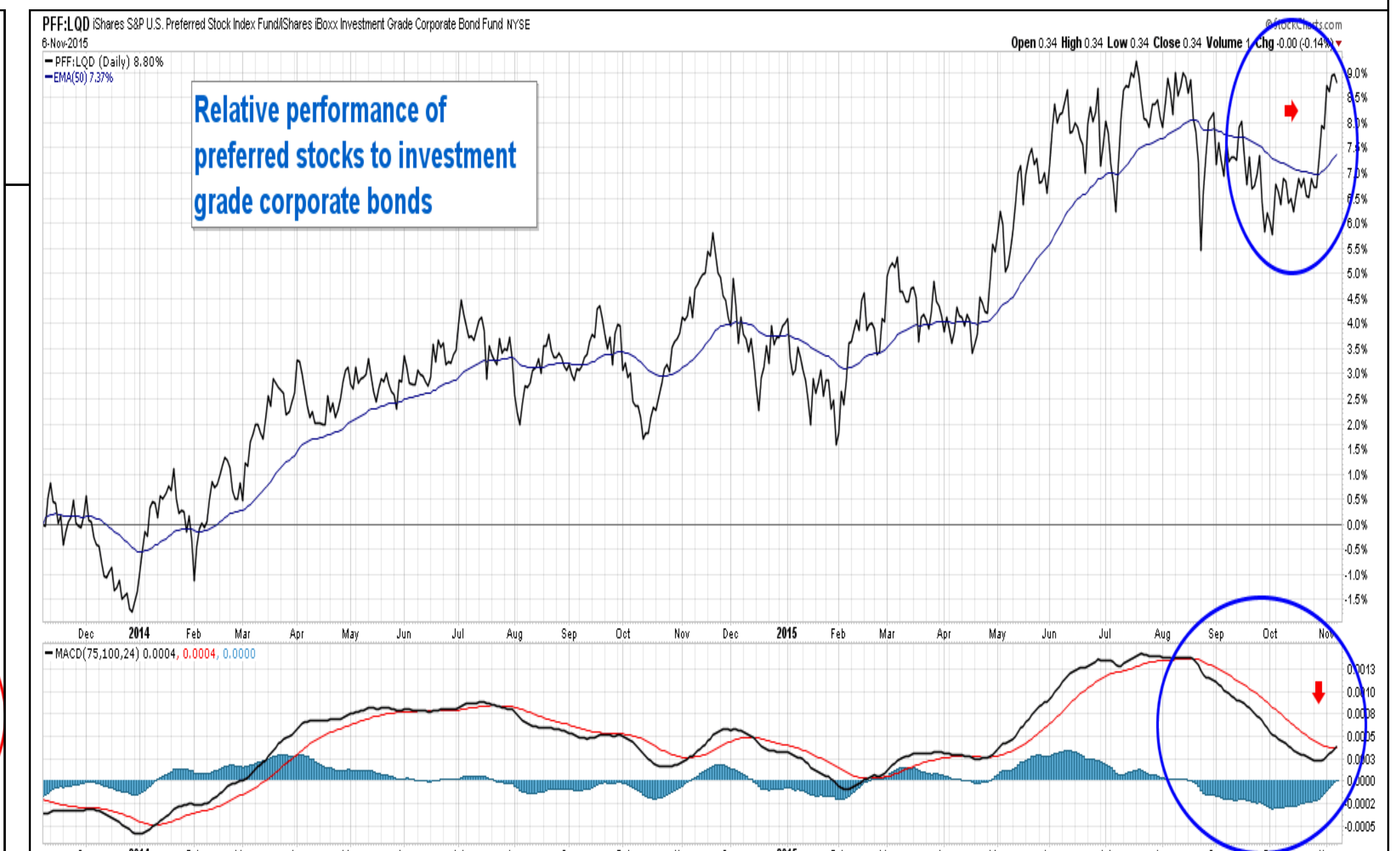


SPY, VEU, and LQD are exchange-traded funds designed to match the experience of the S&P 500, (with dividends), the FTSE All-world (ex US) index, and the iBoxx Investment Grade Corporate Bond Index, respectively. Their prospectuses can be found online. **Past performance is no guarantee of future results.**



Here's what I said last month: ***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."*** **Well, we now have a better idea when "it" will be, namely, at the highly anticipated Fed decision in December, and LQD has responded, as expected.**

Consistent with past experience, the breakdown that occurred in LQD did not carry over to preferred stocks where we now have a reversal in both trend and momentum on a relative performance basis. While such a sharp reversal tends to go through a correction, I'm going to go with past performance that preferred stocks will maintain their outperformance relative to bonds, especially now that it looks like we will be seeing a fed rate hike sooner than later. 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.**

Interest Rates

Shown below are the 2-year and 10-year U.S.Treasury yields for the last three 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 sharply during October as the expected date for the Fed funds rate hike seemed almost certain now to begin in December, absent unexpectedly weak payrolls in November.

The most interesting feature of the chart, I believe, is the continued downward trend in the 10-year yield that began around the beginning of 2014 with a volatile-looking reversal in 2015, now resting at 2.34%. The lack of net movement in 2015 prior to October has been a surprise to many analysts at this point, including me, where the rate was expected to move higher throughout the year. Now that a rate hike is on the table for December, it appears as if the anticipated increase in the 10-year is underway. That said, with comparable government bonds yielding even lower for virtually all other major developed economies, I still don't expect a major up move in the 10-year yield in the foreseeable future, especially if the dollar continues to strengthen and foreign sovereign debt remain at low yields.

$UST10Y 10-Year US Treasury Yield (EOD) INDX
6-Nov-2015
— $UST10Y (Weekly) 2.34
— $UST2Y 0.900
Open 2.20 High 2.34 Low 2.20 Close 2.34 Chg +0.18 (+8.33%)
2-Year Treasury Yield (left hand scale)
10-year Treasury Yield (right hand scale)

Lane Asset Management

Disclosures

Edward Lane is a CERTIFIED FINANCIAL PLANNER™. Lane Asset Management is a Registered Investment Advisor with the States of NY, CT and NJ. Advisory services are only offered to clients or prospective clients where Lane Asset Management and its representatives are properly licensed or exempted. No advice may be rendered by Lane Asset Management unless a client service agreement is in place.

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.

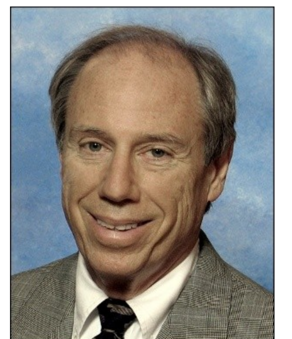
Investors should carefully review their financial situation, making sure their cash flow needs for the next 3-5 years are secure with a margin for error. Beyond that, the degree of risk taken in a portfolio should be commensurate with one's overall risk tolerance and financial objectives.

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.**

Periodically, I will prepare a Commentary focusing on a specific investment issue. Please let me know if there is one of interest to you. As always, I appreciate your feedback and look forward to addressing any questions you may have. You can find me at:

www.LaneAssetManagement.com
Edward.Lane@LaneAssetManagement.com

Edward Lane, CFP®
Lane Asset Management
Kingston, NY



Reprints and quotations are encouraged with attribution.