Retirement Income Solutions

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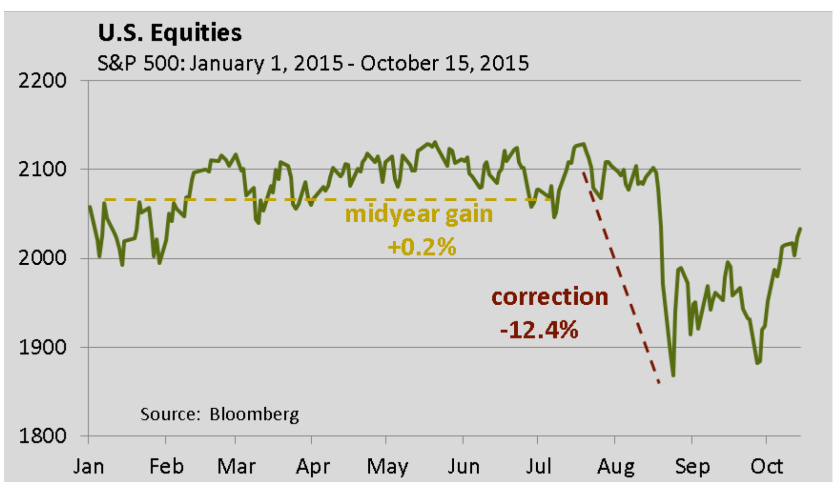
Finally a Correction

October 2015

Summary

After a flat first half of the year, the U.S. stock market realized its first 10% correction since 2011. Although this correction was overdue (and probably healthy), it is still hard to stomach. Five of the last six years generated double digit stock market returns, and investors have encountered almost no bumps in the road over the last four. The equity pullback was driven mostly by global concerns. Economic slowdown in China, continued turmoil in Greece, chaotic energy markets, and stagnant conditions in Europe threatened modest but steady growth in the U.S.

- In the first half of the year, **the U.S. stock market saw many record highs but not meaningful gains**. After 14 record highs between January and June, the maximum gain for the year was 2.9%.
- Economic conditions continue to be quite mixed since growth is steady but profits have slipped. The Fed continues to delay even a token increase to interest rates due to global financial stresses. Whenever the first rate hike comes, monetary policy will still be very accommodative.
- In many ways, **2015 looks like a sequel to both 1998 and 2011**. In all three periods, solid economic growth in the U.S. was overshadowed by global financial stresses, resulting in a stock market pullback. Oil fell sharply, and the Fed reversed course. The prior two cases resulted in strong stock market growth in the next year, but sequels are seldom as good as the original script.
- For four years, volatility in financial markets has been unusually low, and the pullback in stocks in August and September was likely a return to the norm.
- **October has the reputation of being a turnaround month for stocks**. This tendency is even more pronounced after summer stock weakness. In 11 of 12 years when August and September were negative, the fourth quarter of the year has been strongly positive, generating a median return of 9.2%.



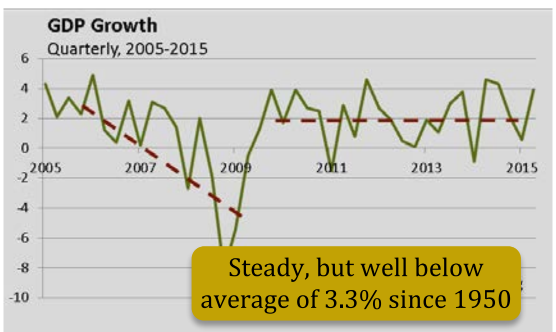
In May, we reduced client exposure to equity markets. The bull market was clearly well-aged, and there had been a loss of momentum in stocks. Valuations were relatively high, and corporate earnings seemed to have peaked. The prospect of a less-friendly Fed seemed a likely catalyst for increasing volatility. Since that time, a series of global financial stresses generated a stock market pullback of 12%. Although there is risk that the market continues its downward slide and becomes a bear market with greater losses, that outcome seems unlikely at this time. **Accordingly, we moved clients back to their maximum equity position on October 13; the S&P 500 was roughly 5% lower than our May exit.**

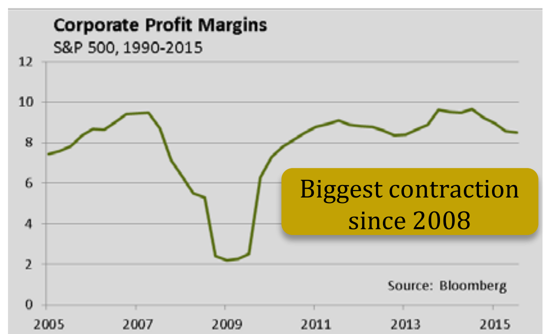
Economic Conditions are Mixed

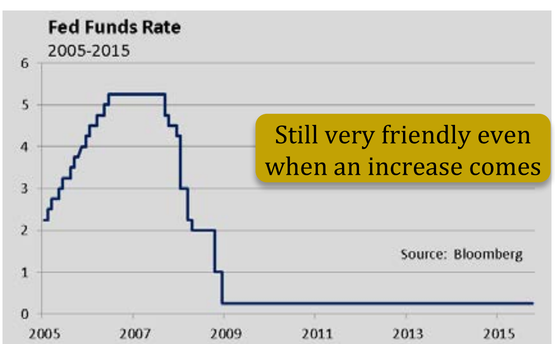
The U.S. economy continues to grow at a modest pace, particularly when compared to prior recessionary recoveries. Economic growth (GDP) has hovered near two percent for the past several years. Although the second quarter was a disappointing 0.6%, the third quarter recovered nicely at 3.9%. Historically, GDP growth after recessions has ranged between 4-6%.

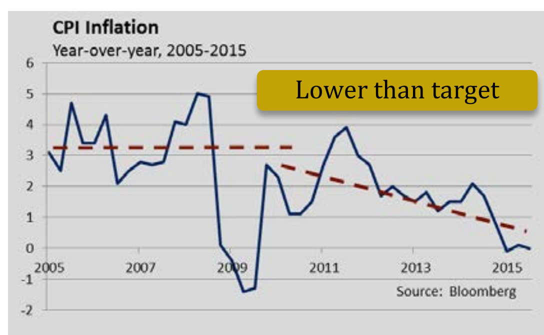
Despite modest growth, corporate profit margins hit new highs in 2013 and 2014 but in 2015 suffered their biggest contraction since the 2008 financial crisis. Part of the decline in profits was caused by appreciation of the dollar (which reduces the value of foreign earnings); another significant factor was profits of energy companies, which have suffered from lower oil prices (the lowest in the past decade except for the depths of the financial crisis). Many other industries, however, benefit from the lower costs associated with cheaper oil. Jobless claims reached the lowest level in 40 years, resulting in the most recent unemployment figure of 5.1%.

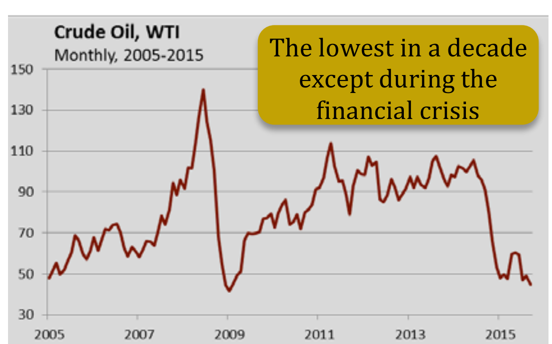
The Fed remains highly accommodative despite headlines of "tightening of monetary policy." The difference between "less easing" and "tightening" is more than just nuance. The Fed funds rate, which is effectively the rate at which banks lend to one another on an overnight basis, is still extremely low and friendly towards economic growth. Slow growth in the rest of the world combined with low oil and commodity prices has kept inflation in check.











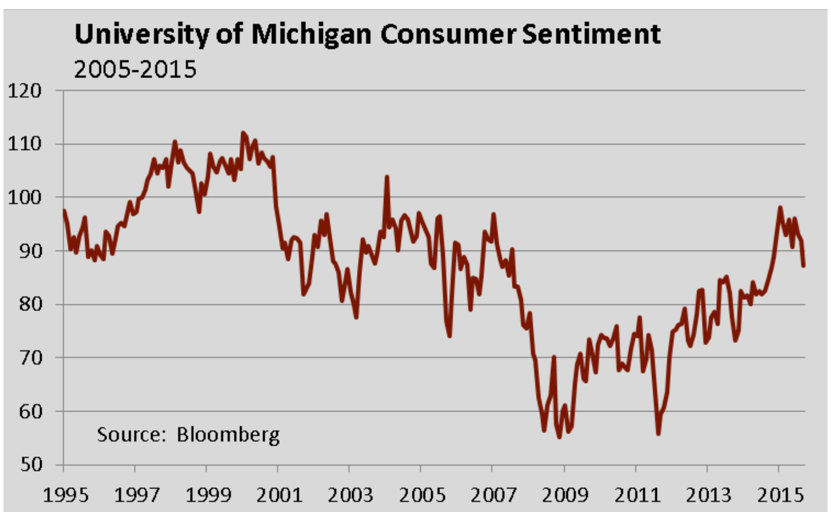
Ending Four Years of Calm

Since 2011, volatility in financial markets has been extremely low. Although the pullback in stocks that occurred in August and September was swift and concerning, it is likely a return to the norm instead of straying from it. Typically, a 10% stock market correction occurs every 8 to 9 months, so the 4-year hiatus from stock market worries is not common. In fact, the duration of this most recent rally was the third longest since 1928, exceeded only by the longer periods of calm from 1990 to 1997 and from 2003 to 2007. Interestingly, both of those extended upswings ended in the month of October.

Another measure of calm is the number of days where the stock market moves by more than 1% in either direction (up or down). In January, we noted that such low volatility was unlikely to persist. During 2013 and 2014, only 15% of trading days saw a move of 1% or greater in either direction. In August and September of this year, over 40% of trading days moved up or down by that amount.

Not only is four years of relative calm abnormal, it can create a less attractive investment environment. As investors perceive less risk, they often end up taking greater amounts of risk and are more surprised when those risks become reality. We discussed this in the May commentary, highlighting the risks of excessive optimism and complacency.

Warren Buffett addressed this tendency from a concurring perspective in his 1990 letter to shareholders, "The most common cause of low prices is pessimism - sometimes pervasive, sometimes specific to a company or industry. We want to do business in such an environment, not because we like pessimism but because we like the prices it produces. It's optimism that is the enemy of the rational buyer."



The Buffett concept of the dangers of optimism can be seen in the University of Michigan Consumer Sentiment Index, which effectively measures optimism (more specifically, it measures near-term consumer attitudes on the business climate, personal finance, and spending). Over the last 15 years, the two worst periods for the stock market (2001-2002 and 2008-2009) occurred after sustained periods of high optimism. Consumer sentiment hit a recent high of 98 in January of this year, but fell back to 87 in September. Lower optimism means less complacency, which should increase the chances of positive stock market returns in the coming year. Regardless, the steady markets from the past few years are gone, and, although it is uncomfortable, some stock volatility is probably more normal and healthy for markets.

October is the Most Interesting Month of the Year

In analyzing the seasonality of the stock market, October is by far the most interesting month of the year. It has the notoriety of hosting numerous market crashes as well as the reputation for being a turnaround month.

According to research by Stock Traders Almanac, market crashes occurring in October included 1929, 1978, 1979, 1987, 1989, 1997 and 2008. The largest weekly drop in history of 18% occurred in October 2008. Stock Trader Almanac describes this unique duplicity, "It is no wonder that the term 'Octoberphobia' has been used to describe the phenomenon of major market drops occurring during the month… But October has become a turnaround month – a 'bear killer' if you will. Twelve post-WWII bear markets have ended in October: 1946, 1957, 1960, 1962, 1966, 1974, 1987, 1990, 1998, 2001, 2002, and 2011."

Why is October so important? The annual calendar tends to put a spotlight on this time period. Markets begin to analyze whether expectations for the year will be achieved or not. This applies to the earnings of individual companies, corporate earnings in aggregate and broader economic indicators such as GDP growth and inflation. October also marks the fiscal year-end for most mutual funds. This is important since the stocks held by mutual funds on October 31 are included in the annual report. Often, mutual fund managers may re-position portfolios to take advantage of gains or losses in the portfolio or to present a certain narrative to investors.

Which October will show up this year? Obviously, each year (including this one) is different. And although the market has finally realized some volatility, we are far from a bear market at this point. October cannot be a "bear killer" without a bear. However, this October may mark a similar but smaller turnaround.

Fourth Quarter Stock Market Returns

S&P 500, 1950-2014

	Median return	Average return	# of years positive Q4	% of years positive Q4
Negative August + September	9.2%	8.6%	11 of 12 years	92%
All years	6.0%	5.0%	54 of 65 years	83%

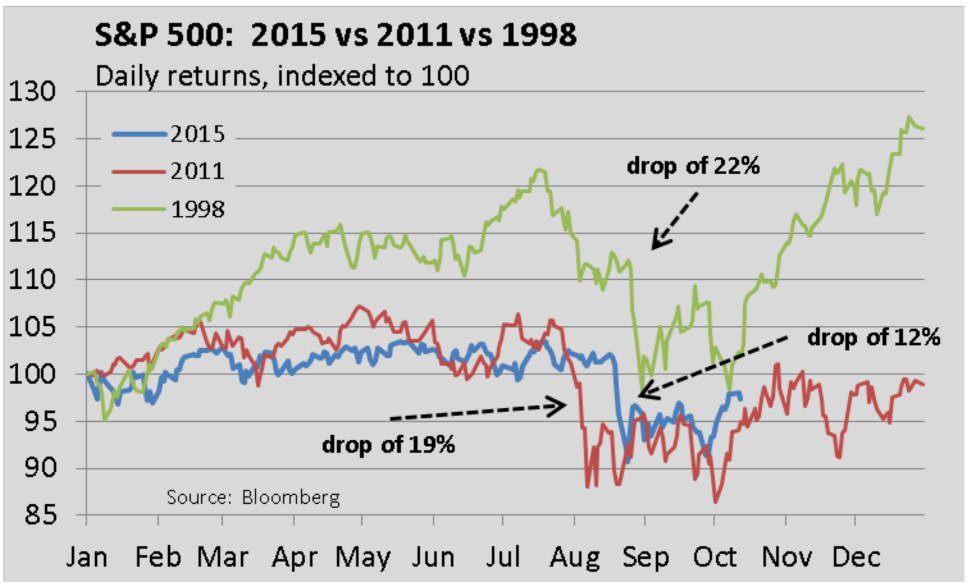
Source: Bloomberg

October also has the tendency to act as a turnaround month after periods of late summer weakness. The fourth quarter is typically the strongest quarter of the year, generating the majority of stock returns each year. Since 1950, the median return for stocks is 6.0% in the fourth quarter (almost half of median annual returns) with positive returns 83% of the time. Weakness in August and September often strengthens that tendency. In years where both August and September generate negative returns, stock returns in the fourth quarter tend to be higher, with a median of 9.2%. In fact, of the 12 years since 1950 with negative August and September returns, 11 of the 12 instances saw positive returns in the subsequent fourth quarter.

Analogies with 2011 and 1998

There are several similarities between the current environment and those of 2011 and 1998. In all three periods, solid economic growth in the U.S. was overshadowed by global financial stresses, resulting in negative stock market returns and increasing uncertainty.

In 1998, world markets were struggling to recover from the prior year crisis in Asian currencies when dramatically lower oil prices triggered a similar currency crisis in Russia. The stock market flattened in the middle of the year before falling 22% in the late summer. The Fed had tightened monetary policy in the prior year, but worries over global financial markets outweighed solid GDP growth in the U.S. The Fed reversed course and cut interest rates three times in the fall. It took the stock market six weeks to confirm the worst was over, and it rallied to new highs by the end of the year.



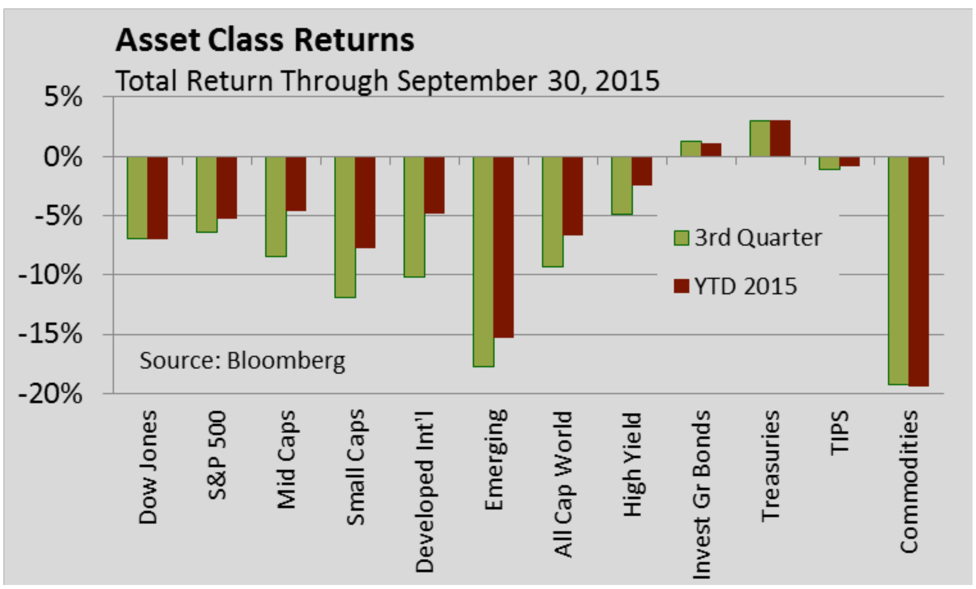
In 2011, world markets were impacted by the debt crisis in Europe. Fear of default grew rapidly as several countries with large debt burdens encountered a tough combination of weak economic growth and rising interest rates. Oil prices fell by 30%, and the stock market moved "sideways" until late summer before falling by 19%. The Fed's second quantitative easing program (QE2) ended in the summer, but the Fed was forced to announce another round of monetary easing dubbed "Operation Twist." After two months of volatile markets, the stock market got back on track, rallying in the fourth quarter and reaching recent highs in early 2012.

	2015	2011	1998
Global stress	China growth / currency + Greek debt turmoil	European debt crisis	Asian & Russian currency crises
Oil prices	-33% over 2 months	-29% over 5 months	-30% over 2 months
Monetary policy	After concluding QE3, the Fed repeatedly delayed planned interest rate increases.	After concluding QE2, the Fed announced a new monetary easing program.	After a tightening monetary policy, the Fed cut rates three times due to global financial stress.
Correction	-12% ?	-19%	-21%

This year, the environment and markets seem to have unfolded in a similar fashion. Greek debt problems resurfaced including a potential exit from the euro, and worries about China's growth dominated headlines. The Chinese government controls the yuan currency value and announced significant devaluations over three successive days, destabilizing many stock and bond markets. Oil fell by 33% from a recent high in the spring, continuing bigger declines from 2014. The stock market traded sideways for the first half of the year, barely squeaking out a positive return over 6 months, before falling 12% in the late summer. The Fed's latest monetary easing policy ended last year, and the Fed was widely expected to raise rates in 2015. However, global concerns continue to prevent the Fed from raising interest rates from a crisis level of zero.

Asset Class Returns

The U.S. stock market was barely positive for the first six months of the year. A sharp pullback in August and September resulted in negative returns year-to-date for U.S. stocks of –5.3%. Developed international stocks (Europe, Japan, etc.) fared slightly better but also generated negative returns of –4.8%. Emerging market stocks fell further with losses of –15.3% as China slowed and many of the commodity-oriented countries suffered from falling oil and commodity prices.



Bond prices were relatively volatile so far this year as well. Interest rates fluctuated significantly as evidenced by the 10-year Treasury bond rate which ranged between 1.7% and 2.5% this year. In spite of the large swings, interest rates are roughly the same now as they were in January, so bond returns are modestly positive. The Barclays Aggregate Bond index returned 1.1% and Treasury Bonds returned 3.0%. High-yield bonds struggled a bit and generated losses of –2.5%, explained mostly by the large weighing of energy companies in the high-yield segment. TIPS bonds (or those with inflation protection) generated a negative return of –0.8%, since inflation worries dropped sharply due to economic weakness from China and continued deflation in Europe.

Assessing the Correction

In May, we reduced exposure for clients to equity markets. At the time, there were several indicators that warranted a more cautious approach. The bull market was clearly well-aged, and there had been a loss of momentum in stocks. Valuations were relatively high, and corporate earnings seemed to have peaked. The seasonal strategy had turned negative after a weak start to the year. Many investors seemed overconfident after experiencing little risk since 2011. Although economic growth has been slow and steady, the prospect of a less-friendly Fed seemed a likely catalyst for increasing volatility.

The typical summer correction came in late August, when markets are ripe for a pullback due to low trading volume. Drama in the euro zone was destabilizing, and significant declines in China's growth rate weighed on markets. As the prospect for an increase in the Fed Funds Rate neared, stocks broke down in the U.S. and in international markets as well. After a 12% retraction in U.S. stocks and several big multi-day swings, markets have stabilized somewhat. This correction should be a healthy one, and it seems that enough of the downside risk in markets has been realized to warrant a move back into equities.

Taking stock of the current environment generates a much more positive view than earlier in the year. The durable and well-aged bull market took its lumps and hit the reset button. Although stock valuations are not cheap, they are clearly more attractive now. Second quarter earnings fell by the biggest amount (11%) since 2009, and the correction shocked many investors out of their complacency. Economic growth saw a nice rebound in the second quarter to 3.7% (albeit after a barely positive first quarter).

China has been the single largest contributor to global growth over the past decade. A slowdown in China's economic growth is concerning. However, the size of China's economy has almost tripled since 1995. China can continue to make substantial contributions to global growth even if the pace of growth is lower than the past. There may be some hiccups as China's economy transitions from manufacturing to servicing their large and growing middle class, but a lower growth rate should be expected.

The likelihood of a Fed rate hike this year is significantly lower now, and even if such a hike occurs earlier than expected, much of the bad news has been realized, so the potential for the Fed as a catalyst is lessened as well. Although the pullback was not comfortable, it should clear the path for equity markets to continue moving forward.

Although there is risk that the market continues its downward slide and becomes a bear market with stock market losses of 20-40%, that outcome seems unlikely at this time. Though bear markets can occur unexpectedly, there are usually some warning signs. For example, tight monetary conditions are usually associated with a bear market. Although the Fed has ended its quantitative easing program and is close to moving short-term interest rates up from zero, it is a stretch to call those actions tightening. This year is the strongest of the four-year presidential cycle; stocks have avoided losses in every pre-election year since 1950. Another warning sign would be slowing in the Conference Board's LEI (Leading Economic Index) which tends to turn downward prior to a recession. The LEI is still positive today.

Summary of Current Positioning

On October 13, we moved clients back to their maximum equity positions. After an overdue correction of 12%, the bull market is still intact. Given that five of the last six years generated double-digit returns, the recent market drop is a reminder that stock investing entails risk. The correction should be healthy for equity markets, and, as global financial stresses lessen, the market should continue its upward trend, albeit at a slower pace.

If you have questions on the investment environment or your portfolio, please call us at 734-769-7727. To find an electronic copy of this document and other recent commentaries, please visit our website at www.risadvisory.com.

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These data are for illustrative purposes only and is not indicative of any investment or strategy result. The S&P 500 is an index of 500 stocks representing major U.S. industry sectors. The Dow Jones Industrial Average is an index made up of 30 large U.S. company stocks. Small Cap is represented by Russell 2000 Index, which is an index of the 2000 smallest companies in the Russell 3000 Index of 3000 broad-based U.S. companies. Mid Cap is represented by S&P Mid-Cap 400 Index, which tracks medium-sized U.S. firms, which is broadly defined as a company with a market capitalization ranging from about $2 billion to $10 billion. Developed Int'l is represented by MSCI EAFE Index, which is an index of major international equity markets as represented by 21 major MSCI indexes from Europe, Australia and Southeast Asia. Emerging Markets is represented by MSCI Emerging Markets Index, which is an index that is designed to measure equity market performance in global emerging markets (over 20 countries including Brazil, Russia, India, and China). World stocks (the All Cap World index) are represented by the MSCI ACWI index and is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI consists of 45 country indices comprising 24 developed and 21 emerging market country indices. High-Yield is represented by the Barclays U.S Corporate High-Yield Index, which measures the market of USD-denominated, non-investment grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's Fitch, and S&P is Ba1/BB+/BB+ or below, excluding emerging market debt. Investment grade and broad market bonds are represented by the Barclays Aggregate Bond Index includes most U.S. traded investment grade bonds, including Treasury securities, government agency bonds, mortgage-backed bonds, corporate bonds, and a small amount of foreign bonds traded in U.S. Treasuries are represented by the Barclays Capital U.S. 7-10 Year Treasury index, which measures the performance of U.S. Treasury securities that have a remaining maturity of at least seven years and less than 10 years. TIPS are represented by the Barclays U.S. Government Inflation-linked Bond Index, which includes publicly issued, U.S. Treasury inflation protected securities that have at least 1 year remaining to maturity. Commodities are represented by the S&P GSCI is a world-production weighted index designed to track investable commodities representing the price movements of the world economy.