Third Quarter 2015 Investment Environment

- Global stock markets had their worst quarter of performance since the third quarter of 2011 as investors aggressively sold risk assets. China took center stage as its plummeting (and volatile) stock market, weakening economy, and surprise currency devaluation shook global investor confidence. Slowing global growth also was a major factor in driving global stock markets lower.
- Emerging market stocks were the worst performers during the quarter as the MSCI EM Index declined 15.5%. China declined 23% during the quarter while Brazil's currency collapse, political crisis, and economic recession caused its stock market to decline 34% during the quarter.
- U.S. stocks were down over 6% for the quarter but this performance was better than all other major regions of the world. The MSCI EAFE Index of developed international markets was down just over 10%.
- Within the U.S. stock market, the Russell 2000 Index of small cap stocks declined nearly 12% and now trails large caps by 2.4% year to date. The worst performing sectors of the U.S. stock market were Energy and Materials which both declined 21%, followed by Healthcare which declined 11%. Defensive sectors like Consumer Staples and Utilities outperformed. The only sector with positive returns year to date is Consumer Discretionary, up only 2.9%.
- The 10-year U.S. Treasury yield declined to 2.05% as slowing growth and a flight to safety trade pushed Treasury bond prices higher. However, credits were weak as investors reduced risk and rotated towards high quality. High yield bonds saw a 5% drop as investors chose to significantly reduce risk and credit spreads widened considerably.
- Oil prices dropped 22% during the quarter, with WTI (West Texas Intermediate - the U.S. oil benchmark) trading near $45 per barrel, down from $58 per barrel at the end of June. The price of gasoline has seen a large drop and is helping the consumer wallet.
- Gold was negative during the quarter, a reflection of continued weak inflation data and the U.S. dollar maintaining its recent strength.
- The table below shows the returns for major asset classes during the quarter and year to date through 9/30/15.

	QTR	YTD
S&P 500 Index (large cap U.S.)	**-6.4%**	**-5.3%**
Russell 2000 Index (small cap U.S.)	**-11.9%**	**-7.7%**
MSCI EAFE Index (large cap int'l)	**-10.2%**	**-5.3%**
MSCI EM Index (emerging mkts.)	**-17.9%**	**-15.5%**
Barclays Aggregate (invt. grade bonds)	**+1.2%**	**+1.1%**
Barclays High Yield (non-invt. grade bonds)	**-4.9%**	**-2.5%**
Barclays Short-term Treasury bills (cash)	**+0.1%**	**+0.2%**
Gold	**-4.8%**	**-5.8%**
WTI Oil	**-22.4%**	**-15.4%**
Lipper Balanced Funds Average	**-5.6%**	**-4.4%**

- The final revision for second quarter 2015 U.S. real GDP growth came in at +3.9%, an improvement from first quarter's -0.2%. However, the preliminary third quarter real GDP estimate produced by the Atlanta Federal Reserve Bank is now just 0.9%. Recent manufacturing data has weakened significantly, and global growth forecasts have been revised lower. The Federal Reserve now expects 2015 real GDP growth to come in at 2.1%, down from their prior expectation of a range of 2.3% to 2.6%.

Fourth Quarter 2015 Investment Outlook

WHAT A BUNCH OF HOMERS

"Bubbles continued to build up until mid-June,"
"The correction in the stock market has now come close to an end,"
"The economy was not much affected by the rout."

— People's Bank of China Governor Zhou Xiaochuan

"Oh, what a tangled web we weave...when first we practice to deceive."

— Walter Scott, Marmion

"D'OH!"

— Homer Simpson

The urban dictionary definition of a homer is a bonehead or someone who possesses a high degree of idiocy. Being called a homer is not all bad. The most lovable and hilarious homer in history is Homer Simpson, the lead character of The Simpson, an animated sitcom created by Matt Groenig. Second only to Matt and the show's team of writers in terms of comedic brilliance is Matt Castellaneta, the voice of Homer, who has given the world the most simple and enduring term that captures the true essence of what it means to be a homer: D'OH!

We are not sure if homer translates in Chinese, but there are a ton of homers in China who will get schooled in the harsh realities of capital markets before it is all said and done. Bank of China Governor Zhou Xiaochuan just became the poster boy for China's homer population. Mr. Zhou and all his other Chinese apparatchik comrades typically make broad public announcements during times of duress that are supposed to be taken as good as gold by the conforming Chinese populace who know nothing else. Now that China has opened its capital markets and there are more savvy global investors playing the Chinese stock market game, public pronouncements from prominent figures like Mr. Zhou and others take on a degree of hilarity similar to a Simpson's episode. As China's stock market plummeted this year, and

despite repeated instances of blatant intervention (reportedly over $230 billion) by the central government to prop up the market, caveat emptor was on full display. The harsh reality of living under a communist regime was front and center as they arrested or detained several high level professionals at major investment firms, arrested several hundred other "guilty" parties, and raided many firms to seize their trading records to identify other parties "guilty" of causing or profiting from the stock market collapse. They also arrested a business journalist and put him on national TV to apologize for sensationalizing the stock market drop and inciting panic with retail investors. In the West, it's called reporting the facts.

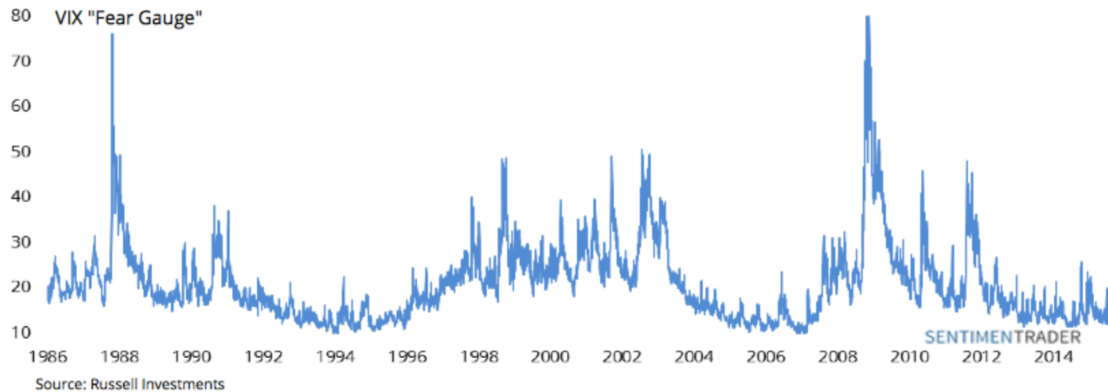
The rolling clouds of financial crisis have finally blown further east and settled over China. It's a particularly delicate time as the global economy has relied heavily upon Chinese growth the past five years to offset the low growth in developed markets. Now, Chinese economic growth is decelerating and its stock market collapse is exporting volatility to global financial markets. Emerging markets are now slowing dramatically due to China's economic slowdown and the rest of the developed world has not rebounded to a level of economic health to offset it.

There are a whole bunch of homers out there because we live in an era where most investors have bought the central bank bailout thesis hook, line, and sinker for seven years. Central banks will do whatever it takes to save the global economy and support financial markets, right? If Janet Yellen, Mario Draghi or Haruhiko Kuroda say it, it must be true, right? The data shows that seven years of extreme central bank policies have not been able to lift global growth rates by any meaningful amount despite trillions of dollars thrown at the problem. Now, some high profile players are calling on the Fed to raise rates, even in the face of weakening growth, because the low rate policy seems to have not been able to do what it was supposed to do and in fact may be doing much more harm than good at this stage of the game. It seems the Fed has now painted itself into a corner. Maybe Janet Yellen should place a call to Homer Simpson and get his input. He has been serving a long time as Nuclear Safety Inspector at Springfield's nuclear power plant. He probably can offer some sage advice, having been involved in hundreds of nuclear safety incidents over the years and is fully versed in never-ending crisis management.

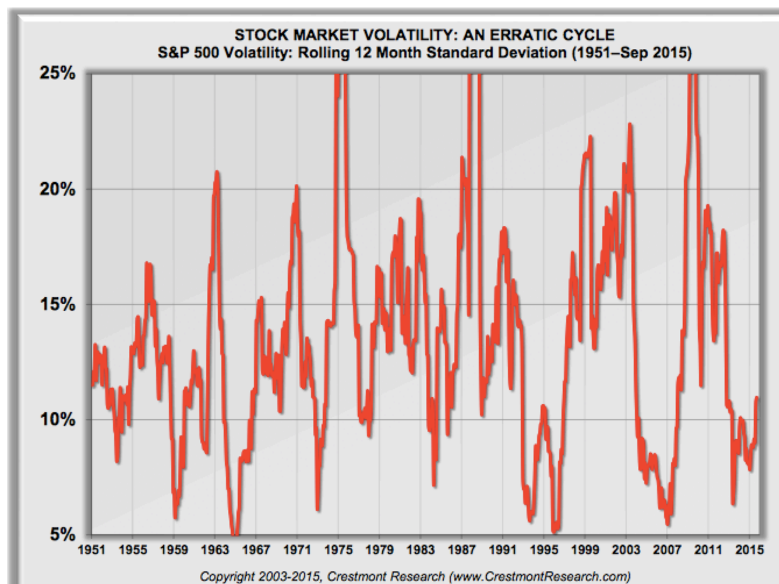
Fear

For the first time in four years, fear readings in the stock market saw a dramatic pop higher during August and September. The most followed stock market fear gauge is called the VIX Index, which captures the forward 30-day volatility of options for the S&P 500 Index. The next chart captures the history of the VIX going back to 1986. The chart shows that the typical range of the VIX Index is between 10 and 80 with 10 representing low expectations for forward stock price volatility and 80 representing an extreme level of expectations for forward price volatility (the world is coming to an end!!). Over the past decade, the fear index experienced its highest readings during the 2008/2009 Global Financial Markets collapse (the reading hit 80) and in 2011 and 2012 when the European sovereign debt crisis (the so called PIIGS) hit global financial markets (readings close to 50). Since 2012, the VIX has been at the low end of its historical range. That is, until the third quarter of 2015 when it ballooned up to the 40 level. Here in early October, the VIX has receded back to below 17. In the context of historical fear levels, the most recent market upheaval was not particularly extreme.

If we plot an average line across the graph below, a guesstimate of the average VIX reading from 1986 to 2015 (or around 30 years) would be somewhere around the 30 level. From 2012 until July 2015, the fear gauge was at the low end of its historical range, most likely a result of investor beliefs that central banks would come to the rescue and save global stock markets if things got bad. The most recent bout of elevated fear has to do with investor concerns over China and that central banks may have lost the ability to support global growth via extreme policy measures.



Another way to view current market volatility within a historical context is by using rolling standard deviations of returns. The next chart captures 12 month rolling standard deviation of returns for the S&P 500 Index since 1951. If we again guesstimate the long-term average of this data, it appears to be around 15%. Even with the recent uptick in volatility, S&P 500 return volatility is still well below the historical average and we are most likely to see volatility head higher if reversion to mean plays out.



Perhaps the most important takeaway from the two preceding charts is that investor complacency readings have been below average for the past several years. Based on history, the VIX rarely stays below 20 for an extended period of time. We can and should expect the VIX to start to increase back to more historical norms, as increased volatility becomes the new normal.

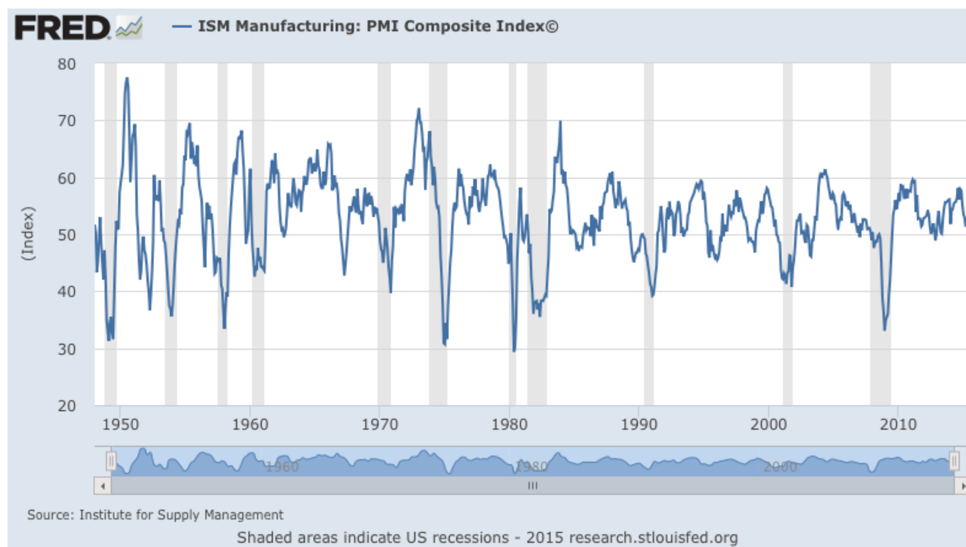
Manufacturing Slowdown

One of the key issues discussed in our 2015 Investment Outlook was the importance of the energy sector to the economic recovery and jobs gains over the past several years. We noted that collapsing oil prices could have a negative impact on the U.S. economic picture because the energy sector was a meaningful source of strength for the U.S. economy that is struggling to maintain real GDP growth above 2.5%.

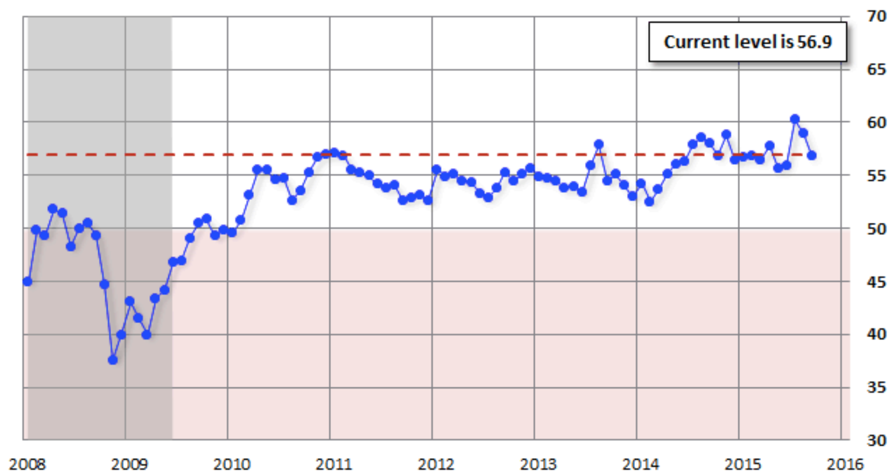
In more recent months, it is now becoming increasingly evident just how important energy capital expenditures (capex) have been to U.S. economic growth. Oil peaked in July 2014 at $105 per barrel and the promptly plummeted to a low of $38 with the current price near $50 per barrel. Oil companies began to dramatically cut their capex budgets starting in the fall of 2014 and have continued to do so throughout 2015 and have also announced major job cuts as well.

The next two charts capture the data of the manufacturing sector over time. We can see from the durable goods chart below that year-over-year durable goods orders are now negative for seven months in a row. Also shown in the chart are the past two recessions (pink or grey area) and what the year-over-year durable good orders looked like during those time periods. Definition wise, the U.S. is not in a recession but the durable goods data suggests the manufacturing sector could be in a recession and is weak enough to suggest that aggregate growth has definitely taken a turn lower.

The Institute of Supply Manufacturing or ISM Manufacturing Index is a monthly diffusion index that captures economic activity trends in the U.S. manufacturing sector. The next chart shows the ISM readings going back to 1948. A 50 reading for the ISM is the demarcation between growth and contraction in the manufacturing sector. A strong U.S. manufacturing sector would have readings above 55. The grey vertical regions of the ISM chart are recessions. Every time there has been a U.S. recession, the ISM Index has fallen below 50. For example, the ISM plummeted to the mid 30's during the 2008/2009 recession. More recently, the ISM peaked in August 2014 near 58. Interestingly, that is around the same timeframe when oil prices peaked at $105. Since then, and as energy prices have collapsed and energy companies have dramatically cut their capex budgets, the ISM has been moving lower and in September registered a 50.1 reading. Additionally, the U.S. dollar has strengthened over this time period and global growth outside the U.S. has slowed. The recent declines in the ISM Index and durable goods data reflect these factors as well.



Although manufacturing is an important component of the U.S. economy (particularly for higher wage jobs), the services component of the U.S. economy is dominant at about 68% of economic activity. To provide a complete economic picture, the next chart shows the U.S. ISM Non-Manufacturing Index data, which is a proxy for the portion of the U.S. economy that is services based. This index is still showing decent readings but has also started to move lower with a recent reading of 56.3 for September, down from 59.0 in August. Still positive, but slowing. Additionally, the orders component of the ISM Non-Manufacturing Index saw a quite large drop from 63.4 to 56.7 from August to September, perhaps a sign of more cautious spending ahead.



In summary, the ISM Manufacturing Index has been slowing for most of this year and is wavering close to the important growth/contraction level of 50. The ISM Non-Manufacturing Index is still at a decent level but the internals of that index are also beginning to weaken.

Global Growth Slowdown

As part of its mandate, the International Monetary Fund (IMF) provides global economic growth forecasts. It recently updated its GDP forecasts for 2015 and 2016. The table below shows the latest forecasts.

Geography	2014	2015 forecast	2016 forecast
World output	3.4%	3.1%	3.6%
United States	2.4%	2.6%	2.8%
Germany	1.6%	1.5%	1.6%
France	0.2%	1.2%	1.5%
Italy	-0.4%	0.8%	1.3%
Spain	1.4%	3.1%	2.5%
Japan	-0.1%	0.6%	1%
United Kingdom	3%	2.5%	2.2%
Canada	2.4%	1%	1.7%
Russia	0.6%	-3.8%	-0.6%
China	7.3%	6.8%	6.3%
India	7.3%	7.3%	7.5%
Brazil	0.1%	-3%	-1%
Mexico	2.1%	2.3%	2.8%

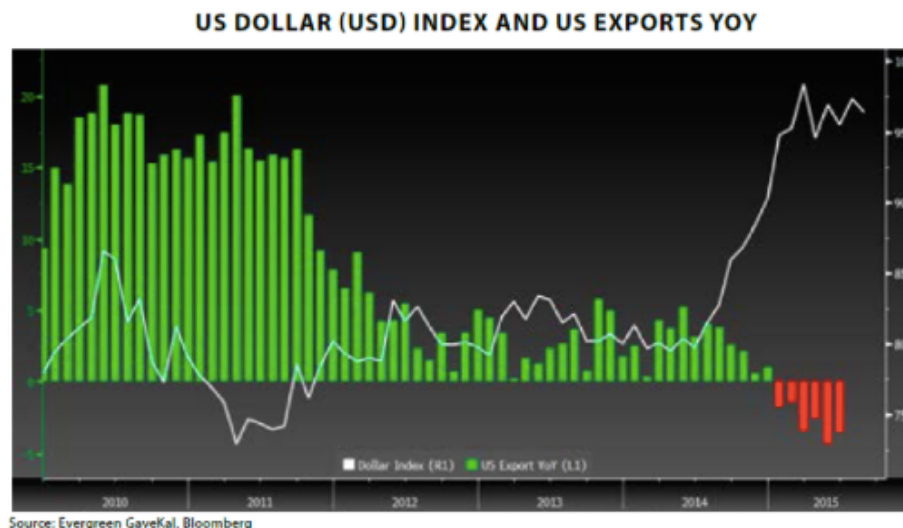
Source: International Monetary Fund

Like the Federal Reserve and many other prominent organizations that forecast economic output, the IMF has been too high in its forecasts of GDP growth. In January 2015, the IMF expected world GDP growth to be 3.5% for 2015 and it now has a 3.1% forecast. The IMF believes 2016 global growth (3.6%) will be higher than the past two years and despite the fact that it forecasts China, the second largest economy in the world after the U.S., will have lower GDP growth in 2016. Additionally, its U.S. growth forecast for 2015 is now at 2.6% when the Federal Reserve itself thinks it will be 2.1%. The IMF forecasts U.S. economic growth to be higher in 2016 at 2.8% even though the U.S. economy has NEVER exceeded 2.5% annual real GDP growth since the 2008/2009 Global Financial Crisis. In summary, expectations for economic growth for 2016 are probably too high.

Dollar Damage

In our 2015 Investment Outlook piece back in January, we highlighted the risk of increased currency wars. This issue has played out in spades during 2015. The recent devaluation of the Chinese renminbi (also called the yuan) highlighted the tremendous pressures facing most economies and the pressure on central banks to devalue currencies in order to make exports more attractive. If every central bank is trying to weaken its currency at the same time in order to boost exports and thus economic growth, then it becomes a currency “war”. The U.S. economy is experiencing increased pressure because the U.S. is in the best economic shape (at least we think we are) and the Federal Reserve is the only major central bank close to considering an interest rate increase. As a result, while most global currencies depreciate, the U.S. dollar has seen a massive jump higher starting at the beginning of 2014. A stronger U.S. dollar hurts U.S. exports, which eventually hurts U.S. GDP growth. The next chart shows how much U.S. exports have slowed as the U.S. dollar has strengthened. There is no doubt the U.S. dollar strength is one of the

key factors that is causing the Fed to delay its interest rate hike decision because a rate hike would cause the U.S. dollar to strengthen further and put even more downward pressure on our exports and eventually on U.S. GDP growth.



U.S. Earnings Outlook – More Headwinds Ahead

The underlying data captured in the ISM and export charts eventually flows into the earnings of U.S. companies. The stock market has traded lower this year because the forward earnings outlook continues to deteriorate. Plus, the possibility of the Fed coming off of its Zero Interest Policy stance has created more caution with most investors. However, the risk of further deterioration in the earnings outlook seems underappreciated by the market.

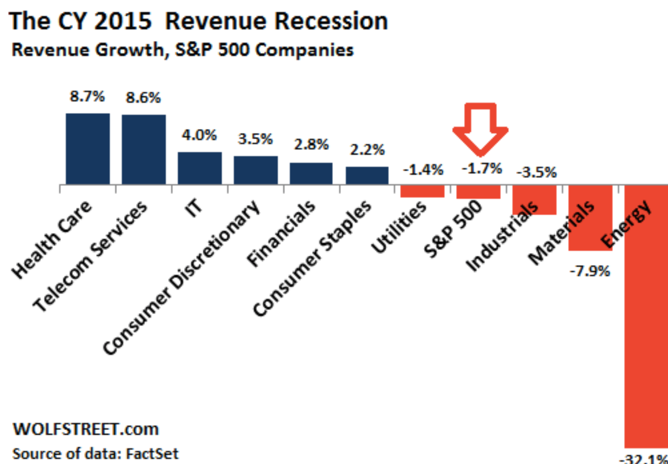
The next chart compares the CRB Index to the forward outlook for S&P 500 earnings. The CRB Index is a broad based commodities index. Commodities demand is a reflection of the strength of the global economy. The greater the demand for commodities (steel, aluminum, copper, etc.) that go into end products, the healthier the outlook for economic growth. Here's the problem. Commodities have been in a major free fall. The CRB Index has seen a massive decline as reflected in the blue (dark) line in the next chart. This is problematic for earnings given the past relationship between the CRB Index and forward earnings. Given the magnitude of the decline in commodities, it suggests that the forward earnings outlook is about to get much worse than the market is currently pricing in. You can see in the chart that the last time commodities collapsed in the 2008 Financial Collapse, earnings also collapsed. Presently, we are also seeing commodity prices collapse but the reset of earnings lower (red or grey line) is lagging the move lower in commodities by a wide margin and has a lot of catching up to do. As of the end of September, the market was expecting S&P 500 operating earnings for 2016 to grow 10% compared to 2015. The chart suggests that this earnings growth expectation could be way off the mark. If earnings rollover to the extent suggested in the chart, the market is poised to face more downside risk.

The next chart captures the annual percentage change in rolling 12-month forward earnings expectations. The data shows that the percentage change is close to moving into negative territory for the first time since 2010. For third quarter, the market is expecting earnings to be down -3.8% year-over-year (3Q14 vs. 3Q15). In all likelihood, fourth quarter earnings will need to be marked down as well.

Houston, We Have A Math Problem

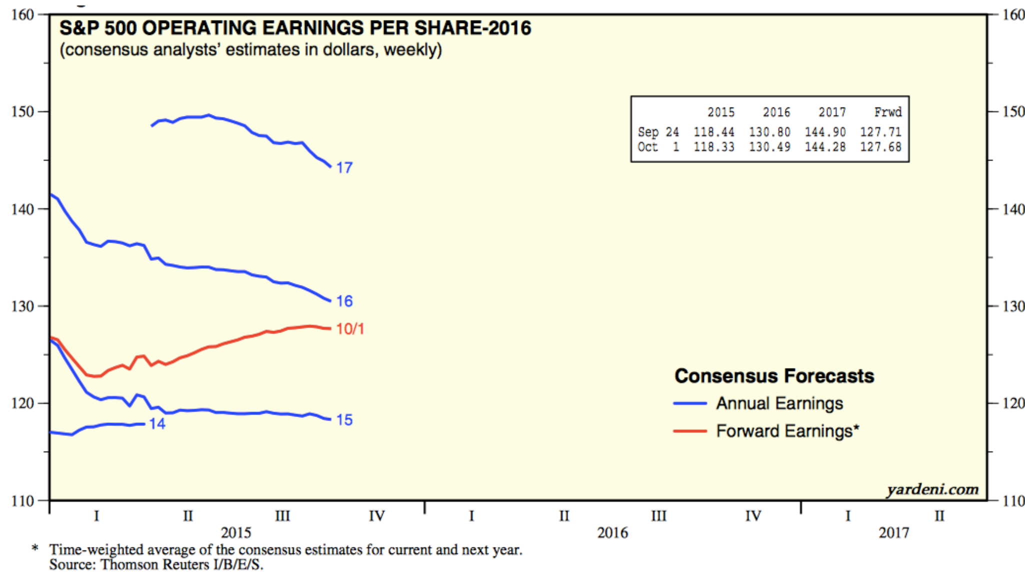
The markets frequently trade in the short-term on technical levels, but the fundamentals ALWAYS win in the long run. Beneath the surface, the fundamentals are not really working very well, and that is the main reason the U.S. stock market is struggling this year, even if China, Greece, oil prices, and homers dominate the headlines.

The math problem is that revenue growth is coming in much worse than expected. The next chart shows the year-over-year (2015 vs. 2014) revenue growth for each sector of the S&P 500 Index and the index itself. In aggregate, revenues are expected to decline 1.7% in total for 2015. Keep in mind this includes actual revenue growth for the first half of the year and estimated revenues for the third and fourth quarters. Clearly, the dramatic decline in oil and commodities has had a major negative impact on revenue growth as the Energy and Materials sectors are seeing the largest year-over-year drop in revenues. Weakening foreign currencies also are a negative factor on revenue growth for U.S. companies selling in overseas markets. There are many talking heads who come on CNBC and make comments like "excluding energy, the market is not doing too bad". Well, two can play that game because excluding healthcare, revenue growth for the S&P 500 Index is not doing too well.



Weaker than expected revenue growth will negatively impact earnings growth, which will ultimately feed through to the valuation level for the stock market. Let's walk through the math of earnings and fair valuation for the S&P 500 Index.

As shown the table in the next chart, the earnings estimates (as of 10/5) for the S&P 500 Index are for 10% earnings growth in 2016 vs. 2015 (130.49/sh vs. 118.33/sh). Keep in mind the earnings estimate for 2015 at the beginning of the year was around $128/sh and we are currently at $118.33/sh (a big chunk of the decline is from the energy and materials sectors). Actual 2014 S&P 500 operating earnings was $118.80/sh so the S&P 500 Index is currently showing slightly negative earnings growth for 2015. Outside of global events, decelerating earnings growth is the real reason the stock market is struggling this year. Giving slowing growth, there should be more negative earnings revisions for the 4th quarter and analysts will begin to reset their 2016 earnings expectations lower off of a lower 2015 base.



At the start of 2015, the S&P 500 earnings multiple was already rich at 17.1X. With 2015 earnings estimates cut to $118.33/sh, and even with the market pullback during the third quarter, the current market multiple on 2015 S&P 500 operating earnings is 17.0X (using the 10/9 S&P 500 Index level of 2015).

Unfortunately, it is unlikely the S&P 500 Index will achieve 10% earnings growth in 2016 with the U.S. economy stuck in its current 2.0% growth profile and with the global economy decelerating. The current revenue growth estimate for 2016 is +5.7%. If the S&P 500 Index 2015 revenue growth is -1.7%, and unless you expect the U.S. economy to reaccelerate in 2016 from the current 2.0% growth rate profile and for global economic growth to improve, the +5.7% revenue growth estimate is a fantasy.

Let's run a what-if valuation scenario. If 2016 S&P 500 operating earnings growth ends up only +5%, and if we assume 2015 S&P 500 operating earnings end up at $117/sh, then 2016 operating earnings would be $122.85/sh and the S&P 500 Index is trading today (using a 2015 S&P 500 index price level) at 16.4X. If the S&P 500 Index were to decline back to the 1820 level it hit on 8/24, the S&P 500 Index would trade at 14.8X 2016 using an operating earnings estimate of $122.85/sh. Below 15X is a better risk/reward setup than >16X to add stock market exposure because that multiple reflects a much lower earnings growth forecast.

Another important to point to make here is that we are no longer in a phase of the stock market where the stock market multiple should expand. Stock market multiple expansion was a key factor driving stock market gains since 2009. Now, earnings growth is going to have to drive the market higher and do all the heavy lifting. With earnings growth likely to be low to mid-single digits at best in 2016, don't expect the stock market to offer much upside until the revenue and earnings growth expectations get reset lower.

Summary

At the beginning of the year, we predicted there would be some tough sledding during 2015 and that valuations did not offer a compelling upside story for stocks. That view has come to fruition as the year has played out. The key issue is that we are still in the midst of a slowing global economy and negative earnings revision environment. The stock market cannot gain traction to the upside when it is facing negative earnings revisions, particularly when the current 2016 earnings growth estimate of +10% is still too rosy. There are still too many homers in the stock market who believe in the power of major central banks to save the day and drive economic growth higher.

Mark J. Majka, CFA
Chief Investment Officer
www.mjminvtadvisors.com

October 11, 2015

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