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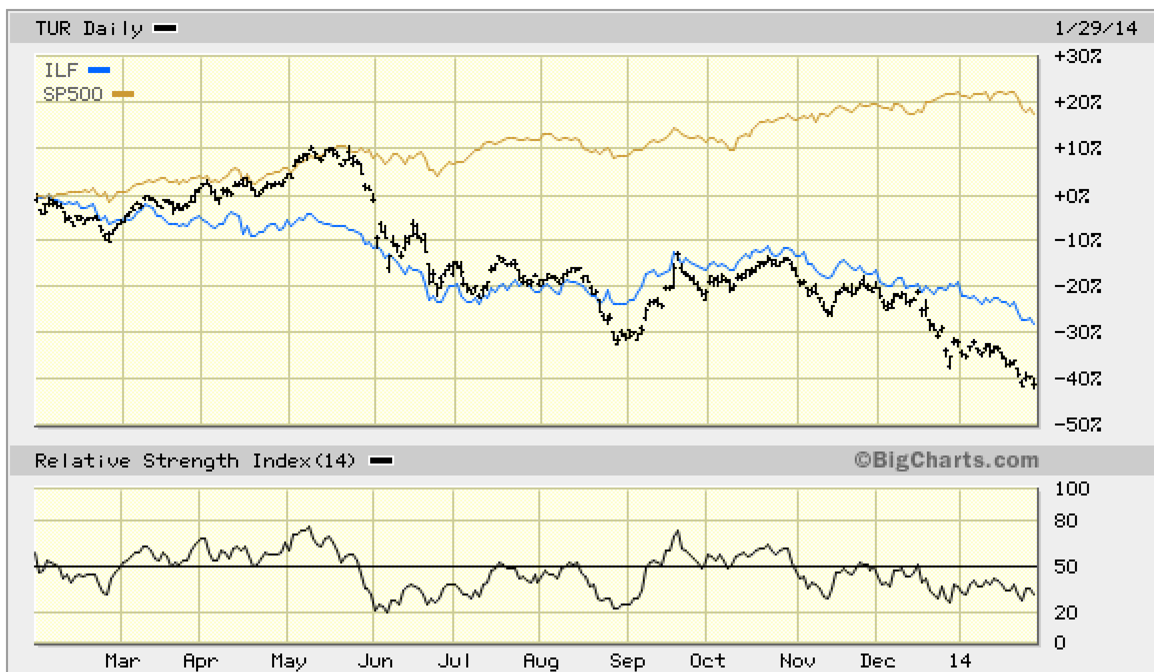
January 30, 2014

What Should Not Have Happened…Will Not Likely Continue To Be

Markets are rarely "wrong", but they can reflect perceptions and circumstances that are not sustainable. The strength in U.S. equity markets during 2013 was not "incorrect" as it properly reflected the net effect of buyers and sellers of equity investments during the year, but the motivations and rationales of those investors are rapidly losing their power to influence capital flows. 2014 may be a good <u>year</u> for global equity markets, but the capital markets may be "chilly" for the remaining winter, the groundhog may see his shadow next month and/or the summer may have its share of doldrums before we enjoy a more prosperous fall/winter season.

<u>This is really not about Turkey, Argentina (Latin America), China or any other emerging market</u>

Here is a 1-year chart comparing the S&P 500 Index ("gold" line) vs. the MSCI Turkey ETF (ticker: TUR; "black" line) and the Latin America 40 ETF (ticker: ILF; "blue" line):



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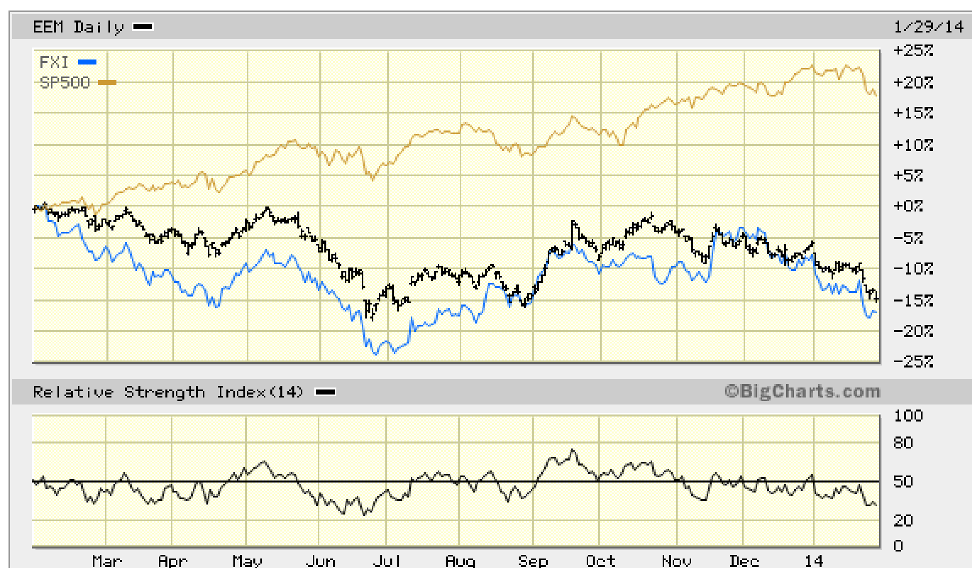
Here is a second 1-year chart comparing the S&P 500 Index ("gold" line) vs. the MSCI Emerging Markets ETF (ticker: EEM; "black" line) and the China Large-Cap ETF (ticker: FXI; "blue" line):



As you review the above charts, please consider the following observations:

1) The correction in the emerging market indices has been in place for much longer than the past month (in fact, it has been evolving since 2011).
2) The weakness in Turkey's stock market began in May of last year (not in the past few weeks) and it has been "playing catch-up" to the other emerging markets ever since.
3) The weakness in the emerging market equity markets as a whole, or in Chinese stocks specifically, may be "testing" the lows that were made last June/July when the Fed began to warn of the tapering of their quantitative easing program, interest rates rose sharply and bond prices fell.
4) The S&P 500 Index largely "ignored" the declines in the emerging country stock markets until very recently.
5) The correction we have had in the S&P 500 so far this year can barely be identified in the above charts.

"Crying wolf? Haven't we heard this before?"

As early as in January of last year, and then again in May, the S&P 500 Index had very large, sharp and mostly uninterrupted upward moves (resulting in high "relative strength readings" (RSI); typically associated with "overbought" situations; small red circles in the chart on the following page). Then in May, Fed Chairman Bernanke began to signal that the Federal Reserve was getting closer to beginning to "taper" their quantitative easing (Q.E.) program (i.e. stop "creating" money and using it to buy primarily U.S. treasuries and mortgage securities). Both the bond and stock markets did not like his message as they interpreted it as a first step towards a broader restrictive monetary policy. As a result, the Fed got a case of "cold feet" and began all manner of "dovish commentary" to sooth the market's fears. It worked and the stock market *prematurely* halted its decline in late June. I use the term *"prematurely"* because the pullback that we had experienced up to that point was well on its way to correcting the overbought situation that had developed in the months prior. The stock market's advance from the lows in June largely continued on until December, despite a government shutdown (thanks to the Fed's decision to postpone the beginning of the tapering program until December).

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1-Year Chart of the S&P 500 Showing the Beginnings of a Correction in May/June (large "red" circle) and the "Fed-Fueled" Stock Market Rebound/Advance ("green" arrow)

<u>We have had brief & shallow pullbacks in the past year, so why might this pullback be longer/deeper?</u>

Three reasons:

1) The longer a market goes without a significant pullback, the more signicant the pullback is likely to be when it does occur. We are at least 7-8 months overdue at this point.
2) The Fed did not get a case of "cold feet" yesterday. Despite global stock market weakness, and turmoil in some of the emerging market currencies, the Fed curtailed their bond/mortgage buying program by another $10 billion.
3) The S&P 500 is losing support from the U.S. retail stocks in a very significant way. U.S. retail company stocks, as represented by the U.S. Retail ETF (ticker: XRT; "black"line in below chart), have been one of the best performing sub-asset classes in the **<u>world</u>** over the **<u>past five years</u>**, but they are now showing substantial loss of stock price momentum. This has accompanied numerous reports of security breaches, weak seasonal sales, narrowing margins, online competition (i.e. Amazon) and a slowing of growth coming from the emerging markets (and that was before the most recent reports of emerging market economic woes):

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<u>If this is "THE" correction, we are likely only about a third into it…in terms of both percentage decline and in duration</u>

A pull back in the S&P 500 to near 1,700 (approximately 8% from the recent market peak) at this point is a reasonable correction scenario, but a deeper pullback to 1,600-1,650, which would meet the textbook definition of a "correction" (down 10% or greater), cannot be ruled out. If the current weakness evolves into a decline approaching these approximate levels, then the stock market will have plenty of time remaining during the course of the year to rebound and reach new highs. On the other hand, if a potential pullback is delayed till the summer months (as it was in 2011) the year will have less of a chance to be an above average performance year. In either scenario, a full bear market decline of 20% or more appears unlikely at this point given that the Fed is still very accommodative and that the economy is likely to grow closer to 3.0-3.5% this year.

There of course remains another scenario, "The Fed Turns-Tail Scenario", where capital market disruptions motivate the Fed to cease, if not reverse, their Q.E. tapering initiative. While this scenario cannot be ruled-out, the new Fed Chairperson (Janet Yellen) has been labeled an "ultra-dove" and that is not a title a Fed Chairperson relishes as it is direct opposition to what many consider the Fed's primary mandate, price stability. As with any person assuming a high-profile position of great authority and importance, she will likely take advantage of any challenging circumstance in her early tenure to prove she is "tough, but fair" and that she is not above some "tough love" if the situation warrants it.

<u>Strategy Implications</u>

We have begun the process (and will continue to do so during the year) of moving some allocations from U.S.-based investments and into more European/Japanese-focused investments as their economies are just starting to return to growth and their stock markets do not face the same headwinds as either the U.S. (lessening of economic stimulus/overbought status) or the emerging markets (economic growth uncertainty/currency volatility/inflationary pressures). The emerging markets are likely to become an attractive investment alternative in late 2014/2015, but there is not sufficient evidence of stabilization at this time to justify pursuing a "value play" in those markets. We remain underweight in commodities, but we are starting to see some initial signs of strength in a few niche areas (i.e. cocoa, livestock and natural gas). Our hedges remain at normal/average levels, but if the market continues to decline, we will begin reducing them in an orderly/disciplined manner so as to more fully participate in a subsequent rebound to new stock market highs as this bull market progresses and completes what is likely to be an additional 2-3 years of remaining life (it just needs a "breather", not a "walker" nor "intensive care", now that it is middle-aged…). The last 10-15% in appreciation in the S&P 500 last year probably should not have happened if the Fed had been more committed to their tapering efforts as outlined in May of 2013. Consequently, some of those returns will need to be given back and put on "lay-away" until we can "earn" enough (via corporate profits/economic growth) to take them back, but they are not likely to be *permanently repossessed* anytime soon.

<u>"Look to the Future, be Optimistic…but Hedge."</u>

(We want to keep these commentaries brief and focused so as to provide a good "information-to-text-length ratio", but if you have specific questions/topics you want me to address, please let us know.)

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