August 25, 2015

Leadership Changes Occur at Bottoms

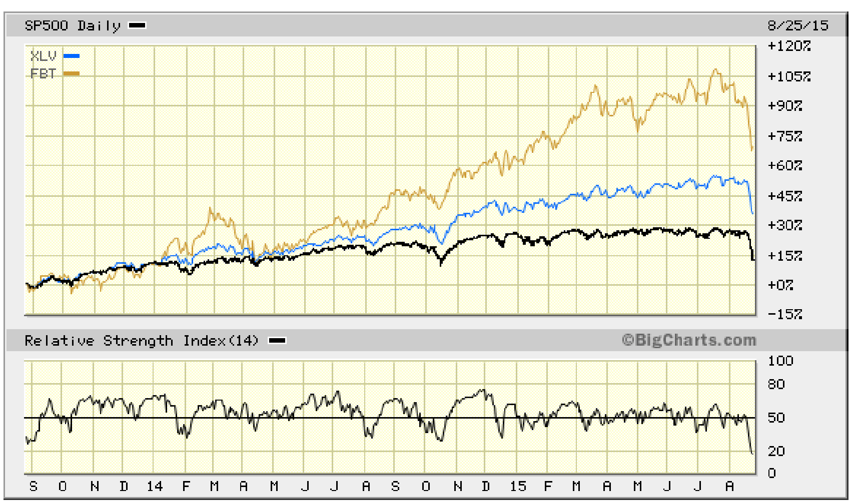
Market & Strategy Update

The recent decline in global equities has been blamed by some on slowing economic growth in China, the "crash" in the Chinese equity market and/or the recent devaluation of the Chinese Yuan. While this makes some sense given the timing of all of these events, it ignores a number of developments that have not gotten much attention, as well as a key capital market behavior: "Changes in market leadership tend to occur near the bottom of stock market corrections".

<u>This correction did not start a couple of weeks ago, it began a couple of years ago</u>

In the below chart you can see that starting almost 2 years ago, 3 of the 4 primary constituents of the global equity markets (Emerging Markets (EEM), Non-U.S. Developed Markets (EFA) and U.S. small company stocks (RUT)) began to underperform the 4th constituent, the S&P 500 (U.S. large company stocks):

During the same time period, non-cyclical industries such as health care (XLV) in general, and biotech (FBT) specifically, dominated the multi-year "momentum" market:



The rationale for the outperformance of health care and biotechnology was easy to discern: 1) demographics (older people need more healthcare); 2) the Affordable Care Act increased access to medical services for some people; 3) breakthroughs in genome sequencing and genetic analysis and 4) because of the preceding factors and others, many health-related companies had levels of revenue growth not easily found in more economically sensitive companies. Also driving the performance of these stocks was capital running away from cyclical areas such as energy, mining, industrial products and emerging market economies.

Despite a large number of distractions, an observable change in trend is developing

Various elements of the cyclical side of the global equity markets are beginning to challenge the prior market leadership (in order of "most recent" to "most developed" emerging trends):

-Over the past 6 months, the highly cyclical U.S. homebuilding stocks have begun to outperform the biotech sector

-On a year-to-date basis, the non-U.S. developed markets (primarily Europe and Japan) have begun to outperform the S&P 500

-The Yen is now positive for the year, and both the Yen and the Euro are outperforming the S&P 500 so far this year

-Since mid-December of last year, the Russian stock market has outperformed the S&P

-Despite the dramatic weakness of the Chinese domestic markets, the Chinese "H" shares are essentially tied with the S&P 500 since the end of September of last year

-Over the past 2 years, the Indian stock market has outperformed the S&P 500

-On both a 1-year and 3-year basis, small company stocks are outperforming the S&P 500

Strategy Implications

At this point, the current stock market correction does not appear to be a precursor to a longer-term, bear market or recession. If that is the case, the duration of the current correction is most likely 2-4 months. While a Fed rate hike in September might cause a deeper correction initially, a delayed Fed rate hike would most likely prolong the correction to the longer end of that estimate.

The above indications of a change in global equity leadership from U.S. large company stocks, especially growth stocks in the life sciences, are still developing and may require another 3-6 months before being reliable enough to make a significant change in strategy. In the meantime, the S&P 500 has corrected more than 10% and we have begun to trim our hedging strategy positions and redeploy those proceeds into our current areas of focus (i.e. homebuilders, financials, broad global sector indices and Europe). If these trends do continue to develop in a meaningful way, we will be looking to increase our allocations to commodities, mining companies, energy-related investments, industrial products, materials and the emerging markets in the coming year. A key indicator of whether this leadership change is truly occurring will be how well the past laggards outperform the past leaders "off of the bottom". For example, today (Tuesday, 8/25) the S&P 500 declined 1.3% while the

Russell 2000 small cap index was down about half that much (-0.7%), Australia was up 5.9%, India was up 2.4%, China up 2.3% and Russia up 1.9% on the heels of a Chinese interest rate cut. "One day does not a trend make", but of this type of strong relative performance of cyclically sensitive indices during the midst of a severe selloff is an encouraging sign that the other three quarters of the global equity markets are preparing to join the bull market run that has now been in place for over six years.

"Look to the Future, be Optimistic…but Hedge."

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