

# Equity Market Update

As of September 30, 2015 / Volume 4, Issue 4 / FFTAM.COM



To start the year, we predicted 2015 would be a volatile year for stocks with limited total return potential. With three quarters of the year now gone, our prediction appears correct. In fact, last quarter was the most volatile three months for the stock market in over four years. Almost all asset classes declined due to Chinese economic uncertainty and the timing of a potential Fed interest rate hike. Also mixed-in were above average valuations for stocks and weak year-over-year earnings growth, thus providing all the ingredients for a bumpy ride for stock investors.

The S&P 500 was the best performer last quarter at -6%. It significantly outperformed its foreign counterparts, EAFE and MSCI Emerging Markets, which returned -10% and -18%, respectively. The negative performance of the last three months has resulted in year-to-date returns of -3.7% for the S&P 500, -3.5% for EAFE and -13.9% for MSCI Emerging Markets.

The Dow Jones Industrial Average fared worse than the S&P 500 with a year-to-date return of -5.8%. This index contains many of the largest companies in the world; therefore, a rising US dollar has negatively impacted the foreign sales of its companies.

The lone large cap index still in positive territory for the year is the NASDAQ. With concerns about global growth slowing, investors have flocked to higher growth, higher momentum names. This has resulted in large increases in biotech, social media, ecommerce and information security stocks. Many of these companies lack earnings, and in some isolated instances, they do not even have revenue. However, with negative tape occurring throughout the remainder of the market, investors have used these momentum names as a place to hide.

Domestic, mid and small-sized companies did worse than their large cap peers in the third quarter, falling 8.50% and 9.27%, respectively. These areas usually perform better when global growth concerns arise because these companies do almost all of their business in America. This was another example of the breadth of investor fear.

As stated above, the fear plaguing the market comes from uncertainty over Fed interest rate policy and perceived economic weakness in China. When taking a deeper dive into these issues, one will see these events are not as big of a deal as investors are making them. We do not want to discredit these concerns; however, China accounts for less than 1% of US GDP with most of its exposure tied to manufacturing. When looking at manufacturing, it only represents 12% of the US economy; therefore, services is a much more important determinant of US economic success. Currently, non-manufacturing ISM is at its highest level in a decade. Finally, the Fed has stated on numerous occasions they intend to raise interest rates in small increments over a prolonged period. In our opinion, a single rate hike of 25 basis points does not destroy the improving economic data we are seeing in the US.

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Abilene	Fort Worth	Stephenville	San Angelo	Sweetwater	Odessa	Beaumont	Lubbock
400 Pine Street Suite 300 Abilene, TX 79601 (325) 627-7100	550 Bailey Avenue Suite 300 Fort Worth, TX 76107 (817) 410-4972	2201 W. South Loop Stephenville, TX 76401 (254) 918-6262	301 West Beauregard San Angelo, TX 76903 (325) 659-5987	201 Elm Street Sweetwater, TX 79556 (325) 235-6644	2651 JBS Parkway Bldg 4, Suite E Odessa, TX 79762 (432) 367-8912	3515 Dowlen Road Beaumont, TX 77706 (409) 600-6460	4903 82nd Street Suite 30 Lubbock, TX 79424 (806) 543-4114

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As we move into the last quarter of 2015 and into the new year, we see corporate earnings being a more important determinant in stock market returns. In the last three months, analysts have taken a knife to soon-to-be released third quarter earnings. They have also trimmed their full year 2015 and 2016 forecasts. Consensus estimates call for earnings to decline 3% year-over-year in the third quarter. This has many wondering if we have entered an “earnings recession.”

Most of the earnings reductions have occurred in the energy sector, which continues to be plagued by low oil and gas prices induced by over supply. Weak commodity prices have also caused analysts to cut forecasts for materials and industrials. Excluding energy, third quarter earnings are expected to rise between 6% and 8%.

One last tidbit about the upcoming earnings season. According to UBS, in the past 18 quarters, corporate earnings have surpassed analyst forecasts by 350 basis points per quarter. In the last two quarters, it was over 500 basis points! If over pessimism by analysts holds true, the concerns about an “earnings recession” may be overblown; therefore, enabling the market to rise from current levels.

The economic tea leaves tell us the US economy is still improving, albeit slowly. Labor markets are growing and wage inflation is running at 2.2% year-over-year. This data, along with low energy prices, is good for consumer spending, which makes up 70% of GDP. Our internal, economic checklist indicates we are in the latter stages of the mid-cycle.

We still believe in our overweight positions in energy, technology, industrials and financials. The energy space has been decimated in the past year, and current valuations are very low by historical standards. However, we believe the recovery in energy will take longer than we initially anticipated, so we have begun lowering the amount in which we are overweight the index.

Finally, the recent sell-off has lowered stock valuations, but they are still above the historical average. We are currently trading at 16.8x 12-month forward EPS estimates, which is higher than the 10-year average of 15.7x. As stated above, we would not be surprised to see the 2015 estimate revised higher after analysts aggressively cut their outlook. Plus, given our view that interest rates will remain low for a prolonged period of time due to structural forces like an aging population and low interest rates around the world, an above average valuation on US stocks is warranted. This does make stocks vulnerable to unexpected short-term events, like the recent sell-off. However, we intend to use those temporary pullbacks as opportunities to put our clients’ cash balances to work.

In closing, it is important to remember the value of diversification. In times like these, investors are tempted to abandon risk assets altogether or to only hold the securities with gains or momentum. This is a dangerous game and can significantly alter your long-term wealth. A study by UBS showed investors sacrificed almost half of their potential total return between 1989 and 2013 by bailing out of the market each time volatility spiked. By hoarding cash, these investors then missed out on the early stages of the bounce back, which happened to be most of the best performing days for the market during these time frames.

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