Smith Group
ASSET MANAGEMENT

MARKET PERSPECTIVES

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So We Had a Correction, Now What?

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Quarter Total Return:	
S&P 500	-6.4%
Russell 2000	-11.9%
MSCI ACWI x US	-12.2%

We are always struck by how quickly the refrain changes from "we need a correction to refresh the market" to "will this correction turn into a bear market". Now that we've had that correction, the question becomes, what next? The peak to trough change in the S&P 500 this year has been -12.4%. While the absolute peak was in the second quarter, most of the drop happened during four days in August. Counterintuitively, growth stocks held up better than value stocks peak to trough, with the Russell 1000 Growth index sliding -11.9% and Russell 1000 Value index slumping -14.0%. Small cap stocks fared worse, with the Russell 2000 trough –16.8% below its record high. Hardest hit were emerging market stocks. The MSCI Emerging Markets index is off its April high by -27.7% in US$ terms (-21.6% in local currency). In dollar terms non-US developed markets also fell further than US stocks, with the MSCI World trough -17.9% below peak (-17.0% in local currency).

Peak to Trough drop in Index Price	
S&P 500	-12.4%
Russell 1000 Growth	-11.9%
Russell 1000 Value	-14.0%
Russell 2000	-16.8%
MSCI Em Market (USD)	-27.7%
MSCI Em Market (Local)	-21.6%
MSCI World x US (USD)	-17.9%
MSCI World x US (Local)	-17.0%

The August correction was triggered by the popping of the Chinese A-share bubble, but the potential for the Fed tightening has again moved to the forefront of investor minds of late. Clearly, a mishandling of either of these concerns have economic implications. But do they overwhelm the continuing progress in the U.S. economy?

China is now the second largest economy in the world and the impact of a slowdown on their trading partners could be meaningful. The planned shift from an economy focused on investment and exports to one driven by consumption is a tricky transition. There is evidence of excess capacity in some sectors and the risk of business default is real. Manufacturing PMI, industrial production, and

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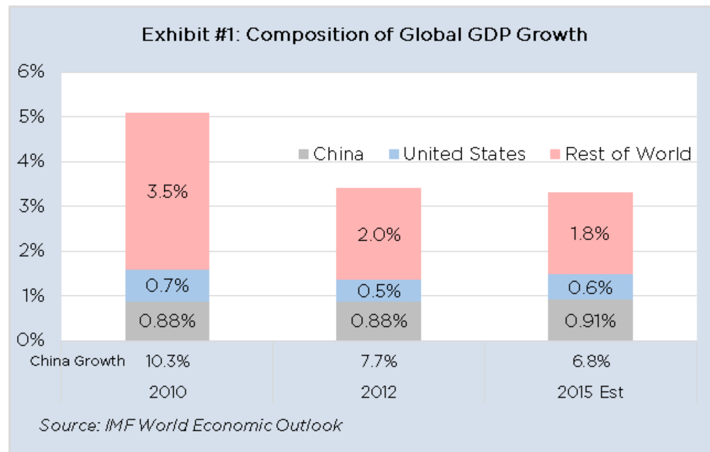
Now What?

construction readings confirm a slowdown in the old economy, but the data looks to be stabilizing. Yet, economic activity on the consumer side, while not robust, is looking quite resilient. Consumer sentiment is improving, while wages and retail sales are growing in the double digits. Clearly, the Chinese economy is emerging from an underdeveloped one boosted by slack in labor and resources to drive growth, to a more developed behemoth where growth is harder to find as those inputs tighten. That is to be expected as growth drivers shift to consumption. But does that lead to doom for the U.S. economy and U.S. companies? Not necessarily. Exhibit #1 shows Chinese growth rates and its contribution to global growth (the gray portion of the bars). The IMF estimated that China was 9% of the global economy in 2010 when it grew 10.3%, which added 0.88% of the global growth total. For 2015, they estimate Chinese output to be 14% of the global economy but growth to slow to 6.8%, yet it would still contribute 0.91% to the global economic growth total, more than when it was growing at double digits. Because China is larger relative to the global economy, it is no longer necessary for the Chinese economy to grow in double digits to have a meaningful impact. Interestingly, the overwhelming majority of China's economy is not reflected in the Shanghai stock exchange (A shares), yet American investors took their lead from that market. The A share selloff was more about the popping of a stock market bubble that inflated earlier in the year than a reflection of underlying earnings vulnerability. In fact, A shares are only down -2% year-to-date after being up +60% in June.



The other major market concern is the potential for a Fed funds rate increase. Yes, after seven years of excessive Fed stimulus, changes to interest rates can be scary. Add to that some confusion around which data the (data dependent) Fed is watching and it should not be a surprise that investors are a bit squeamish. Change combined with uncertainty is a perfect mix for a volatility cocktail. But should it be? Would a 25 basis point move in borrowing rates crush spending? The indicators we watch are showing accelerating demand and better availability of credit. Will there be less liquidity for investment in the stock market? The Fed balance sheet is not contracting and the drain on liquidity from excess U.S. Treasury financing has abated. Japan and the ECB are both injecting liquidity into the global economy. Some of that liquidity is funding rising foreign purchases of U.S. stocks. The latest data shows domestic stock mutual funds have above average cash balances, so there could be some pent-up buying power. We believe volatility driven by Fed concerns are more about change and uncertainty than about actual expected negative consequences.

Because of that we are looking through the current gyrations to a slow, steady economic expansion. For an economy that is two-thirds consumption we feel the keys to further expansion are employment, consumption trends, wages, and inflation. In those economic concepts the data are neither too hot nor too cold. Job growth is running at a modestly above average rate, while job openings are at a record high. Consumers are pretty confident, selectively spending on goods and boosting the wallet share of experiences. Wages have lagged, but the labor market is beginning to tighten so some upward movement should follow.

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Inflation is important because recessions generally happen when the Fed gets aggressive in a tightening cycle. There is little sign of cost push nor demand pull inflation in the system right now, so an aggressive tightening move is not imminent. A sure sign of which would be an inverted yield curve, as illustrated in the table below. The current curve is a normally upward sloping one.

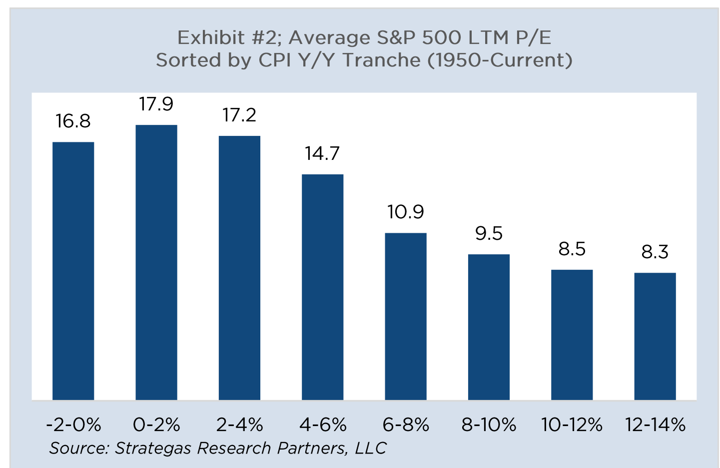
Yield Curve turns Negative	Recession Starts	Months from Yield Curve turn to Recession
8/31/1978	2/29/1980	18
9/30/1980	8/31/1981	11
1/31/1989	8/31/1990	19
2/29/2000	4/30/2001	14
12/31/2005	1/31/2008	25

Source: Strategas Research Partners, LLC

In some respects, the moderate growth experienced since the great recession may allow the economy to extend its recovery longer than normal. Since bear markets are extremely rare without a recession, it is also likely that the trend for stocks is still upward.

Earnings growth has slowed, but it is mostly due to a collapse in Energy earnings. Excluding Energy the median S&P 500 company is still expected to increase earnings in 2015 by 6.7%, which is pretty close to the long-term average. Next year is shaping up to see similar growth rates.

With the Fed beginning to take excess liquidity out of the system, valuations are a big worry for most investors. But while some metrics had gotten extended, most have come back to neutral levels. Compared to other investment alternatives equities are still attractive. So what may be the trigger point for lower valuations? Higher inflation leading to an aggressive Fed tightening would be the most common driver of lower valuations. But when should we begin to worry? Exhibit #2 below gives us some guidance. Historically, price/earnings multiples remain near peak levels up to 4% inflation. With the Fed target of 2% not even being challenged at this point, this would imply that a significant rerating of stock prices is not in the cards near term.



While it is always prudent to pay attention to the issues of the day and carefully assess the possible outcomes, it is often better not to react to them. Today's economic adjustments are changes to the landscape we have been investing in for quite some time. But every expansion evolves in the face of equally scary issues. Investors should be vigilant and the fact that there is worry in the market conversation gives us comfort that the end of the bull has not arrived. It is when everybody is convinced the bull will go on forever despite traditional warning signs that we worry most.

We do not believe the current correction will turn into a rout, but more volatility is likely as we transition to the next phase of the global economic expansion.

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Smith Group Economic Scorecard

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<table>
<tr><th>Economic Concept</th><th>Asset, Liability, or Neutral</th><th>Key Indicators</th></tr>
<tr><td>Consumer Spending</td><td></td><td>Consumer Confidence (YOY), Retail Sales, Consumer Confidence (10YrMA), Real PCE, Disposable Income, Confidence</td></tr>
<tr><td colspan="3">The latest reading of consumer confidence was off highs, but is still elevated compared to the last 10 yrs and is modestly rising on a YOY basis. YOY real personal consumption growth is a positive as is growth in disposable income. Retail sales growth is a neutral. With three indicators better than the asset threshold this concept is an asset.</td></tr>
<tr><td>Credit Environment</td><td></td><td>Loan officer credit conditions survey, Small Business Credit Availability survey, Consumer Credit growth, C & I Credit growth</td></tr>
<tr><td colspan="3">All of the credit indicators are assets, with both availability and demand picking up. Small Businesses are finding credit increasingly easier to get. Growth in loan balances is expanding better than asset thresholds for both consumers and businesses. Loan officers are seeing rising demand.</td></tr>
<tr><td>Employment</td><td></td><td>New Jobless Claims, Change in Private Employment, Job Openings, NFIB Hiring Plans</td></tr>
<tr><td colspan="3">All employment indicators are exceptionally strong making the concept the most positive driver in the scorecard. The last time new jobless claims were this low was the early 1970s. Job openings have accelerated to another new all-time high and now exceed hires. Growth in private sector employment is well above the asset threshold at 2.3%. Small business hiring plans have completely normalized.</td></tr>
<tr><td>Energy</td><td></td><td>WTI - YOY, WTI vs 10yr MA, Pump Prices, Nat'l Gas, Energy Intensity, Energy Imports</td></tr>
<tr><td colspan="3">The impact of lower energy prices is a dual edge sword. Near term capex suffers and default risks could impact credit. But long-term lower prices allow consumers to spend more on U.S. products and services instead of sending dollars offshore. While energy intensity of the economy and dependence on imported oil are falling lower prices are still a net positive for the economy.</td></tr>
<tr><td>Housing</td><td></td><td>Housing starts, Case-Shiller prices, NAHB Survey, Mortgage applications, Mortgage rates</td></tr>
<tr><td colspan="3">Almost all of the housing indicators are better than asset thresholds. New home sales are the best levels in the recovery and starts are picking up. Price appreciation is not robust, but is still firm. There is even a brisk pace of mortgage applications for purchase. Mortgage rates are about even with a year ago, but lower than the 3 year average.</td></tr>
<tr><td>Interest Rate Environment</td><td></td><td>Fed Funds Rate, Yield Curve, Change in 10-year Treasury rate, Change in Fed balance sheet assets</td></tr>
<tr><td colspan="3">The Fed may be contemplating a step toward normalization in short rates and stopped adding to their balance sheet, but 10-year rates are down of a year-over-year basis and the yield curve is still normal with an upward slope. Despite the angst a potential Fed Funds increase is causing it is hard to think of the interest rate environment as anything but stimulative.</td></tr>
<tr><td>Household Wealth</td><td></td><td>Net Worth (YOY%), Net Worth (% of Peak), Debt Service Ratio, House Prices, Stock Prices</td></tr>
<tr><td colspan="3">The September stock market swoon has created some discomfort, but year-over-year stock prices are still about flat, while house prices continue to rise at a moderate rate.While the latest net worth figures are at record highs growth rates have moderated back to the neutral range. The improvement in debt service ratio has also slowed, bringing it back into neutral territory. This concept drops from Asset to Neutral.</td></tr>
<tr><td>U.S. Debt and Budget</td><td></td><td>Interest Payments on National Debt, Maturity Distribution, Deficit & Total Debt, Debt-to-GDP</td></tr>
<tr><td colspan="3">Debt-to-GDP has stabilized, but is not improving. The portion of the federal budget going to interest payments remains flat. While the average maturity is rising, which is a positive, we still worry that once interest rates start to rise this could become a larger issue. For now the concept is a neutral.</td></tr>
<tr><td>Business Spending</td><td></td><td>CAPEX Orders, CAPEX Shipments, CAPEX Surveys, NFIB Small Bus CAPEX Plans</td></tr>
<tr><td colspan="3">Business investment continues to be disappointing. Surveys still indicate that businesses plan to invest, but are not strong enough to make them an asset. Actual orders and shipments have not reflected those plans. Both are now falling on a year-over-year basis, making the overall concept a liability.</td></tr>
<tr><td>International</td><td></td><td>JP Morgan Global PMI, CESI Europe, CESI EM, CESI Japan, Baltic Dry Index, Currency</td></tr>
<tr><td colspan="3">European economic activity is beginning to gain some momentum as seen in a rising, positive CESI. The Japanese CESI is also positive, but not as high as last quarter. Emerging Market CESI is modestly negative, showing they are decelerating as a group. The global PMI is actually quite positive, with the manufacturing component modestly positive and the services much better. With the trade weighted USD up almost 20% YTD it will be harder for U.S. businesses to capitalize in recoveries in Europe or Japan. Neither of our primary trading partners, Canada nor Mexico, are showing robust growth. While global growth is a neutral, the strong USD and our weak trading partners make the concept a modest liability.</td></tr>
</table>

Smith Group Market Scorecard

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Market Concept	Asset, Liability, or Neutral	Key Indicators
Liquidity		Fed Balance Sheet (FRED-WALCL) (YOY%), BOJ Balance Sheet (FRED-JPNASSETS) (YOY%), ECB Balance Sheet (FRED-ECBASSETS) (YOY%), Cash in Money Mkt Funds v. 5yr ave
The Fed balance sheet is flat on a YOY basis, making it a neutral indicator. The BOJ balance sheet is increasing at a fast YOY pace and is an asset. ECB will be an asset soon if they maintain the current pace of purchases. Cash in money market funds is flat with the 5yr ave and credit balances in NYSE accounts are flat YOY. Cash balances in managed mutual funds are above the 20yr ave. Overall the buying power of investors is still supportive.		
Sentiment		AAII Bull/Bear (contrarian), Inv Intel Bull/Bear (contrarian), Retail AA (ICI DomEq/Total), AAII Allocation Survey
AAII survey bull/bear ratio, a contrarian buy signal, fell to an asset level then slipped back above threshold to end the quarter as a neutral. Inv Intelligence survey swung from very optimistic to very pessimistic and is now a contrarian asset. AAII allocation survey shows retail allocations above average, but in the neutral range. Overall, sentiment has moved up to asset from a neutral.		
Asset Flows		Mutual fund flows, Institutional Searches, foreign purchases of U.S. securities, ETF flows, ICI DomEq Flows,
Flows out of equity mutual funds are inserting downward pressure on stocks. Inflows to ETFs still look strong, but the latest data is from July and may be dated. Foreigners are still active buyers of US equities.		
Earnings		F12M YOY EPS Growth, FY2 Diffusion, Guidance, FY2 Diffusion (4-wk change), S&P 500 F12M Expected Growth, % Pos Surp (Latest Report)
Earnings indicators continue to be in neutral territory. The diffusion ratio (#positive to #negative revisions) is tracking close to LT averages. Forward growth expectations are modest, but in neutral territory. Recent earnings surprise experience is in line with the LT ave. The ratio of negative-to-positive guidance is close to the LT Ave.		
Macro		Citi Econ Surprise US, Citi Econ Surprise G10, Citi Econ Surprise China, ISM New Orders Manf, ISM New Orders Services
Economic Surprise index in the US is a bit weaker but well within neutral territory. The G10 CESI index is in neutral territory as well. The Chinese CESI improved, but slipped in recent weeks back below the liability threshold. The ISM New orders for Manufacturing has moderated back to neutral but the Services New orders index is at a record high.		
Valuation		S&P500 F12M PE v 10 yr ave, S&P500 F12M PE v 20 yr ave, S&P 500 PB v 10 yr ave, S&P 500 F12M EY v BAA, Graham & Dodd CAPE
With the market correction, Valuation metrics have improved to neutral. The S&P 500 P/E has moved back below the 10-year and 20-year average threshold. P/B is also back below the 10-year ave threshold. Graham & Dodd CAPE is a liability and EY relative to bond yields is still an asset.		
Geopolitical Risks		Disruptive global events
International headlines continue to be full of risks. The main impact on U.S. markets has been the Chinese stock market gyrations. Despite the refugee crisis, European news that could impact markets have largely abated. The possibility of a U.S. govt shutdown has raised its head of late. While unlikely, the rhetoric is picking up. The potential risks are generally highly visible and in the market, but headlines are likely to continue to result in volatility.		
Revenues		FY2 Diffusion, FY2 Diffusion (4-wk change), S&P 500 F12M YOY%, % Pos Surp (Latest Report)
Forward sales growth expectations have improved and are back in neutral territory. Reported sales for the last quarter were disappointing. Sales diffusion improved back to neutral from low levels, but has turned negative again at the end of the quarter. The disappointing reported sales and recent diffusion deterioration make this concept a liability.		

Disclosures

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