HALBERT HARGROVE

Third Quarter Market Review: "A Tale of Two Signals"

As we look back at 3rd-Quarter markets, we see the periods of extreme volatility that have become all too familiar to equity investors, with relatively few absolute gains among sectors and asset classes. If we use the recent past of market performance as a signal of what we can expect going forward, the "best of times" is not likely the first scenario that comes to mind.

Yet when looking at traditional measures of the health of the U.S. economy, a different story seems to be playing out. This report juxtaposes what these two signals have to say to us, and then turns to questions of inflation and global divergences in monetary policy, along with current equity valuations—and opportunities.

Market Signals

Last Quarter's *Market Insight* report was titled "Pigs Get Slaughtered." While we still have not seen blood in the streets (nor are we forecasting such an event!) there was a solid round-trip move in the markets during the 3rd Quarter that rewarded risk-averse investors on a relative basis. During the past quarter, the best-performing areas were not the types of sectors or assets you'd expect to see leading the charge of a new bull market. Mega-cap U.S. stocks led large-cap stocks (the Russell 50 was +1.7% vs. the Russell 1000's -0.51%); cash-rich technology companies (+3.24%) and relatively defensive health care organizations (+3.73%) were the best sector performers.

While utilities experienced a negative return on the quarter (-3.95%), they still show relatively robust gains on the year (+12.57%). Tech and healthcare markets (+15.85% and +13.93% respectively) have also turned in strong year-to-date returns thus far. Small-cap U.S. stock declines accelerated their sell off in the quarter, down -8.65% for the quarter; they are now down -4.26% year to date. Despite the relative success of developing markets like China, India and Mexico, emerging markets, in the aggregate, were down -6.81% for the quarter, largely due to the downturn in Russian and Brazilian markets. The biggest losers in developed foreign stock markets were Germany, France, Spain and Italy. Indeed, the developed foreign market, as represented by the MSCI EAFE, has continued to trend below its 200-day moving average.

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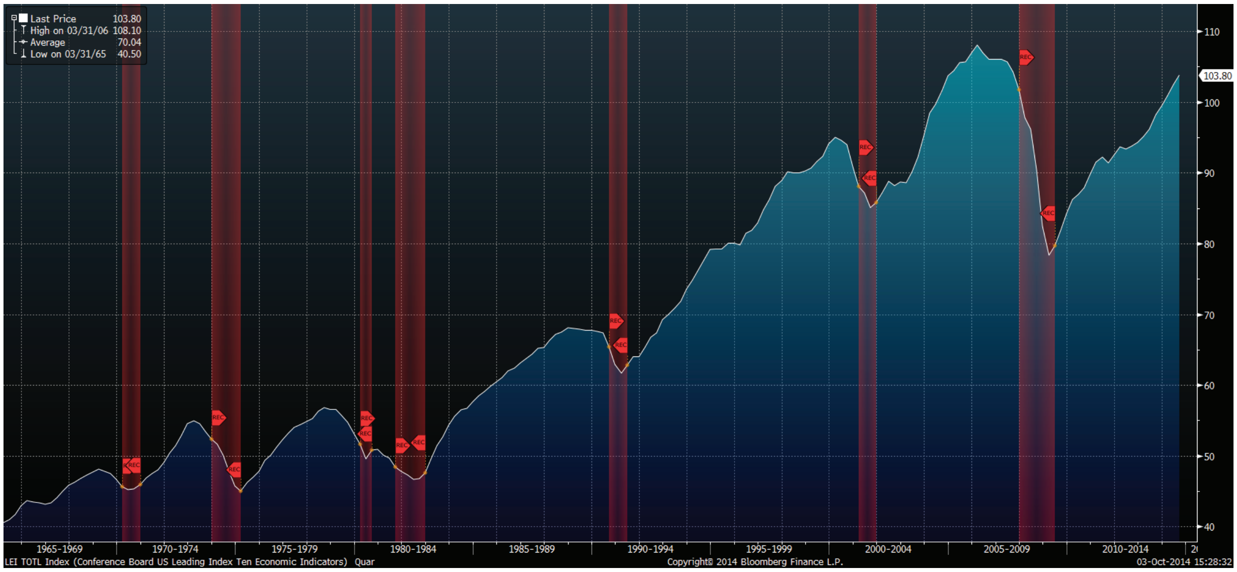
<u>Commodities experienced a strong draw down, off -12.34% for the quarter</u>—and erasing their hard-fought gains established earlier in the year. They're now down -5.68% YTD. The most heavily impacted area of that market on a price return basis was silver, down -19.49% on the quarter, with gold also staging a -15.35% decline.

In sum, in the context of what the markets are signaling to us, near-term performance is a concern. For example, strong moves in long-dated Treasuries (S&P's 30-year U.S. Treasury Bond Futures Total Return Index was +6.7% for the quarter and +10.4% YTD), and market-leading movements from utilities and health care are not typical of a strong bull market. At the time of this letter's publication in mid-October, the broad stock market has continued to contract further. All told, we liken the market's signal to a dog accompanying you on a walk: "You" (the economy) are moving in a certain direction and the "dog" (the market) stops to inspect every fire-plug and fragrant attention-grabbing substance it can find. You might walk two miles to your destination. The dog might walk four miles—occasionally lagging behind, often leading the charge. But in the end, you both will surely end up at the same destination.

U.S. Economic Signals

How different a story is being told by the U.S.'s economic tea leaves? Reviewing the headline Leading Economic Indicator (LEI) index, we still see a high and rising tide. Please note that recessions (red vertical lines) in the chart below do not occur when LEIs are rising:



Source: Bloomberg, Leading Economic Indicators and Recessions (red vertical lines)

From recent Fed communiques, it is clear that they are moving their focus away from headline unemployment statistics and are becoming more focused on indications of inflation pressure. We have seen a steadfast decline in headline unemployment (the latest is 5.9%; 5.4% is considered "full employment" by the Fed) and recently touched business-cycle low jobless claims (the latest four-week moving average was at 295k).

As a lagging indicator, unemployment statistics help confirm that the U.S. economy has indeed recovered dramatically. The question now is whether or not we've reached the expansionary part of the economic growth curve.

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Many cyclical areas of the economy are still showing relatively healthy statistics. The Institute for Supply Management, for example, shows the PMI® at 56.6 (remember that the PMI® composite index is a diffusion index such that readings over 50 indicate growth and readings less than 50 indicate contraction). In other words, the economy is still growing, but at a slightly slower pace than August's 59 reading. Fortunately, we're seeing strength in the New Orders (60.0) and Production (64.6) categories versus Inventories (51.5) and Backlog (47). Global PMI statistics echo the notion that the U.S. economy is particularly strong, but the rest of the globe is still a question mark.

Global Purchasing Managers' Index for Manufacturing

	Oct'12	Nov'12	Dec'12	Jan'13	Feb'13	Mar'13	Apr'13	May'13	Jun'13	Jul'13	Aug'13	Sep'13	Oct'13	Nov'13	Dec'13	Jan'14	Feb'14	Mar'14	Apr'14	May'14	Jun'14	Jul'14	Aug'14	Sep'14
Global	48.9	49.7	50.1	51.4	50.8	51.0	50.2	50.4	50.4	50.6	51.5	51.6	51.9	52.9	52.9	53.0	53.2	52.4	51.9	52.2	52.6	52.4	52.5	52.2
U.S.	51.0	52.8	54.0	55.8	54.3	54.6	52.1	52.3	51.9	53.7	53.1	52.8	51.8	54.7	55.0	53.7	57.1	55.5	55.4	56.4	57.3	55.8	57.9	57.5
Canada	51.4	50.4	50.4	50.5	51.7	49.3	50.1	53.2	52.4	52.0	52.1	54.2	55.6	55.3	53.5	51.7	52.9	53.3	52.9	52.2	53.5	54.3	54.8	53.5
U.K.	47.7	48.0	50.6	51.0	48.1	50.2	50.6	52.2	52.8	55.0	57.4	56.4	56.1	57.9	57.0	56.5	56.4	55.6	57.2	56.8	57.2	54.7	52.2	51.6
Euro Area	45.4	46.2	46.1	47.9	47.9	46.8	46.7	48.3	48.8	50.3	51.4	51.1	51.3	51.6	52.7	54.0	53.2	53.0	53.4	52.2	51.8	51.8	50.7	50.3
Germany	46.0	46.8	46.0	49.8	50.3	49.0	48.1	49.4	48.6	50.7	51.8	51.1	51.7	52.7	54.3	56.5	54.8	53.7	54.1	52.3	52.0	52.4	51.4	49.9
France	43.7	44.5	44.6	42.9	43.9	44.0	44.4	46.4	48.4	49.7	49.7	49.8	49.1	48.4	47.0	49.3	49.7	52.1	51.2	49.6	48.2	47.8	46.9	48.8
Italy	45.5	45.1	46.7	47.8	45.8	44.5	45.5	47.3	49.1	50.4	51.3	50.8	50.7	51.4	53.3	53.1	52.3	52.4	54.0	53.2	52.6	51.9	49.8	50.7
Spain	43.5	45.3	44.6	46.1	46.8	44.2	44.7	48.1	50.0	49.8	51.1	50.7	50.9	48.6	50.8	52.2	52.5	52.8	52.7	52.9	54.6	53.9	52.8	52.6
Greece	41.0	41.8	41.4	41.7	43.0	42.1	45.0	45.3	45.4	47.0	48.7	47.5	47.3	49.2	49.6	51.2	51.3	49.7	51.1	51.0	49.4	48.7	50.1	48.4
Ireland	52.1	52.4	51.4	50.3	51.5	48.6	48.0	49.7	50.3	51.0	52.0	52.7	54.9	52.4	53.5	52.8	52.9	55.5	56.1	55.0	55.3	55.4	57.3	55.7
Australia	42.8	44.3	44.3	40.2	45.6	44.4	36.7	43.8	49.6	42.0	46.4	51.7	53.2	47.7	47.6	46.7	48.6	47.9	44.8	49.2	48.9	50.7	47.3	46.5
Japan	46.9	46.5	45.0	47.7	48.5	50.4	51.1	51.5	52.3	50.7	52.2	52.5	54.2	55.1	55.2	56.6	55.5	53.9	49.4	49.9	51.5	50.5	52.2	51.7
China	49.5	50.5	51.5	52.3	50.4	51.6	50.4	49.2	48.2	47.7	50.1	50.2	50.9	50.8	50.5	49.5	48.5	48.0	48.1	49.4	50.7	51.7	50.2	50.2
Indonesia	51.9	51.5	50.7	49.7	50.5	51.3	51.7	51.6	51.0	50.7	48.5	50.2	50.9	50.3	50.9	51.0	50.5	50.1	51.1	52.4	52.7	52.7	49.5	50.7
Korea	47.4	48.2	50.1	49.9	50.9	52.0	52.6	51.1	49.4	47.2	47.5	49.7	50.2	50.4	50.8	50.9	49.8	50.4	50.2	49.5	48.4	49.3	50.3	48.8
Taiwan	47.8	47.4	50.6	51.5	50.2	51.2	50.7	47.1	49.5	48.6	50.0	52.0	53.0	53.4	55.2	55.5	54.7	52.7	52.3	52.4	54.0	55.8	56.1	53.3
India	52.9	53.7	54.7	53.2	54.2	52.0	51.0	50.1	50.3	50.1	48.5	49.6	49.6	51.3	50.7	51.4	52.5	51.3	51.3	51.4	51.5	53.0	52.4	51.0
Brazil	50.2	52.2	51.1	53.2	52.5	51.8	50.8	50.4	50.4	48.5	49.4	49.9	50.2	49.7	50.5	50.8	50.4	50.6	49.3	48.8	48.7	49.1	50.2	49.3
Mexico	55.5	55.6	57.1	55.0	53.4	52.2	51.7	51.8	51.3	49.7	50.8	50.0	50.2	51.9	52.6	54.0	52.0	51.7	51.8	51.9	51.8	51.5	52.1	52.6
Russia	52.9	52.2	50.0	52.0	52.0	50.8	50.6	50.4	51.7	49.2	49.4	49.4	51.8	49.4	48.8	48.0	48.5	48.3	48.5	48.9	49.1	51.0	51.0	50.4

Source: Markit, J.P. Morgan Asset Management.

Heatmap colors are based on PMI relative to the 50 level, which indicates acceleration or deceleration of the sector, for the time period shown.

Guide to the Markets – U.S.

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Bottom line, we see a growing economy that is not quite reaching escape velocity to the point where we would have significant concerns about inflation (more on this in subsequent pages) or strongly rising interest rates. But economic conditions are clearly not indicating an impending recession, either.

Global Divergences in Monetary Policy

One challenge facing market participants is that global central bank coordination has now given rise to a divergence in monetary policy. We believe that part of the increased volatility we have seen in the latter half of the quarter stems from concerns over this divergence. The U.S. was the global leader in terms of responding to the cyclical weakness of the Great Recession and has now almost completed its tapering efforts. Fearing future uncontrollable inflation, the ECB and BOJ have been reluctant to recognize the benefit of aggressive monetary policy.

That said, given recent deflationary concerns, global central banks have been given ample cover to take even greater steps (negative deposit rates are a prime example) towards the type of easing that may force market participants to accept/purchase risk assets in their region. [For the record, we believe that any additional QE here in the U.S. is likely off the table as the Fed recognizes that its bond-buying efforts actually had the opposite effect than hoped—that is, bond yields rose during periods of QE!]

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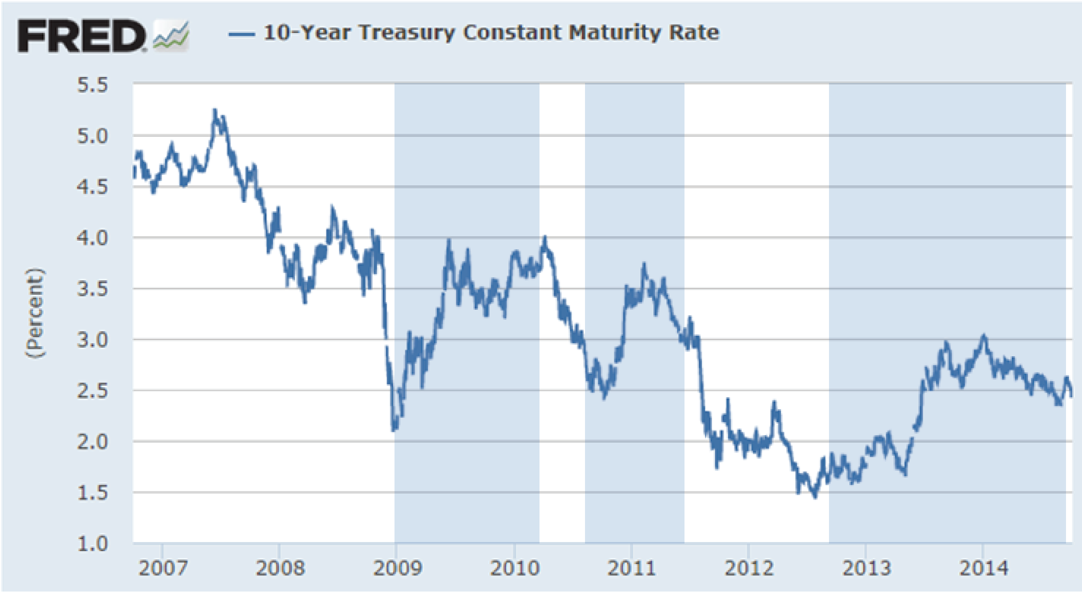

Source: Federal Reserve Bank of St. Louis; HH
QE1 - 12/2008 to 3/2010; QE2 - 11/2010 to 6/2011; QE3 - 9/2012 to 10/2014(?)

As mentioned above, one risk of this divergence is that low-volatility investing may be a thing of the past. Since 2009, stock market pullbacks have been shallow, particularly over the last two-and-a-half years. We would not be surprised to see more material pullbacks on the horizon (at the time of publication, this most recent pullback has now exceeded ~7% in terms of drawdown from the September 18th high).

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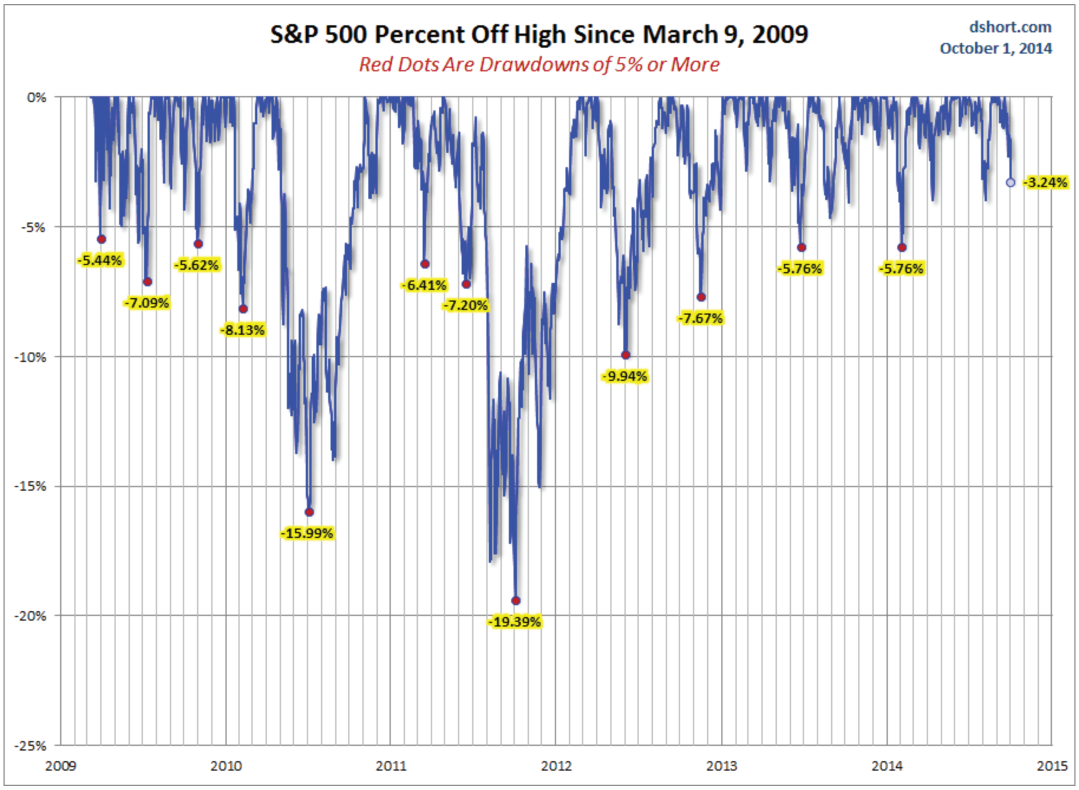

Whither Valuations?

One question we've been asked a lot lately is whether or not the stock market, particularly the U.S. stock market, is overvalued. The financial press has been focusing a lot of attention on the CAPE ("Cyclically Adjusted Price/Earnings" ratio, colloquially known as the Shiller P/E), a method used to normalize and smooth inflation-adjusted earnings comparisons over time. As of October 1st, the CAPE is 25.79 for the S&P 500:

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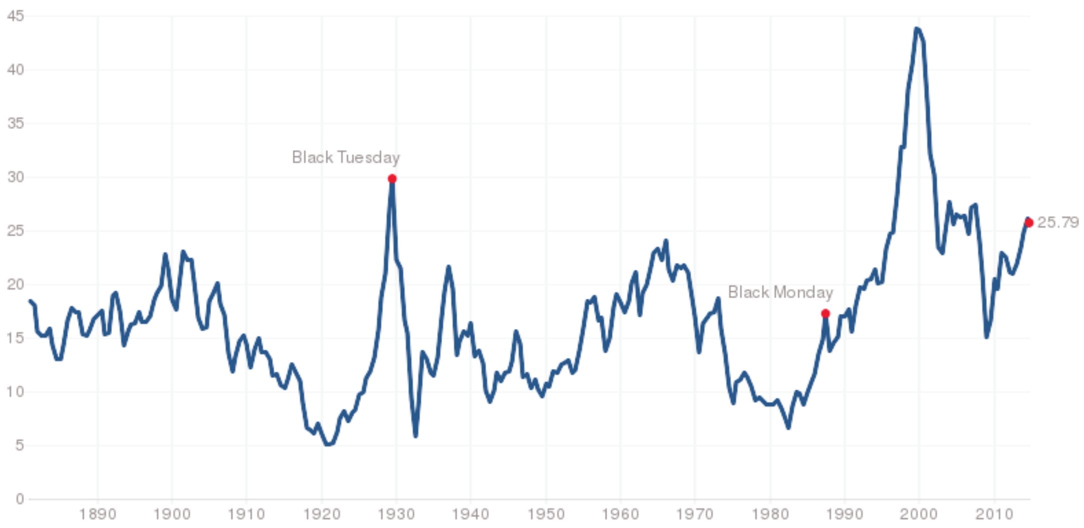

Source: multpl.com/shiller-pe/

Without context, one could look at this chart and suggest that it's time to get out of stocks (or at least U.S. stocks). That said, there might be macro forces at work that suggest that the entire level of "normal" should be shifted upwards. Specifically, discounting the future value of earnings at pervasively low rates of interest and inflation suggest that the future value of earnings may be worth more than in the past.

In any case, whether you believe that we're in a "New Neutral" environment for rates, or a "New Normal" environment for valuations, the CAPE method shown above should not be used as a timing tool. It can, however, give an investor some context in looking at longer-term expected returns. All else being equal, with higher valuations it is tougher to count on long-term, above-average nominal (gross of inflation) returns from U.S. stocks. Most major/reputable institutions we survey are looking at 10-year expected returns for U.S. stocks in the 6-to-8% range per annum—not the historical "10%" commonly referenced. However, this comes on the heels of lower expected inflation (~2-2.5%), such that the real return on stocks may still be a healthy 4-to-5.5% range. Note, however, these comments are looking at the next 10 years—and not the next day, week, month, quarter or year.

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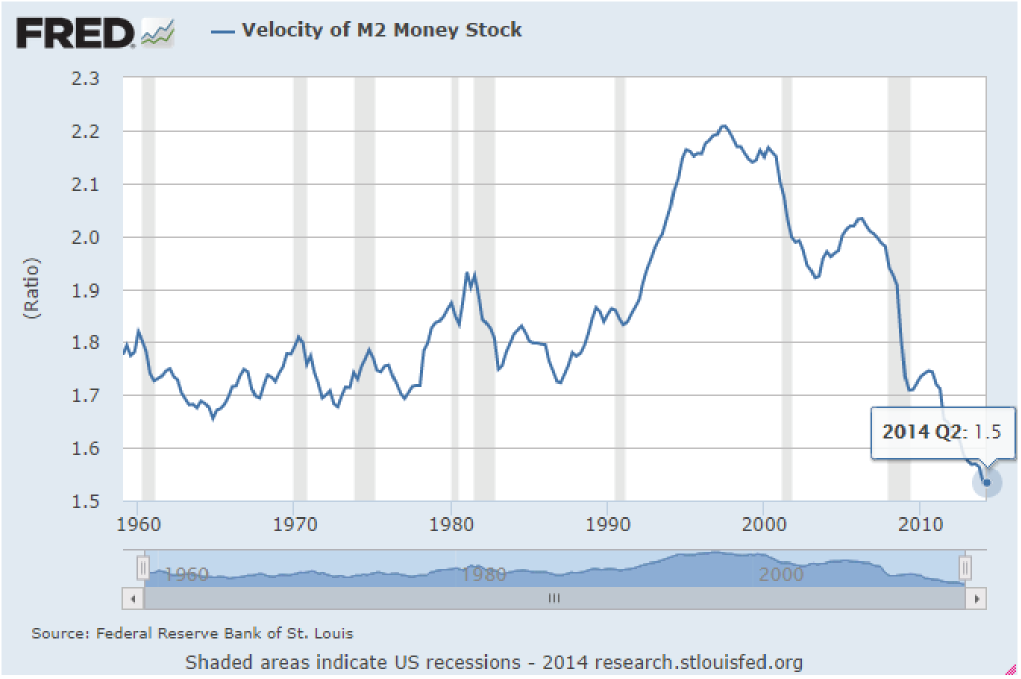
Wither Inflation?

Another popular question lately is whether or not we expect significant inflation pressures. This generally arises from the notion that with the past efforts of QE, here and (now) abroad, we have far too much money chasing too few goods. It is true that the globe is awash with capital, but in most cases, we're not seeing an improvement in the velocity of money changing hands. The more frequently cash (M2) changes hands, the more productive that capital is from a GDP perspective. Thus far, all this QE capital-sloshing has not significantly benefited economic activity; it did, however, help forestall the global liquidity route that occurred during the Great Recession. In our view, this has been a worthy effort and one that likely kept the global financial system from falling further into a deflationary cycle.



Fortunately, one major area of cost pressure for U.S. consumers has improved markedly during the 3rd quarter: gasoline. Retail gasoline has dropped from an average of $3.68/gallon at the end of the 2nd Quarter, to a forecasted rate of $3.50/gallon at the end of the 3rd Quarter. Given continued weakness in crude prices, further downside in gasoline prices may exist. This is a tailwind for consumer spending, particularly for those at the lower end of the income scale.

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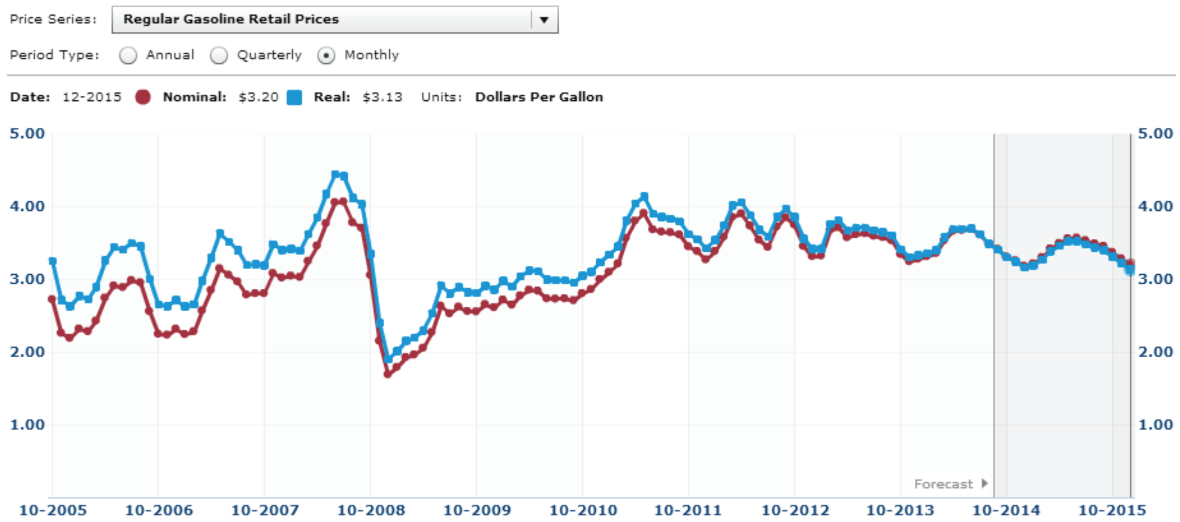

Source: U.S. Energy Information Administration

With regard to inflation pressures, another useful statistic to consider is the Employment Cost Index (ECI). July 2014's release showed that wages and salaries are starting to show some improvement, up .6% in the 2nd Quarter, and up 1.8% over the past year. This is good for consumption and was reflected in strong consumer-spending data in the 2nd Quarter's robust real GDP figures (+4.6%). Wages make up approximately 70% of the ECI, with benefits making up the remainder. Unfortunately for businesses, we saw a higher rise in the cost of benefits, which rose 1.0% in the 2nd Quarter (up 2.5% over the past year). Net-net, we see wage growth as di minimis and not a source of inflation pressure—yet.

Another source of anti-inflation power is the current strength of the U.S. Dollar. The U.S. Dollar Index was on a tear during the 3rd Quarter, up almost 8% against a basket of other countries. This has had a direct impact on commodities during the quarter given that many commodities trade in U.S. Dollars (all else being equal, a higher U.S. Dollar equals lower prices for commodities and vice versa). Some pundits are concerned that a higher U.S. Dollar will impact our economy by virtue of reducing demand for our exports. Fortunately, total goods and services exports only make up ~13% of our GDP. In other words, internal growth within the U.S. is more important to our health than external demand from our trading partners.

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It should be noted here that U.S. Dollar strength does exert a negative influence on returns for investments made in other currencies that must, eventually, be repatriated into U.S. Dollars. To that end, we have seen a fairly significant divergence in the performance of local-currency returns in foreign markets versus U.S. Dollar-denominated returns in those same markets.

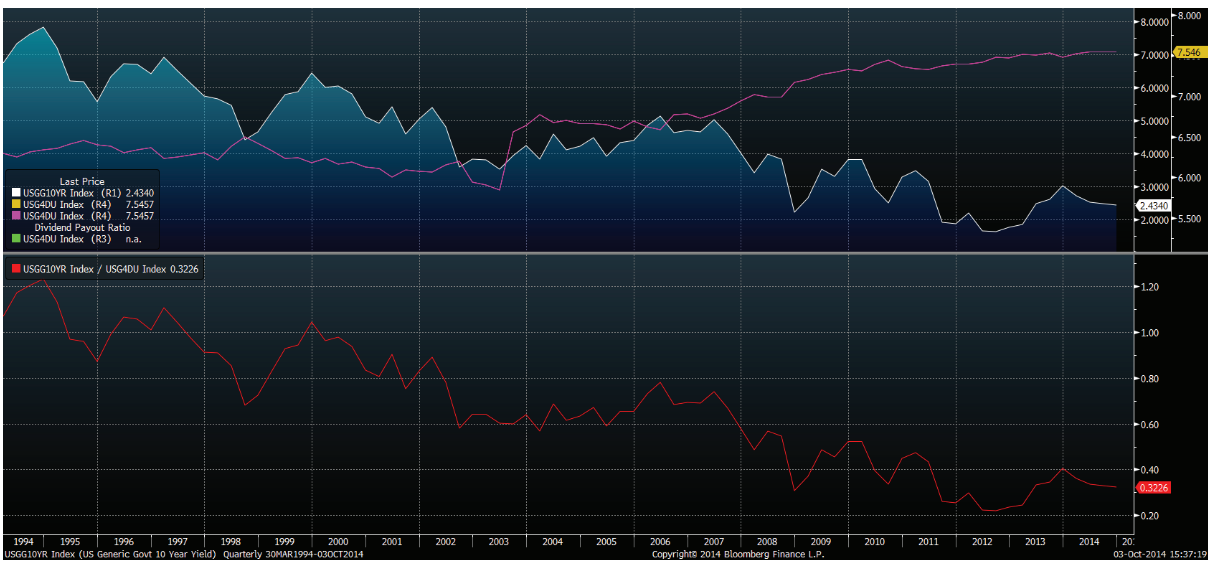
Opportunities

With the challenge of mixed signals from the market and the economy, opportunities for investors should be reviewed both on an absolute and relative basis. In this context, “absolute” can be defined as whether or not you are getting paid enough for the risk you are taking with the investment; default or bankruptcy risk come strongly to mind (this can often be viewed as the risk of permanent loss). “Relative” opportunities should be reviewed in the context of what your other investing options actually are. In the short run, even in a zero-yield environment, cash can “make” money by virtue of the fact that the prices of other assets decline. In the long run (i.e., 10+-year time horizons), it’s difficult to suggest that investments in stocks are a risky bet, even if they pose a short-term risk of volatility:

Source: Wilshire Associates; CalPERS website, through Dec. 2013.

The preceding chart shows that since the start of the S&P 500 in 1926, there have been only four rolling 10-year periods of negative total returns out of a total of 79. <u>In other words, in just 5% of the history of the S&P 500 did an all-stock portfolio lose money during a rolling 10-year period!</u>

In the fixed-income markets, one could argue that longer-term return challenges may exist. The top half of the chart below shows the duration of a 7-to-10-year Treasury bond index (purple line) versus the current yield of the 10-year Treasury bond (white line with shading). The bottom half of the chart shows the ratio of the two items – currently ~32%. In the early 90s, this ratio was well above 100%. In other words, we are currently at very low levels of return (yield) per unit of risk (duration). Only in mid-2012 and early 2013 did we see lower levels; the taper-tantrum in 2013 at least helped improve (slightly) this measure of opportunity.



Note, however, that "relative" opportunities may also exist within different components of the fixed-income markets. Assuming a continued slow-growth expansion, the spread return received on high-yield fixed income may be valuable enough to compensate investors on a relative basis, given low inflation and currently low default rates. That said, we are keeping a watchful eye on the high-yield market, given the fact that those spreads may not be attractive enough on an absolute basis.

Of course, directly focusing on the returns of bonds/fixed income misses the larger point: that the stabilizing effect of core bonds permits an investor to hold a higher percentage of the portfolio in return-generating assets. That is, part of the "return" to bonds is therefore an insurance cost or option premium forgone.

Clear Signals: Moving Averages

During the last quarter, as developed international markets showed relative weakness, our proprietary moving average signal on the foreign developed equity market identified that it was time to move some capital to the sidelines. As of August 6th, we raised approximately 5% cash from the foreign equity portion of our clients' accounts. Thus far, this has been a profitable move relative to the continued weakness in that marketplace. It should also be noted that the recent negative price action in U.S. stocks since the end of the 3rd Quarter generated an additional sell-signal on the Large-Cap U.S. portion of our moving average strategy. Following, we have raised an additional 5% cash from the U.S. portion of our clients' accounts.

In combination, the two signals referenced above have us moving approximately 20 to 25% of our typical clients' equity allocation to cash. Why not more? Moving-average signals are not the end-all-be-all to portfolio management. There is no perfect solution that allows an investor to capture all the upside of a stock market and none of the downside. Given that these signals also inform our decision to re-enter the market when price action improves, we expect to have periodic whipsaws that may have this portion of our portfolios modestly underperform during a choppy market. We believe this is a price well worth paying if it helps our clients dodge a significant portion of an inevitable bear market.

Ultimately, any tactical decision making should be limited and rules based, or non-existent. A portfolio strategically aligned with your long-term growth objectives and needs should be the priority. To revisit our earlier analogy, the mixed signals from the market and economic data referenced above are not a far cry from the "dog" that has taken one of its many deviations from the path to sniff a bush or chase a squirrel. In other words, focusing on where you'd like to walk is paramount—and at the heart of our mission statement: Investing to integrate your money and your life™.