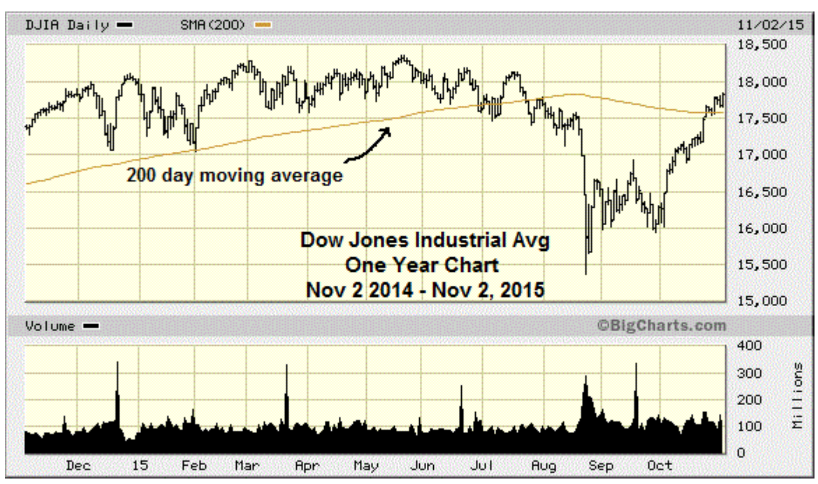
American Heritage Financial

November Update **November 3, 2015**

Tail Wagging the Dog?

October was a great month for the stock market, offering much needed relief from the ugly decline of August through September. October delivered the best monthly performance in four years with the Dow Jones Industrial Average surging 8.5% and the S&P 500 nearly as good with an 8.3% advance. The October rebound wiped out most of the 8.9% August/September decline in the S&P and it leaves the major market indices back near breakeven for the year—the Dow is negative by zero point nine (–0.90%) year-to-date while the S&P is positive by zero point nine-nine (+0.99%).

Market commentators are comparing the late summer swoon and strong October rebound with the market of 2011 which followed an almost identical pattern. If history were to continue to repeat, we could expect November to be a volatile but negative month; in November 2011 the S&P declined by 0.5%. On the other hand, according to the *Stock Trader's Almanac,* November is one of the best performing months for stocks, producing an average gain of about 1.5%. Further, from a "history repeating itself" perspective, S&P Capital's *MarketScope* reviewed the correction we have been through: Peak to trough, the 2015 decline was 12.5% and it recovered that loss in just a few more days than the median 66 days that similar corrections have taken to recover. Further, if this correction followed historical median patterns, there would be another 6.5% move to the upside before stocks pull back as much as 5% or more.



While looking at such historical statistics is interesting, it provides just slightly more value than astrological signs when it comes to predicting the future direction of the stock market. Perhaps it is an indication of just how murky the "more useful" indicators are that we have resorted to reviewing historical patterns and median statistics. By "more useful," we mean indicators such as interest rates, earnings and the overall state of the economy. A big reason for the current difficulty in anticipating near term market direction is the continual conflicting signals these indicators have been flashing.

Is the Fed leading the economy or is the economy leading the Fed? The biggest area of confusion is the result of vacillating leadership from the Fed. For nearly two years, the Fed has intimated that they are close to "normalizing," or increasing, interest rates. This past September's meeting was one in which investors felt certain they would learn of either a rate hike or a clear explanation as to when a hike would occur. Stocks generally react favorably to the Fed keeping interest rates low and monetary policy accommodative but stocks did not rise on September 17, when the Fed left interest rates unchanged; they fell that day and for six of the next seven trading sessions. The reason was the uncertainty reinforced by the Fed announcement; uncertainty about Fed policy as well as uncertainty about the economy. Investors were asking, "Does the Fed know something (negative) we don't know?"

As it turned out, maybe the Fed did have some insight on economic weakness. On September 30, the jobs report was shockingly weak with only 142,000 new jobs created along with downward revisions from the two prior months removing another 59,000 jobs. Through October, the economy produced other lackluster numbers for housing, industrial production and consumer spending. By the close of October, third quarter GDP estimates were down to just 1.5%, compared to the strong 3.9% growth in the second quarter.

Perhaps economic weakness encouraged the recent stock rally since further accommodative policy from the Fed seems sure to continue if the economy is slipping. In fact, at least two

Fed governors reiterated their belief in continuing easy money. For example, Fed Governor Tarullo, on October 13, said "…the U.S. central bank should not hike interest rates this year."

But wait! In their most recent announcement, Wednesday, October 28, the Fed surprised again by *specifically—and* ***unusually****—emphasizing* the potential for a rate hike at its next meeting, December 15-16. As confusing as all the various messages are, the most recent statement implying an eminent rate hike probably makes the most sense as economists continue to point to underlying strength in the economy and explain that the recent soft patch of indicators is only temporary.

Moving back to something more substantive, in our opinion, the current earnings season has definitely been positive for stocks. Overall, earnings are expected to be about 3% lower for the third quarter due to weakness in energy and currency headwinds, but the market reacts to *expectations*. With 341 of the S&P 500 companies reporting, so far, 76% of them have beat their estimate compared to 66% beating expectations in an average quarter. Even more important are extremely strong reports from market and economic bellwethers like Amazon, Microsoft, Alphabet (Google's new name), Dow Chemical, PepsiCo, GE, LinkedIn and even Exxon Mobil. Notice that technology dominates that list and tech has been one of the most favored sectors of the current rally. On the other hand, stocks that miss earnings (Twitter, GoPro and Pandora are some of the higher profile misses) have been hammered. And demonstrating that it is becoming more and more a stock picker's market.

Putting it all together still makes for a somewhat murky outlook. We expect the Fed to continue with inconsistent messages leading to more uncertainty which will create continued volatility. We are in the camp which still expects solid additional growth from the economy through yearend and into 2016. Not discussed above, but Europe and China offer challenges while showing signs of bottoming out. The market is not "cheap" (currently trading near 16.5 future earnings) but, as this quarter is showing, many companies have great earnings potential and those stocks are rewarding investors. It is a time to watch all the various headwinds and tailwinds as we continue to look for the solid, long-term investments that can help you achieve your long term objectives.

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Questions or comments?

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