"Expect The Unexpected"
Market Commentary – October 2015

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The third estimate of Gross Domestic Product (GDP) shows that the output of goods and services produced by labor and property located in the U.S. grew at an annual rate of 3.9% in the second quarter of 2015. This is higher than the advance estimate of 2.3% and the second estimate of 3.7%. On September 17, the Federal Open Market Committee (FOMC) revised its June forecast for economic growth. The FOMC now projects GDP growth of 2.1% in 2015, 2.3% in 2016, 2.2% in 2017 and 2.0% in the "longer run". The June projections were 1.9%, 2.5%, 2.3%, and 2.0%, respectively. Overall, the FOMC sees slow, steady growth continuing into the foreseeable future. All of this is expected to happen with unemployment hovering around 5% and inflation slightly below 2%.

In one of the most anticipated FOMC meetings in years, the FOMC decided on September 17 to leave its benchmark federal funds rate unchanged at a rock-bottom range of 0% to 0.25%. In its announcement, the FOMC expressed concern that "recent global economic and financial developments may restrain economic activity somewhat and are likely to put further downward pressure on inflation in the near term." Moreover, Fed Chair Janet Yellen stated in her press conference following the FOMC announcement, "The stance of monetary policy will likely remain highly accommodative for quite some time after the initial increase in the federal funds rate in order to support continued progress toward our objectives of maximum employment and 2 percent inflation." Collectively, the 17 FOMC members see the federal funds rate at a weighted-average of 0.40% by the end of 2015, 1.48% in 2016, 2.64% in 2017, and 3.46% in the longer run. Two more FOMC decisions are scheduled for 2015: October 28 and December 16. Once the Fed gets the first rate hike out of the way, the focus will be on the pace of future increases. The Fed will remain in the spotlight for months to come.

Technical factors of the market are bearish (more supply than demand), while fundamentals are attractively priced – therefore, we are bearish on the market. The Standard & Poor's forecast for S&P 500 operating earnings per share (EPS) over the next 12 months is $125.17, which implies a price-to-earnings (P/E) ratio of 15.3 with the S&P 500 at 1,920. The earnings yield (E/P) of 6.52% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.06%. As stocks have corrected in recent weeks, the spread relative to interest rates has grown. Stocks are becoming an even better value.

Weakness continues to plague the charts of major stock market indexes. In August, the S&P 500 hit a low of 1,868. After bouncing up to an intraday high of 2,021 on September 17 (minutes after the FOMC announcement), it fell back to an intraday low of 1,872 on September 29. Should support at the August low fail, technicians look for lower levels of support. From August 17 to August 25, the S&P 500 fell 235 points. The consolidation from August 25 to September 17 may prove to be a pattern called a "bear flag". In that case, another drop of 235 points from 1,995 would be in order, which would put the S&P 500 at 1,760. If there is a liquidity crunch, perhaps caused by algorithmic trading involving Exchange Traded Funds, we could see a 1987-like plunge to around 1,500 (a 22% drop from current levels and a 30% drop from the stock market peak). Should this happen, we believe that interest rate hikes will be off the table and the Fed will implement a fourth round of quantitative easing (QE).

Market volatility to the downside should be embraced, not feared. If we get a steep market decline, our stocks would most certainly be down in price. However, this is where we earn the real return on cash. You need to have cash before a decline in order to buy stocks that other investors are foolishly throwing away. We have performed detailed fundamental analysis on several new companies in recent weeks, and we remain ready to pull the trigger. Absent clairvoyance, we rely on our trusted friends "balanced" and "incremental" to manage downside risk. Portfolio management is not about "timing the top" or "timing the bottom". Instead, we do our best to be prepared for a variety of scenarios, including the unexpected.