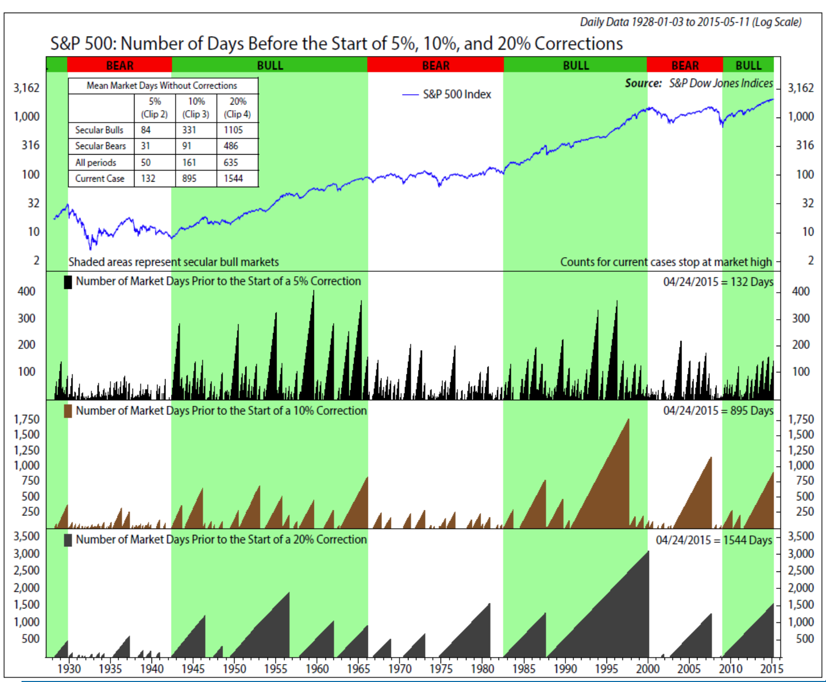
Investment Commentary: 6/2015

U.S. stocks were positive in May, with smaller-company stocks outperforming large-caps, 2.28% vs. 1.29%. For the year, the Russell 2000 (small-caps) has risen 3.98% and the S&P 500 is up 3.23%. Economic news during the month was mixed. Housing showed some positive signs in new home sales and construction, and employment has generally been on a path of improvement. However, manufacturing indicators weakened and consumer spending continues to be below expectations, even with lower oil prices. ***Sluggish economic reports have increased uncertainty about the strength of the economy and the ultimate timing of when the Federal Reserve will start raising interest rates.*** While the Fed's April statement (released in May) characterized a June hike as unlikely, Chair Janet Yellen continues to indicate that the Fed expects sufficient improvement in economic conditions to warrant a rate hike later this year. Market participants expect the first move to occur in September if not later.

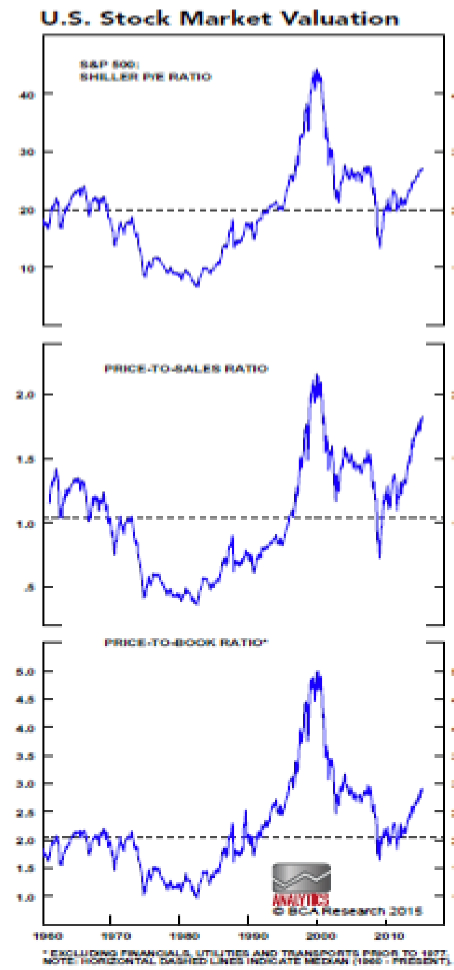
International markets were down in May but remain ahead of U.S. stocks for the year. International developed stocks were down 0.40% for the month and are up 8.93% for the year-to-date. ***Europe's economy has shown improvement, boosted by a weaker currency and lower oil prices; while Japan has also shown solid positive economic growth so far this year.*** An agreement on Greece's debt has remained elusive (though the country's creditors were close to presenting a proposed deal to Greece as June got underway). Emerging markets fell 3.6% in May as a variety of countries declined amidst varied economic outlooks and uncertainty regarding U.S. monetary policy. For the year-to-date, emerging markets are up 5.78%.

In the bond market, interest rates rose in May as the yield curve steepened (i.e., rates on longer-term bonds rose more than those on short-term securities). The Barclays Aggregate bond index fell 0.24%. Our alternative bond managers and strategies performed relatively well and in line with our expectation for these investments in a rising-rate environment.



Update on the Bull Market

By most measures ***the current bull market is getting "long in the tooth***." The chart to the left from Ned Davis Research shows the number of days since we have seen a correction of 5, 10 or 20%. The length of time since the last significant correction is near record levels, suggesting that complacency on the part of investors is increasing. The ***chart does not suggest that a correction is imminent, but it does suggest a correction is probably overdue and likely to occur in the next year***. Usually, the longer it takes for a correction to occur, the greater the magnitude of the decline is likely to be when it does arrive.



We have also been on record that valuations for the stock market are now overvalued, but have not yet reached extreme levels (e.g. the late 1990's). The BCA chart to the right highlights a few valuation metrics that show the market's current above average valuation. However, valuation by itself is a notoriously poor market timing tool. Anyone remember what year Alan Greenspan's Irrational Exuberance speech took place? It was 1996, right before the market went on to produce 20% + returns in 1997, 1998 and 1999! A good reminder, that valuation by itself only becomes a good market timing tool when it reaches extremes, like it did in 1999.

In our opinion, successful long-term investors need to be able to recognize both value and have a general sense of timing, when looking for opportunities to both seek and take profits. This is easier said than done, and the normal fundamental signals we look for may be skewed due to the "artificial" monetary policies in place the past six plus years. Frequently the internal action of the market can provide clues when market conditions are changing. In this age of artificial monetary policy and pricing of asset classes, the market internals may provide more insights than normal. These internal indicators are far from fool-proof, however we have highlighted below some that we believe are worthy of watching:

- ***New 52-week highs can be an early indication that a market is turning unhealthy.*** Look for divergences between index-price highs and new 52-week highs. When a major index such as the S&P 500 is making new highs but the number of SPX stocks making 52-week peaks begins declining, that divergence can be a warning sign.
- We monitor for ***divergences between the advance/decline line*** (stocks going up vs. down) and the broader markets. Similar to new 52-week highs this ***is a signal of market breadth***, a term that describes how much of the market is participating in the advance. As markets peak we often see fewer and fewer stocks are pulling the market upward. We saw a classic example in the "Nifty Fifty" during the 1960s, and again in the dot-com bubble with a handful of leading stocks driving the NASDAQ.
- Another signal we look for is a ***change in market capitalization leadership***. Usually when markets begin to peak we start to see small caps underperform. Often the smallest companies start to turn south, while the rest of the market appears healthy. The tendency for big-cap-dominated indices to peak last is a function of their composition. Since these indices are market-cap weighted, a small number of the mega-caps can keep the index moving higher while the majority of stocks lag.
- Another interesting factor worth watching is the ***percentage of stocks in a bear market***. As a rough estimate, any equity down 20 percent from recent highs can be considered in its own bear market. Based on Lowry market studies it is typical during healthy bull markets that less than 10 percent of

stocks are down 20 percent from recent highs. As the small caps and mid-caps roll over, this percentage will increase. At the market peak, we typically see one-fifth of stocks in their own bear market.

Currently, there has been some deterioration in the above indicators, but we are not seeing any imminent danger signs that would cause us to be overly defensive. However, that could change quickly which may lead us to adopt a more conservative position in portfolios at some point. Especially since valuations are stretched and we have some concerns about global liquidity and how markets will adjust to any changes in global monetary policy. We hope that we have provided you with some insights to the things we are monitoring for signals on the direction of markets. Just to be clear, we are not advocating a market timing approach, however, we do think it is important for long-term successful investors to look for clues that can improve both their sense of timing and value.

—AWM Investment Team