# Investment Commentary: 11/2015

Stocks rallied sharply around the world in October, recovering most of the fear-driven declines of the third quarter. The S&P 500 was up 8.4% in October, while mid- and small-caps also generated strong returns of 6.2% and 5.6% respectively. Year to date, the S&P 500 has moved back into the black, up 2.7%, while mid- and small-cap stocks remain in negative territory.

Developed international stocks were also up strongly in October, with the MSCI EAFE up 7.8% and European stocks were up 5.9%. Both regions are also back in positive territory year to date. Emerging-markets stocks gained 7.1% in October yet remain well in the red year to date, down roughly 9.2%.

As is often the case in periods with strong equity gains, lower-quality credit outperformed higher-quality credit. In October, the core bond index was flat, while high-yield bonds gained close to 2.7%. Year to date high quality bonds continue to outperform.

**Planning For Fed Lift-off?**

Early November employment numbers came in stronger than expected and dispelled fears of a sharp labor market showdown. Giving the market confidence that job creation is growing at a pace sufficient to keep unemployment steady. The improved data combined with steadfast communication from Fed Chair Yellen has increased the odds that the FOMC will hike the funds rate on December 16th. The current Fed position has shifted from "hike if the data and market will support it" to "hike unless the data and market perform poorly." The message being that it will probably take major downside surprises in the data or markets to dissuade the FOMC from starting the normalization of interest rates next month. How the financial markets respond to the change in policy, after seven years of zero rates, will depend on the message that accompanies any change to policy. The best case scenario for stock markets would be a "dovish hike" where the Fed communicates it will take significant time to evaluate the effect of the initial hike and consider how gradual the pace of the subsequent hikes will be. We believe the Fed will still be a key driver of market performance, stay tuned.

**Q3 Earnings Themes**

Each quarter S&P 500 companies gear up for 'earnings season', producing their financial results and management providing insights into current performance and their outlook. One of our favorite research reports to read each quarter is Goldman Sach's "S&P 500 Beige Book." In the report they review corporate earnings reports and management conference calls in order to aggregate anecdotal fundamental and thematic trends. Providing key insights into the factors driving corporate performance, below are the key themes that emerged this quarter and our notes on each:

> **Theme 1: Divergence between consumer and industrial economies.** Suggesting the economy continues to diverge along two paths. Consumer-facing companies experienced steady and positive growth, benefitting from a steady economy and an improving labor market. In contrast, the industrial economy experienced some recession-like conditions as a result of low oil prices, a strong dollar and weak global demand.

**Note-** We expect this theme to continue, however we believe that many consumer oriented companies are now overvalued and many of the industrial companies are reaching attractive long-term valuations. We expect to be selectively rotating into high quality industrials as opportunities arise.

**Theme 2: Early signs of inflation, particularly in the labor market**. Some consumer-facing companies, particularly food and retailing, are experiencing mandatory wage changes and providing additional benefits to workers, placing upward pressure on wages.

**Note-** Although the seeds of inflation may be appearing we expect overall inflation to remain well contained due to global deflationary forces, a strong dollar and an increase in rental housing supply. We are watching for inflation to reignite, but do not currently see it as a big concern in 2016.

**Theme 3: Buybacks remain a popular use of cash.** Companies continue to evaluate how best to invest their cash, and many firms are opting to increase their share buybacks or pursue merger and acquisition activity.

**Note-** This theme clearly brings into question if companies are using their cash wisely and if long-term growth will be hampered from a lack of investment. We are fairly agnostic on buybacks and evaluate them on a case-by-case basis; clearly it makes sense when management is disciplined and buys shares when they are trading at a discount to fair value. Unfortunately, history shows that most companies aren't that disciplined, wasting shareholder capital on over-priced shares. We want to avoid those companies.

**Theme 4: Foreign exchange headwinds expected to continue.** The strong US dollar has been a drag on top and bottom line results. As the US dollar strengthens it becomes less competitive with other global currencies. In general, management teams expect the headwind of foreign exchange to persist into 2016.

**Note-** We expect the strong dollar to continue as the Fed begins to normalize rates, which is likely to keep pressure on emerging market currencies and commodities. We are starting to get interested in these asset classes, however our experience and intuition tells us we may see better opportunities ahead.

**Year-End Planning**

As we approach year-end it's a good time to look for opportunities to maximize after-tax returns and build long-term wealth. Below are some of the techniques we regularly use with clients and you should consider for any funds that you self-manage.

- **Review your overall portfolio and rebalance assets to keep them in-line with your investment objectives and risk tolerance.** If an investment has done well, it may now represent a larger percentage of your portfolio than intended. Selling some of the appreciated asset and rotating into other assets will keep your portfolio in balance with its objective. Growth stocks are a good candidate to implement this strategy this year.

- **Hold investment assets more than a year before selling them so that the long-term capital gain rate will apply to the transaction.** There is still a large tax benefit for holding assets for longer than a year, as the top long-term capital gain rate is 19.6 percentage points lower than the top short-term capital gain rate (20% vs. 39.6%). Generally taxes should not outweigh investment considerations so it's important to review the potential risk or return trade-offs before blindly selling.

- **Place the interest-earning portion of your portfolio in your tax-deferred accounts.** With top marginal tax rates being so high it's best to hold high yielding assets (taxable bonds, REITs, etc.) in tax-deferred accounts, keeping your income sheltered from tax until distributed.
- **At year end, sell positions with built-in losses to offset realized gains**. Proceeds can be placed in a comparable investment to maintain exposure to that type of investment, allowing you to benefit both from the tax-loss and future appreciation. For example, if you sell an emerging-markets stock fund to take a loss, the proceeds can be re-invested in a comparable emerging-markets stock fund or ETF.

The above is an abbreviated list of the investment moves to make each year. Every person's tax situation is different. We suggest consulting with your advisors before implementing any changes to portfolios you self-manage.

**AWM Investments (11/9/15)**