HBK Wealth Management
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WEEKLY MARKET COMMENTARY

A Candid Look into the Current State of the Markets

May 2016

Making a positive impact on as many lives as I can.

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Weekly Market Commentary | Week of May 23, 2016

KEY TAKEAWAYS

- The S&P 500 celebrated the one-year anniversary of its all-time high on May 21, 2016.
- One-year periods without new highs during bull markets have often preceded strong stock market gains.
- We continue to expect a volatile, range-bound stock market for the balance of 2016.

SPINNING OUR WHEELS

The one-year anniversary of the S&P 500's all-time high took place on May 21, 2016. Stocks have largely been spinning their wheels for the past year. The S&P 500 has failed to return to its May 21, 2015, record high for 12 months. Stocks have actually been spinning their wheels for even longer, considering the S&P 500 is at the same level as it was on November 18, 2014--an 18-month stretch. This week we take a look at what the stock market's lackluster performance since the last record high might mean for the current bull market, now the second longest since 1950.

DID THIS BULL MARKET ALREADY END?
So does this long period without a new high mean the aging bull market, now more than seven years old, is about to end? Before we answer that question, keep in mind that it is possible that the current bull market actually ended on May 21, 2015. If the S&P 500 does not reach another new high before dropping 20% from that high (which would leave the S&P 500 at 1704), then the bull market will have ended in May 2015. We don't know yet, but it's possible that the bull market will not have celebrated its seventh birthday on March 9, 2016 (don't we all wish we could undo previous birthdays). We see the potential for more new highs before the next bear arrives; but just in case, now we know what's at stake.

WHERE DO WE GO FROM HERE?
So what does this drought mean? For perspective, going back to 1955 and including the most recent period, the S&P 500 has gone a full calendar year without a new high 13 times (no new highs were made from 1929 through mid-1954 so there is no need to look further back). Six of those new high droughts took place during bull markets, six were during bear markets, and we'll call the current one a question mark [Figure 1]. The droughts lasted as little as 259 trading days in 1994-95 (for reference, one calendar year is 252 trading days), or as long as nearly 1900 trading days during the late 1970s and early 1980s.

Looking at all of those 12 previous instances when the S&P 500 didn't make a new high for a full year, subsequent near-term returns were lackluster. Three and six months out, the average and median gain for the S&P 500 was very close to flat. But going out a full year, average and median performance was close to the long-term average annual gain for stocks at about 9% [Figure 2].

Isolating the bull markets reveals that one-year periods without a new high have actually been very good times to buy stocks. As shown in Figure 3, those instances were followed by 6- and 12-month gains of 12.5% and 20.5%, on average, and were higher in all six periods both 6 and 12 months later. The most recent bull market example, February 1995, preceded double-digit gains over the subsequent 3- and 6-month periods and a tremendous 35% gain over the following 12 months as the tech boom got underway. Stocks also produced very strong gains after the August 1987-88 all-time high drought, as that bull market continued through July 1990.

The most recent two occurrences--March 2001 and October 2008--did not take place during bull markets and are certainly not comforting. Six months after those one-year droughts, stocks dropped by 9.7% and 13.0%, respectively. Looking at all six bear market periods, the average performance over the following 6 and 12 months was -11.5%, and -1.8%, respectively, and stocks were lower 6 months later in all instances. Like virtually any stock market analysis, the key is to avoid the bear markets-clearly easier said than done.

1 SEVERAL LONGER ALL-TIME HIGH DROUGHTS TOOK PLACE IN BULL MARKETS

Date	S&P 500	Number of Trading Days Without a New High	During a Bull Market?
08/05/57	47.26	539	No
08/02/60	55.04	374	Yes
12/12/62	62.63	433	Yes
02/09/67	87.36	309	Yes
12/03/69	91.65	822	No
01/11/74	93.66	1896	No
11/27/81	125.09	487	No
10/08/84	162.13	323	Yes
08/23/88	257.09	484	Yes
02/02/95	472.78	259	Yes
03/26/01	1152.69	1802	No
10/08/08	984.94	1375	No
05/20/16	2052.32	252*	?

Source: LPL Research, FactSet 05/20/16

* There are 252 trading days in a year.

Data are back to 1955.

Indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results.

2 MIXED STOCK MARKET PERFORMANCE AFTER ONE YEAR ALL-TIME HIGH DROUGHTS

Subsequent S&P 500 Performance After 12 Months Without a New All-Time High

	1 Month	3 Months	6 Months	12 Months
Average	0.9%	-0.4%	0.5%	9.4%
Median	2.3%	-0.2%	-0.2%	8%
% of Time Higher	67%	50%	50%	75%
Maximum	6.6%	10.1%	18.2%	35%
Minimum	-8.1%	-14.4%	-14.3%	-22.5%

Source: LPL Research, FactSet 05/20/16

Data are back to 1955.

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3 ONE YEAR ALL-TIME HIGH DROUGHTS DURING BULL MARKETS HAVE BEEN BULLISH SIGNALS

Subsequent S&P 500 Performance After 12 Months Without a New All-Time High

	1 Month	3 Months	6 Months	12 Months
Average	3.6%	4%	12.5%	20.5%
Median	3.8%	4.1%	12.3%	20.3%
% of Time Higher	100%	83.3%	100%	100%
Maximum	5.1%	10.1%	18.2%	35%
Minimum	1.2%	-3%	9.4%	2.9%

Source: LPL Research, FactSet 05/20/16

Data are back to 1955.

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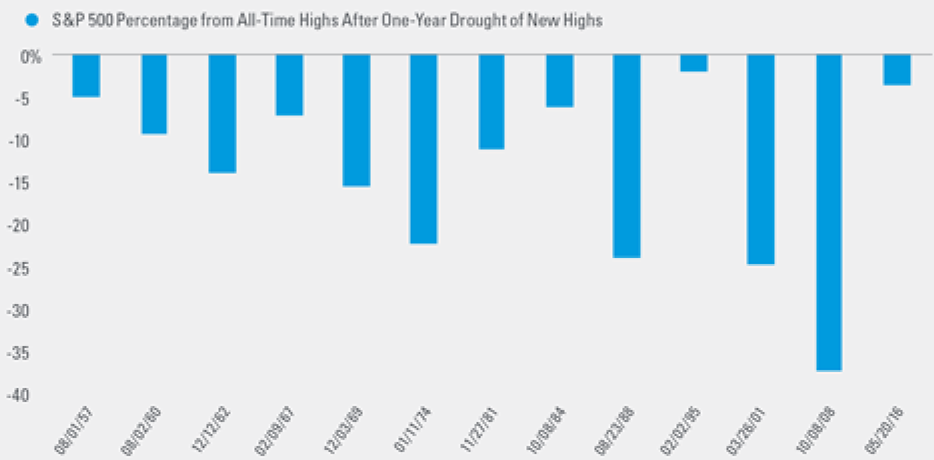
THE CLOSER THE BETTER

What stands out about this most recent drought without a new high is how close the S&P 500 is to its record high after one year. In fact, the current 3.7% shortfall from the new high is the second closest to a new high among all 13 new high droughts [Figure 4], with only 1994-95 closer (1.9% off the high). That mid-1990s drought took place right ahead of the tech boom and spectacular late 1990s rally.

The two other most recent instances that the S&P 500 was within 10% of a new high after a year without one were in the late 1960s and mid-1980s. Both of those times saw continued gains and an eventual resumption of the bull markets. In other words, if a full year goes by without a new high but the S&P 500 is close to its highs, the odds have historically been good that stocks will set a new high and continue higher before the bull market ends.

Also note that the maximum drawdown over the past year, at 14%, compares favorably to these other one-year periods, with only the 1959-60 and 1994-95 periods experiencing smaller maximum drawdowns.

4 MOST RECENT ALL-TIME HIGH DROUGHT STAYED CLOSE TO RECORD HIGHS



Source: LPL Research, FactSet 05/20/16

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THEN AND NOW

So now that we've gone another year without a new stock market high, does that make stocks a better opportunity? Below we address that question, comparing the investment environment today to one year ago for some perspective [Figure 5].

- Market performance. A year ago stocks were up 13% over the trailing one-year period, compared with the S&P 500's drop over the past 12 months of 3.7%. Oil is lower (but has stabilized), interest rates (based on the 10-year Treasury) are down 0.34%, and the yield curve is flatter. The defensive utilities sector has topped the sector rankings, while a year ago the leaders were more cyclical (biotech-driven healthcare, technology, and consumer discretionary). Stocks have been adjusting to a weaker global growth environment for a year and we have not seen much evidence to date that things will get much better--or worse--in the near term.
- Valuations. The better stock market performance and stronger earnings growth in the year leading up to May 21, 2015, left stocks more expensive a year ago than they are today based on price-to-earnings ratios (PE). Despite a 0.6-0.7 point reduction in the S&P 500 PE, we still see stocks as slightly overvalued based on long-term averages, but fair when factoring in low interest rates. The good news is earnings are poised to improve in the second half of 2016.
- Sentiment. Sentiment has been subdued for much of this bull market, but has deteriorated over the past 12 months. Fewer bulls (based on the American Association of Individual Investors [AAII] survey) and lower consumer confidence readings are consistent with market-based indicators cited above that show slightly weaker market conditions.
- Economic growth. A year ago the U.S. economy was coming off of a year-over-year increase in gross domestic product of 2.9% for Q1 2015, followed by 2.7% for the second quarter of 2015, better than today's level (2.0%) based on first quarter 2016 data. Other key measures of U.S. economic growth--the Institute for Supply Management (ISM) indexes--have weakened slightly. Generally, the economic growth outlook today is a bit softer than a year ago.
- Employment. The U.S. economy produced similar job growth over the past year as it did the year prior. The economy added slightly fewer jobs in the year ending May 2016 compared to the year ending May 2015, but job gains were sufficient to push the unemployment rate down to 5.0% from 5.4%. The job market has also been strong enough to help push wage growth high enough to get the Federal Reserve's (Fed) attention, as evidenced by the minutes from the latest Federal Open Market Committee (FOMC) meeting, released on May 18, 2016.
- Inflation. That wage growth over the past year has shown up in inflation measures such as the Consumer Price Index (CPI). The good news is the economy and labor markets are healthy enough to create some inflation. The bad news is fears about Fed rate hikes may continue to create market volatility.
- Fed policy. A year ago, market expectations for the federal funds rate at the end of 2016 were about 50 basis points higher (0.5%) than they are today, based on fed fund futures, reflecting a slightly weaker macroeconomic environment. That translates to market expectations taking about two rate hikes off the table over the last year. The Fed's expectations have contracted more rapidly, falling 1.0% based on the Fed's most recent "dot plots," but still exceed market expectations for the end of the year by about two rate hikes.

All in all, based on our assessment of the current market environment, we see no reason to change our expectation for a volatile, range-bound stock market for the balance of 2016, with an eventual full-year 2016 return in the mid-single-digits.*

Thank you to Ryan Detrick for his contributions to this report.

** Historically since WWII, the average annual gain on stocks has been 7-9%. Thus, our forecast is roughly in-line with average stock market growth. We forecast a mid-single digit gain, including dividends, for U.S. stocks in 2016 as measured by the S&P 500. This gain is derived from earnings per share (EPS) for S&P 500 companies assuming mid-to-high-single-digit earnings gains, and a largely stable price-to-earnings ratio. Earnings gains are supported by our expectation of improved global economic growth and stable profit margins in 2016.*

5 **THEN AND NOW**

	5/21/15	5/21/16
Markets		
S&P 500	2130.82	2052.32
S&P 500 1-Year Performance	12.9%	-3.7%
Top Performing Sector (1 Year)	Healthcare	Utilities
Crude Oil, $/barrel (% Change YoY)	60.72 (-41%)	47.75 (-21%)
10-Year Treasury Yield	2.19%	1.85%
Yield Curve	1.59%	0.94%
Valuations		
12-Month Trailing PE	17.8	17.2
12-Month Forward PE	17.1	16.4
Earnings Growth (Trailing 4 Quarters)	6.6%	-2.3%
Sentiment		
AAII Bulls 8-Week Avg.	31.3%	26.3%
Consumer Confidence	101.4	94.2
Economic Growth		
GDP	2.9%	2.0%
ISM Non-Manufacturing (Services)	57.5	55.7
ISM Manufacturing	51.6	50.8
Employment		
Jobless Claim 4-Week Avg.	270,500	275,750
Unemployment Rate	5.40%	5.00%
Payroll Growth 3-Month Avg.	200,000	184,000
Payroll Growth 12-Month Avg.	241,583	223,545
Inflation		
CPI YoY	-0.10%	1.10%
Core CPI YoY	1.81%	2.15%

Source: LPL Research, FactSet, Haver Analytics, Thomson Reuters 05/20/16

May 21, 2015 represents all-time closing high for S&P 500 Index.

Data are back to 1955.

AAII = American Association of Individual Investors.

GDP = gross domestic product.

PE = price-to-earnings ratio.

ISM = Institute for Supply Management

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The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.

All investing involves risk including loss of principal.

The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

The AAII Investor Sentiment Survey measures the percentage of individual investors who are bullish, bearish, and neutral on the stock market for the next six months; individuals are polled from the ranks of the AAII membership on a weekly basis. Only one vote per member is accepted in each weekly voting period. For more information, go to: http://www.aaii.com/sentimentsurvey.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Institute for Supply Management (ISM) Index is based on surveys of more than 300 manufacturing firms by the Institute for Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders, and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

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CAN CHINA'S CRACKS BE REPAIRED?

KEY TAKEAWAYS

- China's recovery from the global economic crisis of 2008 was built on significant and unsustainable debt levels.
- Total Chinese debt is believed to be $30 trillion, with consensus building that something must be done.
- Despite its debt problems, China still has resources available to combat the problem.

China's increasing debt may be approaching the tipping point. China's economic growth has been driven largely by capital investments-buildings, roads, factories, even entire cities-since the 1990s. In the process, Chinese regional governments, banks, and companies built up large debts. As the global economy slowed, Chinese leaders have increased infrastructure investments to maintain employment and "social harmony." However, these investment programs have added to the debt problems. Increasingly, the conversation about Chinese debt, both internally and externally, is about the economic risks it has created. Although unlike other highly indebted nations, China has options. Most of its debt is owed internally; it controls its own destiny, unlike Greece or Argentina. It also has high levels of foreign currency reserves and domestic savings.

CHINA'S DEBT: HOW MUCH IS TOO MUCH?

The absolute number is scary. Chinese entities-its government, companies, and households-now owe approximately $30 trillion. We, along with most market participants, believe the best way to evaluate a nation's debt load is by looking at debt relative to gross domestic product (GDP) **[Figure 1]**. After all, a nation's GDP will provide the wherewithal to repay that debt. From 2004 to 2008, overall Chinese debt was fairly stable at just over 150% of GDP. The government responded to the financial crisis in 2008 by creating a $600 billion fiscal stimulus program, over 13% of GDP at the time. Much of this stimulus was debt fueled and put in place by encouraging corporate borrowing. Some of this borrowing resulted from traditional monetary policies like lowering interest rates and amending rules to make credit more accessible. But much of stimulus came from the government's control of the economy through its state-owned enterprises (SOE), the major companies that at the time comprised 40% of the economy. Although the state sector has shrunk in relative terms since then, it still represents over 30% of the Chinese economy.

EVALUATING CHINA'S DEBT

As a general rule, evaluating Chinese data can be challenging due to heavy government intervention in the economy. The distinction between the private and public sectors in China can be blurry, if not totally illusory. Yet, when evaluating the China's debt, these distinctions become much less important. The default of a major SOE will reflect just as negatively on the government had it been a technical government default.

Though China's debt has been worrisome for some time, the concern has been growing recently. **Figure 2** shows two ways to gauge market fears of defaults in China. Credit default swaps (CDS) on Chinese debt provide a direct window into major market participants' views on Chinese debt. CDS represent the costs of insuring against a Chinese default. Major global financial investors and institutions trade these contracts. Though the cost of insuring Chinese debt can be volatile and is off its recent highs, the overall upward trend in price shows the market's increasing concern. The fact that there are even traded contracts like this is evidence the market is looking to price some probability of default. We also show the decline in the value of the Chinese yuan against the currency of China's major trading partners, not just the U.S. dollar. Many factors influence a currency's value. However, fears of economic instability and possible default have contributed to recent currency weakness.

2 WORRIES OVER CHINA DEBT—MODERATING, BUT STILL HIGH

Source: LPL Research, Bloomberg 05/20/16

A credit default swap (CDS) is designed to transfer the credit exposure of fixed income products between parties. The buyer of a credit swap receives credit protection, whereas the seller of the swap guarantees the credit worthiness of the product. By doing this, the risk of default is transferred from the holder of the fixed income security to the seller of the swap.

AUTHORITATIVE CONCERN

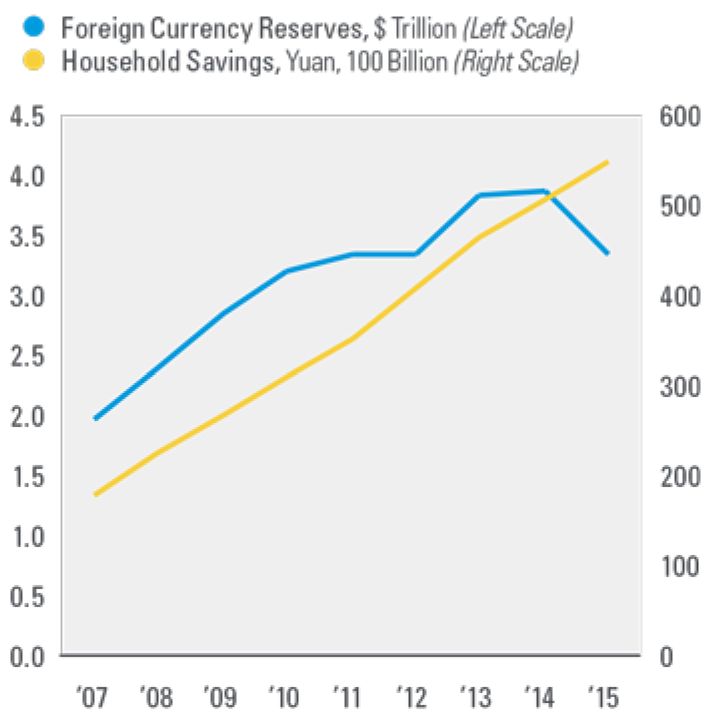
China watchers were struck recently when an article published in the Chinese People's Daily, the official news outlet for the Communist Party (and therefore, the Chinese government), condemned the country's reliance on leverage. Debt was referred to it as an "original sin" that leads to subsequent risks. The article also called on the government to stop resorting to additional debt-fueled stimulus to prop up failing industries and zombie SOEs. The interviewee was identified only as "an authoritative person" believed to be either President Xi Jinping or one of his most senior advisors. That an article so openly critical of government policy was published in an official news outlet shows that the level of concern in China is high and reaches the top levels in government.

CHINA CRACKED BUT NOT SHATTERED

China's debt problems are bad, but not insurmountable, for several reasons. First, most of the debt is owed internally. Furthermore, to the extent that the government is often a partner, officially or not, with the lenders (mostly banks) and debtors (mostly SOEs), the Chinese asset/liability equation is closer to balance than many people understand. In many instances, though not all, the Chinese government owes money to itself. When countries typically have debt problems, it's because they have external creditors that cannot be satisfied. Recently this has been the situation with Greece and Argentina. Greece had external debt equal to over 75% of its GDP. That figure for China is under 10%.

The other bit of positive news from China can be seen in **Figure 3**. We see the steady growth in household banking deposits in China. The Chinese people save a lot, approximately 30% of their income, compared to roughly 5% savings rate for the U.S. As their income has grown, so have their savings in absolute terms. This provides the ability for Chinese companies and government entities to finance their expansion without having to look overseas. But China's high savings rate has proven to be as problematic as it appears virtuous. By most accounts, the Chinese save too much and spend too little, undermining the government's attempts to rebalance the economy away from investment and toward consumption.

3 CHINA HAS SAVINGS TOO



Source: LPL Research, Bloomberg, Haver Analytics 05/20/16

Data are as of 12/31/15

The other item displayed in **Figure 3** is Chinese foreign currency reserves, which declined last year as the government sought to stabilize both the economy and the value of the yuan. But even so, with over $3 trillion in total reserves, including approximately $2 trillion in U.S. Treasury bonds, China has a massive war chest that can be used to at least pay off its foreign creditors if need be.

HOW BAD ARE THE CRACKS IN THE CHINA?

So what is everyone, including senior Chinese leaders, worried about? The concern comes from the realization that-assuming the debt level is manageable-fixing the problem will cause unrest within the country. Bad debts would presumably result in layoffs, primarily by the large SOEs that employ so many Chinese workers. The economic uncertainty that would result from widespread defaults in China would likely further encourage savings by Chinese consumers, further weakening the economy by curtailing consumer spending.

If one person's debt is another one's asset, the difference between the ultimate winners and losers may be vast. Officially, China's bankruptcy laws became effective in 2007 and are very similar in structure to U.S. and European laws. In practice, the broad discretion afforded judges and the influence of the politically connected results in relatively few cases with largely uncertain outcomes. Combined with the questionable value of some underlying assets, the holders of Chinese debt could see a significant reduction in their assets.

The good news is that most of the impact of these changes would be felt within China. We believe that the government would intervene in a way that would limit global impact-not because the government is necessarily concerned about the damage done to foreign companies, but because it will make sure that basic Chinese needs are being met. For example, if China needs to import raw materials such as oil and coal to run its economy, it will do so. It may be a different SOE that is doing the purchasing, but the government will do what it can to maintain its economy. These imports have slowed down, and may continue to do so. But it is not Chinese debt levels that mandate the slowdown, it's the realization that the Chinese economy no longer needs and cannot support such a high level of infrastructure investment. Debt is the symptom of China's problems; it is not the root cause of them.

CONCLUSION

China remains a heavily indebted country, but one that owes most of the debt to itself. The political climate in China clearly shows a willingness to discuss Chinese debt, and that in and of itself is a significant development. Because China owes its debt to itself, the major impacts of China dealing with its debt problems will be felt within its borders. The timing is uncertain, however, and this process will be very painful for the Chinese people and for Chinese companies.

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Investing in foreign and emerging markets securities involves special additional risks. These risks include, but are not limited to, currency risk, geopolitical risk, and risk associated with varying accounting standards. Investing in emerging markets may accentuate these risks.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments, and exports less imports that occur within a defined territory.

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