HBK Wealth Management
Haire · Bohmer · Kilcoyne

WEEKLY MARKET COMMENTARY

Insight into the Current Economic Climate and Ongoing Market Events

October 2015

Our roads to success may have twists and turns and ups and downs; together we can navigate a course and enjoy the scenery along the way.

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Weekly Market Commentary | Week of October 5, 2015

KEY TAKEAWAYS

- Non-energy companies may potentially grow earnings by 10% during the third quarter, excluding the impact of currency fluctuations on profits earned overseas.
- The potential acceleration in earnings growth over the next few quarters is one of several reasons we expect stocks to finish the year strongly.
- However, reaching our 5-9% S&P 500 total return forecast for 2015* following the latest correction may be difficult.

EARNINGS PREVIEW

Third quarter earnings season will potentially look a lot like the second quarter. This quarter's earnings preview could almost be a copy and paste of the second quarter preview: It looks like we will get meager earnings growth, if we get any at all. The media will again tout earnings recession, which we discussed on April 6, 2015. The big headwinds from energy sector weakness and a strong U.S. dollar remain. And the big overseas worries are again unlikely to have much impact on earnings overall, as business conditions in the U.S.--outside of the energy sector--are pretty good. However, several things make this quarter more interesting, as we discuss below.

The Source

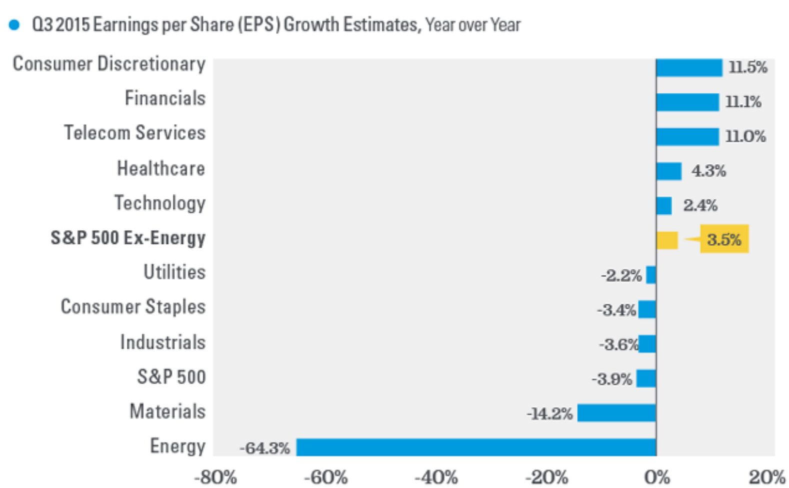
Different sources such as FactSet, Bloomberg, and others have different calculations than Thomson Reuters for S&P 500 earnings, based on various methodologies and different interpretations of what constitutes operating earnings.

MORE OF THE SAME (NOT THAT BAD)

The third quarter of 2015 may look a lot like the second quarter in terms of the limited earnings growth the S&P 500 will likely produce (at best). The dual drags of depressed energy sector profits and a strong U.S. dollar are likely to sap what would otherwise be healthy earnings gains. Consensus estimates from Thomson Reuters are calling for a 4% year-over-year decline in S&P 500 earnings (other data sources have slightly different but generally lower numbers).

Breaking earnings down reveals a more encouraging picture of corporate America's earnings power. Based on a quiet earnings preannouncement season, we expect at least 4% upside to published forecasts, in-line with last quarter and the long-term average. If we then remove the energy sector [Figure 1], where temporary outsized declines in earnings are about a 7% drag on overall S&P 500 profits, earnings get a big bump up. Finally, if the temporary drag from U.S. dollar strength is excluded (though it will be with us for a while longer), we estimate earnings get bumped up by another 3-4%.

1 EARNINGS POWER UNDERNEATH THE ENERGY DRAG STILL HEALTHY



Source: LPL Research, FactSet 10/02/15

Indexes are unmanaged and cannot be invested in directly.

Sector performance data are represented by S&P 500 GIC sectors.

Adding this up, non-energy companies may potentially grow earnings by 10% during the third quarter, excluding the impact of currency fluctuations on profits earned overseas. That's pretty good underlying earnings power and speaks to the health of the broader U.S. economy.

The revenue story looks similar to the earnings story in the third quarter. S&P 500 revenue will possibly be down about 3% again this quarter, but would be solidly positive without the drags from energy and the U.S. dollar. Historically, revenue growth tracks growth in gross domestic product (GDP), including inflation, which we expect to be over 3% this quarter--after coming in at about 5% in the second quarter. Revenue growth will fall well short of that target in the third quarter; but the size of the gap, we believe, indicates better underlying revenue production and an upward trajectory.

WHAT MAKES THE THIRD QUARTER DIFFERENT?

Although many similarities exist between the upcoming earnings season and the last one, there are some notable differences. The big one is that stocks have fallen heading into this earnings season (the S&P 500 fell 12% peak to trough from July 20, 2015, through August 25, 2015). Given this latest stock market correction was the first drop of more than 10% in four years, it has been a while since investors were as negative as they are now heading an earnings reporting season. Surveys also suggest widespread investor pessimism, meaning we may be set up for a potentially positive reaction to results.

Regardless of stock performance ahead of earnings, the stock market has generally welcomed earnings reporting season. Since 2010, spanning 22 quarters, the S&P 500 is up an average of 1.5% during the four weeks after Alcoa's results and has risen during 68% of those periods [Figure 2]. (Alcoa has historically marked the "unofficial" start of earnings season because it has been the first major company to report quarterly results.) We expect gains this reporting season even though this pattern has been mixed over the past year. Turning the market's attention away from investors' concerns about the Federal Reserve (Fed) and China is likely to be a good thing, especially if what we hear from companies about the Chinese demand environment is sanguine, as we heard from Nike on September 24, 2015, when reporting its results.

Another difference between this quarter's earnings season and last is more evidence of slower growth in China. But given China represents an estimated less than 5% of S&P 500 profits, we do not expect much direct impact. China is responsible for a lot of the weakness in commodity sector earnings, though that is certainly not a new development.

Click here for Figure 2, "Stocks Have Done Well During the First Four Weeks of Earnings Season in Recent Years."

OPPORTUNITIES

We believe these two sectors are well positioned for earnings season and may outperform over the next month or so:

- **Healthcare.** Healthcare was one of the worst performing sectors during the third quarter with a 10.7% loss. The primary reason for the weakness was concern about drug price controls after Democratic presidential candidate Hillary Clinton proposed a plan to rein in the high cost of drugs, especially those produced by biotech companies. We see little chance of any such plan being passed regardless of the outcome of the 2016 elections, and expect the now reasonably valued group to do well on what should be solid results.
- **Consumer discretionary.** The consumer discretionary sector was one of the top performing sectors during the third quarter and will likely produce solid third quarter results due to cheaper gas prices and low input cost inflation. In addition, with relatively less overseas exposure, this group is somewhat insulated from the slowdown in China.

We continue to favor the industrials and technology sectors, but slower growth overseas may negatively impact certain parts of these sectors. And given the 21% drop in oil prices during the third quarter, it is difficult to have much confidence that the energy sector will surprise positively.

2015 STOCK MARKET FORECAST

In November 2014, we forecast a total return for the S&P 500 in 2015 of 5-9%, a forecast we stood by in June 2015. Although we have not officially lowered our forecast (we typically only publish two forecasts each year), we acknowledge that following the latest stock market correction it is going to be difficult to reach the low end of that target. That forecast was predicated on high-single-digit earnings growth that will not likely materialize (again, energy and the dollar are the main culprits). S&P 500 earnings for 2015 will likely end up growing in the low-single digits, which has, in part, translated into lower stock prices.

However, we remain confident that stocks will rally over the rest of the year and stand a good chance of ending in positive territory, driven by easing China fears, increased comfort with the Fed's go-slow approach to raising rates, a likely solid earnings ramp-up over the next several quarters, stability in the energy sector, and favorable seasonal patterns (the fourth quarter has seen a median S&P 500 gain of over 5% and has been positive 80% of the time since 1980). Reaching the low end of our target (3% price gain plus 2% from dividends) may not be probable at this point but is still possible.

CONCLUSION

Third quarter 2015 earnings season may look a lot like second quarter, with little, if any, earnings growth amid big headwinds from the energy sector and a strong U.S. dollar. But underneath those drags is some healthy earnings power that we believe will help propel stocks higher in the coming weeks. Looking forward, a potential acceleration in earnings growth over the next several quarters is one of several reasons we expect stocks to finish the year strongly.

**Historically since WWII, the average annual gain on stocks has been 7-9%. Thus, our forecast is in-line with average stock market growth. We forecast a 5-9% gain, including dividends, for U.S. stocks in 2015 as measured by the S&P 500. This gain is derived from earnings per share (EPS) for S&P 500 companies assuming mid-single-digit earnings gains. Earnings gains are supported by our expectation of improved global economic growth and stable profit margins in 2015.*

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.

Weekly Economic Commentary | Week of October 5, 2015

KEY TAKEAWAYS

- The service sector, which accounts for 70% of U.S. GDP, remains robust per the latest ISM Non-Manufacturing Report.
- However, the manufacturing economy is teetering on the edge of contraction.
- A dip in the manufacturing ISM to below 50 would not be (and has not been) a signal that the broader economy is headed for recession.

ISM INDICATES FAIRLY ROBUST ECONOMIC ACTIVITY CONTINUES

The Institute for Supply Management (ISM) released its Non-Manufacturing Report on Business for September 2015 on Monday, October 5, 2015, as this *Weekly Economic Commentary* was being prepared for publication. It showed that the service sector remains robust, with the non-manufacturing ISM hitting 56.9, which over time, is consistent with real gross domestic product (GDP) of 3.5%. However, the report, as usual, was largely ignored by market participants, even though non-manufacturing activity (mainly the service sector) represents 70% of the U.S. economy. Financial markets, however, correctly focus more closely on ISM's Manufacturing Report on Business, as S&P earnings--which over time, drive stock prices--are much more closely correlated to the manufacturing portion of the economy than to the service side.

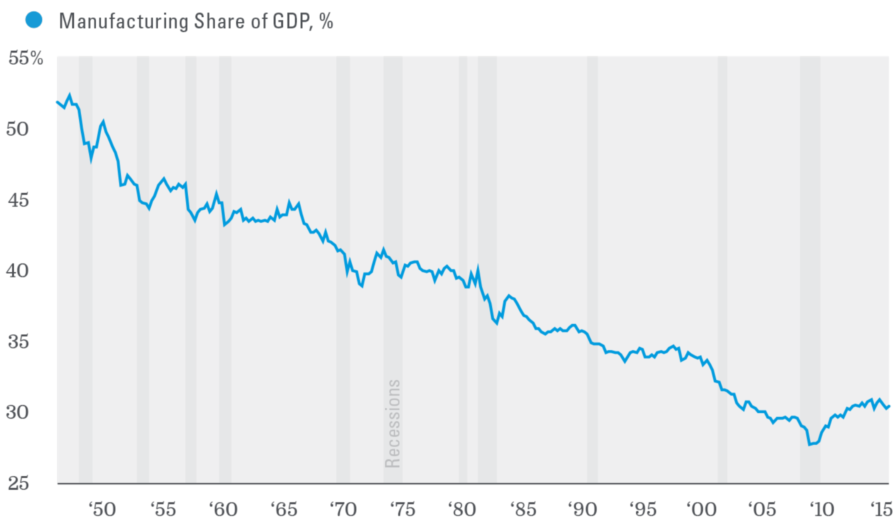
HOW IS S&P DIFFERENT FROM GDP?

S&P 500 companies have different drivers for earnings than the components that drive GDP. There are several key factors that differentiate the economic data from the earning power of corporate America that we think are important for investors to keep in mind:

- Corporate profits are more manufacturing driven. Two-thirds of S&P 500 profits are from manufacturing, while two-thirds of U.S. consumption in GDP is services.
- Corporate profits are less consumer driven. While 70% of GDP is consumer spending, only one-third of it is from discretionary categories, while an even lower 15% of S&P 500 profits come from consumer discretionary spending.
- Corporate profits are more international trade driven. International trade only accounts for about 10% of GDP, and it acts as a drag on growth for most quarters because the U.S. imports more than it exports.
- Corporate profits are hurt much less by higher commodity prices than GDP. In fact, higher commodity prices generally benefit S&P 500 companies because most of them either produce commodities (energy and materials); supply commodity producers with equipment (largely industrials); or are not heavy commodity users, and therefore, are not impacted much by higher commodity prices (technology, healthcare, financials, and telecommunications).

But for those concerned about a U.S. recession, the recent data on both the non-manufacturing and manufacturing ISMs are comforting. As noted above, the non-manufacturing ISM readings of 56.7 in September and 57.3 so far in 2015 indicate fairly robust economic activity continues in 70% of the U.S. economy. The manufacturing ISM data, however, are more concerning. Released last week, the manufacturing ISM for September 2015 came in at 50.2, below the consensus of economists as polled by Bloomberg News (50.6) and the August 2015 reading of 51.1. In fact, the September 2015 reading on the ISM was the lowest since May 2013, and indicates that the manufacturing economy, which accounts for just 30% of the U.S. economy [Figure 1], is teetering on the edge of contraction. But what about the broader economy? The ISM noted in the press release accompanying the data that "a reading above 50 percent indicates that the manufacturing economy is generally expanding; below 50 percent indicates that it is generally contracting."

1 MANUFACTURING'S SHARE OF GDP HAS BEEN FALLING STEADILY FOR 6 DECADES



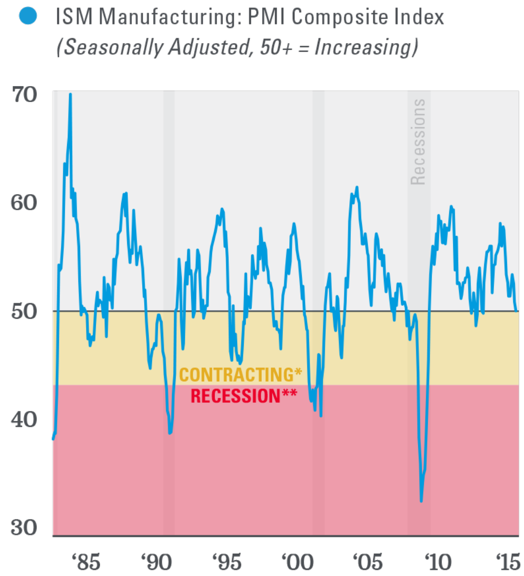
Source: LPL Research, Haver Analytics 10/04/15

The manufacturing ISM has averaged 52.2 over the first nine months of 2015, which, if sustained, would be the lowest average reading on the ISM since 2012, when it averaged 51.7. But the Institute for Supply Management press release notes that an average reading of 52.2 on the manufacturing ISM is consistent with growth in real GDP of 2.9%, which is just shade below our long-held forecast of 3.0%+ for 2015.

The last time the manufacturing ISM averaged below 50 was in the recession years of 2008 (45.5) and 2009 (46.4). As a reminder, the ISM would have to dip to the low 40s to indicate that the overall economy was in recession [Figure 2].

As the manufacturing ISM nears 50 in the current business cycle--close to indicating a contraction in the manufacturing sector but still a long way from signaling an economy-wide recession--we note that the manufacturing ISM has dipped to 50 (or below) in each of the last three expansions without a recession actually occurring. Similar to today, a substantial drop in oil prices played a part in all three of these episodes.

2 HISTORICALLY, THE MANUFACTURING ISM HAS TO FALL INTO THE LOW 40s TO INDICATE RECESSION IN THE U.S. ECONOMY



Source: LPL Research, Institute for Supply Management, Haver Analytics 10/04/15

*Between 50–43: manufacturing economy is contracting.

**Below 43: U.S. economy is in recession.

LESESONS FROM PAST ECONOMIC EXPANSIONS

A hallmark of the 2001-2007 economic expansion was the relentless rise in oil prices, driven by voracious demand from emerging market economies, led by China. Still, pauses in that run-up in oil that ultimately contributed to the Great Recession did correspond to dips in the manufacturing ISM. Just 18 months into the expansion, in July 2002, the manufacturing ISM slipped to 50.2 and remained below 50 through mid-2003. During that time--although short lived--oil prices fell about 15%. The manufacturing ISM dipped from a high of 61.4 in May 2004 to as low as 50.8 by May 2005, but that dip was not associated with a drop in oil prices. The manufacturing ISM moved below 50 again in January 2007, from as high as 57.2 in October 2005. Here again, oil may have been a culprit--along with tightening financial conditions--as oil prices fell more than 20% over that time, before nearly tripling between early 2007 and mid-2008.

In the economic expansion that began in 1991, the manufacturing ISM fell below 50 on several occasions and a recession did not ensue. Each time, the dip below 50 was accompanied by a substantial decline in oil prices, but overall economic growth remained solid. Early in the recovery (mid-1991 through mid-1993), the manufacturing ISM was at or below 50 three times before accelerating through 1993 and 1994. Oil fell 25% between mid-1991 and mid-1993 while real GDP averaged 3.0%. In the middle of the expansion that began in 1991, the manufacturing ISM fell below 50 in May 1995 and remained there for a full year, as oil prices fell 15%. Real GDP growth averaged 3.1% during this period. Late in the 1990s expansion, as oil prices fell 50% in reaction to the Asian financial crisis in 1997-1999, the manufacturing ISM again dipped below 50 (June 1998) and stayed there until December 1998. Real GDP growth averaged 6% in the second half of 1998.

In the economic expansion that began in late 1982, the manufacturing ISM crossed below 50 in September 1984. For the next 27 months, through December 1986, the manufacturing ISM was above 52.0 in just two months and was below 50 nearly half the time. During that year, real GDP growth averaged 3.5% even as oil prices fell 60%, from $29 per barrel to as low as $12.

OIL'S IMPACT

History doesn't always repeat itself, and each business cycle is different. For example, in the expansions of the early 2000s, 1990s, and 1980s, the U.S. oil and gas industry was in the midst of a long-term decline. In the current economic expansion that began in mid-2009, the oil and gas industry has been on the rebound, reversing a multi-decade decline in oil and gas output in the United States. Thus, while still a net plus for the U.S. economy (see the *Weekly Economic Commentary,* "Before and After"), the recent drop in oil prices has had a significant impact on the U.S. manufacturing economy, and that impact can be seen in not only the weakness in the manufacturing ISM, manufacturing industrial production, and employment in the manufacturing sector, but also in the 60% drop in earnings for companies in the S&P 500 energy sector.

Because the U.S. economy is still a net beneficiary of low energy prices and the service sector accounts for nearly 70% of GDP, a dip in the manufacturing ISM to below 50 would not be (and has not been) a signal that the broader economy is headed for recession.

DEFINITIONS

The Institute for Supply Management (ISM) index is based on surveys of more than 300 manufacturing firms by the Institute of 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.

Purchasing Managers' Indexes (PMI) are economic indicators derived from monthly surveys of private sector companies, and are intended to show the economic health of the manufacturing sector. A PMI of more than 50 indicates expansion in the manufacturing sector, a reading below 50 indicates contraction, and a reading of 50 indicates no change. The two principal producers of PMIs are Markit Group, which conducts PMIs for over 30 countries worldwide, and the Institute for Supply Management (ISM), which conducts PMIs for the U.S.

The S&P 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.

Millennials: The "Slow and Steady" Generation of Investors

With some $30 trillion poised to change hands over the next several decades from parents and grandparents to so-called Millennials -- those 90-million-plus Americans aged 18 to 33 -- the financial services industry will have its work cut out for it. Popular investing wisdom states that the younger you are, the more time you have to ride out market cycles and therefore the more aggressive and growth-oriented you may be in your investment choices. Yet Millennials are hearing none of it.

For Millennials, the Great Recession was a wake-up call that investing presents real risks -- and their approach is to take steps to avoid falling foul of that risk even though they have decades of investing ahead of them.

As Investors: Wary and Conservative

Indeed living through the Great Recession and watching their parents and other older family members suffer financial losses may have taken a toll on these young investors -- and made them wary of investing in general and conservative in their investment choices. For instance, according to Wealthfront, an online financial services start-up that caters to this demographic group, Millennials "have lived through two market crashes … " and … "value simple, transparent, low-cost services," typically favoring index-based fund options over more exotic investment fare.[1]

Elsewhere, research conducted by MFS Investment Management found that Baby Boomers take a more aggressive approach to retirement investing than the much younger Millennials. Further, each group's selected asset allocation is inconsistent with what financial professionals would consider to be their target asset allocation, given their age and investment time horizon.

For example, Baby Boomers, on average, reported holding retirement portfolio asset allocations of 40% stocks, 14% bonds, and 21% cash, while Millennials allocated less than 30% of their retirement assets to stocks, and had larger allocations to bonds and cash than their much older counterparts -- 17% and 23% respectively.[2,3]

Further, when asked about their retirement savings priorities, 32% of Baby Boomers cited "maximizing growth" as the most important objective, while two-thirds of Millennials cited conservative objectives for their retirement assets -- specifically, 31% said "generating income" was a top concern and 29% cited "protecting capital" as their main retirement savings goal.[3]

Perception Is Reality

The study's sponsors infer that the seemingly out-of-synch responses from survey participants reflect each group's reactions -- and perhaps overreactions -- to the recent financial crisis. For Baby Boomers, the loss of retirement assets brought on by the Great Recession has made them more aggressive in their attempts to earn back what they lost. Fully half of this group reported being concerned about being able to retire when they originally planned. For Millennials, the Great Recession was a wake-up call that investing presents real risks -- and their approach is to take steps to avoid falling foul of that risk even though they have decades of investing ahead of them.

Educating Investors: An Opportunity for Advisors

Cumulatively, recent research suggests that there is a considerable opportunity for advisors to dispel fears and misperceptions by educating investors of all ages about the importance of creating and maintaining an asset allocation and retirement planning philosophy that is appropriate for their investor profile.

[1]*Wealthfront.com, Wealthfront News, "$1 Billion in 2.5 Years," June 4, 2014.*

[2]*Investing in stocks involves risks, including loss of principal. Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and are subject to availability and change in price. An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the fund seeks to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in the fund.*

[3]*Plansponsor, "Baby Boomers, Millennials Should Switch Retirement Investing Goals," October 2, 2014.*

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Since your teen will probably apply to only a handful of schools, you may need to narrow the field by comparing schools on big issues such as course offerings, tuition costs, and financial aid packages.

Life After High School: Educating Your Teen

Choosing the right college or trade school may be the biggest decision you and your teen make together. Above all, you will likely be looking for a quality education at a reasonable price. But other factors will affect the decision. Here are some ideas and resources for organizing your search.

First Things First

Set priorities: Ask your teen to list 10 things he or she would like to see in a college or trade school. Also, keep your teen's school records handy. Being able to match strengths and goals to a school's offerings will help when making a decision.

Other factors to consider include:

- Size/setting: Should it be a big public school or a small private one? Is a big city preferred over a small-town setting?
- Campus/social life: Should it be a same-sex or co-ed school? What about religious affiliations? Sports and arts programs?

The Selection Process

Since your teen will probably apply to only a handful of schools, you may need to narrow the field by comparing schools on big issues such as course offerings, tuition costs, and financial aid packages.

While costs for colleges and trade or vocational schools will differ, the average tuition and fees at public, in-state, four-year institutions increased about 2.9% for the 2014-2015 academic year. Tuitions and fees at four-year private schools increased about 3.7% over the prior year. When you add in room and board costs, today's college bill adds up to roughly $19,000 a year for a four-year, in-state public college and $42,400 for a four-year private school.[1] And if your child is still many years away from college you can undoubtedly expect to pay more.

Finding Financial Aid

Billions of dollars are available in federal, state, and privately funded financial aid if you know where to look. Start with guidance counselors and financial aid offices. In addition, the following organizations offer ample, free information:

- The College Board: Call your regional office or visit www.collegeboard.org.
- FinAid: Visit www.finaid.org.
- U.S. Department of Education, Federal Student Aid Information Center: Call (800) 433-3243 or visit www.fafsa.ed.gov.

[1]*The College Board, "Trends in College Pricing 2014," November 13, 2014.*

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