HBK Wealth Management
Haire · Bohmer · Kilcoyne

WEEKLY MARKET COMMENTARY

A Candid Look into the Current State of the Markets

April 2016

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

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In This Issue

Weekly Market Commentary | Week of April 18, 2016

KEY TAKEAWAYS

- The latest rally has been driven by many factors and has pushed the S&P 500 to within 2.4% of its all-time high.
- Here we assess the likelihood that the rally continues from this point forward, and, if so, how much further it might have to go.
- Historical stock market performance after sharp rallies does not sway us from our expectations for mid-single-digit returns for stocks in 2016.

TAKING STOCK AFTER THE RALLY

Stocks have had quite a nice run. Since the February 11, 2016 lows the S&P 500 has gained 14%. The rally has been driven by many factors--chief among them, better U.S. economic data, higher oil prices, the Federal Reserve's (Fed) slower rate hike timetable, increased confidence in China, and more stimulus from overseas central banks. These factors have enabled stocks to trade more on fundamentals than fear, and have pushed the S&P 500 to just 2.4% below its all-time high. Here we assess the likelihood that the rally continues from this point forward, and, if so, how much further it might have to go.

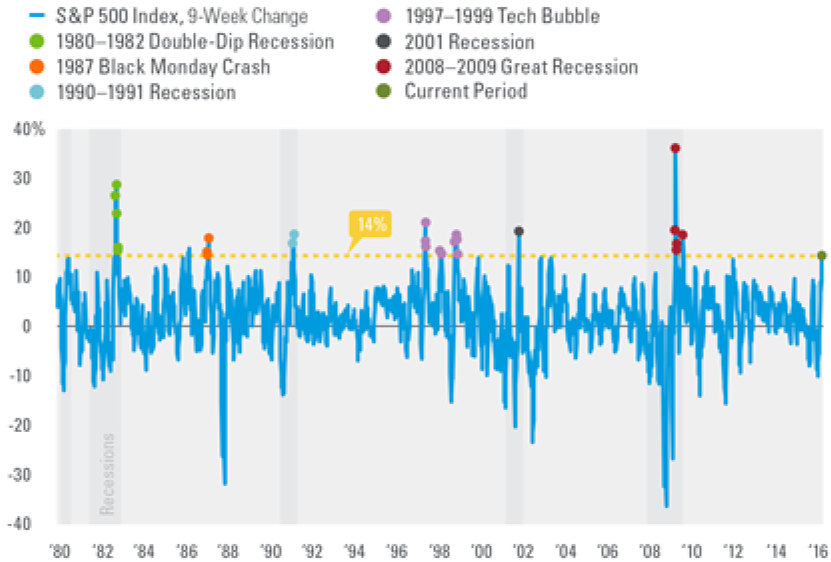
RARE RALLY

The 14% rally in 9 weeks is not completely unprecedented, but it is rare. Based on weekly data back to 1950, just 1.4% of all the 9-week periods saw the S&P 500 gain more than 14%. So on average, we have less than one of these each year. What is interesting about the history of these sharp rallies is that most of them occurred early in business cycles, shortly after recessions, including 1982, 1991, and 2009-10. Several others could be characterized as crisis recovery periods, including following the 1987 crash and the latest downdraft. We also saw several of these rallies during the tech boom of the late 1990s [Figure 1].

We do not believe the U.S. economy is in the early part of the cycle. Nearing the seventh year of the economic expansion, and based on the business cycle indicators we follow, we believe we are moving into the cycle's latter stages. That suggests tempering enthusiasm for stocks following recent gains. Some may view a stock market that has more than tripled since 2009 amid unprecedented Fed policies as a bubble, which would certainly be cause for some caution. (We do not share this view at this point but acknowledge the potential for an inflation problem in the years ahead.) Finally, we do not think we just experienced a full-blown, non-recessionary crisis like the 1987 crash or even the 2011 debt ceiling debacle, although it may have felt as bad.

Bottom line, we would characterize this latest volatile market action as more of a mid-to-late cycle recession scare, and we expect the low-return environment stocks have experienced may to continue.

1 BIGGEST 9-WEEK RALLIES FALL MOSTLY IN EARLY CYCLE OR BUBBLE PERIODS



Source: LPL Research, FactSet 04/14/16

The S&P 500 Index is an unmanaged index that cannot be invested into directly. Past performance is no guarantee of future results.

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.

The logical next question is: What have stocks done after these sharp rallies? The answer is mixed. Figure 2 shows that after a 9-week rally of 14% or more, the S&P 500 averages another 3-5% gain over the next 9 and 18 weeks and is higher 79% and 88% of the time, respectively. This is clearly good news for stocks; however, it should be tempered by business cycle considerations. Many of these periods were early cycle when stocks were embarking on significant, extended bull market rallies, or in the bubble period of the late 1990s.

Also note that stock market gains tapered off over the 27-week periods following these sharp rallies, with the S&P 500 roughly flat on average and gains only slightly more than half the time. Each period is different, but this may mean that we could go a bit higher before correcting again and possibly end the year with just a modest gain, as we forecast in *Outlook 2016: Embrace the Routine*.

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2 **SHARP RALLIES TEND TO BE FOLLOWED BY MORE GAINS, BUT ONLY IN THE SHORT TERM**

S&P 500 Performance Following 9-Week Rallies of 14% or More

	Subsequent Periods		
	9 Weeks	18 Weeks	27 Weeks
Average	3.0%	4.6%	0.1%
% Positive	79.0%	88.0%	58.0%
Max	11.8%	18.6%	9.8%
Min	-7.0%	-5.0%	-14.0%

Source: LPL Research, FactSet 04/14/16

Analysis based on S&P 500 weekly data back to 1950 covering 48 9-week periods with S&P 500 gains of at least 14%.

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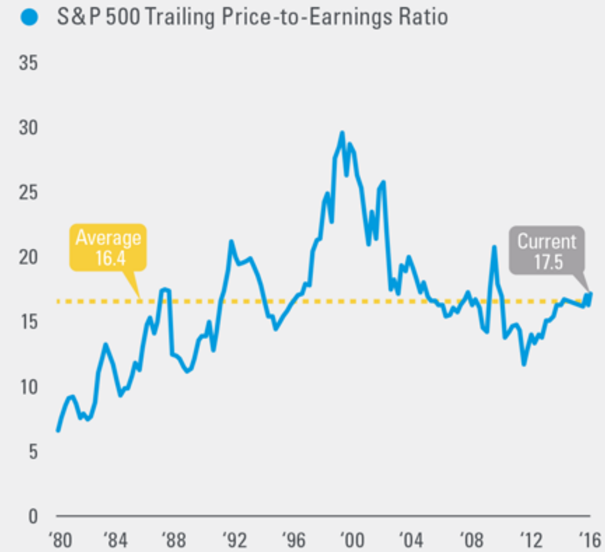
VALUATIONS CREEPING UP

It is logical to think stocks are expensive after such a sharp rally, but we still characterize valuations as fair. Price-to-earnings ratios (PE) remain near long-term averages, and interest rates are low (interest rates support stock valuations by making bonds less competitive relative to stocks). On a trailing 12-months basis, recent gains have pushed the S&P 500 PE up to 17.5 [Figure 3], about 1 point above the long-term average (post-1980). It is somewhat concerning that prior bull markets have mostly ended at valuations similar to current levels (excluding the 1990s, when the PE approached 30). However, valuations can stay above average for long periods during the latter half of bull markets while stocks are lifted by earnings gains.

3 **VALUATIONS HAVE CREPT HIGHER BUT REMAIN NEAR LONG-TERM AVERAGES**



Source: LPL Research, FactSet, Thomson Reuters 04/15/16

The S&P 500 Index is an unmanaged index that cannot be invested into directly. Past performance is no guarantee of future results.

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.

Trailing PE is the sum of a company's price-to-earnings, calculated by taking the current stock price and dividing it by the trailing earnings per share for the past 12 months.

WHAT'S NEXT?

Earnings will be particularly critical for markets this week, the first busy week of earnings season with 100 S&P 500 companies slated to report results. Although earnings may present an opportunity for stocks to push higher, they are also a risk. Should earnings estimates get revised sharply lower during this earnings season (as they were last quarter) and push out the return of positive earnings growth, stocks may have a more difficult time adding to recent gains. We continue to expect strong earnings improvement beginning in the second quarter (the current quarter), and we continue to believe that the consensus expectations for mid-single-digit earnings gains in the second half of 2016 are achievable, should the drags from oil and the strong U.S. dollar abate. (For more on earnings, see our recent earnings preview.)

BOTTOM LINE

After such a strong rally off of the February lows, the key question for markets is: Where do stocks go from here? A look at historical stock market performance after sharp rallies does not sway us from our expectations for modest, mid-single-digit returns for stocks in 2016. We acknowledge that technical conditions for the market have improved, sentiment remains relatively contained (there is still a wall of worry to climb), and the potential exists for a strong earnings rebound in the second half of 2016. These factors, along with dimming prospects of recession, have left us a bit more constructive on stocks than we were at the start of the year.

But several risks prevent us from considering getting more aggressive here, particularly the potential for oil to give back recent gains (WTI crude oil futures opened 6% lower overnight after global oil producers failed to agree to a production freeze, but pared losses after trading resumed in other markets). Other market risks we continue to follow closely include a possible "Brexit" (the U.K. exiting the European Union), a potential hard landing in China, and U.S. election uncertainty.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific *advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results.*

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.

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.

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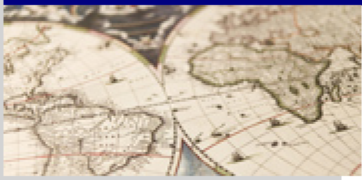

Weekly Economic Commentary | Week of April 18, 2016

Emerging markets (EM) tantalize investors with the prospects of higher returns; yet the key to these returns may be the value of the U.S. dollar.

FOLLOWING THE MONEY IN EM CURRENCY MARKETS

KEY TAKEAWAYS

• The direction of emerging market (EM) currencies relative to the U.S. dollar is a key element of EM returns.

• The value of the U.S. dollar is determined by many factors, including global fund flows.

• EM currencies may continue to rebound; if so, overall EM assets should perform well.

Emerging markets (EM) tantalize investors with the prospects of higher returns; yet the key to these returns may be the value of the U.S. dollar. Currency movements impact all aspects of international investing, starting with the basic impact of adjusting gains for the change in currency value when determining total returns. However, changes in currency also impact areas like corporate earnings, the ability to repay debts, and the overall economic health of the country. These impacts are greater for EM investments, where currencies are more volatile and countries are more economically dependent on trade.

The value of EM currencies has depreciated significantly since mid-2011 for many reasons, including a reduction in capital flows into these countries. In turn, this has significantly reduced the return on EM investments to U.S. investors. The trend of EM currency devaluation appears to be turning; if the reversal continues, and if capital flows into EM countries resume, both debt and equity investments in these regions may be very attractive.

Following the Money

Emerging market countries tend to be very dependent on capital flows to finance trade and budget deficits and to bolster investment. Money flows into EM countries for a number of reasons. Multinational companies, which set up manufacturing facilities to take advantage of cheaper labor and better access to EM consumers, are one source of investment. Investors focused on long-term growth purchase shares of companies to diversify their portfolios and seek another source of gains. Shorter-term investors often engage in the "carry trade," borrowing money in low-yielding currencies-like the Japanese yen and U.S. dollar-to buy higher-yielding, but riskier fixed income assets from EM countries.

Capital flows into and out of EM countries are important for several reasons. Unlike richer countries, most EM countries don't generally have enough internal savings to finance their growth (China is the major exception). Without external financing, they may not be able to build out infrastructure basic needs like transportation or power generation. More developed countries may need to import capital to build factories to produce goods necessary for both domestic consumption and exports. Yet, if a country has capital inflows too fast, it can result in an unwanted appreciation of its currency, making its exports more expensive than competitors. Like Goldilocks, EM countries need capital flows to be just right. Over time, the relationship between capital flows and currency can be tenuous; many factors influence currency. Yet, despite the conventional wisdom that "correlation does not prove causation," we cannot help but remark that the current outflow from EM countries came just as their currencies were collectively declining.

Since 2010, flows into EM countries have declined, recently turning negative [Figure 1]. Capital flows relative to gross domestic product (GDP) is the best way to measure this, as an outlier in a larger economy could otherwise distort the data. The International Monetary Fund (IMF) also examined the same data, separating out Russia (because of the sanctions imposed on it in 2014) and China (due to its large size and rapid growth), but there is very little difference between these two and the remaining countries.

Another important consideration is that capital outflows are often connected with a currency crisis. A currency crisis is defined as a sharp decline in the value of a currency, or when a government must spend significant resources to prevent such a decline. The most recent outflow from EM has not coincided with a currency crisis (or other financial crisis).

The inherent instability in EM is one reason investors limit their allocation to the asset class, regardless of how attractive the fundamentals may be. Like so many aspects of international economics, the relationship between cause and effect is often circular. Many economists suggest that the reason EM countries have been able to withstand sharp changes to capital flows is because their currencies are able to adjust to current conditions. Prior to the EM crisis of the late 1990s and early 2000s, many EM countries had currencies that were pegged to the U.S. dollar. Today, very few countries do. Even China has abandoned its dollar peg for a more globally diverse basket of currencies.

The Currency Tells the Story

If a picture is worth a thousand words, Figure 2 is a novel. The top half of the chart shows the performance of the JP Morgan Emerging Market Currency Index, and also the performance of the MSCI Emerging Markets Index relative to the Russell 3000 Index. They rise and fall together fairly consistently. The bottom piece of the chart shows the rolling correlation between the two, which, on average, is 0.44-a noteworthy correlation. A closer look at the bottom half of Figure 2 reveals additional insights into the relationship of the data. Notice that the pattern is somewhat saw-toothed, with periods of high correlation, over 0.7, and periods where the correlation is nonexistent, near 0. However, the relationship is almost never negative, and when it is negative, it is only modestly so for a brief period of time. This suggests that while EM equities may not always outperform when their currencies are strong, historically it is rare that they outperform when their currencies are declining.

What caused the multiyear decline in EM currencies, and what may be causing their recent rebound? This is a complex problem, but there are some points of agreement. It is hard to ignore the impact of reduced capital flows into, and eventual capital flows out of, EM countries generally. Many EM countries are experiencing an economic slowdown, making their currencies less attractive and less in demand around the world. This may be especially true for commodity-oriented countries that have been hurt by the price decline in their primary source of trade. Fear of instability across EM countries is another contributing factor to currency declines.

By definition, currencies are priced on a relative basis, usually against the U.S. dollar. Recently, the dollar has been strong against all currencies, in both developed and emerging markets. Support for the dollar has come from many sources, including the belief that the Federal Reserve (Fed) would begin to raise interest rates in 2015 and that there would be as many as four rate hikes in 2016. As the Fed delayed the start of its rate hike campaign until December 2015, and as predictions for the number of further increases has declined, the dollar has reversed course against most EM currencies. Figure 2 suggests that should the recent trend of EM currency strength continue, it could last for an extended period.

What's the Play: EM Stocks or Bonds?

Investors looking for a rebound in EM currencies may reasonably ask, should we use stocks or bonds as the vehicle? For reasons we stated in last week's *Weekly Market Commentary*, "Emerging Market Earnings: Is the Tide Turning?" EM equities appear reasonably valued, and even cheap relative to developed market equities, provided earnings come in close to expectations. Stronger currencies relative to the dollar are generally not considered a positive for earnings. However, EM companies operate around the world, and increasingly with each other; strength against the dollar should only be one consideration.

The term "emerging markets" is repeated often, but it means different things depending on context. EM equities are issued by companies, many of which were state owned and then privatized. Most EM debt issues, on the other hand, are sovereign debt, meaning the bonds are issued by the government. Therefore, the universe of available stocks and bonds are very different from each other in terms of country of issue, which impacts the degree of currency, liquidity, and other risks. Just because both are labeled as "emerging markets" does not mean they are the same asset class. Figure 3 shows the top 10 countries in both the primary EM debt and EM equity indexes.

Conclusion

Though many factors impact investor returns on EM investments, capital flows and, by extension, currency movements are two important elements in the performance of these asset classes. There are early signs of strength for EM currencies, and therefore, in EM stock and bond markets, though the composition of these markets is very different from each other. By their nature, these markets have a higher risk profile, but have the potential to positively impact portfolios should the most recent trends continue.

but are not limited to, currency risk, geopolitical risk, and risk associated with varying accounting standards. Investing in emerging markets may accentuate these risks.

Investing in foreign and emerging markets debt securities involves special additional risks. These risks include, but are not limited to, currency risk, geopolitical and regulatory risk, and risk associated with varying settlement standards. These risks are often heightened for investments in emerging markets.

Currency risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

INDEX DESCRIPTIONS

The Russell 3000 Index measures the performance of the largest 3,000 U.S. companies representing approximately 98% of the investable U.S. equity market.

The JP Morgan Emerging Market Currency Index (EMCI) is a tradable benchmark for emerging markets currencies versus the U.S. Dollar.

The JP Morgan EMBI Global Core Index is a subset of the broader JP Morgan EMBI Global Index and measures the performance of most liquid USD-denominated emerging market sovereign or quasi-sovereign bonds.

The MSCI Emerging Markets Index captures large and mid cap representation across 23 emerging markets (EM) countries. With 822 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.