HBK Wealth Management
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WEEKLY MARKET COMMENTARY

A Candid Look into the Current State of the Markets

July 2016

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

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In This Issue

Weekly Market Commentary | Week of July 25, 2016

KEY TAKEAWAYS

- This week we look at some interesting, under-the-radar breakouts in the economy and markets.
- The breakout in economic surprises is a positive sign for the stock market and cyclical sectors.
- The breakout in valuations suggests only potential moderate gains for stocks in the near term.
- The breakout in emerging markets suggests strong recent performance for that group may continue.

BREAKOUT

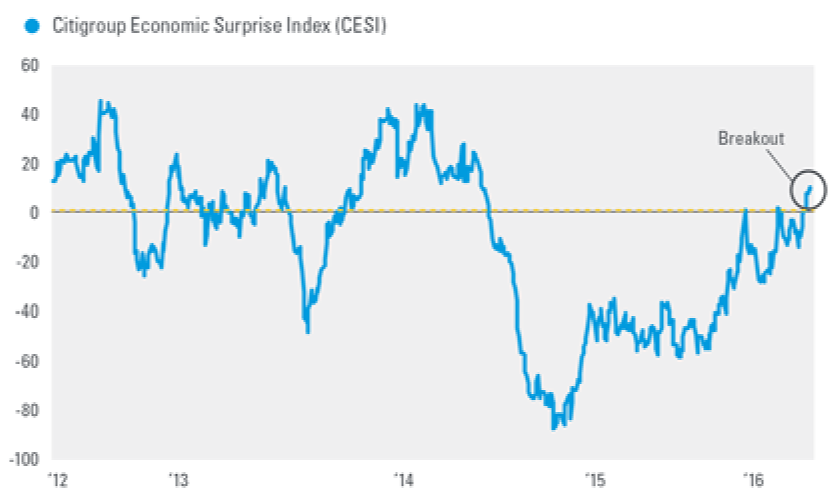
The S&P 500, Dow Jones Industrials, and other major indexes have recently broken out to new highs. But this commentary is not about the breakouts in those indexes (check out lplresearch.com for more on those). Nor is this commentary about the classic video game called Breakout that debuted in the mid-1970s, which some of us more seasoned investment professionals recall. And it's definitely not about the 2008 Miley Cyrus album by that name (even though the authors of this report have six daughters between the two of them). In this week's commentary, we look at some interesting, under-the-radar breakouts in the economy and markets.

BREAKOUT #1: ECONOMIC SURPRISES

Many wonder how the stock market can do so well when S&P 500 earnings have not produced any gains since the second quarter of 2015, and even then earnings grew by a meager 1.3%. Valuations have risen, which has been helpful (more on that below). Central banks have also helped, which could explain why the VIX measure of stock market volatility is sitting near post-financial crisis lows and about 7 points (or 35%) below its 25-year average. But another reason that few would cite is that economic data have been increasingly beating expectations--our first featured breakout.

The Citigroup Economic Surprise Index, or CESI, tracks how economic data are faring relative to expectations. The index rises when economic data exceed economists' consensus estimates and falls when data come in below estimates. After an 18-month stay in negative territory, the July 8, 2016 reading put the index above zero [Figure 1].

1 ECONOMIC SURPRISES HAVE BROKEN OUT ABOVE ZERO FOR THE FIRST TIME IN 18 MONTHS



Source: LPL Research, Bloomberg 07/22/16

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

The Citigroup Economic Surprise Index is an objective and quantitative measure of economic news. It is defined as weighted historical standard deviations of data surprises. A positive reading of the Economic Surprise Index suggests that economic releases have on balance beaten consensus. The index is calculated daily in a rolling three-month window.

Economic growth has not picked up during this time period but the data have been better than expected, supporting stocks during their recent ascent--including the month since the Brexit vote in the U.K.--highlighted by the June Institute for Supply Management (ISM) Purchasing Managers' Index (53.2 versus 51.4 expected) and the June Employment Situation report (287,000 net new jobs versus 175,000 expected).

More data beats than misses is an encouraging sign for stocks. Over the past 10 years, when the CESI breaks above zero (14 instances), the S&P 500 was higher over the subsequent 6 months 79% of the time with a median gain of 5.2% (the average is lower, dragged down by a 35% drop in 2008). Excluding the Great Recession, stocks rose in 11 of 12 instances with a median gain of 6.3% (and an average of 6.9%) over the subsequent 6 months. We have also observed better performance from the more economically sensitive sectors in these scenarios. Both good signs.

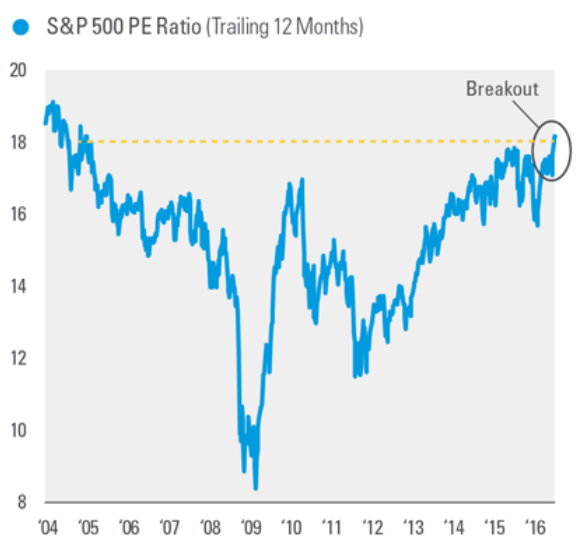
The second quarter 2016 gross domestic product (GDP) report will be released this Friday, July 29, which may deliver another surprise. GDP is expected to pick up strongly from the tepid 1.1% annualized growth rate posted in the first quarter of 2016. The Bloomberg consensus forecast for the second quarter is 2.6%.

Something else that is poised for a breakout after an extended stay below zero is earnings growth. After what will likely make four consecutive quarters of earnings declines in the second quarter of 2016, consensus estimates are calling for a modest low-single-digit gain in the third quarter. More on earnings in the coming weeks.

BREAKOUT #2: VALUATIONS

Our next breakout is not as upbeat, and that is valuations. Based on the trailing 12 months price-to-earnings ratio (PE), one of our preferred valuation measures, stock valuations have broken out to a new post-financial crisis high. In fact, you have to go back more than 11 years--to November 2004--to find a higher PE than the current 18.3 [Figure 2].

2 VALUATIONS ARE AT POST-FINANCIAL CRISIS HIGHS



Source: LPL Research, FactSet 7/22/16

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Trailing price-to-earnings ratio (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. This measure differs from forward PE, which uses earnings estimates for the next four quarters.

These lofty valuations are understandably concerning to many. Most bull markets since WWII have ended at similar PEs to where we are today (the 1990s bull market ended at a much higher valuation of near a 30 PE). These multiples are now above long-term averages. Stock market corrections tend to be more painful when they come at higher valuations.

Even more worrisome, some other valuation measures look even more stretched than this one. Professor Robert Shiller's Cyclically Adjusted PE ratio (or CAPE), which uses 10-year average S&P 500 earnings, is over 26, versus a long-term average at 17. The median PE for stocks in the S&P 500 is 23, compared with an average of 17. And the S&P 500 PE based on GAAP, or as reported accounting earnings, is 21, above its average at 18. These are all valid concerns and certainly play into our cautious second half outlook for stocks.

Two things keep us from getting overly worried about this breakout. One, valuations have not historically been good market timing tools (Shiller publicly admits this about his own valuation metric). From year to year, it is random whether higher or lower valuations will lead to better returns. And second, inflation and interest rates are low. Lower interest rates and less inflation make future earnings more valuable and make bonds a less attractive opportunity than stocks. We continue to watch for downside catalysts that may suggest valuations will become problematic.

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.

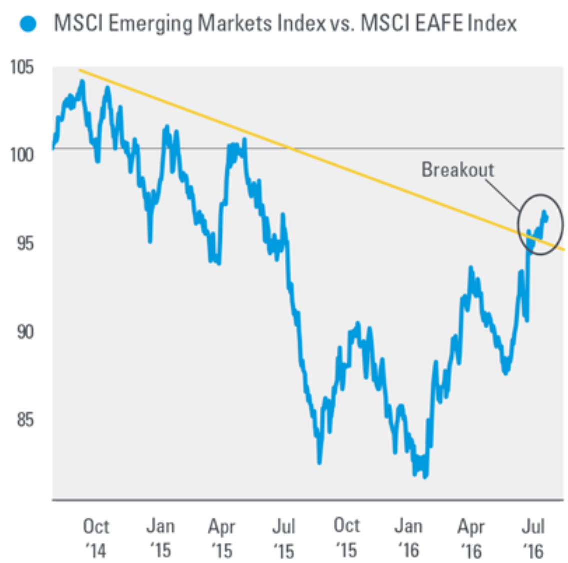
BREAKOUT #3: EMERGING MARKETS

Emerging markets (EM) is another group that is on the verge of a potential breakout. EM has been a major underperformer relative to U.S. equities over the past five years, mainly due to a combination of earnings weakness, commodity declines, political strife, and U.S. dollar strength. With commodities performing well so far this year and earnings and currency stabilizing, EM has finally begun to reverse the tide.

EM is not near a breakout on an absolute basis like the S&P 500--the MSCI Emerging Markets Index is still more than 30% below its all-time high set back in October 2007. But on a relative basis versus developed foreign markets, EM has broken above a two-year downtrend line [Figure 3]. After numerous head fakes in recent years, it may be a good time to accumulate this beaten down group from a technical perspective.

In next week's *Weekly Market Commentary*, we will continue the breakout theme and discuss some sentiment indicators that could be considered breakout candidates and potential contrarian bearish indicators.

3 EMERGING MARKETS IN PROCESS OF BREAKING TWO-YEAR DOWNTREND



Source: LPL Research, FactSet 7/22/16

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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.

The MSCI EAFE Index is a free float-adjusted, market-capitalization index that is designed to measure the equity market performance of developed markets, excluding the United States and Canada.

CONCLUSION

The breakouts for the S&P 500 and the Dow Jones Industrials are getting the most attention, but they are not the only ones. The breakout in economic surprises is a positive sign for the stock market and cyclical sectors, though the breakout in valuations suggests only potential moderate gains for stocks in the near term. Finally, the breakout in emerging markets, coupled with improving fundamentals and attractive valuations, suggests strong recent performance for that group may continue.

Thanks to Ryan Detrick for his contributions to this commentary.

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.

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.
The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

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.

The Dow Jones Industrial Average is comprised of 30 stocks that are major factors in their industries and widely held by individuals and institutional investors.

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.

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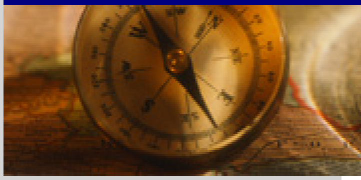

Weekly Economic Commentary | Week of July 25, 2016

FOLLOW THE LEADERS

KEY TAKEAWAYS

- The LEI provides a valuable monthly guidepost regarding the state of the current economic expansion.
- Looking at past and present readings of the LEI provides added context for the potential direction of the U.S. economy.
- Despite a recent weak reading, we do not think the LEI is signaling a recession in the near term, although global and policy risks remain.

The Conference Board Leading Economic Index (LEI), one of our Five Forecasters, provides a valuable monthly guidepost regarding where we are in the economic expansion. The latest reading on the LEI, based on June 2016 data, revealed that the index climbed just 0.7% since June 2015. The month-over-month change in the LEI has been negative half the time over the past year, while the year-over-year change has decelerated from a high of 6.7% in July 2014 to the 0.7% today. This weakness has many observers concerned that the LEI is signaling a recession. In our view, the recent weakness in the LEI reflects the impact of the stronger dollar, the fall in oil prices and resulting decline in oil-related capital spending, and the general weakness in the manufacturing sector that has beset the U.S. economy since oil prices peaked in mid-2014. As we noted in our recent Midyear Outlook 2016: A Vote of Confidence, we expect many of those factors to fade in the second half of 2016.

The Five Forecasters

There is no magic formula for predicting recessions and bear markets-every cycle is different. But we believe the Five Forecasters cover a variety of perspectives and help capture a more complete view of the economic and market environment. They are meant to be considered collectively, not individually. For more on the Five Forecasters and other components we're watching, see the latest Recession Watch Dashboard.

WHAT DOES THE LEI REPRESENT?

The LEI is designed to project the probable path of the economy 6-12 months in the future. Since 1960, a span of 678 months (or 56 years and 5 months), the LEI's year-over-year increase has been at least 0.7% (as it was in June 2016) in 487 months. Not surprisingly, the U.S. economy was not in a recession in any of those 487 months. Thus, the odds that the U.S. economy was in recession in June 2016 are close to zero. As we've noted in prior commentaries, when the economy has not been in a recession, the S&P 500 has been positive 82% of the time and provided low-double-digit returns. When the economy has been in a recession, the S&P 500 has been positive just 50% of the time, with average returns in the low-single-digits.

But the LEI is designed to forecast the potential direction of the U.S. economy and tell market participants what may happen, not what has already happened. Three months after each of the 487 months that the LEI was up 0.7% or more, the economy was in a recession just four times. Six months after the LEI was up by 0.7% or more on a year-over-year basis, the U.S. economy has been in a recession 12 times, or 3% of the time. Looking out 12 months after the LEI was up 0.7% or more, the economy was in a recession in just 33 of the 487 months, or 7% of the time. Based on this relationship, the odds of a recession within the next 18 months and 24 months are 11% and 12%, respectively **[see the first chart in the infographic on page 3]**; thus, despite the recent weakness in the LEI, the forward-looking economic indicators suggest that the odds of a recession in next few years are very low.

Another way to look at the LEI is by its level relative to its prior peak **[the second chart shown in the infographic]**. Sometime in the next several months, the level of the LEI may reach its prior peak (125.0), hit in March 2006. As is often the case when any indicator hits an all-time high or reaches a prior peak, this may raise concerns that a negative downturn is ahead, and in this case, that the economic cycle is nearing an end. But in fact, during the last three economic recoveries (commencing in 1982, 1991, and 2001), the recovery continued, on average, for another 6 years after the LEI hit its prior peak. During the 1982-1990 recovery, the LEI finally hit its prior peak in November 1984, and the economic expansion continued for another 67 months (nearly 7 years) before entering a recession in July 1990. During the 1991-2001 recovery, the LEI hit its prior peak in December 1992, and the economic expansion continued for another 98 months (more than 8 years) before entering a recession in February 2001. During the recovery that began in 2001, the LEI passed its prior peak in January 2004, almost 4 years before the Great Recession began in December 2007.

WHAT IS THE LEI SUGGESTING FOR WHAT'S AHEAD?

So, what happens next? Perhaps the LEI-past and present-can help answer that question. The deceleration in the LEI in mid-2014 coincided with the rise in the dollar, the drop in oil prices, and the subsequent decline in oil-related capital expenditures and manufacturing. Since that time, the average monthly gain in the LEI was 0.3%, which matches the average monthly gain in the LEI during the last three economic expansions (1982-1990, 1991-2001, 2001-2007). If the LEI averages 0.3% per month over the next 12 months, in June 2017, the year-over-year increase in the LEI would be 3.7%; this would suggest that the odds of a recession in the 12 months ending in June 2018 would be just 5%.

However, we believe the U.S. economy has the potential to pick up some steam in the coming quarter-not by much, but some-and could match the recovery to date gross domestic product (GDP) growth rate of 2.0-2.5%. During that time (mid-2009 through today), the average monthly gain in the LEI was 0.4%. If sustained over a full year, the 0.4% gain would translate into a robust 6.7% year-over-year gain in the LEI in June 2017, which would put the odds of recession occurring by June 2018 at just 3%. The **infographic (the third chart)** also shows what the LEI would look like a year from now at 0.1% and 0.2% gains per month.

It is possible that the LEI doesn't move at all, as perhaps the uncertainty around Brexit tightens U.S. financial conditions; or a sharply stronger dollar puts renewed downward pressure on oil prices, capital spending, and manufacturing; or a policy mistake at home or abroad dampens growth. In that case, no change in the LEI would put the odds of recession occurring between June 2017 and June 2018 at just 8%.

On balance, the LEI, even at just 0.7% year over year, says the risk of recession in the next 12 months is very low (7%), but not zero; and based on the level of the LEI relative to its prior peak, the current economic expansion may last at least another 4 years. Although the odds of a recession increase when looking out 18 months (11%) and 24 months (12%), they remain low-but again, not zero. We note that economic recoveries do not generally die of old age, but end due to excesses building up in one or more sectors of the economy. In the past, overbuilding in housing or commercial real estate, borrowing too much to pay for overbuilding and overspending, or even overconfidence by businesses and consumers have all led to overheating and recession.

The current recovery has been relatively lackluster by historical standards, and the excesses that have triggered recessions in the past are not present. Still, a dramatic deterioration of the financial or economic situation abroad, a fiscal or monetary policy mistake here in the U.S. or abroad, or an exogenous event (a major terror attack, natural disaster, etc.), among other events, may cause us to change our view.

INDEX DESCRIPTIONS

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.

The Conference Board Leading Economic Index (LEI) is a measure of economic variables, such as private sector wages, that tends to show the direction of future economic activity.