RAYMOND JAMES

Gleanings
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Gleanings

A Monthly Chart Presentation and Discussion Pulling Together the Disciplines of Economics, Fundamentals, Technical Analysis, and Quantitative Analysis

"Lethargy Bordering on Sloth?!"

In his 1996 letter to shareholders Warren Buffett wrote, "Inactivity strikes us as intelligent behavior. Neither we nor most business managers would dream of feverishly trading highly profitable subsidiaries because a small move in the Federal Reserve's discount rate was predicted or because some Wall Street pundit had reversed his views on the market." And, that is the strategy we have been employing over the past few months. It has been a difficult strategy because there seems to be a human need to be active, when sometimes, in the markets, the best strategy is to be inactive. Nevertheless, it has been three months (early July) since our models/indicators suggested the equity markets were going into a period of contraction. Quite frankly, we did not think the contraction would be as deep as it has been. In fact, we did not believe the D-J Industrials, and D-J Transports would travel below their respective October 2014 closing lows. When that happened, however, it produced a Dow Theory "sell signal," which has us worried. We have temporarily chosen to ignore that signal for reasons often stated in our missives. It has been our hope that the equity markets are in a process of forming a bottom. As stated, forming a bottom is typically a "process" and not an "event." The sequence tends to be a decline into a "capitulation low," followed by failed rally attempts, and then a retest of the "capitulation low," or sometimes a marginal "undercut low" below the "capitulation low." The resulting chart pattern often looks like a "W," or a double bottom. We have compared the current bottom pattern to those of 1978, 1979, and 2011, but some of the metrics now are quite different than what occurred during the 2011 bottoming sequence. As the astute Lowry service notes, during the 2011 sequence there was little evidence of falling demand (read: buyers) and rising supply (read: sellers), but that is not the case currently. Also, in 2011 the Advance/Decline Line was actually improving near the lows, but again that is not the case here. Indeed, the Advance/Decline Line (read: stock market breadth) has been diverging with the major market indices for months. Accordingly, at least from a technical standpoint, the conditions preceding the 2011 selloff and bottoming sequence were much more favorable than they are in 2015.

Speaking to the fundamentals, we see nothing that indicates the U.S. economy is about to tip over into recession. While it is doubtful the recent 3.9% GDP growth rate is sustainable, the economy should still be able to maintain a growth rate north of 2%. When combined with a 2% inflation rate, that gives us nominal GDP of 4%. While that's not great, it is also not all that bad. That growth rate should permit earnings growth to resume after this quarter's reports. In this earnings season, we expect overall earnings to decline by between 4% - 5%, but, excluding Energy, earnings should actually be positive. And, if S&P's earnings estimate for 2016 is anywhere near the mark at $129.45, it implies the S&P 500 is trading at 15x next year's estimate. In summary, while we are hopeful the equity markets are trying to bottom, the jury is still out. Therefore, if we are going to error, we are going to error on the side of caution, consistent with the prime tenet of investing, "Do no harm!"

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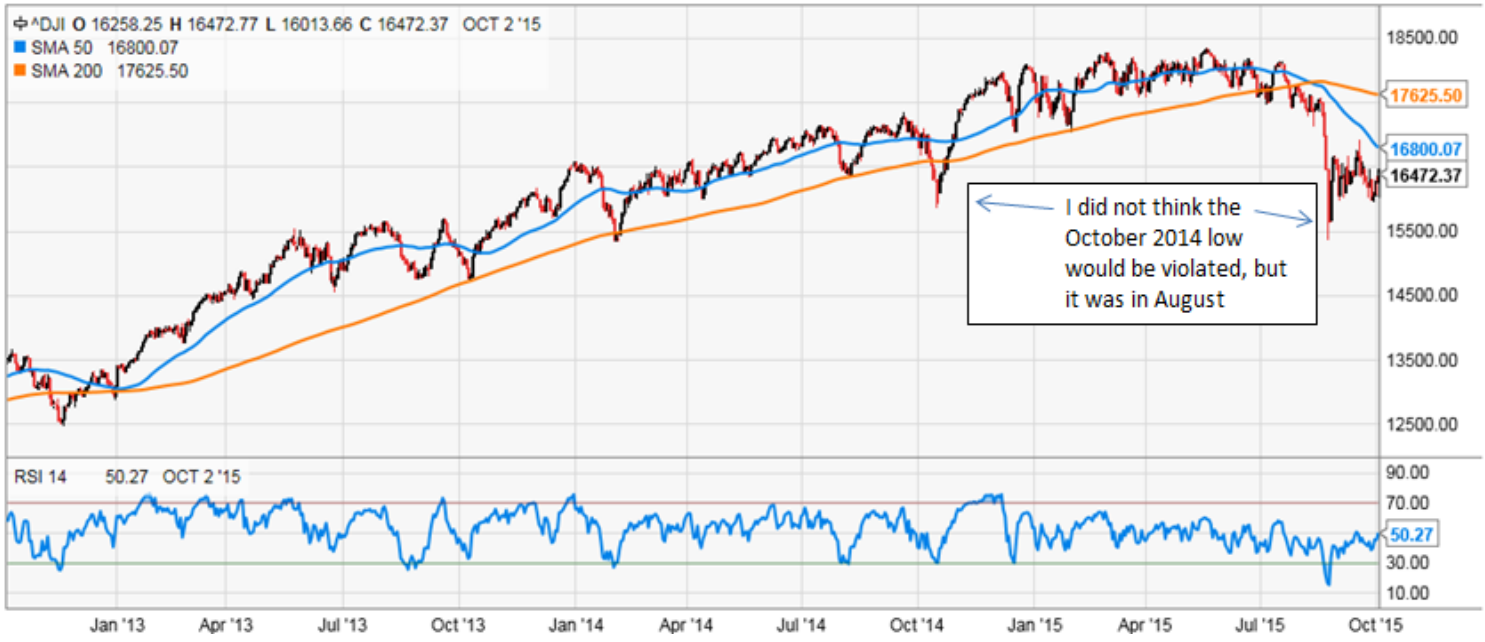
Jeffrey Saut

Dow Theory "Sell Signal" – False?

In early July, our models/indicators suggested the equity markets were going into a period of contraction. Quite frankly, we did not expect it to be as severe as it has been. In fact, we did not think the October 2014 lows would be violated. But when that happened, it registered a Dow Theory "sell signal." There has only been one false Dow Theory signal in the last 18 years and that was the last time the D-J Industrials were down 1000 points on an intraday basis. That proved to be a false signal that was quickly corrected. Accordingly, we are hoping the Dow Theory "sell signal" of August 25th will prove false as well, but we are cautious.

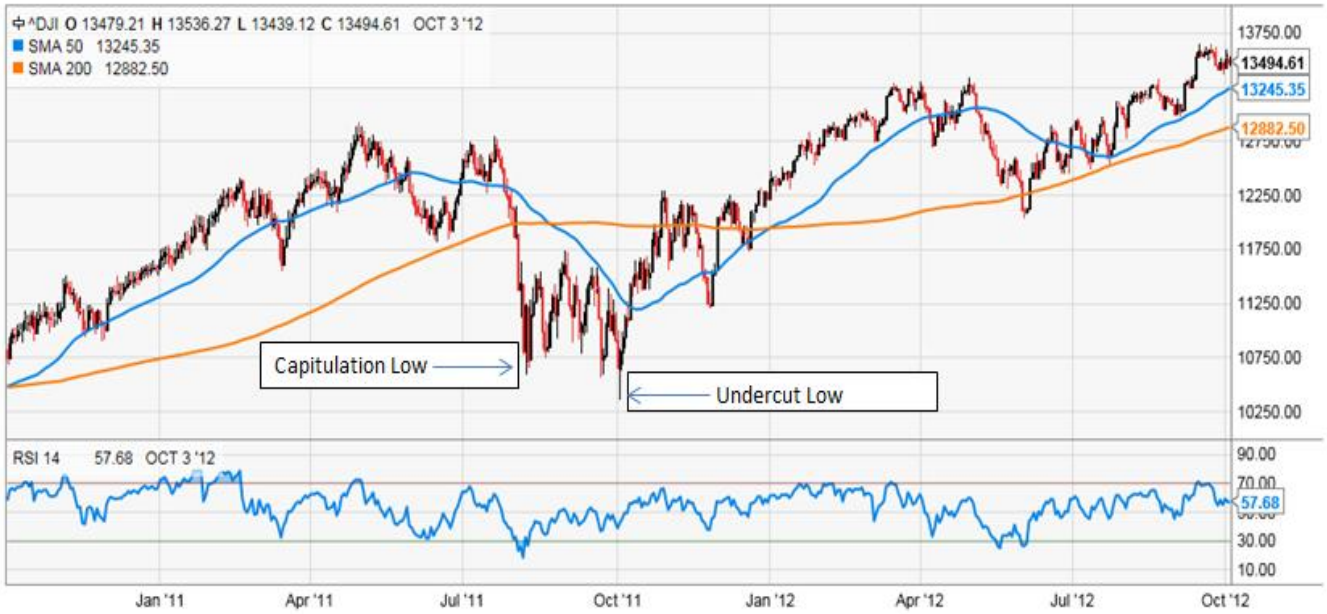


Source: YCharts.

Jeffrey Saut

Bottoming Process Similar to 2011?

We have likened the current bottoming process to hopefully that of 2011 where the Industrials dove into a "capitulation low" (-20%), followed by a series of failed rally attempts, and then coming back down to test the "capitulation low." In the 2011 case, we actually got an "undercut low" below the "capitulation low" and the bottom was in.



Source: YCharts.

Jeffrey Saut

2011 Bottoming Sequence vs. 2015 Action

While we are hopeful the 2011 bottoming sequence plays again, there are a number of metrics that are vastly different than in 2011. According to the astute Lowry organization, during the 2011 sequence there was little evidence of falling demand (read: buyers) and rising supply (read: sellers), but that is not the case currently. Also, in 2011 the Advance/Decline Line was actually improving near the lows, but again that is not the case here. Indeed, the Advance/Decline Line (read: stock market breadth) has been diverging from the major market indices for months. Accordingly, at least from a technical standpoint, the conditions preceding the 2011 selloff and bottoming sequence were much more favorable than they are in 2015.

Source: Stockcharts.com

Jeffrey Saut

Little Evidence of Imminent Recession

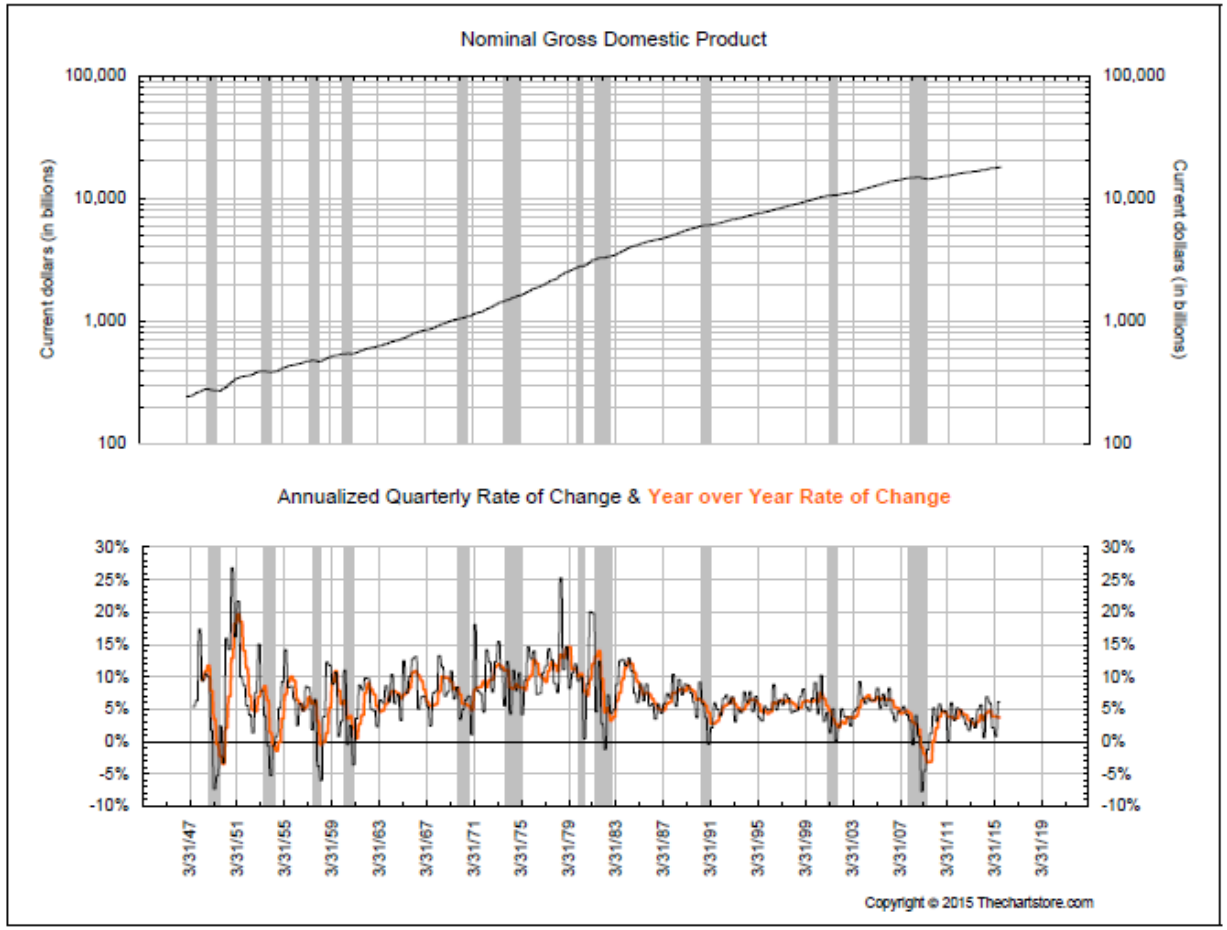
Fundamentally, we see nothing that suggests the U.S. economy is about to tip over into a recession.

Nominal Gross Domestic Product

Category	Seasonally adjusted at annual rates (in billions of current dollars)					Percentage Change from:	
	Jun 2014	Sep 2014	Dec 2014	Mar 2015	Jun 2015	Last Year	Last Quarter
Gross Domestic Product	17,270.0	17,522.1	17,615.9	17,649.3	17,913.7	3.73%	6.13%
Personal consumption expenditures	11,813.0	11,949.1	12,061.4	12,055.5	12,228.4	3.52%	5.86%
Goods	3,951.5	3,987.4	3,980.1	3,901.5	3,978.1	0.67%	8.09%
Durable goods	1,279.1	1,295.1	1,303.5	1,301.8	1,326.4	3.70%	7.78%
Nondurable goods	2,672.4	2,692.2	2,676.6	2,599.7	2,651.8	-0.77%	8.26%
Services	7,861.5	7,961.7	8,081.3	8,153.9	8,250.2	4.94%	4.81%
Gross private domestic investment	2,841.6	2,910.2	2,937.2	2,995.9	3,025.5	6.47%	4.01%
Fixed investment	2,752.7	2,821.8	2,848.7	2,868.6	2,897.9	5.27%	4.15%
Nonresidential	2,211.7	2,267.0	2,274.1	2,280.7	2,297.9	3.90%	3.05%
Structures	505.7	505.4	512.0	499.3	503.8	-0.38%	3.65%
Equipment and software	1,023.2	1,065.3	1,055.0	1,063.5	1,064.6	4.05%	0.41%
Intellectual property products	682.8	696.3	707.2	717.8	729.6	6.85%	6.74%
Residential	540.9	554.8	574.6	588.0	600.0	10.93%	8.42%
Change in private inventories	88.9	88.3	88.5	127.3	127.5		
Net exports of goods and services	-530.9	-514.6	-545.2	-551.6	-519.3		
Exports	2,356.2	2,360.6	2,349.5	2,257.3	2,280.0	-3.23%	4.08%
Goods	1,628.0	1,641.9	1,616.5	1,517.5	1,535.5	-5.68%	4.83%
Services	728.2	718.7	732.9	739.8	744.5	2.24%	2.57%
Imports	2,887.0	2,875.2	2,894.6	2,808.9	2,799.3	-3.04%	-1.36%
Goods	2,403.8	2,392.7	2,400.0	2,311.7	2,299.9	-4.32%	-2.03%
Services	483.3	482.5	494.6	497.2	499.5	3.35%	1.86%
Government consumption expenditures and gross investment	3,146.3	3,177.4	3,162.5	3,149.5	3,179.2	1.05%	3.83%
Federal	1,216.9	1,233.1	1,214.7	1,218.2	1,220.7	0.31%	0.82%
National defense	748.4	759.5	738.2	739.0	740.1	-1.11%	0.60%
Nondefense	468.4	473.6	476.5	479.2	480.6	2.60%	1.17%
State and local	1,929.4	1,944.3	1,947.8	1,931.3	1,958.4	1.50%	5.73%

Jeffrey Saut

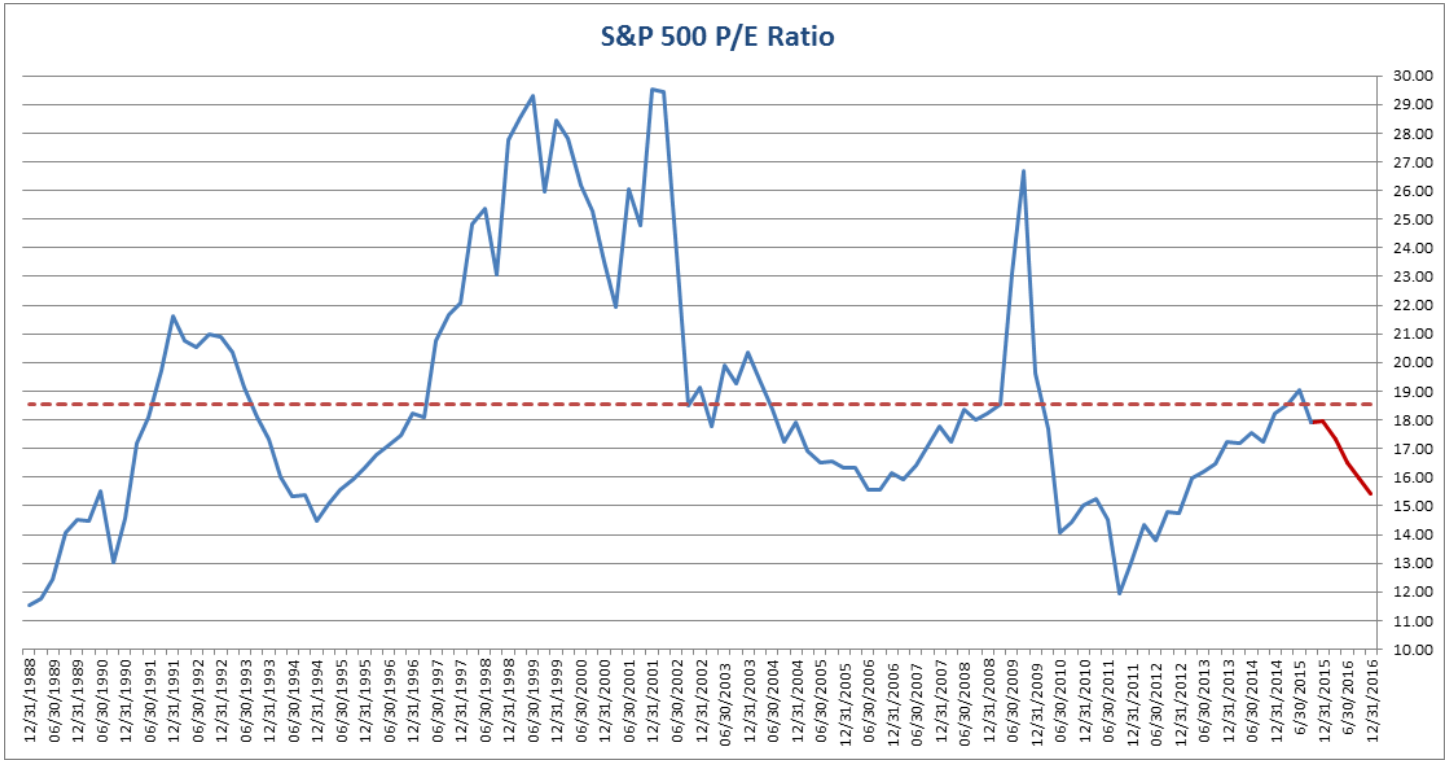
Graphically, Nominal GDP Looks Like This



Jeffrey Saut

Stocks Not All That Expensive

If S&P is anywhere near the mark with their 2016 earnings estimate for the S&P 500, the index is trading at roughly 15x the $129.45 estimate. That is certainly not all that expensive.



Source: Standard & Poor's, Down Jones Indices, Raymond James research.

Jeffrey Saut

"Do No Harm"

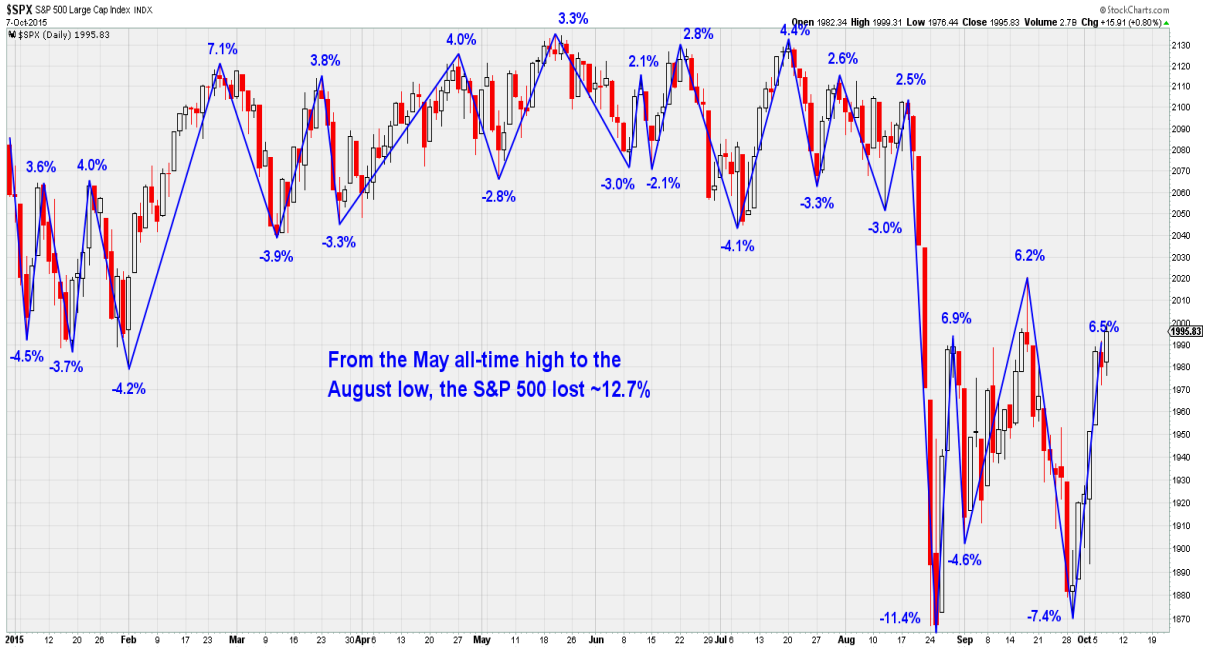
To summarize my thoughts, while we are hopeful the equity markets are trying to bottom, the jury is still out. Therefore, if we are going to error, we are going to error on the side of caution consistent with the prime tenet of investing, "Do no harm!" Benjamin Graham once wrote, "The essence of portfolio management is the management of risks, not returns."

Larry Cyna, the captain of the CymorFund, expands on Dr. Graham's comments by noting, "Risk control is a careful aligning of interests combined with a balance between greed and fear. Above all it is the willingness to hold cash when opportunities are scarce and the odds are not tipped in favor of a particular investment."

Andrew Adams

The Roller Coaster Enthusiast Market

Unless you happen to be a short-term swing trader who is only looking to hold positions for a few days, it's been a rough go out there so far in 2015. The chart below highlights the rollercoaster nature of the S&P 500 this year, with two prolonged sideways periods bookending the sharp decline in August. The sell-offs indicated below have averaged about -4.3%, and the rallies have averaged 4.2%, once again emphasizing the trendless drift we have experienced. But while the back-and-forth action has been frustrating, the maximum loss of 12.7% from the 2015 high to the low is actually less than the average 14.2% intra-year drawdown of the last 35 years. So keep in mind, it could be a lot worse.

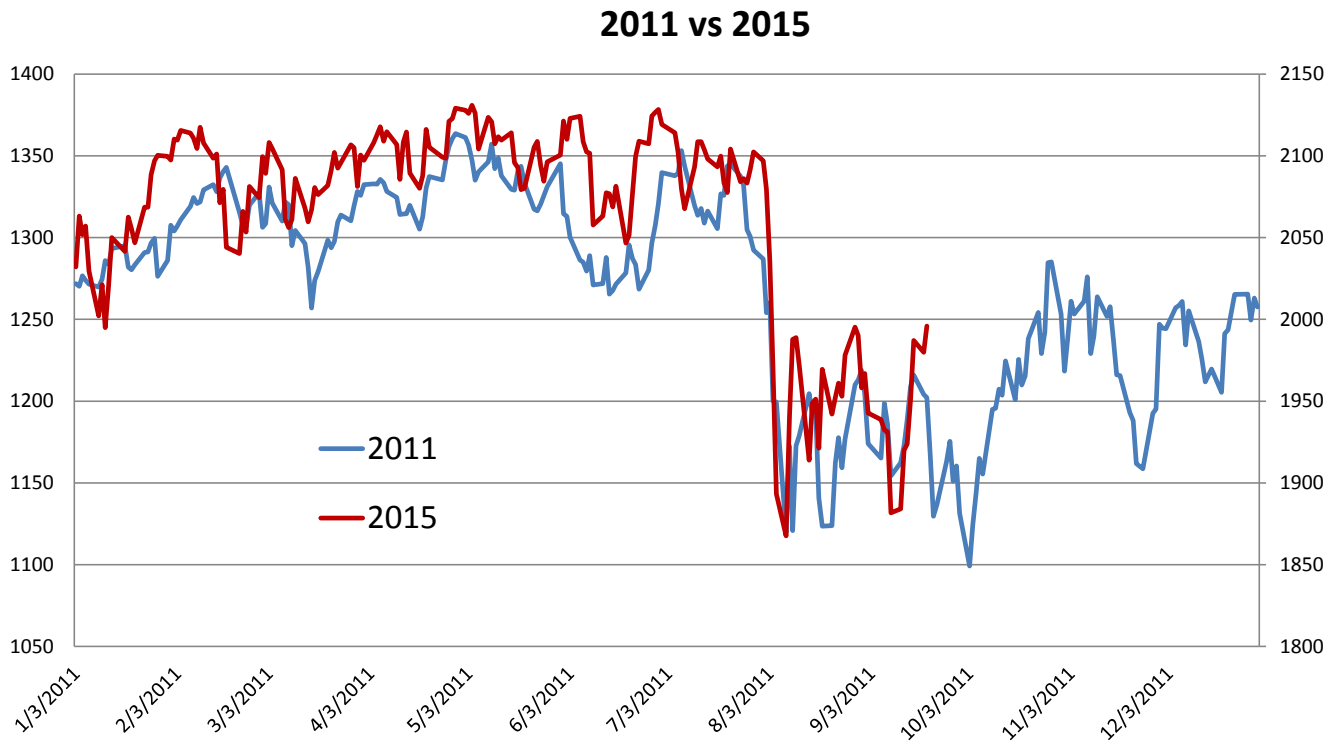


Source: Stockcharts.com

Andrew Adams

Déjà vu All Over Again

We have recently discussed how the price action of 2015 feels an awful lot like what we experienced in 2011, and when you lay the price charts of the S&P 500 over one another, it is easy to see why. The correlation between the two markets is pretty astounding, and if this analog model continues to hold, we may be in for another downturn here shortly before rallying into the end of the year.

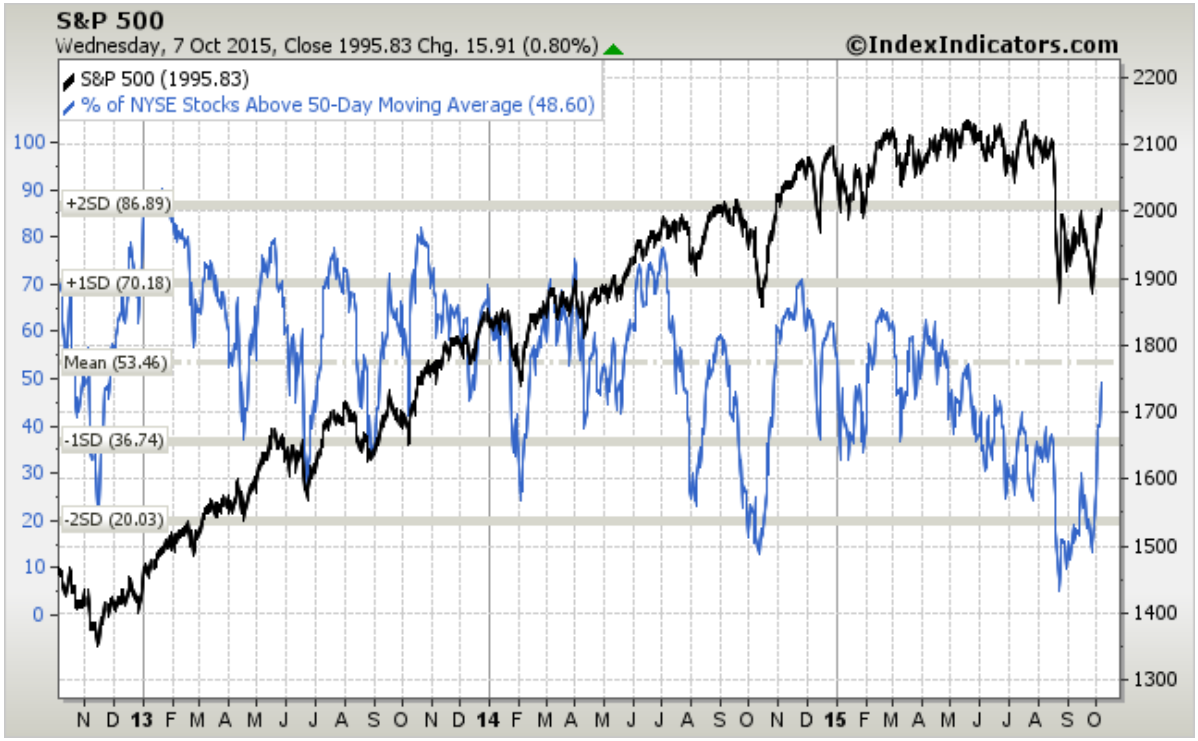


Source: FactSet, Raymond James research.

Andrew Adams

Breadth Improving but Still Below Average

The most recent rally has been accompanied by broader participation across the stock market, with the percentage of NYSE companies trading above their 50-day moving average jumping from the oversold extremes we saw during the last few months. The rise of this indicator is promising, since we want to see a majority of stocks in uptrends, but we are actually still below the three-year average of 53.46%. This means the market is no longer oversold, but is still far from being overbought, which hopefully indicates there is decent upside from here.

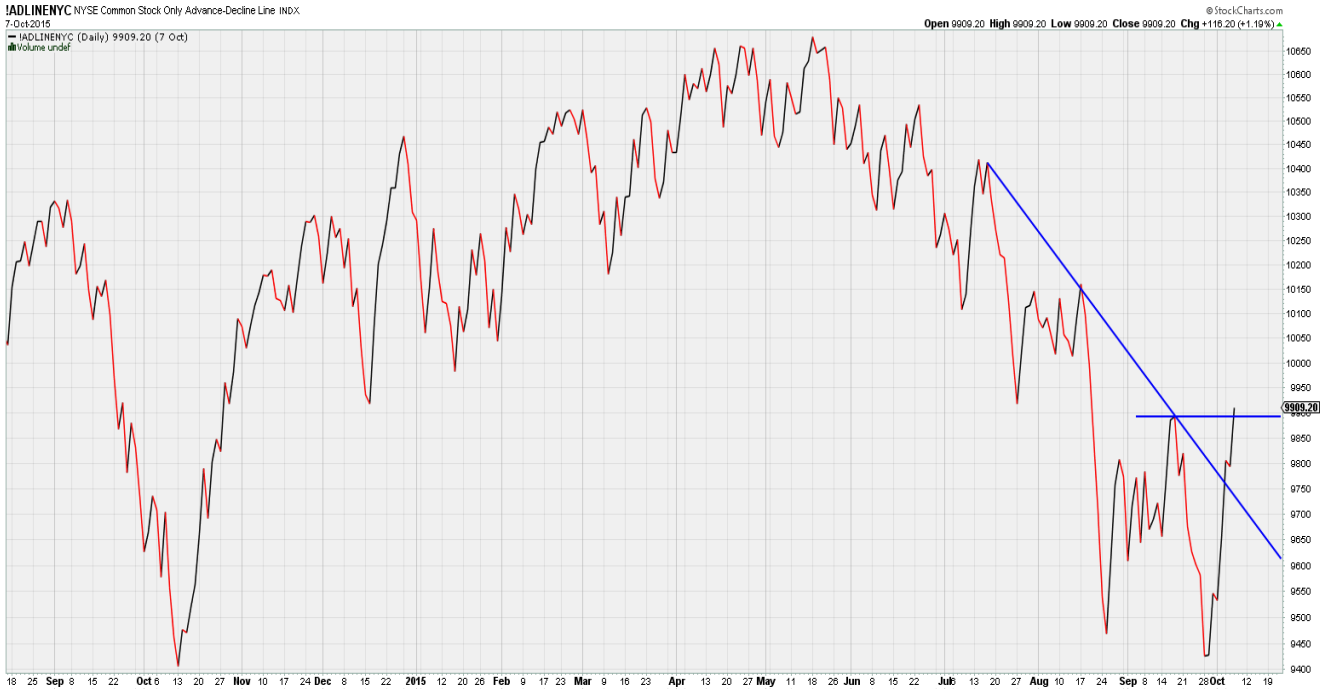


Source: IndexIndicators.com.

Andrew Adams

Another Look at Breadth

Monitoring the difference between the number of advancing and declining stocks is another way to gauge market breadth, and my favorite way to do this is by watching the NYSE Common Stock Only Advance/Decline Line. This indicator strips out the closed-end funds and ETFs that are traded on the NYSE and only includes the actual companies with common stock, providing a more representative look at how the broad market is doing. And with the most recent rally, this line has broken above a couple of important trend lines, which may indicate that breadth is improving and the multi-month downtrend is over.



Source: Stockcharts.com

Andrew Adams

The Big Picture

Below is a weekly chart of the S&P 500 going back to the 2009 bottom. Obviously, we have been in a fairly strong Bull phase during this time, but that steep upward trajectory was never going to continue and, accordingly, in June the market broke down through that lower diagonal trend line that had been acting as support since 2009. That was not a favorable technical sign and the market then proceeded to sell-off in August. However, that does not mean that the Bull market is necessarily over and the bottom is now going to drop out of the market. The prolonged sideways action of the last year has allowed those major trend lines that have bracketed the S&P 500 over the last six years to extend upward, now giving us approximately 20%-30% upside before they are again a factor. If the Bull market is still intact, those rising, diagonal lines are the most likely targets over the next year. The worst case scenario, on the other hand, would be if the index rises a bit more, then falls down below the 1867 low of this year, as this would likely complete a large head-and-shoulders pattern (the head and left/right shoulders are indicated below).

Source: Stockcharts.com

Andrew Adams

Can Energy Power this Market?

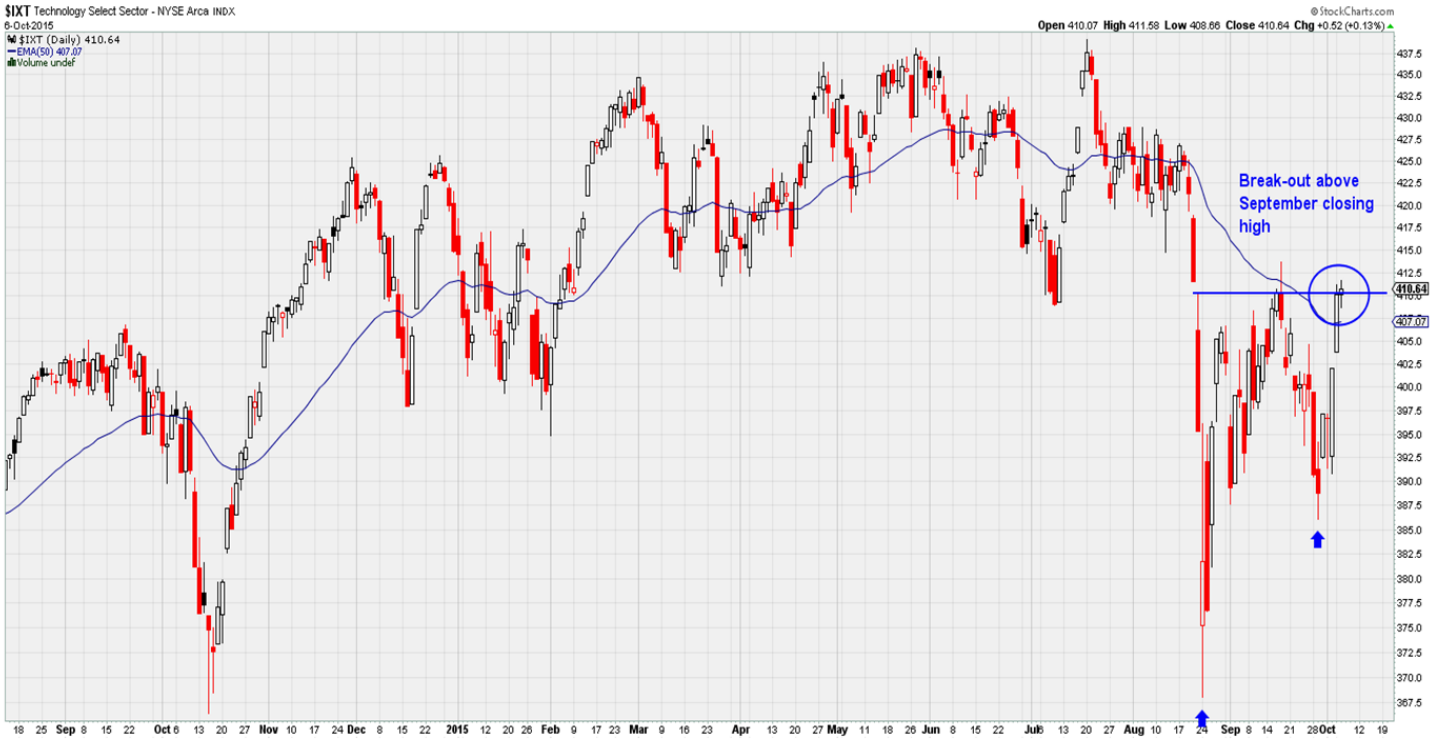
The Energy sector has been a major drag on both corporate earnings and the overall stock market over the last year, as the steep decline in the price of oil has weighed on what had been a booming U.S. Energy industry. However, these beaten-down companies are finally showing some signs of life as the commodity itself appears to be in a bottoming process. The Energy Select Sector SPDR ETF (XLE), recently put in a higher low, broke out above its September highs on high volume, and is back above the 50-day moving average for the first time since May. And with some fairly favorable year-over-year earnings comparisons coming up next year, this laggard sector could have the potential to surprise a lot of investors who have been spurned by the oil collapse.

Source: Stockcharts.com

Andrew Adams

Technology Looking Good

Strong markets are generally led by more cyclical sectors like Technology, so it is a good sign that the Technology Select Sector ETF (IXT) has broken out above its 50-day moving average and the closing high from September after making a much higher low at the end of the month. I want to see Technology play the role of leader if the broad market does go higher, since that should indicate that investors are willing to take on some risk.



Source: Stockcharts.com

Andrew Adams

An Important "Oktober" for Germany

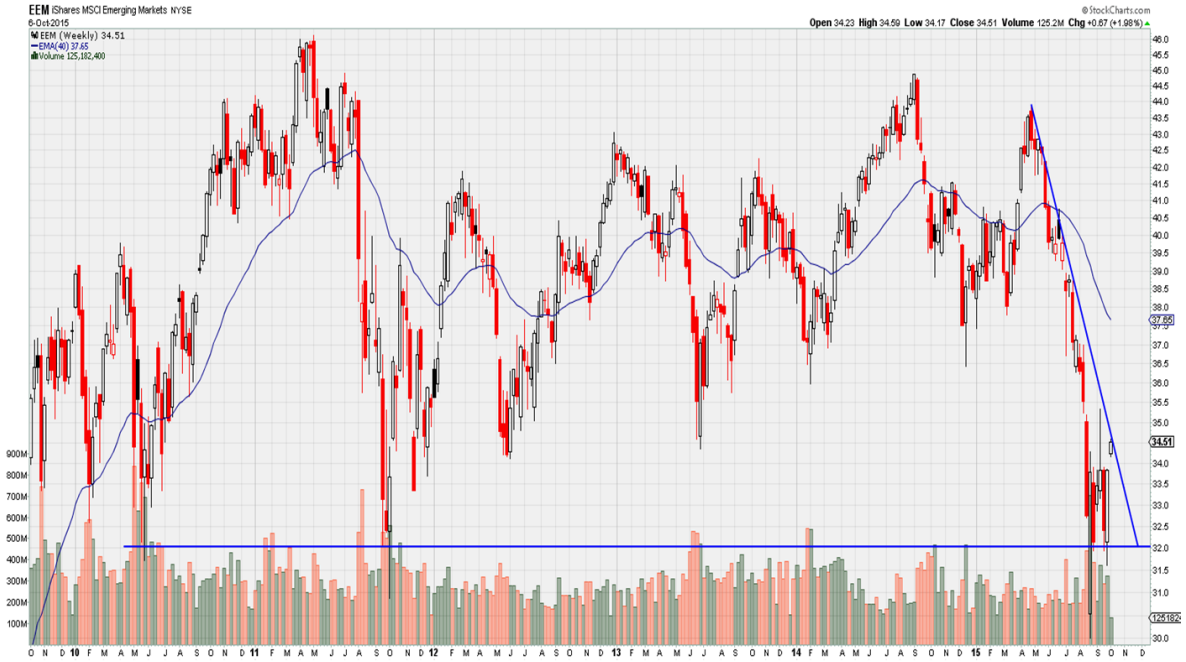
While we tend to focus much of our research on U.S. stocks, it is still important to watch what is going on in other parts of our inter-connected global market. As the fourth-largest economy in the world (by GDP) and biggest in Europe, Germany is being monitored very closely by technical analysts since it is right up against a long-term trend line drawn off of the important lows of the last few years. The monthly chart below shows that the DAX Composite Index has not closed a month below that trend line since the bull market began in 2009, and the index has also pulled back to the 36-month (three-year) moving average that has a history of importance. A drop below these two key lines would not be a good sign for global stocks.

Source: Stockcharts.com

Andrew Adams

Emerging Markets Emerging

One major story of 2015 has been the steep decline of emerging market assets, as reflected by the iShares MSCI Emerging Markets ETF (EEM) weekly chart. With a strong U.S. dollar, falling commodity prices, and a perceived slowdown in China, there hasn't been much positive news to buoy stocks in the developing parts of the world. But steep trend lines are made to be broken, and EEM is close to breaking up through the falling diagonal one below after bouncing off of long-term horizontal support around $32. As you can see from the chart, emerging markets have vacillated between multi-month up and down trends over the past five years, and it may be time for the weakness to reverse and money to flow back into these assets. EVERYONE seems to be negative on emerging markets, which is when I typically like to begin looking the other way. EVERYONE is usually wrong.



Source: Stockcharts.com

Scott Brown

Economic Outlook – Key Themes

Mixed Fundamentals

- Impact of slower global growth and a strong dollar
  - Wider trade gap to subtract about 0.7 percentage point from 3Q15 GDP
  - Manufacturing activity mixed, but about flat overall
  - Slower inventories expected to subtract (0.5 to 2.5 percentage points) from 3Q15 GDP
- Domestic strength
  - Inflation-adjusted consumer spending tracking at 3.5-4.0% in 3Q15
  - Factory shipments: moderately strong growth in business fixed investment
  - Housing: improving

Federal Reserve

- Timing of initial move still data-dependent
  - September 17: delay, Fed cites uncertain impact from global economic & financial developments
  - Recent Fed speeches: still on track for an initial tightening by year-end
  - Federal funds futures: 25 bp hike not fully factored in until March 2016
  - No need to hit the brakes, but need to take the foot off the accelerator at some point
- Path of future Fed rate increases expected to be gradual
  - Monetary policy will still be accommodative after the first couple of rate hikes

Rest of the World

- China and emerging market slowdown
  - How slow? How long?

Scott Brown

China and Emerging Markets

China: Two major transitions

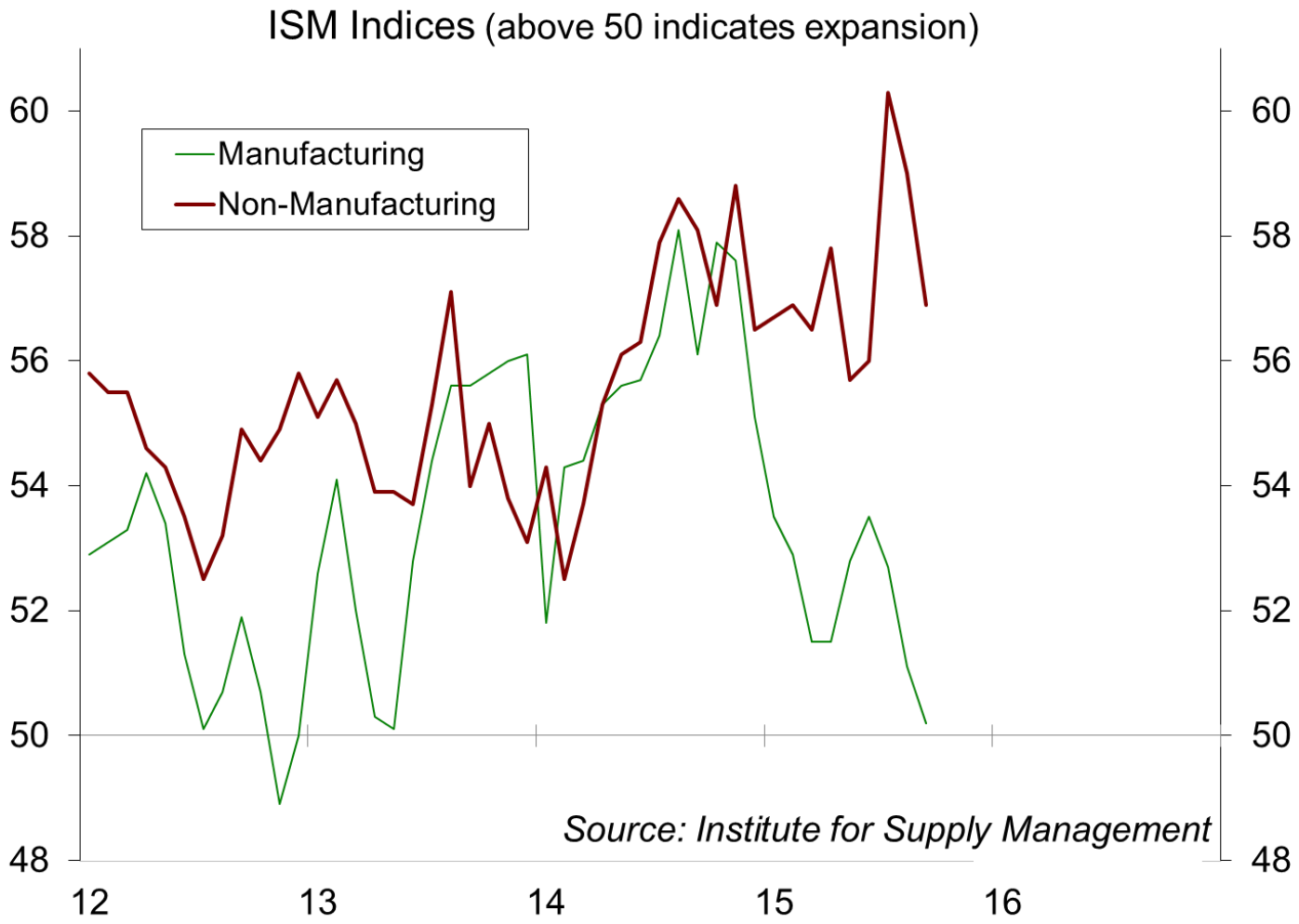
- A change in economic structure
  - Away from an economy led by export growth and infrastructure spending
  - Toward one driven by domestic demand
- Financial Liberalization
  - Move toward free-market (currency, stock market)
  - Recent developments suggest this may be a very slow transition
- These transitions are fraught with danger
  - Capital market turmoil (see, for example, Latin America)
  - Slower end growth

Impact on U.S. and others

- Direct effect on U.S. economy is small
  - China accounts for less than 8% of U.S. exports (less than 1% of GDP)
  - Consumers and businesses benefit from lower prices of oil and other commodities
- Impact on exporters of raw materials should be greater
  - Australia, Brazil, Canada, South Korea all export a lot to China
  - We're looking at a broader global slowdown
- Uncertainty
  - Official economic data from China are unreliable
  - Recovery may come sooner, but hard to say…

Scott Brown

ISM Surveys Reflect the Mixed Economy



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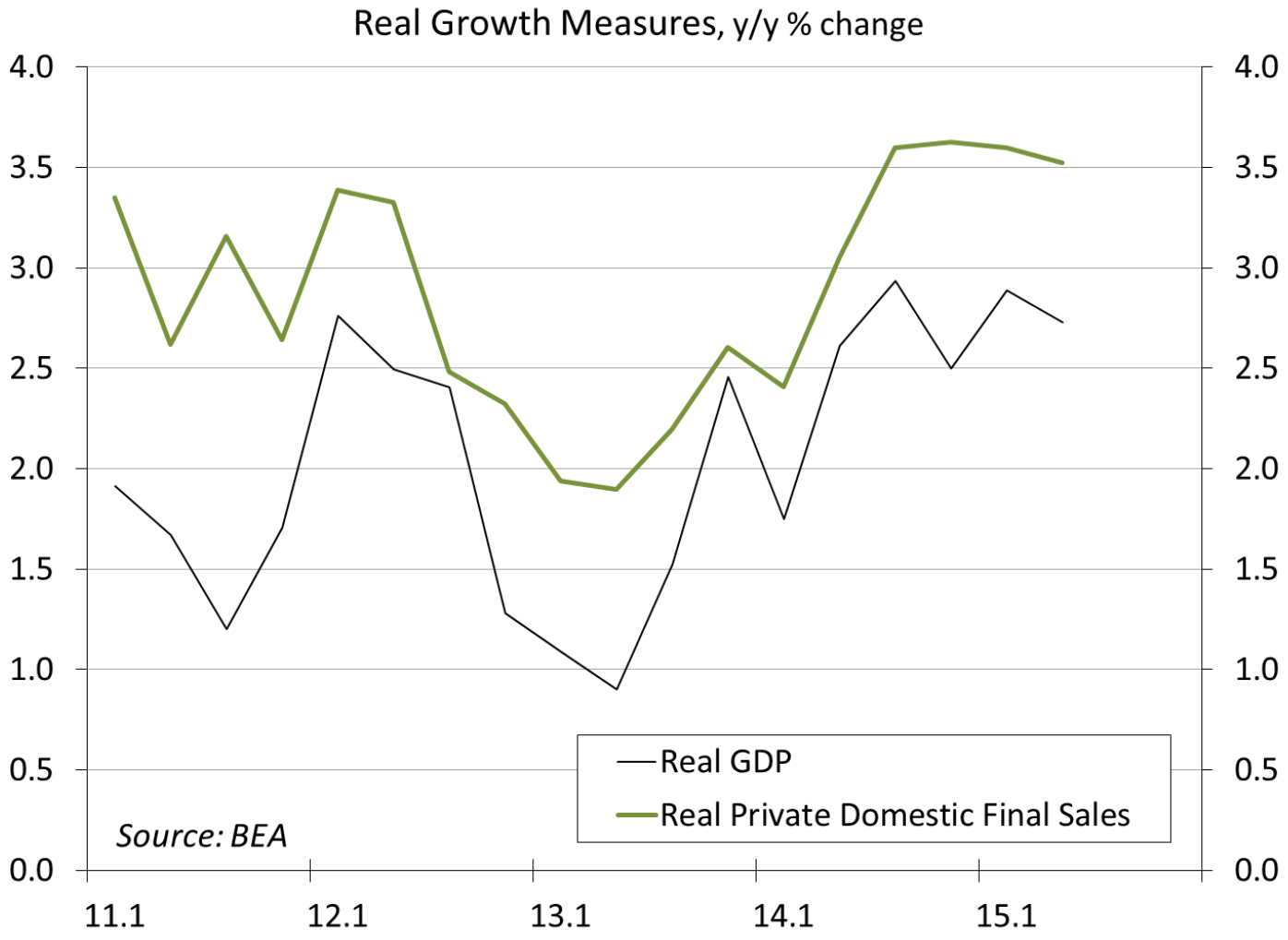
Underlying Domestic Demand has been Strong



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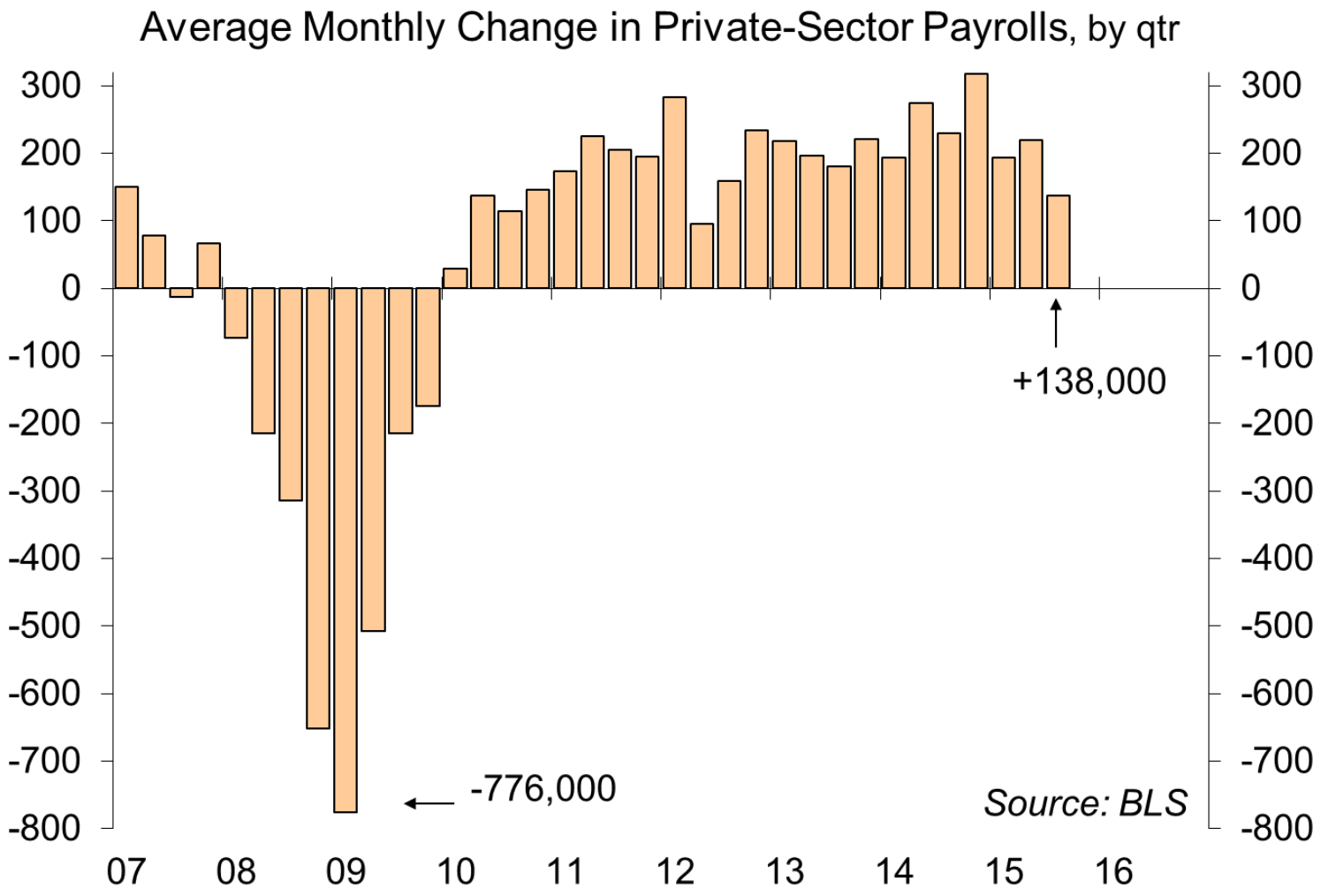
Job Growth: Slower, but Still Moderately Strong



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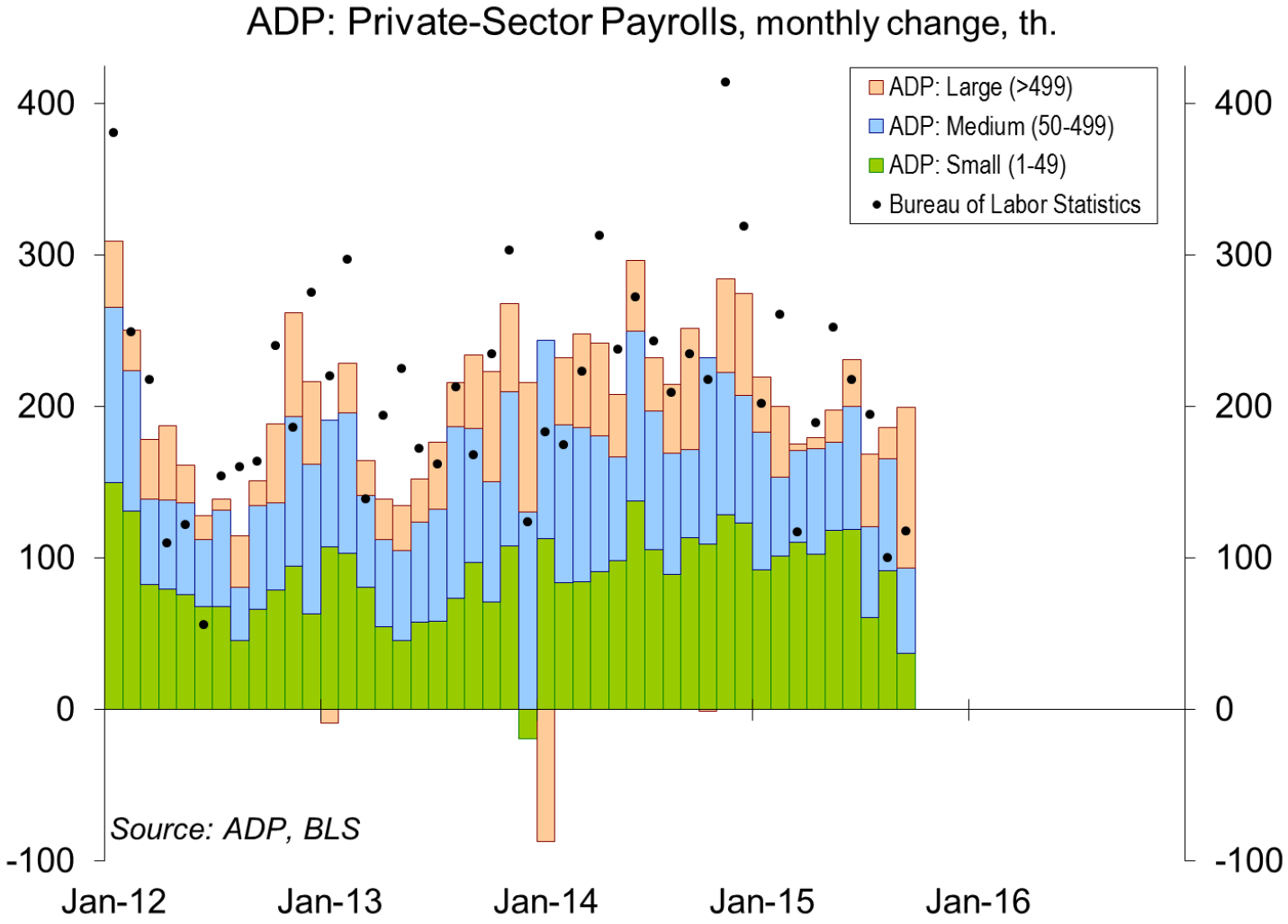
Hiring by Small Firms May be Slowing



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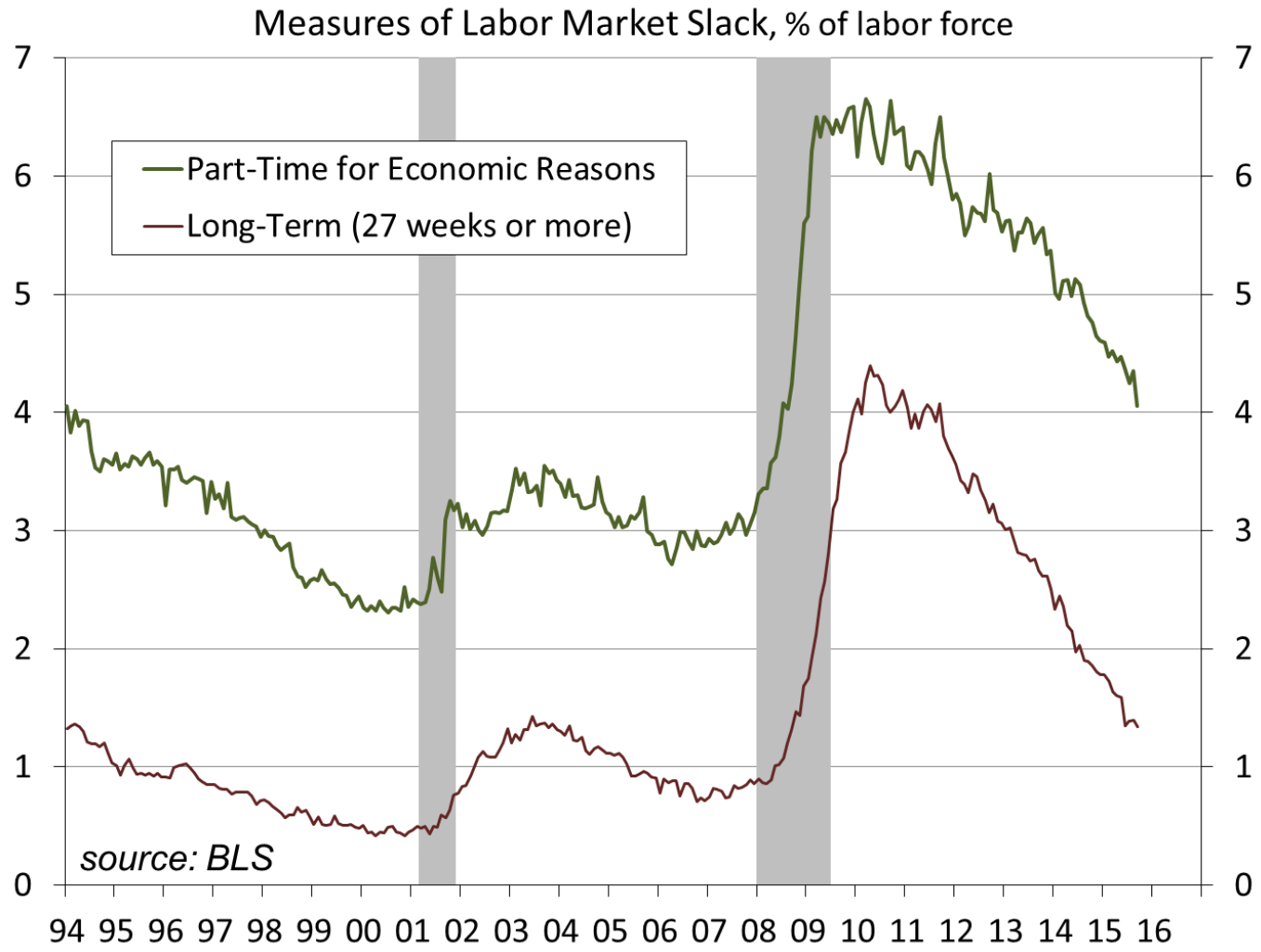
Labor Market Slack is being Gradually Reduced



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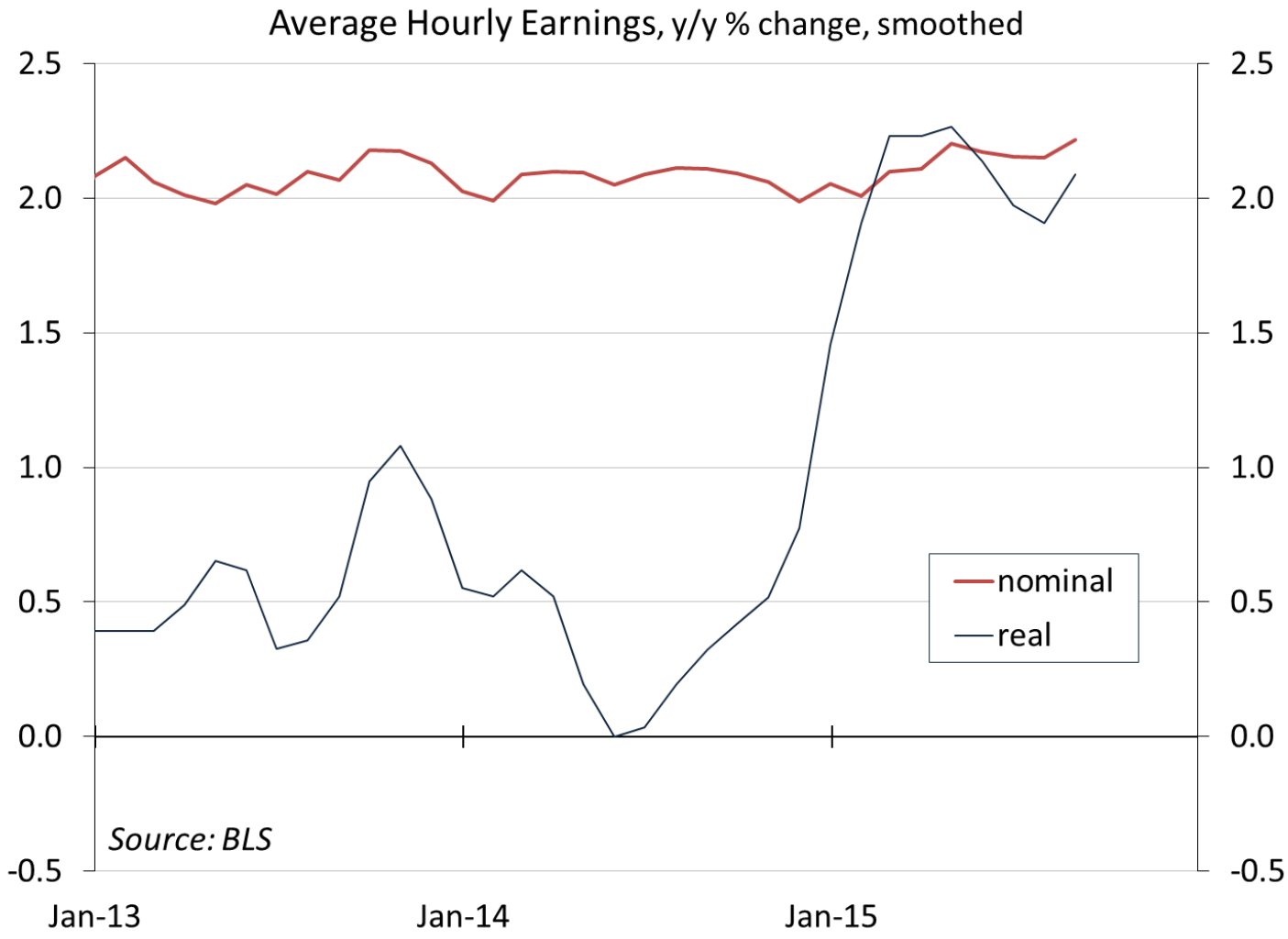
Lackluster Nominal Wage Growth, but Strong in Real Terms



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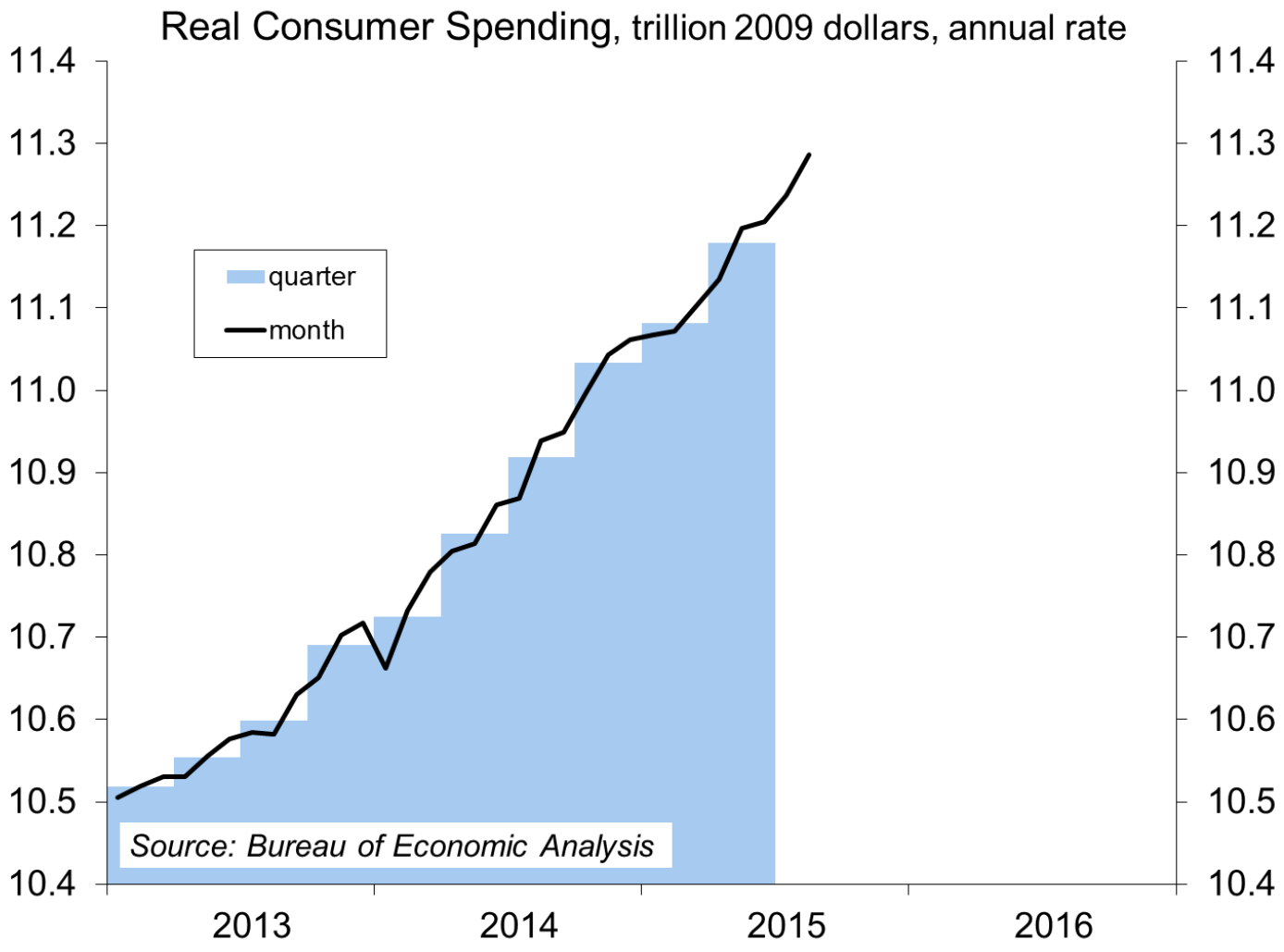
Consumer Spending Growth has been Strong



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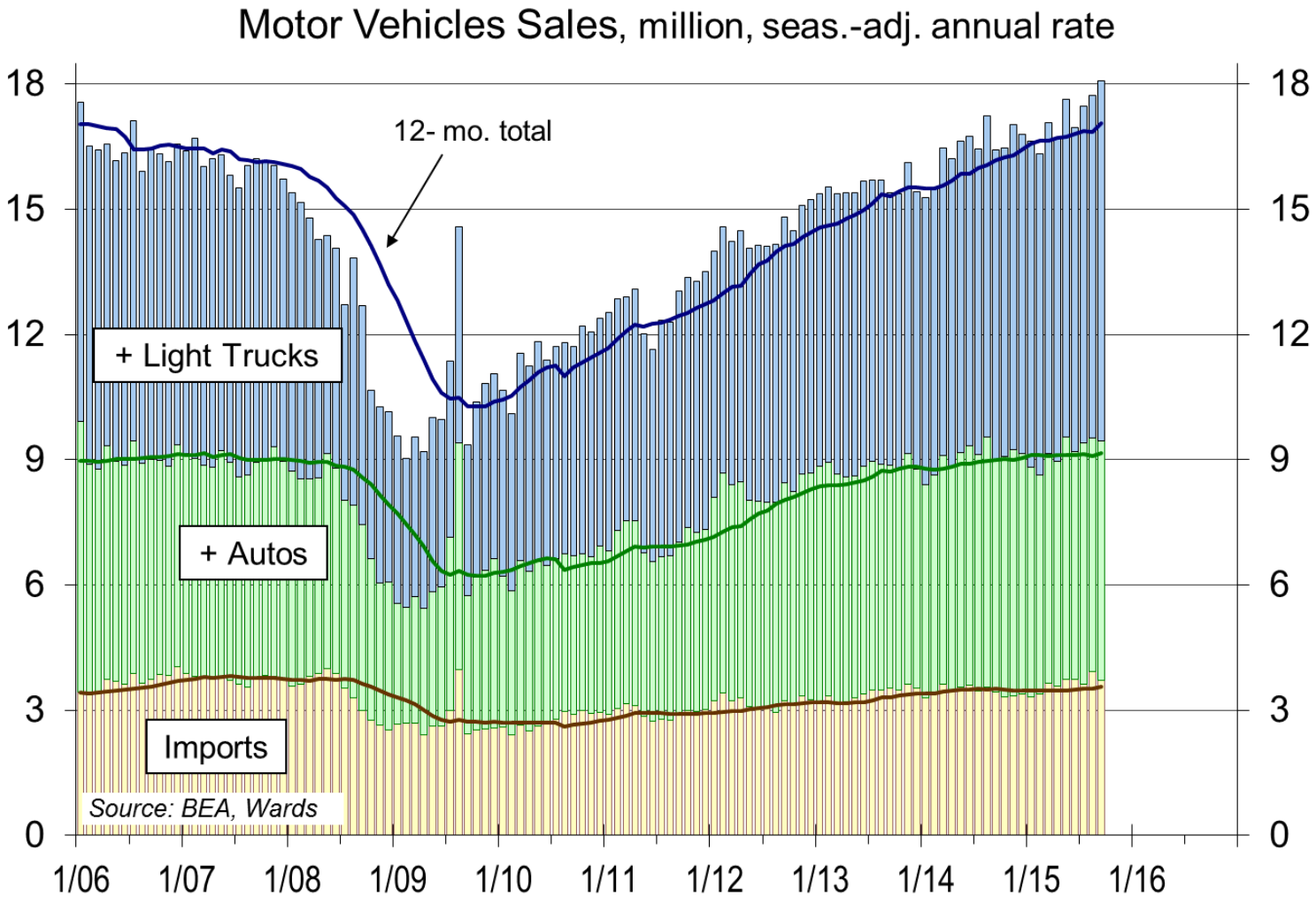
Motor Vehicle Sales Continue to Improve



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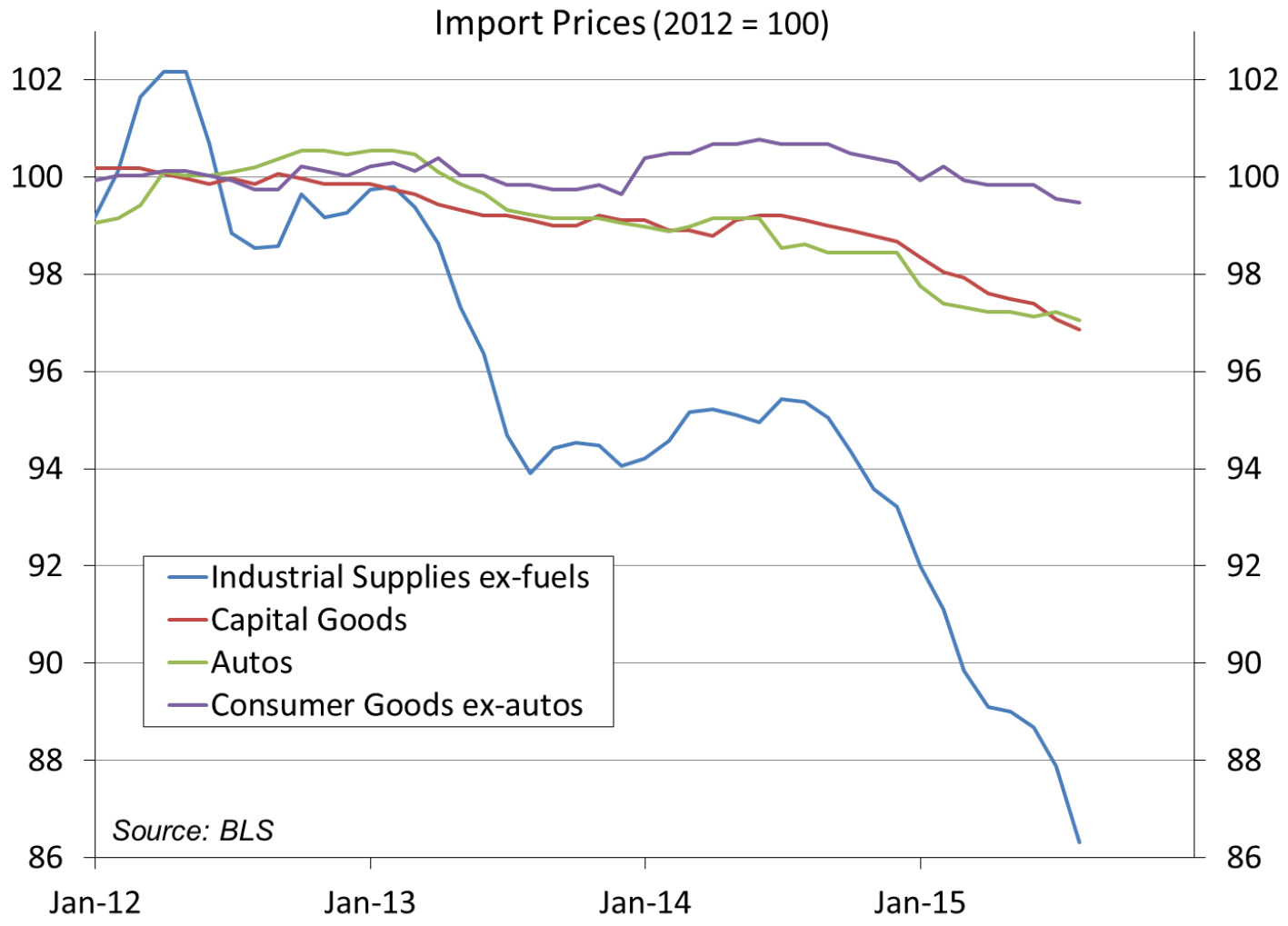
Import Prices are Falling



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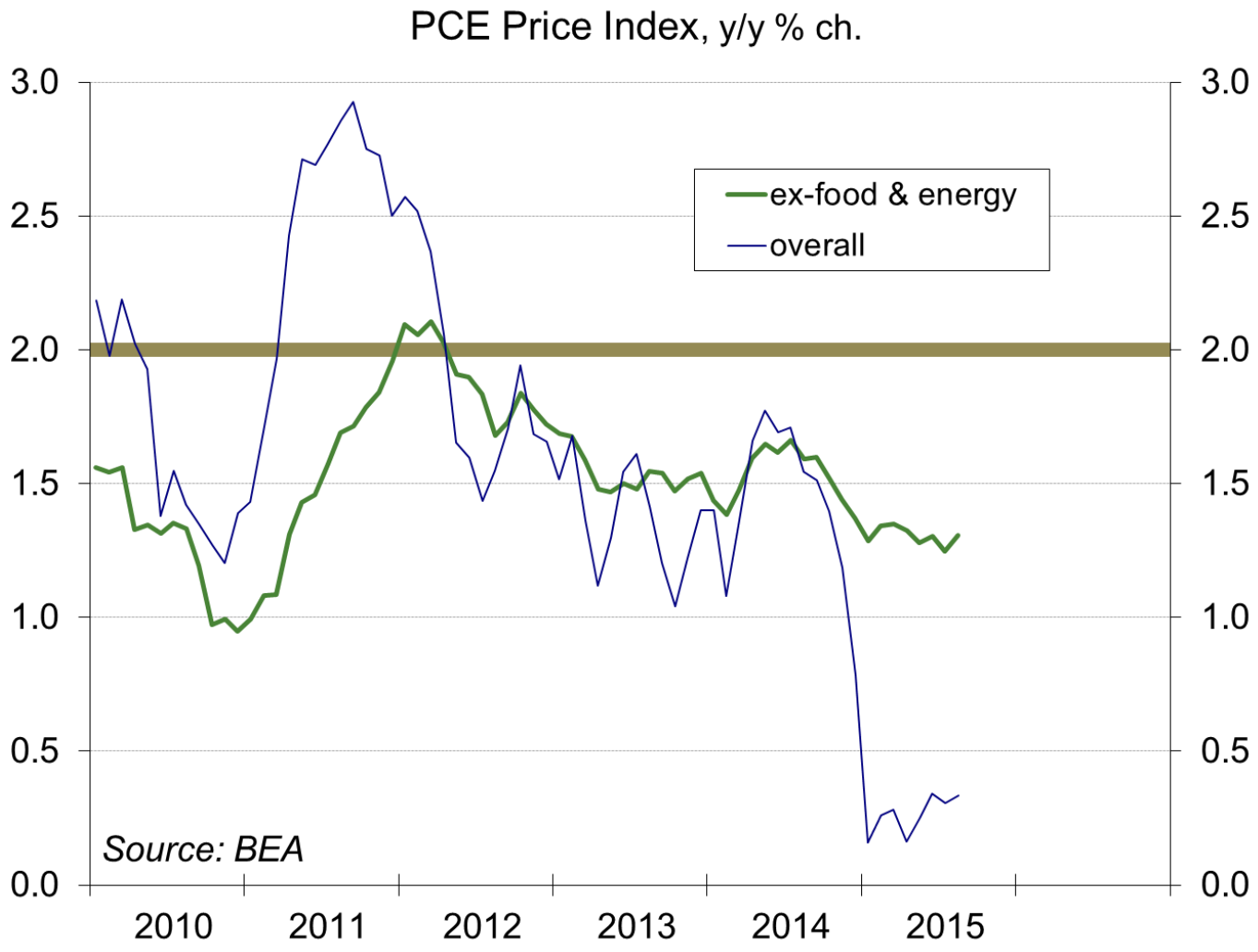
The Underlying Inflation Trend is Below the Fed's 2% Goal



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Fed Policy

Fed's Revised Summary of Economic Projections:

- At every other policy meeting (four times per year), senior Fed officials (the governors and the 12 district bank presidents) submit forecasts of GDP growth, unemployment, and inflation.

	2015	2016	2017	2018	longer run
Real GDP (4Q/4Q)	**2.1%**	**2.3%**	**2.2%**	**2.2%**	**2.0%**
July Projections	*1.9%*	*2.5%*	*2.3%*		*2.0%*
Unemployment Rate (4Q)	**5.0%**	**4.8%**	**4.8%**	**4.8%**	**4.9%**
July Projections	*5.3%*	*5.1%*	*5.0%*		*5.0%*
PCE Price Inflation (4Q/4Q)	**0.4%**	**1.7%**	**1.9%**	**2.0%**	**2.0%**
July Projections	*0.7%*	*1.8%*	*2.0%*		*2.0%*
Core PCE Price Inflation (4Q/4Q)	**1.4%**	**1.7%**	**1.9%**	**2.0%**	
July Projections	*1.3%*	*1.8%*	*2.0%*		

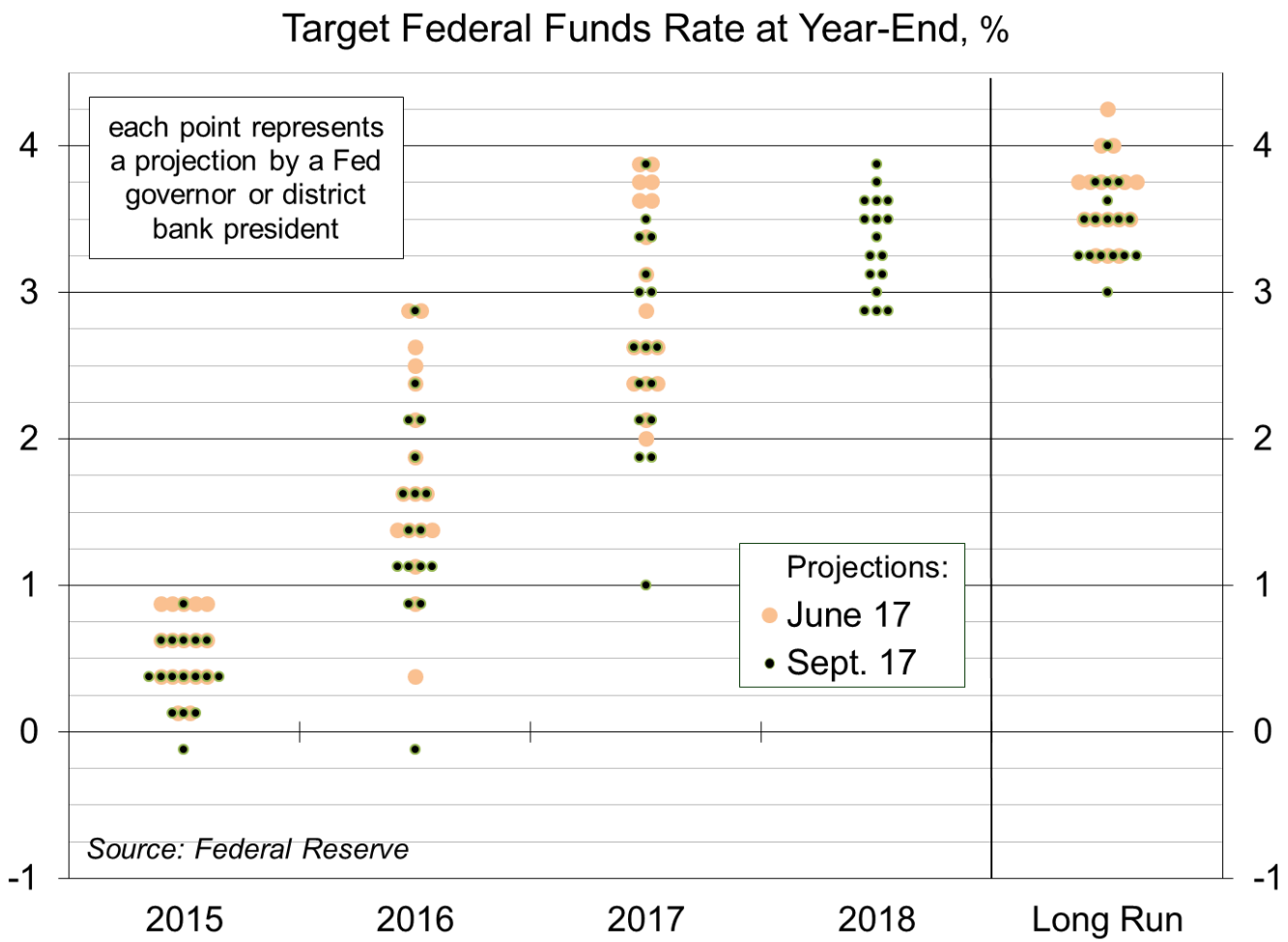
Source: Raymond James research, Federal Reserve.

(these are median figures; there can be a lot of uncertainty around each forecast)

Fed officials also forecast the appropriate level of the federal funds target rate…

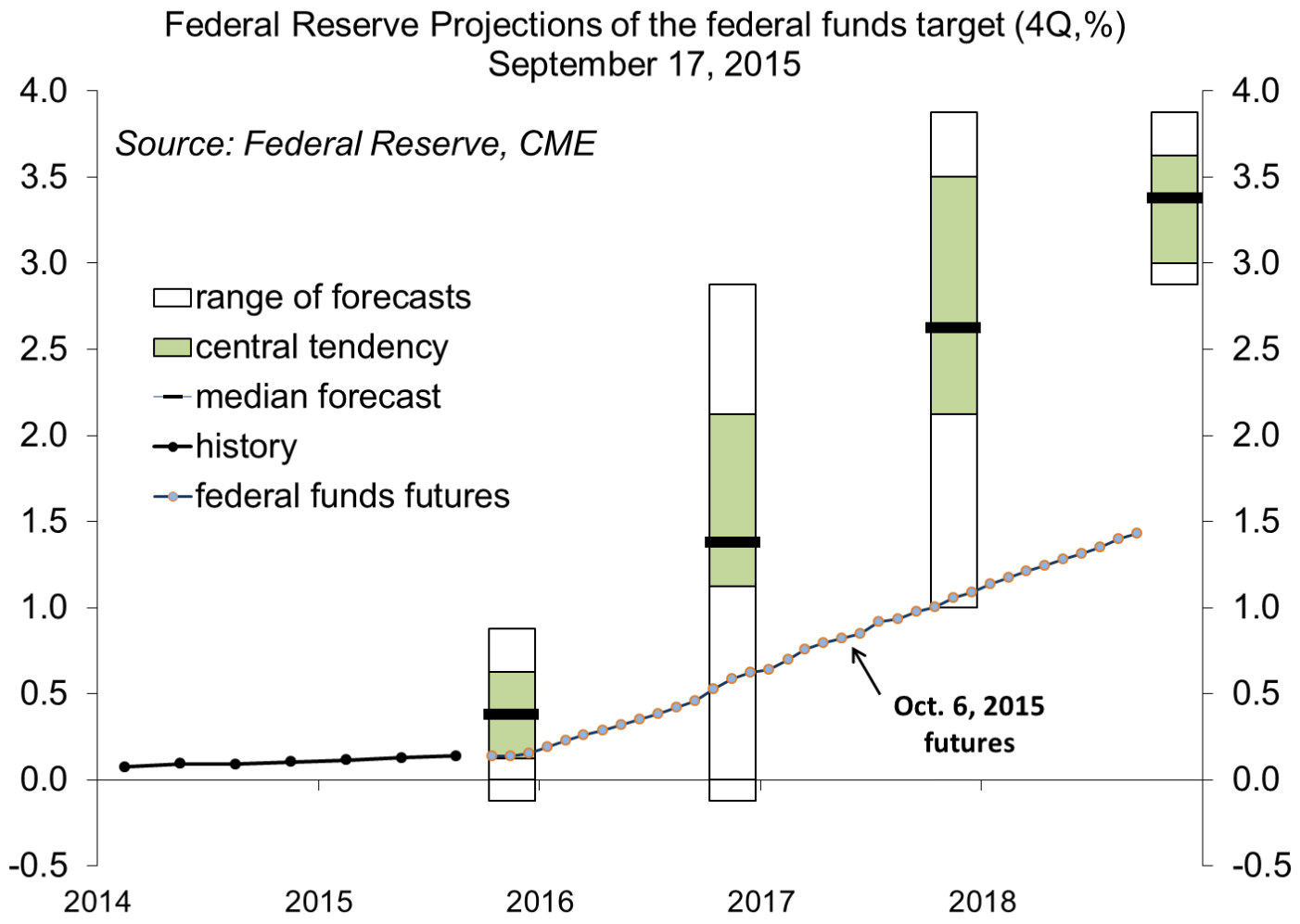
Scott Brown

Most Fed Officials Expect that it will be Appropriate to Begin Raising Short-Term Interest Rates this Year



Scott Brown

The Market Expects a Slower Glide Path for Short-Term Rates



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Federal Budget and Debt Ceiling

Congress

- Republicans have a majority in the House
  - 247 seats with 218 votes needed to pass legislation
- The Freedom Caucus (Tea Party offshoot) has 42 members
  - Without the Freedom Caucus, Republicans need to work with Dems to get things done
- House Speaker John Boehner has resigned (effective October 30)
  - He would likely have lost his position due to his willingness to work with Dems
  - Next Speaker is expected to be less willing to compromise

Budget

- Current Continuing Resolution will fund government to December 11
- A real budget or another Continuing Resolution will be needed

Debt Ceiling

- Treasury: extraordinary efforts will reach their limit by November 5
- Debt ceiling will have to be raised before that

Danger of government shutdown, but odds may be declining

- Boehner is still Speaker
- Debt ceiling limit should generate some haste to get a solution in October
- A budget/debt ceiling deal would remove a key uncertainty for the markets

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Key Calendar Dates

- October 12 – Columbus Day (bond market closed)
- October 14 – Retail Sales (September)
- October 15 – Consumer Price Index (September)
- October 16 – Industrial Production (September)
- October 20 – Building Permits, Housing Starts (September)
- October 27 – Durable Goods Orders (September)
- October 28 – Fed Policy Decision, no press conference
- October 29 – Real GDP (3Q15, advance)
- October 30 – Employment Cost Index (3Q15)
- November 2 – ISM Manufacturing Index (October)
- November 6 – Employment Report (October)
- December 16 – Fed Policy Decision, Yellen press conference
- January 27 – Fed Policy Decision, no press conference
- March 16 – Fed Policy Decision, Yellen press conference

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