TAIBERKOSMALA

Market Turbulence – Flash Update October 1, 2015

Given the recent market turbulence, we thought our clients may appreciate some quick data points and perspectives on the recent market action and uptick in volatility.

Executive Summary

- We view the recent volatility in global developed market equities as garden variety and do not feel it warrants rebalancing actions at this time. China's growth trajectory and Fed policy have dominated market psyche, not crumbling fundamentals in most developed markets.
- Emerging equity and commodity markets have, rightly so, borne the brunt of the pain thus far and we recommend maintaining a cautious posture in those spheres at this time.
- The speed and breadth of recent market declines does warrant close examination. Bank proprietary trading, HFT/algorithmic trading, proliferation of ETF's, and 'macro driven' markets have all contributed in some respects. Ultimately, market liquidity is the likely casualty and should be front and center in terms of investment implications.
- Stay constructive on bond markets in the near term and view any selloffs as opportunity. Bond market spreads and liquidity suggesting caution on risk premiums at this time.

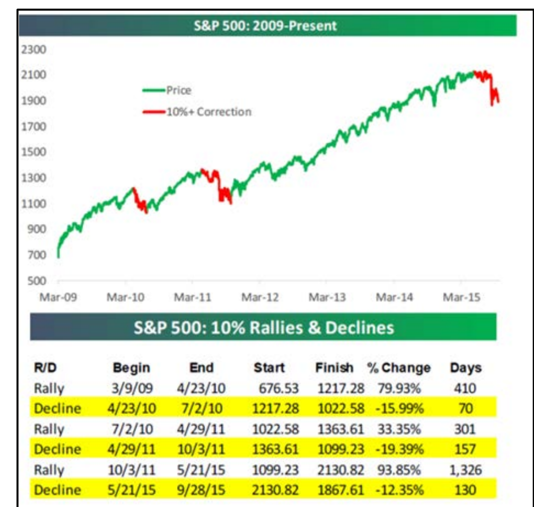
#1 This is Normal

We are in the midst of the third 10% correction of this bull market. This is a normal occurrence. In fact, on average over the past 100 years, 10% corrections happen every 14-15 months; however, 10% down in 4 days is unusual. 10% down moves in just 4 days has happened 9 times in the past 80 years. In all but one instance, a retest or lower move occurred subsequent to the rapid decline. The table and chart below capture both patterns. Gap low, bounce, retest, stimulus, and then higher 3, 6 and 12 months out as panic/algorithmic/block selling subsides.

10% Declines Within a 4 Day Period

	1 Week	1 Month	3 Months	6 Months	12 Months	
8/25/2015	2.52	3.59	?	?	?	China & Fed Policy Anxiety
8/8/2011	7.67	6.20	14.66	21.99	28.08	U.S. Loses AAA Rating
10/7/2008	0.25	(6.30)	(8.23)	(16.83)	9.06	Height of Financial Crisis
7/23/2002	13.20	18.15	12.84	12.26	26.19	Worldcom Default
8/31/1998	1.77	6.41	22.03	30.28	39.82	LTCM Crisis
10/19/1987	1.26	7.07	12.01	16.87	27.90	Stock Market Crash
5/28/1962	3.19	(1.96)	6.90	13.97	30.73	Kennedy Steel Tariffs
5/14/1940	(11.09)	(3.31)	(1.18)	14.05	(1.44)	Invasion of France/Netherlands
3/29/1938	9.23	12.69	35.04	39.72	42.60	Depth of 1937/38 Depression
Average	**3.111**	**4.726**	**11.758**	**16.540**	**25.366**	

Source: Bianco Research



S&P 500: 10% Rallies & Declines

R/D	Begin	End	Start	Finish	% Change	Days
Rally	3/9/09	4/23/10	676.53	1217.28	79.93%	410
Decline	4/23/10	7/2/10	1217.28	1022.58	-15.99%	70
Rally	7/2/10	4/29/11	1022.58	1363.61	33.35%	301
Decline	4/29/11	10/3/11	1363.61	1099.23	-19.39%	157
Rally	10/3/11	5/21/15	1099.23	2130.82	93.85%	1,326
Decline	5/21/15	9/28/15	2130.82	1867.61	-12.35%	130

Chart Source: Bespoke

#2 Bear Market Signs are Not Flashing Red

Bear markets have some very common and repeated traits including inverted yield curves, high real interest rates, deteriorating fundamentals, and recession. We do not see material evidence of any of these at this time.

1. In the last 11 bear markets/recessions, and 13 of the last 14, we have seen an inverted yield curve. With short rates anchored at 0% and the Fed on record to be slow, measured, and sensitive to financial market conditions, we do not see short rates elevating any time soon. Inverted yield curves hamper bank lending and stifle economic growth – clearly not a top objective of the Fed right now.
2. Low to negative real rates currently prevailing in the U.S. and globally. Money markets and short Treasuries are currently yielding less than prevailing inflation. Investors are more reluctant to take risk when there is an alternative of a real return on cash.
3. Economic conditions have not rolled over. GDP, LEI, PMI, retail sales, & bank lending exhibit decelerating rates of change during a bear market. Currently, all of these metrics are increasing, albeit at a slow clip.

As the chart below shows, a bear without recession is very unusual.

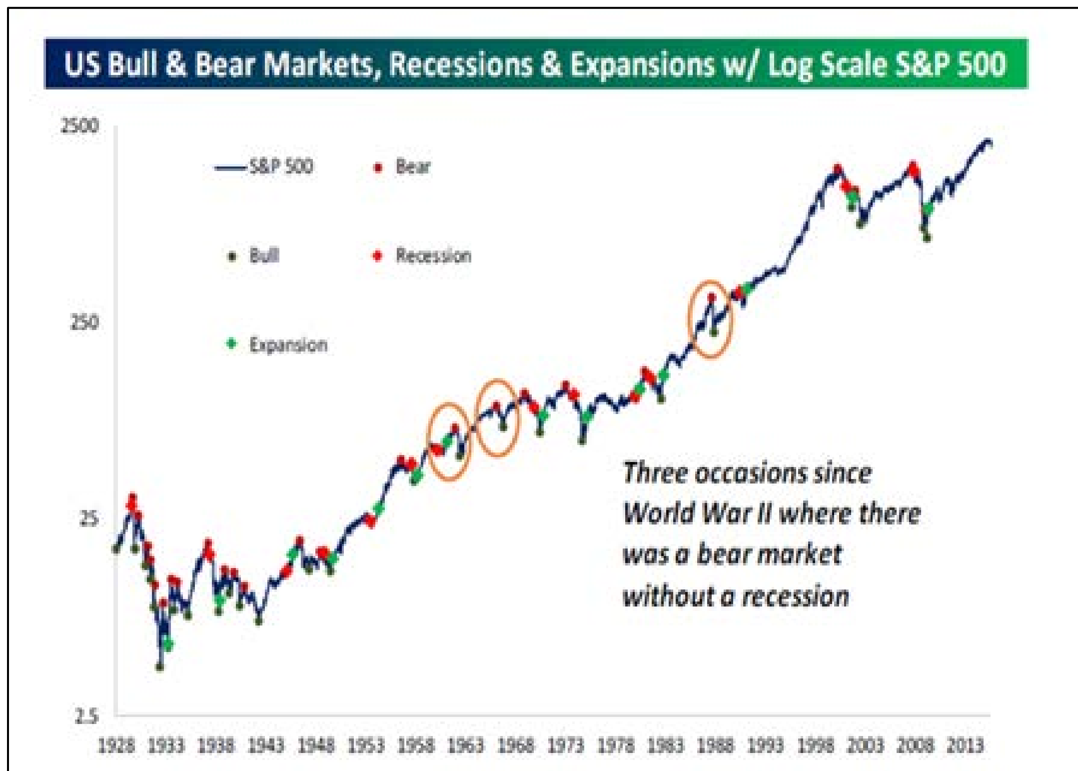
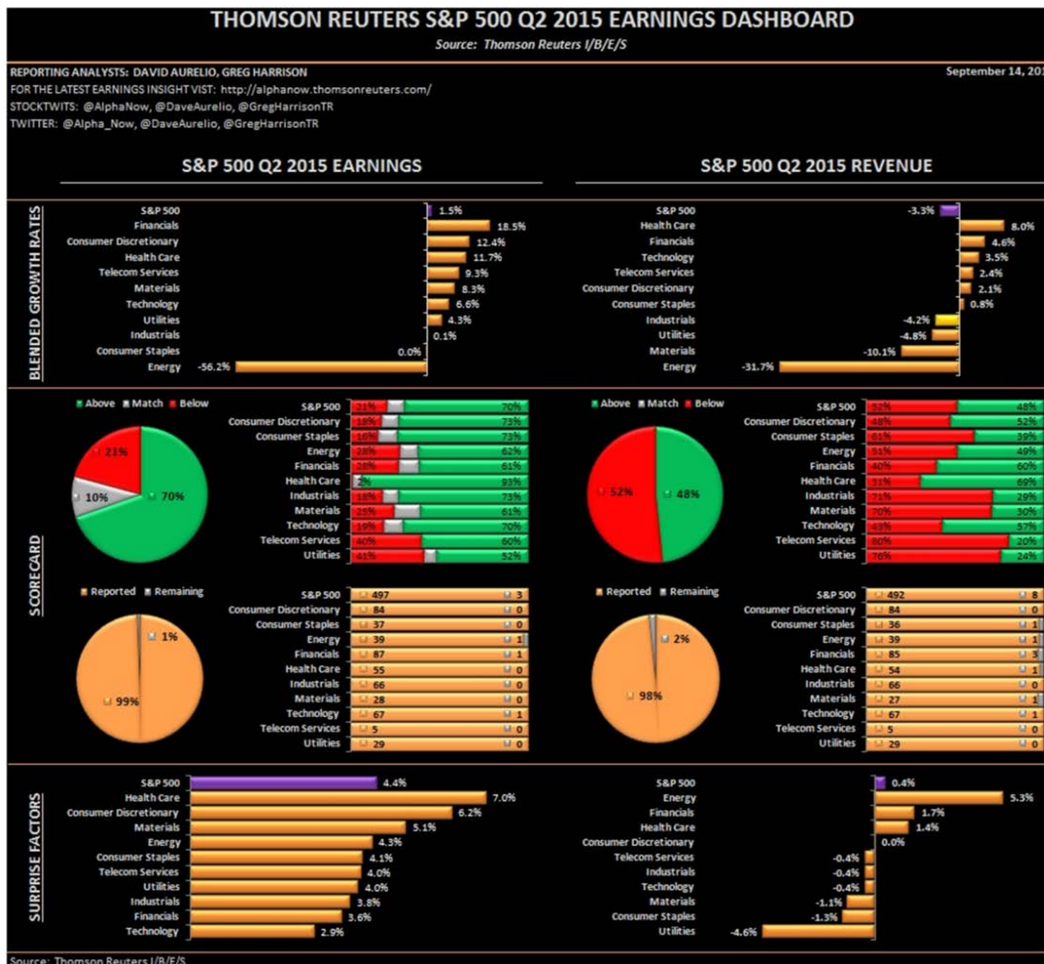


Chart Source: Bespoke

#3 Earnings Looking Decent (ex-energy)

Second quarter earnings (ex-energy) grew at a 9% clip. Third quarter earnings season is less than 10 days away and forecasts are again relatively constructive with Fact Set projected earnings growth of 2.9% (ex-energy). Earnings fundamentals ultimately drive equity market returns this metric again seems to remain in the constructive territory.



#4 Volatility to Remain Elevated

The impacts of trading technologies, indexation product, and bank regulations (Dodd Frank) have resulted in more fleeting market liquidity fundamental market dislocations. Most bank proprietary trading desks (70%-80% reductions) and floor market making operations have been dramatically scaled back. The result is that there are not as many active (human) investors to take the other side of the trade when volatility becomes erratic. Additionally, the proliferation of ETFs, now a $3 trillion dollar business, has increased basket selling (and buying) of equities in rapid fashion. Unlike mutual funds, there are no short term redemption fees and therefore the fast trading crowds (not just retail, but hedge funds) pile in and out. As a result, we are seeing correlations rise across the board, fostering this risk on/ risk off tone to the markets.