

Author Jacob Braude is quoted as saying, "Always behave like a duck – keep calm and unruffled on the surface but paddle like the devil underneath". The markets seem to be taking Mr. Braude's advice to heart, as the impression that they give from above belies entirely what is going on beneath the surface of the water.



As our recent writings have discussed at length, the most widely followed of the domestic stock market gauges, the Standard & Poor's 500 Index and the Dow Jones Industrial Average have spent the vast majority of the year mired in one of the longest and most narrow trading ranges in modern market history. If you just take a cursory look at those two indexes (or even the broad market, as illustrated by the Russell 3000 Index), you will see what appears to be a "duck" that is resting peacefully on the surface of a calm body of water.

However, a peak below the surface reveals a totally different story, with 56% of all stocks in the S&P 500 (and 60% of all stocks in the Russell 3000 Index) already down more than 10% from recent highs, and the average S&P 500 stock down over 14% from its 52-week high. Indeed, of the 500 stocks listed in the S&P 500, 120 are down at least 20% from recent highs and 19 of them are down at least 50% from their 52-week highs. If you look at small and mid-capitalization stocks, the damage is even worse. The average stock in the Russell 2000 Index (a composite of small and mid-sized companies) is already down a massive 24% from its 52-week high.

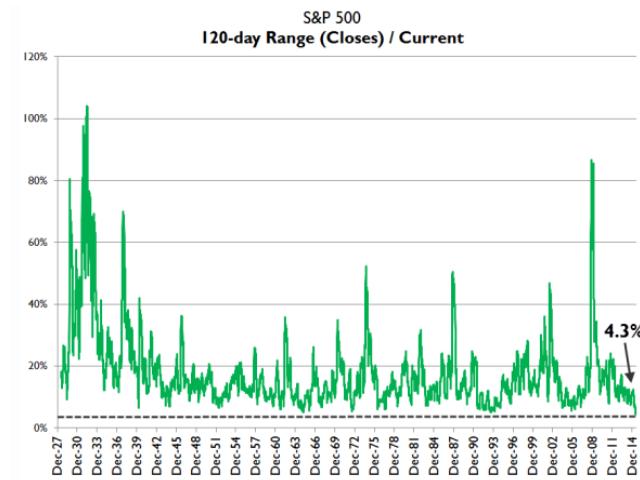
In last month's *Outlook*, we noted that, "we do believe that we are very over-due for a correction [in the domestic equity markets] of 10% or so". Based on the recent churning underneath the surface, one could make a strong argument that we have already experienced that 10% decline or, perhaps, that an even larger decline is already significantly underway.

Unfortunately, we have not seen many signs of capitulation selling, which would provide a pretty clear indication that a healthy skepticism had returned to the markets, and that investors had already priced an interest rate hike into their expectations. Instead, we are left making a judgment call about whether such an "internal correction", where different sectors fell in and out of favor, will be sufficient to restore reasonable value (and investor interest) to the markets around current prices, or if the indexes themselves must break sharply below their recent trading range before the markets can generate enough investor interest to allow them to launch a new assault on their old highs.



According to Morningstar, this selling under the “surface” is having an impact on individual investors who themselves have been paddling like a duck under water. Non-institutional investors, who still rely overwhelmingly on mutual funds for their investing, have pulled \$78.7 billion dollars from domestic equity mutual funds on a year-to-date basis. This is the

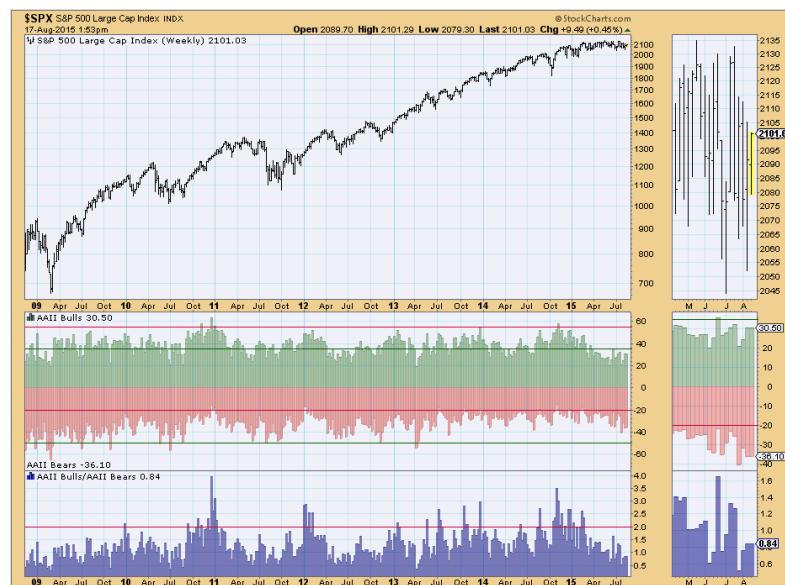
biggest withdrawal from equity mutual funds since 1993, which means that it exceeds withdrawals during any year of the financial crisis or the bursting of the internet bubble. Moreover, for the first time in history, we are seeing net outflows from domestic equity exchange-traded funds.



themselves), created enough bears (potential purchasing power) to break the equity markets out of this pattern of historically low volatility or is a further correction still needed?

Of note, with a top-to-bottom trading range over the past 120 days of only 4.3%, this is now the tightest trading range, over such a long duration, in the history of the domestic equity markets. There are two things that history teaches us about extended periods of suppressed volatility in stocks. First, the longer that such periods last, the harder they normally are to break out of. Second, they have historically resolved themselves very violently in one direction or the other.

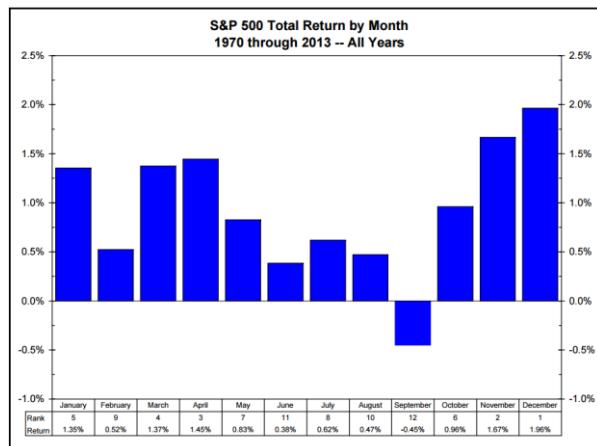
Very tight trading ranges are considered to be indications of a sort of equilibrium between bulls and bears. You can see this in the American Association of Individual Investors (AAII) Bull/Bear Survey. At present, 30.5% of respondents are bullish (green bars) and 36.1% are bearish (red bars).



Of note, when the green bars drop below a reading of 35%, which is well above the current reading of 30.5%, it is considered to be indicative of excessive bearishness and is generally considered to be a buy signal. However, the signal would be even more definitive if the red bars also broke below a reading of -50, which would confirm that most of the potential sellers of equities had already sold.

We can at least take some comfort from the fact that bearish sentiment is growing, as it means that the cash necessary to power the next move higher is increasingly building up on the sidelines. However, we suspect that negative sentiment is going to need to get quite a bit

stronger before the equity markets will have enough firepower to go back on the offensive.

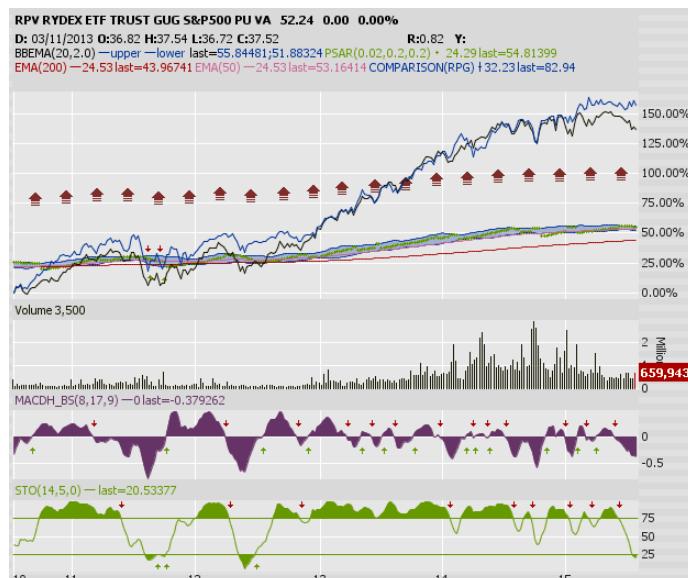


After all, stocks are facing in impressive array of headwinds, including the likelihood of an imminent rate hike by the Fed, the fact that the third quarter is historically a difficult period for equity market performance, and the fact that the unraveling of the Chinese equity markets is likely to push the U.S. dollar to problematic levels (as is the significant

slowing in the Chinese economy). As it is, our base near-term assumption is that the equity markets will need a fairly significant catalyst to break out of their current trading range, and that there are at least as many potential bearish catalysts as there are bullish ones.

Importantly, when the market finally does break out of this range (in either direction); it would be reasonable to expect a potential change in leadership for a variety of reasons. First of all, market leadership will often change concurrently with such changes in macroeconomic fundamentals, and this tendency may be particularly relevant this time given the current historically low interest rates, the expected reversal in those interest rates, and the fact that there is historically a very tight correlation between low interest rates and the market's ability to sustain itself at the higher-than-average valuations that we see today.

This is one of the major reasons why value-oriented stocks often replace growth-oriented stocks as leaders late in economic cycles, when interest rates start to move higher. This might be particularly likely this time, since growth stocks have out-paced value stocks by a much wider than average margin. You can see this in the five-year chart, which uses ETFs to illustrate just how dramatically the most growth-oriented stocks on the S&P 500 Index (blue line) have outperformed the most value-oriented stocks (black line) in that index.



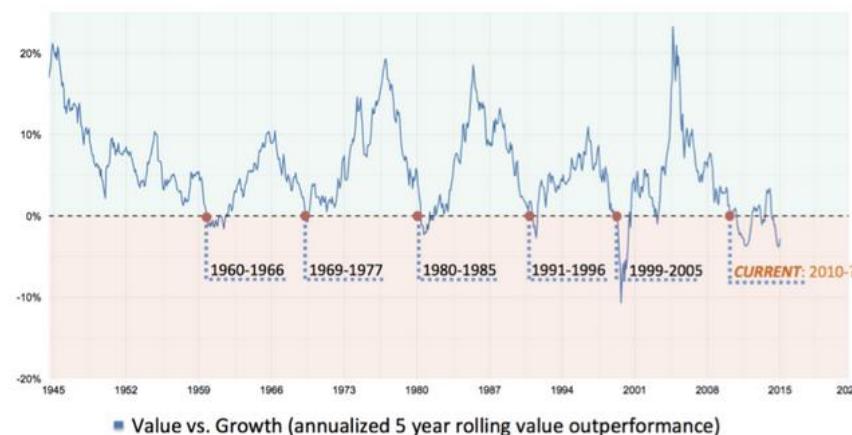
At the bottom of the chart, you will find a stochastic valuation oscillator. The fact that the green shaded area is below 25 means that value stocks are extremely undervalued (when compared to growth stocks). Further, while the past is not necessarily prelude, there has been a strong tendency for readings below 25 to anticipate periods when value stocks start to out-pace their more growth-oriented brethren.

For the purposes of this discussion, we will define “growth” stocks as equities that are compelling because of their rapid acceleration in growth dynamics, such as profits, revenues, market share, intellectual property, etc. In contrast, “value” stocks are attractive to investors because they are being priced at unjustifiably low levels relative to, for example, their

business prospects, their earnings and the break-up value of the company.

Growth Has Outperformed Value Six Times Since 1945

Each Time Value Has Had A Significant Recovery



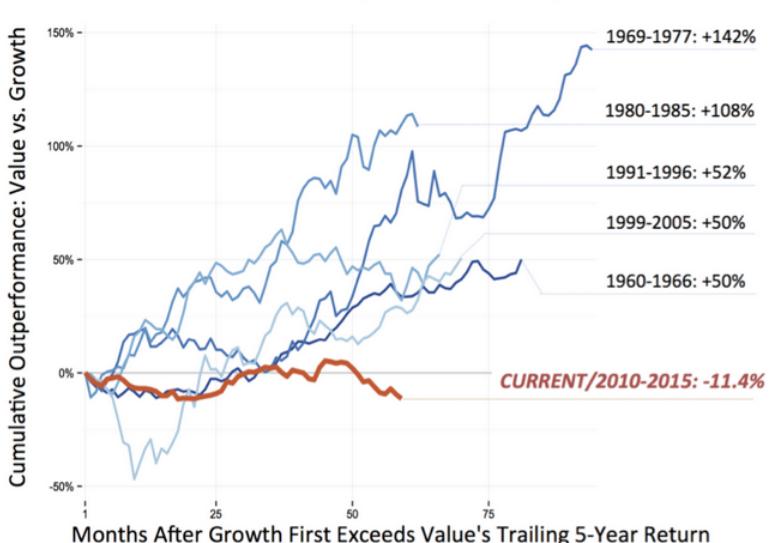
to lose less than have growth stocks during the current decline, but that could be expected regardless of whether or not a more sustainable change in leadership is under way.

On the other hand, it is very unusual for growth stocks to outperform value stocks over an extended period, and the current period of out-performance has been extreme in both its duration and its performance differential.

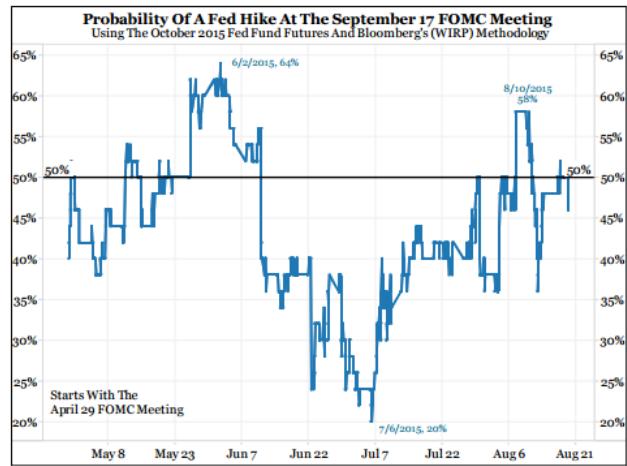
In fact, since the end of World War II, there have been only six times, including the present, when growth stocks have out-performed value stocks on a sustained basis. This history is illustrated above, with periods of value stock out-performance noted above the horizontal line and periods of growth stock out-performance illustrated below that line.

It is also noteworthy that each of these periods of sustained value stock under-performance were followed by periods of their remarkable out-performance over growth stocks. You can also make an argument that growth stocks are more expensive versus their growth fundamentals than they have been historically and that most value stocks offer even more relative value (versus growth stocks) at present than they have historically.

The Current Value Recovery Has a Lot of Upside Potential



Another indication that such a rotation should be expected is that it has been the most highly valued stocks (the polar opposite of value stocks) that have been suffering the worst losses during the decline, including the stocks of smaller and mid-sized companies and stocks in the very growth-oriented sectors that have led the markets higher over recent years. This includes, as examples, stocks of companies involved in the biotechnology, cyber security, cloud computing, and solar energy sectors. This too could be interpreted as investor “de-risking”, which is a mindset that would also favor a move towards value stocks.



for policy firming had not yet been achieved, but they noted that conditions were approaching that point”. This conflicts with recent Fed guidance and suggests that the Fed may wait until December to raise rates for the first time in almost a decade.

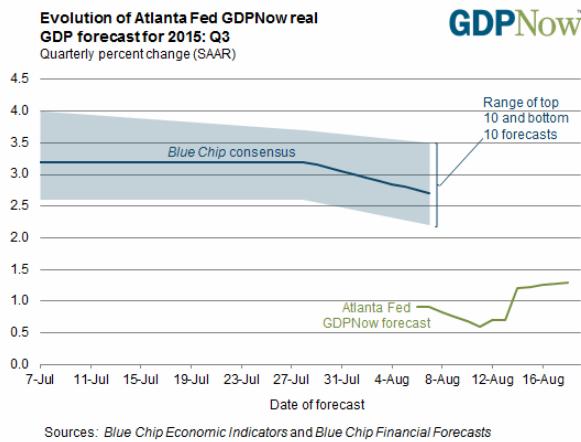
This more cautionary language may be a result of the slowing in the Chinese economy and recent currency devaluations by China, Indonesia, and Malaysia, the impact of which might be greatly magnified by a U.S. rate hike. This would likely push the value of the dollar even higher versus the currencies of America’s major trading partners and further exacerbate the problems that are already being caused by the dollar being so strong that it is hurting America’s international competitiveness.

The situation developing in the Pacific Rim, where countries are starting to debase their respective currencies to gain a trade advantage, is uncomfortably reminiscent of the “competitive devaluations” that led to the “Asian Contagion” crisis of 1997.



In that instance, countries throughout the region devalued their currencies, one after another, in order to gain a competitive trade advantage. Ultimately, it led to the overthrow of governments, speculative attacks on currencies, the biggest sovereign bond default in history (Russia) and a financial crisis throughout the region. This time, there is already evidence that Taiwan, South Korea and Vietnam may be the next in line to follow this devaluation course, and each such currency debasement is likely to be exacerbated by higher interest rates in the United States and the resulting appreciation in the dollar.

Yes, by most accounts, the Federal Reserve is about to raise interest rates, which is almost always a headwind in the face of equity prices. At the same time, the capital markets have weathered past interest rate increases, and we are confident that they will ultimately do so again this time. However, it would likely be a mistake to consider this as just another in a long line of tightening cycles.



not at any risk of getting too strong and inflation still remains well below the Federal Reserve's 2% target rate. If anything, with the exception of the unemployment rate, most of the major indicators of domestic economic growth (including the comprehensive Gross Domestic Product itself, which is designed to measure the size of the entire economy) are weaker now than they were when the Federal Reserve introduced its last stimulus program (QE3) in late 2012. Moreover, if you look at the Atlanta Fed GDP Now Forecast, which has been one of the Fed's most accurate predictive indicators since it was first introduced early this year, it is predicting third quarter growth of only 0.7%

No, this time, the Fed will be raising rates at a time when much of the global economy is weakening, the dollar is appreciating and the global economy as a whole is stuck in neutral. This means that stocks may not have the benefit of a recovering economy to offset the drag of higher rates this time, which could lead to a rather bumpy ride.

Another thing to be considered, particularly in light of how much equity markets hate uncertainty, is that the anticipated increase in rates will be unlike any other process in the history of the Federal Reserve. As recently summarized by Bianco Research, the Fed will be raising interest rates from virtually 0%, which has never been done before, ultimately must unwind quantitative easing, which it has never done before, and must accomplish those feats using tools that were dreamed up in the wake of the financial crisis, and which have never been used before. As was noted in the Bianco report, "this is a different type of rate hike and it might lead to unintended consequences".

While we still consider ourselves to be more cautious than bearish, we do think that this is a higher risk period than we have seen in some time, which we believe calls for risk management and patience until we see how the markets react to a change in Fed policy, which we believe should be ultimately instructive.

For example, the Fed traditionally starts raising rates for a variety of very bullish reasons. Normally, the economy is strong and getting stronger, corporate earnings are impressive and improving, and inflation (which normally helps corporate profits) is starting to make modest gains. These factors help offset some of the drag on stock prices caused by higher interest rates.

However, this time, the Fed is raising rates for very different reasons (a move towards monetary policy normalcy). The economy is

