August 9, 2015

Lane Asset Management

Stock Market Commentary

Market Recap for July and Early August 2015

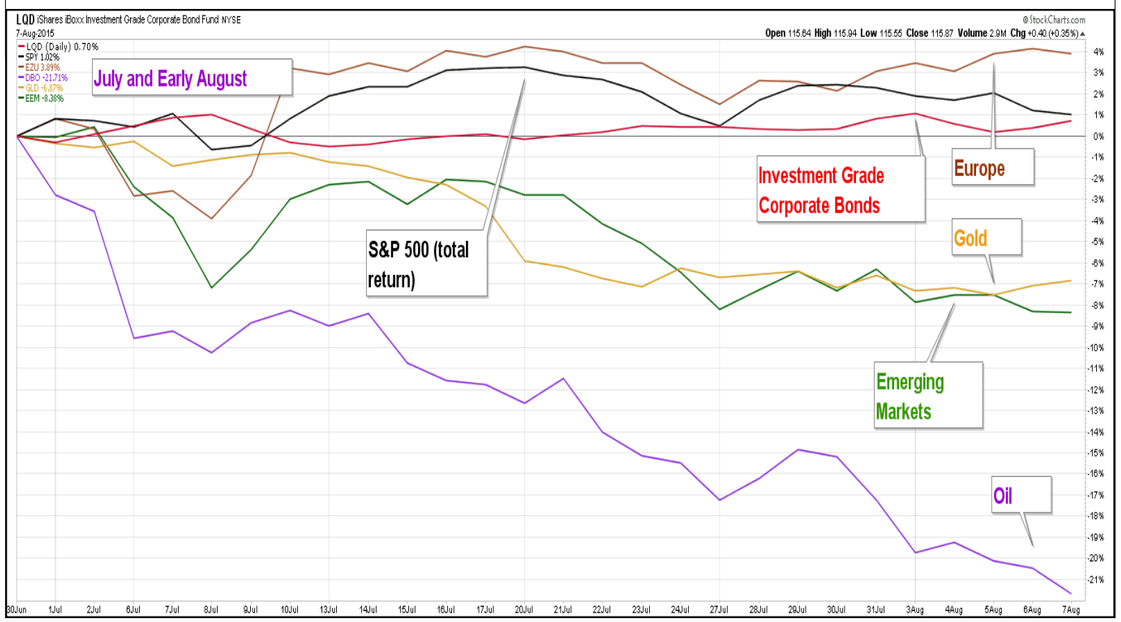
U.S. equities recovered from June losses in July though there was some deterioration in early August as the energy sector absorbed further decline in oil prices. A summary of domestic and international events::

- **Corporate earnings for about 86% of the S&P 500 have now been reported for Q2. While EPS for the broad index have fallen 2.4%, excluding energy companies raised the outcome to a very healthy +5.3%. That said, revenue growth remains very weak.**
- **U.S. single family home sales reached their highest level in 10 years with building permits at their highest level since 1990.**
- **Q1/2015 GDP was revised upwards from -0.2% to +0.6% while the first print for Q2 fell a bit short of expectations at 2.3% vs. 2.5% expected.**
- **The employment cost index recorded its lowest quarterly gain since 1982.**
- **The June release of the Conference Board's Leading Economic Index is nearing an all-time high.**
- **The 10-year U.S. Treasury bond rate has fallen from a high of 2.5% in mid-June to 2.18% as of this writing, reflecting dollar strength and a lack of concern about the potential impact of an increase in the Fed funds rate, among other things.**
- **The core PCE inflation index came in at 1.27%, well below the Fed's 2% target.**
- **The minutes from the Fed's June meeting and Chair Yellen's recent comments have done nothing to dissuade analysts from expecting a September Fed funds rate increase.**
- **Greek default was averted, at least for now.**
- **China A-shares (stocks that trade on Chinese stock exchanges) plummeted nearly 15% in July and over 21% in the last 2 months. Chinese manufacturing activity was reported to fall to a 2-year low. Commodity producers in Canada, Australia and emerging markets have all lost ground.**

Market Outlook

I expect U.S. equities to be helped by improvements in the U.S economy offset by dollar strength that will sap earnings for global companies and exporters, the net result of which will be a slow grind upwards. For international equities, I expect the broad index will be kept in moderate territory for the balance of the year on account of conflicting pressures around the globe, especially in emerging markets. On a country-specific basis, the developed economies in Europe and Japan should continue to outperform the broad index.

The question many people are trying to answer is what will happen to interest rates when the Fed funds rate starts to rise, especially the benchmark 10-year U.S. Treasury yield since this rate is closely tied to mortgage and corporate borrowing rates. My view is that the 10-year will remain subdued for quite a long while to come on account of a number of factors, including low sovereign rates in developed economies around the world, low inflation, low global growth and dollar strength (generally negatively correlated in recent years).



The charts on the following pages use mostly exchange-traded funds (ETFs) rather than market indexes since indexes cannot be invested in directly nor do they reflect the total return that comes from reinvested dividends. The ETFs are chosen to be as close as possible to the performance of the indexes while representing a realistic investment opportunity. Prospectuses for these ETFs can be found with an internet search on their symbol. Past performance is no guarantee of future results.

2015 PREDICTIONS (UPDATED)

As the year unfolds, I'll offer updates to my 2015 predictions. Here's where I come out after three months. Revisions/comments are shown in *blue italics*.

U.S. Equities

As I believe the primary drivers of stock market returns in 2015 will be corporate earnings and modest, if any, movement on the federal funds rate, my expectation for the S&P 500 for 2015 is for a total return of 8-10% (measured by SPY) with risk to the downside on account of international considerations. On a sector basis, I expect healthcare, technology, consumer discretionary and small cap stocks to outperform. There may be a rebound in energy, but I'm not prepared to go there now.

The S&P 500 (SPY) recovered from June losses in July, but fell back in early August. As of this writing, the annualized return is about 3.5%, — well below my target for the year. Healthcare, consumer discretionary, and technology stocks are all well ahead of the broad index, while small cap stocks have fallen back.

With about 86% of the S&P 500 reporting, according to Zacks, Q2 EPS is down 2.4% and revenues are down about 4.1%. HOWEVER, excluding energy companies, the results are much better with EPS up 5.3% (on track for an all-time quarterly record) for the quarter and revenues up 1.3%. Results like these underscore the usefulness of identifying sector results for relative performance.

International Equities

My estimate for total return from international equities, as measured by the Vanguard All-world (ex U.S.) fund, VEU, is 2-3% less than SPY which, given the above estimate, is 5-8% for VEU. I believe the international equity returns will be very region specific with India and China leading the way and commodity-producing regions lagging. Europe is a wild card as the broader economy struggles while the ECB may come to the rescue. I'd keep an eye on Germany as Europe's bellwether country.

VEU had difficult month owing to the weakness in emerging markets and Canada, offset by recovery in Europe. As of this writing, VEU is up about 4.1% YTD, about 6.9% annualized and about 2 percentage points ahead of SPY, and on target with my expected result for the year.

The standouts so far this year are Japan and Europe where the related ETFs have soared nearly 20% on a hedged basis. While India is marginally ahead of the broad index, China has come back to earth with, by one measure, a 2% loss for the year.

Bonds and Other Income Securities:

The 10-year Treasury yield surprised everyone in 2014, especially after its rapid increase in 2013. The yield currently rests at about 2% and I believe it will end the year near 2.5%. Total return for 7-15 year U.S. government bond funds in 2014 was a bit over 9% while investment grade corporate (IGC) bonds funds returned a bit over 8%. For 2015, I expect total return for IGC bonds between 6% and 8%, still better than current yield. I believe the best opportunities for income investing will come from preferred stocks, REITs and established, long term dividend paying common stocks.

The 10-year Treasury yield dropped back a bit in July and early August to 2.18%, down from 2.27% reported last month, roughly where it began the year. Investment grade corporate bonds (LQD) gained a little ground since last month's report with the weakness in Treasury yields and now sit with a 1.1% decline YTD, about 3% below the S&P and well below my 2015 forecast. Preferred stocks (PFF) and dividend-paying stocks remained steady and ahead of LQD. REITs staged a recovery in July, ending up roughly in the same place as LQD so far this year.

While I believe the economic backdrop is not strong enough to warrant raising the Fed funds rate, especially on account of weakness in employee earnings, inflation, and the potential for a government shutdown, the market seems primed for an increase in September. To give the Fed credit, it has done a marvelous job preparing the market for an eventual increase and I expect the impact, when it occurs, to be modest, if any. Those folks who bet on a much worse outcome will be disappointed. That's not to say other factors couldn't bring the market down, but I don't believe it will come with an increase in the Fed funds rate.

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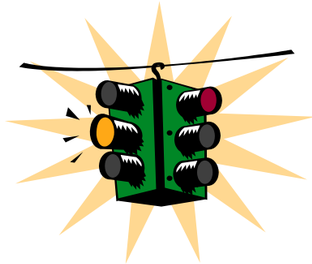
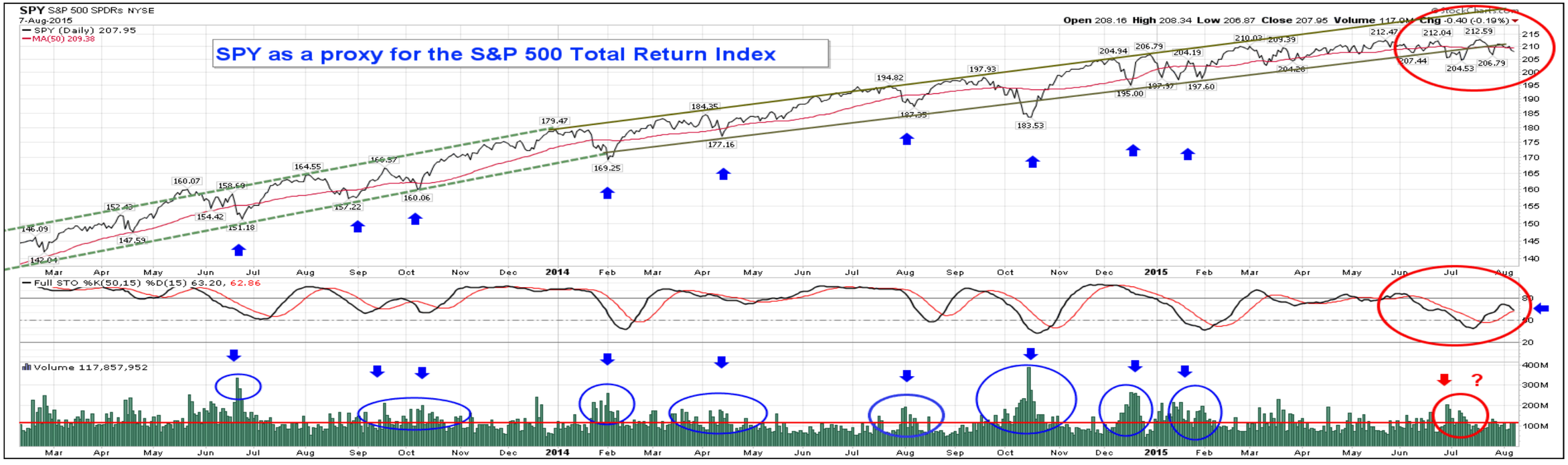
S&P 500 Total Return



The S&P 500 recovered in July what it lost in June, but the first few days of August have nearly reversed July's gains at this writing. We have some troubling signs similar to prior years at this time, hopefully caused by no more than investors taking risk off the table as their attention turns to summer's end. Among those signs are: a third breakdown below the trend channel, a declining 50-day moving average trend and a reversal in momentum (MACD). Leading up to this point, 2nd quarter earnings have been weak, though largely driven by the energy sector. In addition, the volume spike that occurred in early July was insufficient to pull the index out of its slump. As of this writing, the YTD total return of the S&P 500 index proxy SPY is roughly 2.1%, or about 3.5% annualized, down from 4.2% reported last month and a much lower trajectory than the 11% gain over the last 12 months (these percentages are volatile and highly dependent on the starting and ending points).

While I am primarily guided by the emerging reality of technical analysis, I can't help but believe that the weakness of the equity market is being mostly driven by slowing global demand (caused in no small part by China) with an overlay of concern about the impact of the Fed's eventual revision of the Fed funds rate. Despite the views of some that the market is due for a tumble on account of overvaluation, that's not where my head is at. Frankly, I see the slow grind like we have been experiencing so far this year as a healthy adjustment and much more desirable than a more precipitous decline such as occurred last October.



SPY is an exchange-traded fund designed to match the experience of the S&P 500 index adjusted for dividend reinvestment. Its prospectus can be found online. **Past performance is no guarantee of future results.**

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Portfolio Protection

Reflecting the concerns of most investors, this chart has been prepared to assist in making a decision about portfolio protection, in particular, protecting against a major market sell-off such as occurred in 2000 and 2008. The chart shows, since January 1980, the weekly value of SPY (the ETF proxy for the S&P 500 index on a total return basis). The red line is a 50-week moving average (50WMA) and the green line, called a "Chandelier Exit," is a form of a trailing stop-loss (see www.stockcharts.com). The red arrows show when the weekly price has fallen below the 50 WMA. This is often accompanied by the Chandelier Exit falling below the 50 WMA.

To me, events such as these would be an important signal that it would be timely to reduce equity exposure, perhaps significantly so if the 50WMA also had an inflection point and began a downward slope. In the last 36+ years, this has happened 8 times; 6 if you exclude 1998 and 2011 when the 50WMA did not turn negative. Since it's the major negative market sell-offs that are to be avoided (and reversals to be taken take advantage of), this is the kind of evidence I would be looking for to protect the equity portion of a portfolio. While it's true there can be false or short-lived signals, as there were in 1984, 1990, and, if you like, in early 1998 and 2011, taking steps to protect assets at the "wrong" moment is, I believe, a small price to pay, especially since we don't know how "wrong" the moment is at the time it occurs.

As the chart stands today, for the S&P 500 to have another "red arrow event" of the type that occurred in 2000 and 2008, the current price would need to fall about 5% (see the magnified insert for 2015) and the 50-week moving average trend would need to turn south. During July, while there was little net movement in this indicator, the long-term momentum indicator became weaker, giving rise to continued caution. While this analysis would not necessarily work for other securities, the action of the S&P 500 would be enough for me to react across the board. Also, if such an event were to happen, I'd probably go to cash rather than, say, the investment grade bonds or preferred stocks, depending on the interest rate outlook at the time.

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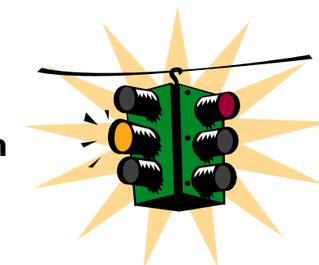
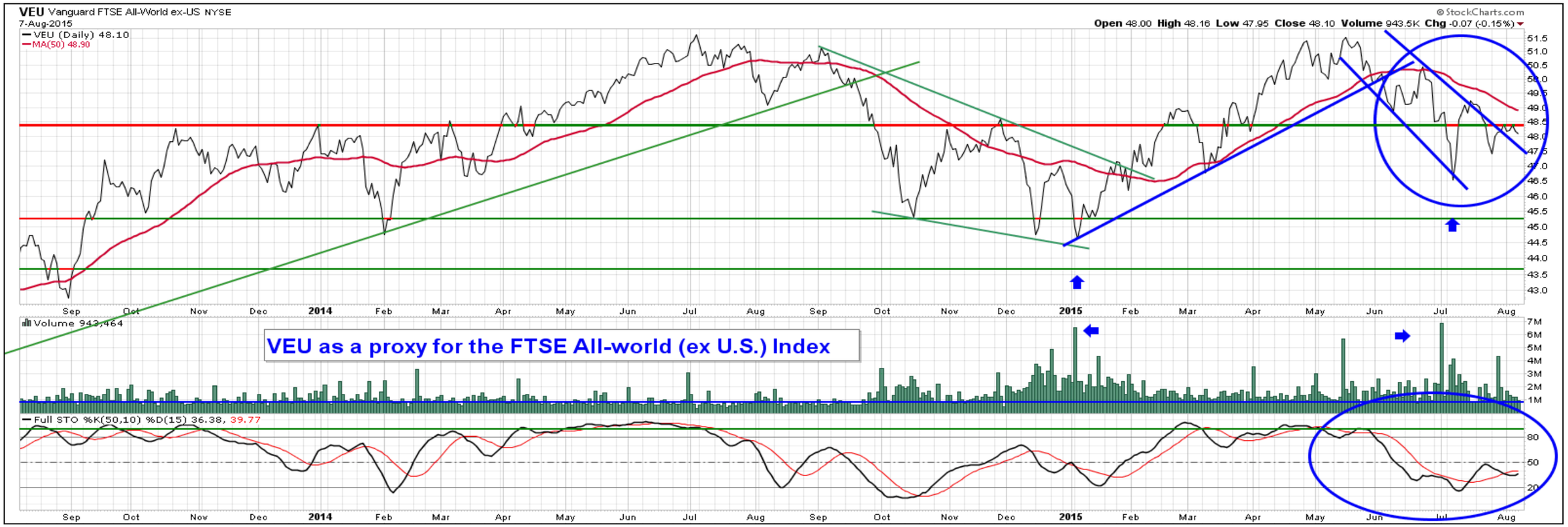
All-world (ex U.S.) Equity Index



International equities, represented here by VEU, experienced another volatile month in July owing to Greek debt negotiations (settled, for now, at the beginning of the month) and major deterioration in emerging markets, especially Asia (except Japan), Brazil, Chile, Canada and other countries dependent on commodity exports, especially to China. On the other hand, European and Japanese equities did quite well during the month and saved the overall index from a much worse showing. Following slippage in the first half of this year, India, by some measures, is now moving ahead of VEU.

The technical outlook for the broad category of international equities looks challenging, to say the least. During July, price broke below the line of support at $48.50 twice and did so again in early August, the sort of behavior that is generally associated with further deterioration. While the 50-day moving average trend line has retained its downward slope, momentum has been struggling to move into positive territory.

As weakness is coming mostly from emerging markets and commodity producers, a condition I think will persist for a while, investors looking for international exposure should concentrate on Europe, Japan and India.



VEU is a Vanguard exchange-traded fund designed to match the experience of the FTSE All-world (ex U.S.) Index. Its prospectus can be found online. As of 12/31/14, VEU was allocated as follows: approximately 19% Emerging Markets, 46% Europe, 28% Pacific and about 7% Canada. **Past performance is no guarantee of future results.**

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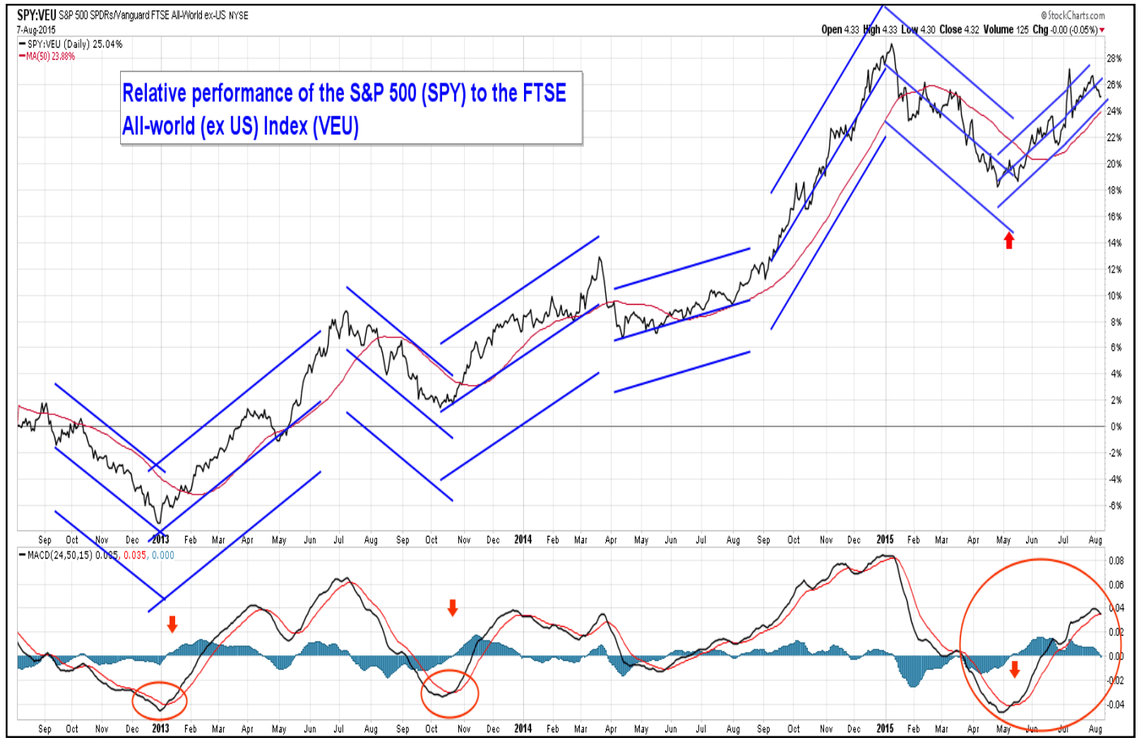
Asset Allocation and Relative Performance

Asset allocation is the mechanism investors use to enhance gains and reduce volatility over the long term. One useful tool I've found for establishing and revising asset allocation comes from observing the relative performance of major asset sectors (and within sectors, as well). The charts below show the relative performance of the S&P 500 (SPY) to an investment grade corporate bond index (LQD) on the left, and to the Vanguard All-world (ex U.S.) index fund (VEU) on the right.

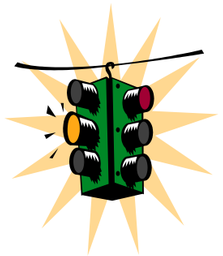
On the left, the trend of the relative strength of U.S. equities over investment grade corporate bonds continued for the 3rd straight month with weakening momentum in July and early August as earnings weighed on equities and the 10-year Treasury rate fell, boosting bonds. Importantly, the broad trend of relative outperformance of equities remained in the channel established at the beginning of 2014, albeit with a fair amount of volatility. I expect this relationship to continue.

On the right, the outperformance of domestic equities over international came about on account of the significant weakness in emerging and commodity producing markets. While all technical measures favor domestic equities at the moment, the recent sharp losses among the emerging markets may potentially be seen as overdone, resulting a setback for the domestic equities in coming weeks. If so, I'm not expecting it to last. I continue to underweight the broad international index.

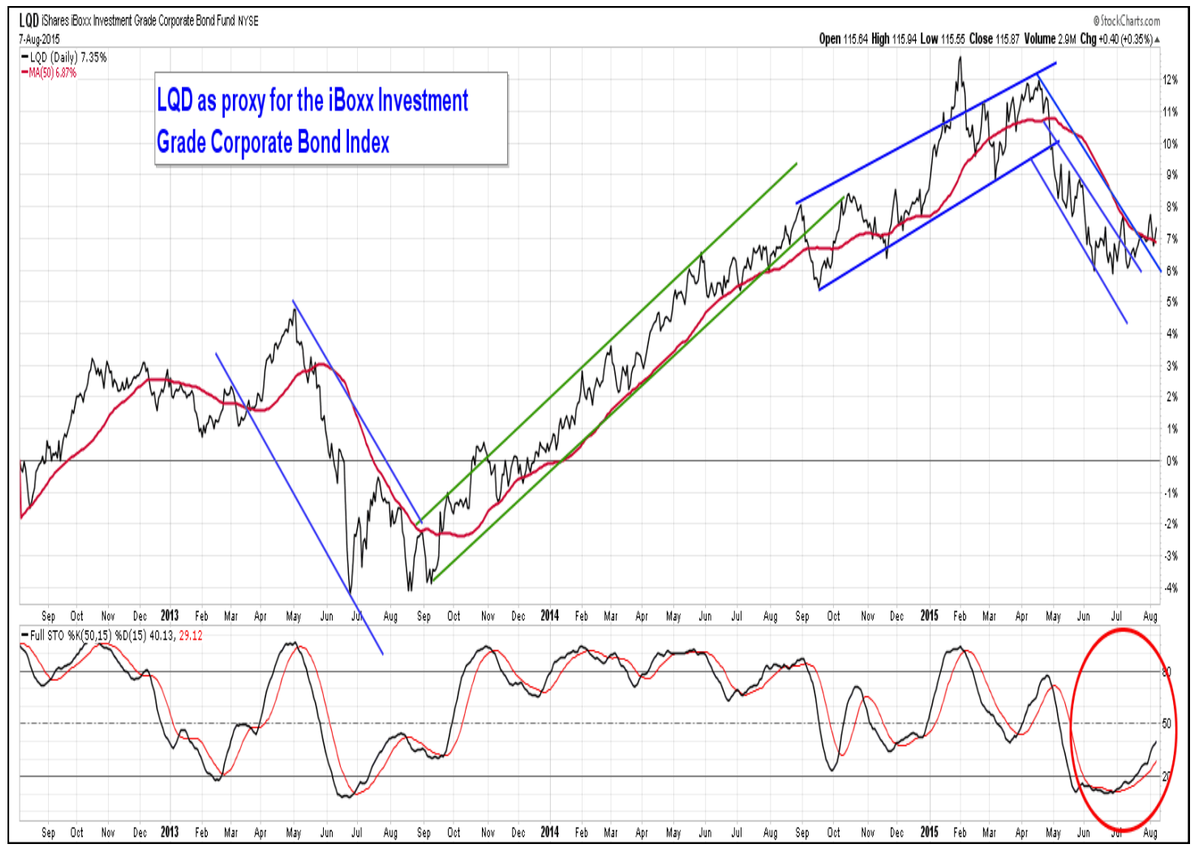


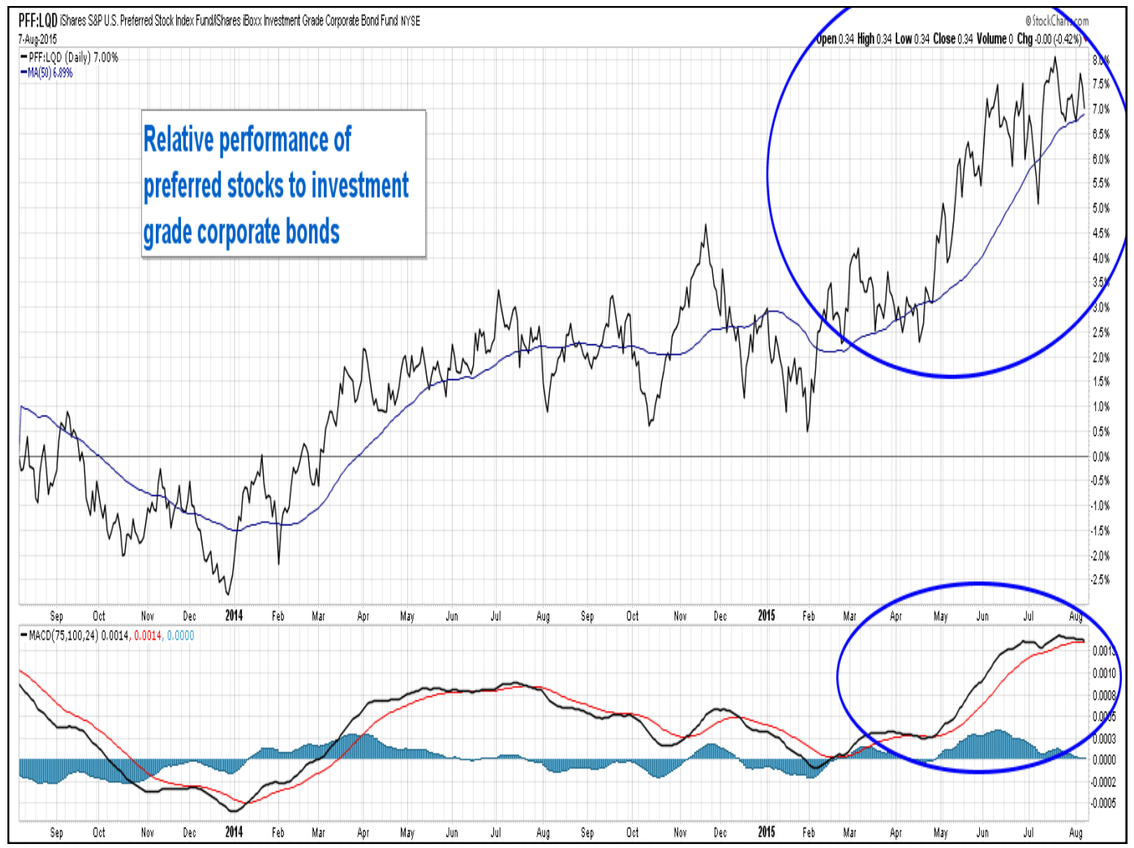
SPY, VEU, and LQD are exchange-traded funds designed to match the experience of the S&P 500, (with dividends), the FTSE All-world (ex US) index, and the iBoxx Investment Grade Corporate Bond Index, respectively. Their prospectuses can be found online. **Past performance is no guarantee of future results.**

Despite my views last month that investment grade corporate bonds (LQD) would continue their decline, the index began to reverse course and gained strength in late July and early August as the 10-year Treasury yield backed off. On a technical basis, the price has broken free of the trend channel with further gain in momentum and an emerging shift in the 50-day moving average. If the 10-year Treasury yield is close to bottoming, as I think it may be, I'm not expecting much follow-through on the technical shift we're seeing at the moment.



While we wait to see how the bond picture unfolds, preferred stocks gained about 0.3% in July and early August relative to LQD., bringing their YTD performance to about 2.9% vs. –1.0% for LQD. Unlike LQD, preferred stocks have been largely uncorrelated with the 10-year Treasury yield (not exactly what I would have expected, but there you have it). Although momentum is beginning to weaken, if I'm right about the 10-year Treasury yield increasing bottoming here, I expect preferred stocks will continue to outperform the investment grade corporate bonds.



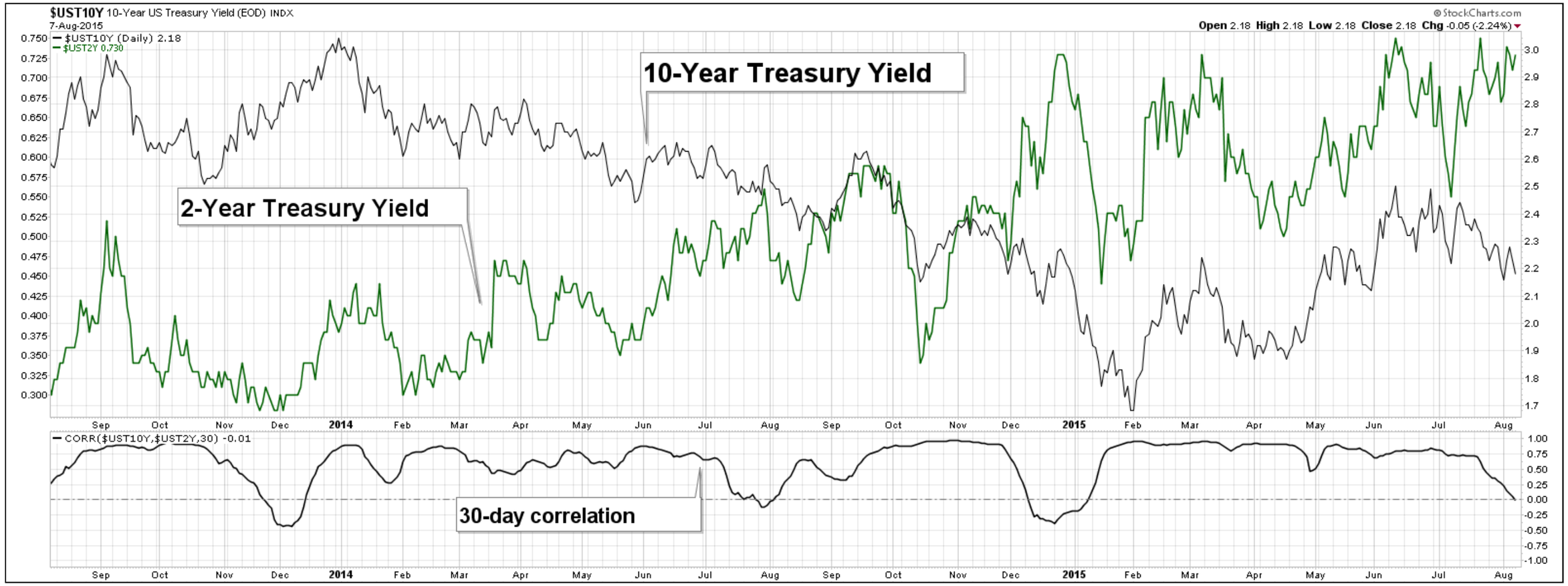


LQD is an ETF designed to match the experience of the iBoxx Investment Grade Corporate Bond Index. Prospectuses can be found online. TLT seeks to track the investment results of an index composed of U.S. Treasury bonds with remaining maturities greater than twenty years. PFF seeks to track the investment results of the S&P U.S. Preferred Stock Index (TM) which measures the performance of a select group of preferred stocks. **<u>Past performance is no guarantee of future results.</u>**

Interest Rates

Shown below are the 2-year and 10-year U.S. Treasury yields for the last two years. The 2-year yield might be taken as a proxy for the market's opinion about what will ensue for the Fed funds rate. The 10-year yield is a reflection of not only domestic attitudes about changes in the Fed funds rate, but also the global interest rate environment and the developing strength or weakness in the U.S. dollar. The correlation between the two is high over longer periods, but not so much in recent days.

As you can see, the 2-year yield rose sharply in July reflecting the increasing expectations of a Fed funds rate increase in September. On the other hand, the 10-year yield is just under 2.2% at this writing, down slightly from 2.3% reported last month. The divergence between the two yields in the current environment reflects a modest flattening of the yield curve and growing strength in the U.S. dollar. This outcome, so far at least, is contrary to the view held by some that the 10-year yield was destined to rise with the Fed funds rate. In fact, as I see it, the pressures on the two are coming from different places with the short term yield reflecting anticipated Fed funds rate movement while the longer term yield reflects global market factors that go way beyond domestic considerations.



Disclosures

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Investing involves risk including loss of principal. Investing in international and emerging markets may entail additional risks such as currency fluctuation and political instability. Investing in small-cap stocks includes specific risks such as greater volatility and potentially less liquidity. Small-cap stocks may be subject to higher degree of risk than more established companies' securities. The illiquidity of the small-cap market may adversely affect the value of these investments.

Investors should consider the investment objectives, risks, and charges and expenses of mutual funds and exchange-traded funds carefully for a full background on the possibility that a more suitable securities transaction may exist. The prospectus contains this and other information. A prospectus for all funds is available from Lane Asset Management or your financial advisor and should be read carefully before investing.

Note that indexes cannot be invested in directly and their performance may or may not correspond to securities intended to represent these sectors.

Investors should carefully review their financial situation, making sure their cash flow needs for the next 3-5 years are secure with a margin for error. Beyond that, the degree of risk taken in a portfolio should be commensurate with one's overall risk tolerance and financial objectives.

The charts and comments are only the author's view of market activity and aren't recommendations to buy or sell any security. Market sectors and related exchanged-traded and closed-end funds are selected based on his opinion as to their usefulness in providing the viewer a comprehensive summary of market conditions for the featured period. Chart annotations aren't predictive of any future market action rather they only demonstrate the author's opinion as to a range of possibilities going forward. All material presented herein is believed to be reliable but its accuracy cannot be guaranteed. The information contained herein (including historical prices or values) has been obtained from sources that Lane Asset Management (LAM) considers to be reliable; however, LAM makes no representation as to, or accepts any responsibility or liability for, the accuracy or completeness of the information contained herein or any decision made or action taken by you or any third party in reliance upon the data. Some results are derived using historical estimations from available data. Investment recommendations may change without notice and readers are urged to check with tax advisors before making any investment decisions. Opinions expressed in these reports may change without prior notice. This memorandum is based on information available to the public. No representation is made that it is accurate or complete. This memorandum is not an offer to buy or sell or a solicitation of an offer to buy or sell the securities mentioned. The investments discussed or recommended in this report may be unsuitable for investors depending on their specific investment objectives and financial position. The price or value of the investments to which this report relates, either directly or indirectly, may fall or rise against the interest of investors. All prices and yields contained in this report are subject to change without notice. This information is intended for illustrative purposes only. **PAST PERFORMANCE DOES NOT GUARANTEE FUTURE RESULTS.**

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