Stegent Equity Advisors Investment Letter

Stegent Equity Advisors, Inc. **October 2015**

Third Quarter 2015 *Key Takeaways*

September Benchmark Returns (Preliminary)			
Large Cap Benchmarks	**Sep**	**3Q**	**YTD**
Vanguard 500 Index	-2.5%	-6.5%	-5.4%
iShares Russell 1000	-2.8%	-6.9%	-5.3%
iShares Russell 1000 Growth	-2.6%	-5.4%	-1.7%
iShares Russell 1000 Value	-3.1%	-8.4%	-9.1%
Mid-Cap Benchmarks			
iShares Russell Midcap	-3.6%	-8.0%	-5.9%
iShares Russell Midcap Growth	-3.9%	-8.1%	-4.3%
iShares Russell Midcap Value	-3.4%	-8.2%	-7.8%
Small-Cap Benchmarks			
iShares Russell 2000	-4.9%	-11.9%	-7.8%
iShares Russell 2000 Growth	-6.3%	-13.0%	-5.4%
iShares Russell 2000 Value	-3.5%	-10.8%	-10.2%
Other Benchmarks			
Vanguard FTSE Developed Markets ETF	-4.1%	-9.7%	-3.9%
MSCI World ex USA Index	-5.0%	-10.5%	-6.3%
Vanguard FTSE Europe ETF	-4.1%	-8.5%	-3.7%
Vanguard FTSE Emerging Markets ETF	-2.9%	-17.9%	-15.2%
Vanguard REIT Index	3.0%	2.0%	-4.5%
Vanguard Total Bond Market Index	0.8%	1.2%	0.9%
BofA Merrill Lynch U.S. High Yield Cash Pay	-2.6%	-4.9%	-2.5%
Vanguard Int. Term Tax-Exempt Fund	0.7%	1.6%	1.5%
S&P/LSTA Leveraged Loan Index	-0.6%	-1.4%	1.4%
Citigroup World Gov't Bond Index	0.8%	1.7%	-2.4%

Increasing concern about China's economy, accompanied by a surprise albeit modest devaluation of the Yuan currency, helped trigger a sharp drop in global equity markets in late August, with the S&P 500 falling 12% from its high reached just a month earlier. The S&P 500 then bounced briefly from its August 25 low but dropped an additional 2.5% in September, ending the quarter down 6.5%. This marks the first negative quarterly return for the index since 2012.

Developed international stocks, as measured by the Vanguard FTSE Developed Markets ETF, also dropped 12% intra-quarter, from high to low. For the quarter as a whole, they were down 9.7%. European stocks did a bit better, losing 8.5% in dollar terms and 7% in local-currency terms.

Emerging-markets stocks fared the worst, dropping 21% from their intra-quarter high in early July to their low on August 24. For the quarter, the emerging-markets stock index was down 18%. That return includes several percentage points of losses to dollar-based investors from the continued depreciation of emerging-markets currencies against the U.S. dollar.

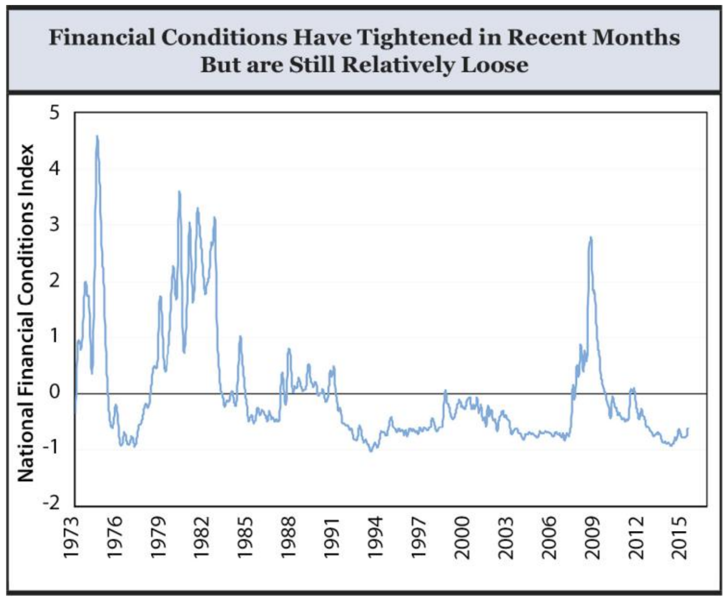
Moving on to the fixed-income markets, the core bond index gained about 1% during the U.S. stock market's 12% intra-quarter drop. While this was strong *relative* outperformance versus most other (riskier) asset classes, with yields on core bonds so low (around 2.3%), their potential to generate strong absolute/positive returns over any meaningful time frame is very limited, unless we continue to see deflationary pressures on economic growth and producer prices.

We finally received some positive contribution from our precious metals holdings, with gold up about 1.5% during the August-September stock sell off. Similar to fixed income, we expect metals to act as a shock absorber in times of financial crisis and market panic but the cushion we received this quarter was too small to offset all the global equity losses. However, precious metals continue to do well in October, especially the mining stocks, which appear to have bottomed after a four year decimating bear market for metals producers.

Third Quarter 2015 Investment Commentary

Given the market's historical pattern of corrections, we shouldn't be surprised by the volatility witnessed in the third quarter. And, knowledge of market history and cycles is useful for putting the present moment into context and thinking through different potential scenarios, risks and investment opportunities. We will discuss the impact of the recent market turbulence on our asset class views and portfolio positioning later in this commentary, but first we will spend a bit of time discussing the proverbial elephant in the room: the Federal Reserve.

The big question looming for the markets over the quarter was whether the Federal Reserve was going to raise interest rates for the first time in more than six years. Ultimately, the Fed decided to hold off on a rate hike, citing that "recent global economic and financial developments may restrain economic activity somewhat and are likely to put further downward pressure on inflation in the near term." Fed Chair Janet Yellen pointed specifically to the recent developments in China and emerging markets as factors that gave them pause. She also noted the "tightening of financial conditions" due to stock market declines, a stronger dollar, and wider credit spreads since the FOMC's last meeting. Thirteen out of the 17 Fed policymakers indicated they expect to raise rates at least once this year, with six of the 13 expressing a preference for two rate hikes. Regardless of interest rates, monetary policy is loose and will remain that way even when (if) the Federal Reserve starts raising rates.



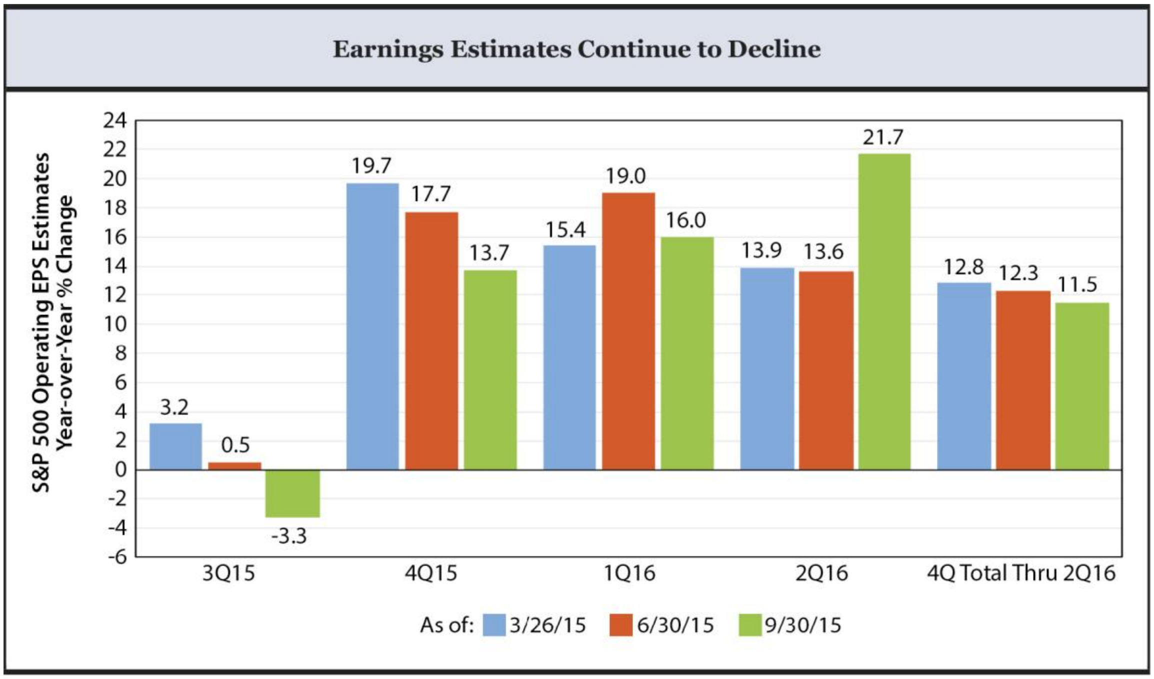
Source: Federal Reserve Bank of Chicago. Data as of 9/18/2015.

Monetary policy works as the Fed adds or subtracts reserves from the banking system. By adding or subtracting reserves, they are able to increase or decrease aggregate demand (total spending). When the Fed wants the federal funds rate to rise, it withdrawals reserves from the banking system by selling bonds to banks. Interest rates rise as liquidity is withdrawn, but the primary impact on the economy is from the slowdown in money growth, not the rise in rates.

Currently, banks have excess reserves totaling in excess of $2.5 trillion, the highest level in history due to QE, with no plans by the Fed to start selling Treasuries to reduce the level of reserves. The spread between what the Fed paid banks last and what it collected as interest on those Treasuries was roughly $100 billion, which the Fed returned to the US Treasury. If the Fed had increased what it paid banks on reserves to 0.5%, it would have reduced the Treasury's cash inflow by about $7 billion over the next year with this money going to banks. Following the money, we can surmise that the Fed and Treasury have an incentive to keep rates very low so that their profits stay high.

Impact of Market Volatility on our Asset Class Views and Portfolio Positioning

U.S. Stocks: While the market decline made future returns for U.S. stocks look incrementally better, valuations are still stretched and earnings are well above normalized levels for a variety of reasons (e.g., due to unsustainably high profit margins). Earnings estimates also continue to decline. So there is a substantial risk of earnings disappointment and valuation multiple contraction, implying subpar returns.



Source: Ned Davis Research / S&P Dow Jones Indices. Data as of 9/30/2015.

Weighing even more heavily on stocks than the fundamentals are the technical measures, which are pointing to an end to the current bull market for US stocks. Bear markets are difficult to identify for several reasons. First, most investors rely on the DJIA or the S&P 500 Index to be an accurate proxy for the broad list of stocks. As long as the S&P 500 is in a positive trend, all is well. While that may be true during the early stages of a new bull market, the patterns of the large, cap-weighted price indexes are highly deceptive during old bull markets. Consider that the S&P 500 Index is virtually always at it high the day before each bull market ends, thus misleading investors.

Further, history shows that the internal weakness leading to major bear market declines typically begins in the small-caps, an area that few investors ever watch. Eventually the weakness spreads to the mid-caps, while the large-caps are always the last to weaken. Thus, when the DJIA reached a new bull market high on Jan 14, 2000, which also subsequently proved to be the top day of the bull market, only 3.5% of NYSE traded stocks were at new highs, while 55% were already down 20% or more from their bull market highs, qualifying as bear market losses. Investors relying on the guidance of the DJIA or S&P 500 were blindsided. It is the internal condition of the market--not the big-cap price indexes—that provides the invaluable warnings of a developing bear market. Currently, 57% of small-caps, 32% of mid-caps and 24% of large-caps have already lost 20% or more of their value—far more intense than the losses found in a typical short term correction.

The question now facing investors is whether the advance underway in October marks the start of a strong rally that might push most stocks to new bull market highs. To answer that critical question, we turn to the Law of Supply and Demand, which infers that strong rallies require two elements: evidence of dynamic buying enthusiasm accompanied by a significant withdrawal of sellers. Therefore, if an important bottom occurred in late August, we should be seeing a strong uptrend in technical measures of buying pressure, accompanied by a sharp drop in selling pressure. However, since August 25th, buying pressure measurements have increased at a relatively sluggish pace, while selling pressure measurements have dropped far less than typically found at the start of important, broad market advances.

These sluggish patterns since late August appear to be the result of a concentration of investor demand in large-cap stocks, while small-caps and mid-caps have lagged, following the classic patterns of gradual deterioration seen at major market tops. Thus, it is possible the current rally could persist, fueled by a relatively few large-cap or mega-cap stocks, causing the major indexes to rise to a deceptive new high, encouraging many investors to buy aggressively at perhaps exactly the wrong time—similar to the final bull market peaks in January 2000 and October 2007. Accordingly, we are using caution in the months ahead by starting to build a cash position equal to 10% of non-fixed income exposure in each model, which may increase to 20% by year end if technical measures of supply and demand do not improve. Additionally, small and mid-cap stock exposure was decreased during the third quarter from 8% of US equity exposure to 4%.

Developed International Stocks: We continue to have an overweight to European stocks. European stock valuations are much more attractive than those of U.S. stocks, while European corporate earnings are well below normal (unlike in the U.S. where earnings are well-above their long-term trend). As such, we have the opportunity to see both improved earnings growth as well as some multiple expansion, implying significant outperformance for European stocks compared to the U.S. market over the next few years.

Emerging Markets: After recent declines in emerging-markets stocks, some analysts now view them as more attractive, to varying degrees, than U.S. and European stocks. While the return potential for emerging markets appears to have increased and they may be relatively cheap, it is hard to say they are absolutely cheap. As such, we should remain concerned about the potential for shorter-term downside risk. Accordingly, in a recent tactical move we decreased our emerging-markets stock positions by about 50% to better manage each portfolio's risk threshold.

Investment-Grade Bonds: The events of the latter part of the third quarter led us to increase our fixed income exposure in our balanced models anywhere from 5 to 20%, depending on the model. Even though our expected returns for core bonds are very low looking out over the next several years in almost any reasonably likely macro scenario, the risk of a deflationary cycle, even if short lived, is increasingly likely. This defensive measure will help protect against the downside shock of that impact on financial markets…until another round of QE is unleashed.

Alternatives: We continue to see some benefits—in terms of diversification and expected contribution to overall portfolio risk-adjusted return—from exposure to a highly select group of alternative strategy managers. The alternative strategies we own are intended to generate long-term returns that are better than core bonds, with much lower downside risk and volatility than stocks and relatively low or no correlation to stock and bond market indexes. The exception has been master limited partnerships (MLPs), which have demonstrated higher than normal volatility and correlation to energy prices, leading to significant losses in this portion of our portfolios.

Precious Metals: Gold is down more than 40% from its 2011 peak and most of us who have invested during that time are down, with many wanting to give up in disgust on gold. Sentiment in the metals and in mining stocks is the worst it has been in a decade. However, factors are starting to work in favor of metals.

One of the most important factors, US dollar strength, has been hurting precious metals' prices because gold is considered a form of currency. When the dollar is strong, gold is weaker. The best measure of dollar strength is the Price-Adjusted Broad Dollar Index maintained by the Federal Reserve Board. The all time low for this dollar index was 80.5 in July 2011, corresponding exactly to the all-time high dollar price for gold. Conversely, that index in early October was at 95.60, the highest reading in six years. With the Fed postponing interest rate hikes, the global economy continuing to slow, including the US, and currency wars raging around the world, the Fed has demonstrated they cannot tolerate a strong dollar because it imports deflation from around the world.

Concluding Comments

The reality of owning stocks is that occasionally, inevitably, we will experience bear market losses. This underscores the importance of our risk management, in which we seek to reduce our balanced portfolios' vulnerability to stock market downturns through strategies that include owning "insurance" assets such as bonds and lower-risk alternatives, and even cash. This is based on our tactical asset allocation approach that centers on analyzing long-term fundamentals and valuations, while remaining sensitive to shorter-term portfolio risks.

Another key ingredient in managing through bear markets is helping clients accurately assess their risk tolerances and investment objectives. If you are in an appropriately structured portfolio, there is no reason to worry. If you are worried, then please contact us to reassess your current portfolio mix.

As always, we are grateful for the opportunity to continue to serve as your trusted advisor.

Loyd J. Stegent, President
Stegent Equity Advisors, Inc.