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Gleanings
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Gleanings

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

"Just One Thing"

I have always liked the movie "City Slickers." I especially like the scene where Curly (Jack Palance) turns to Mitch Robbins (Billy Crystal) and asks, "Do you know what the secret of life is?" Mitch responds, "No what?" Curly says, "This" and holds up one finger. Confused Mitch inquires, "Your finger?" Curly utters, "Just one thing. You stick to that and everything else don't mean &%$#!" Mitch: "That's great, but what's the one thing?" Curly: "That's what you gotta figure out." A similar thing can be said about the stock market. In fact it was pointed out vividly in a book written in the 1920s about a shrewd stock operator named Mr. Partridge, often referred to as "Old Turkey." Many Wall Street wags would ask him, "What do you think I should do in the stock market?" Old Turkey would cock his head to one side, contemplate the question, and with a fatherly smile he would say, "You know it's a bull market." It was as if he were giving you a priceless talisman wrapped up in a million-dollar accident-insurance policy. And currently, the just one thing you need to know is that – it's a bull market! Indeed, "just one thing" because in secular bull markets all of the surprises come on the upside. Well that's not entirely true; in the 1982 to 2000 secular bull market there was a pretty big mishap in October 1987. Still, in retrospect, that mishap was a great buying opportunity. BMO's strategist Brian Belski has done a study of equity markets when they emerge from a long sideways trading pattern, like 1964 to 1982, to the upside. In every case you have been in a secular bull market. Using historical data, Brian opines this current bull market should endure until 2025 with a price target for the S&P 500 (SPX/1984.13) of about 4300; and that's all you really need to know. Of course there some other things worth considering

First is that since 1989 bottom-up operating earnings for the S&P 500 have grown at 6.15% per year. Extrapolating that into 2020 yields an earnings estimate of $183.36. Using the historical median P/E of 15.5 times earnings yields a price target of 2842 for the SPX in 2020, or 43% higher than now. If we use Benjamin Graham's formula, or the Rule of 20, for determining what the P/E should be, the price target for the S&P 500 is higher. Second, a capital expenditure cycle appears to be picking up as a survey of CFOs at the beginning of the year showed only a 1% expectation of cap ex spend, while the recent survey targets a 6% spend. That, combined with the recently better economic reports, should lift GDP going forward. Indeed, the economy is doing better with the Trucking Survey at new reaction highs, the labor market is improving, credit expansion is accelerating, housing is picking up, autos too, China has stabilized, the geopolitical environment seems somewhat contained, Europe has basically announce QE as Draghi wants a lower euro currency, which has caused the U.S. dollar to strengthen noticeably. That dollar strength is putting pressure on all commodities paving the way for continued low inflation. All of this suggests things are getting better. As often stated, the equity markets do not care about the absolutes of good or bad, but only if things are getting better, or worse, and things are getting better. Stay bullish my friends!

--Jeffrey Saut, *Chief Investment Strategist*

Please read domestic and foreign disclosure/risk information beginning on page 32 and Analyst Certification on page 32.

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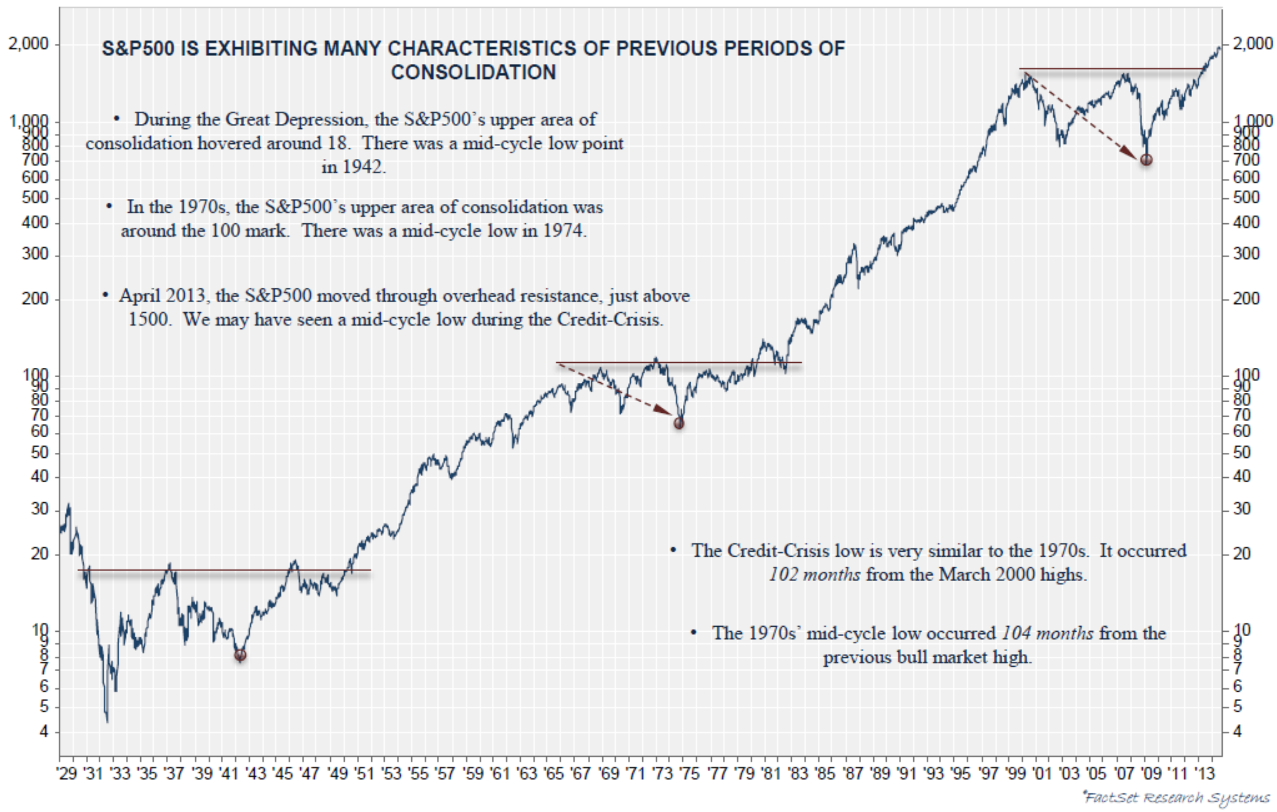
Signs of a Secular Bull Market

Every time the equity markets have emerged to the topside from a long range-bound environment (red horizontal lines) like 1964 to 1982, they have always been in a secular bull market.

S&P 500 Price Index - 1929 to present



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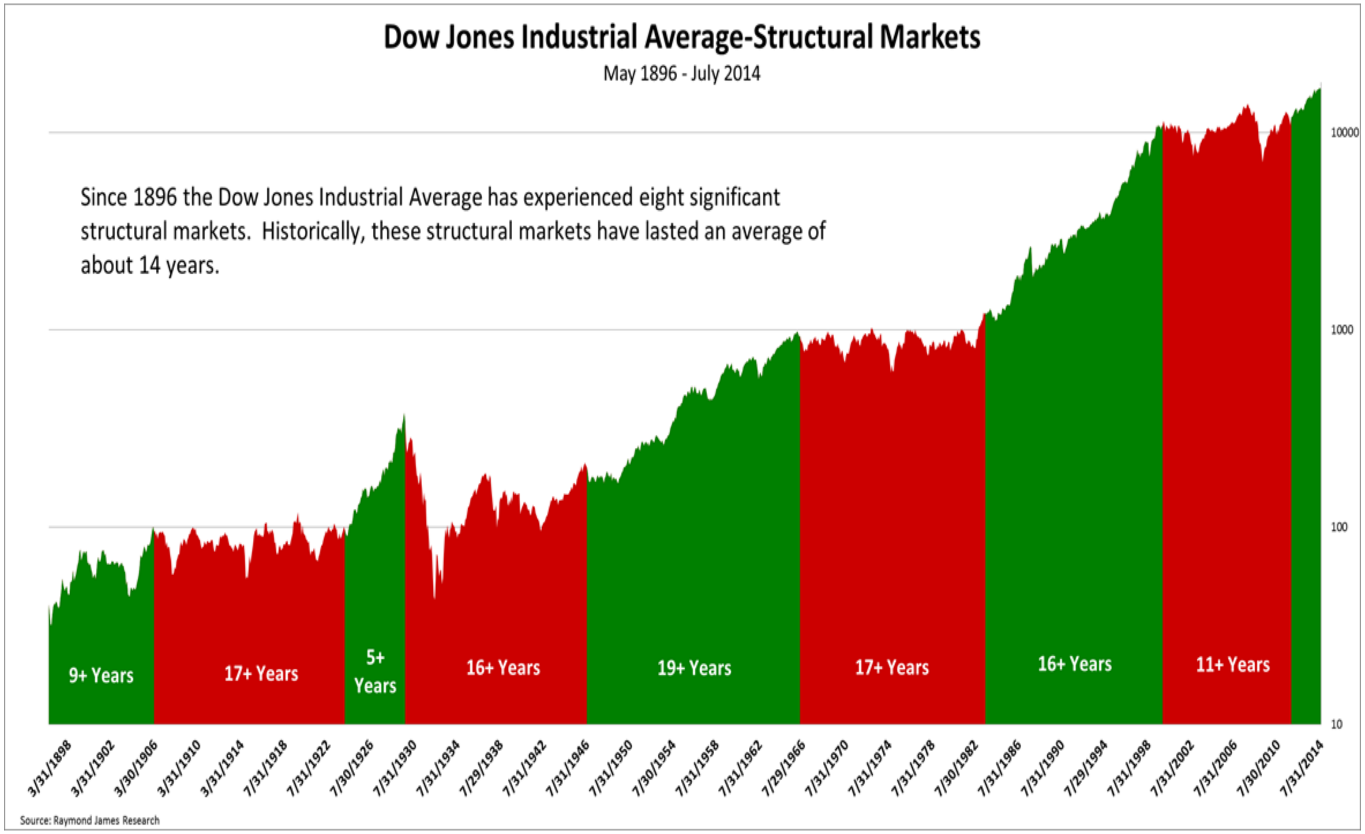
"Valuation" Low in October 2011

I maintain that the bull market began in October 2011 at the "valuation" low, or the cheapest the S&P 500 would get on forward earnings estimates, and not at its "nominal" price low of March 2009. Nobody measured the 1982 to 2000 secular bull market from its "nominal" price low of 1974, but rather the "valuation" low of 1982.



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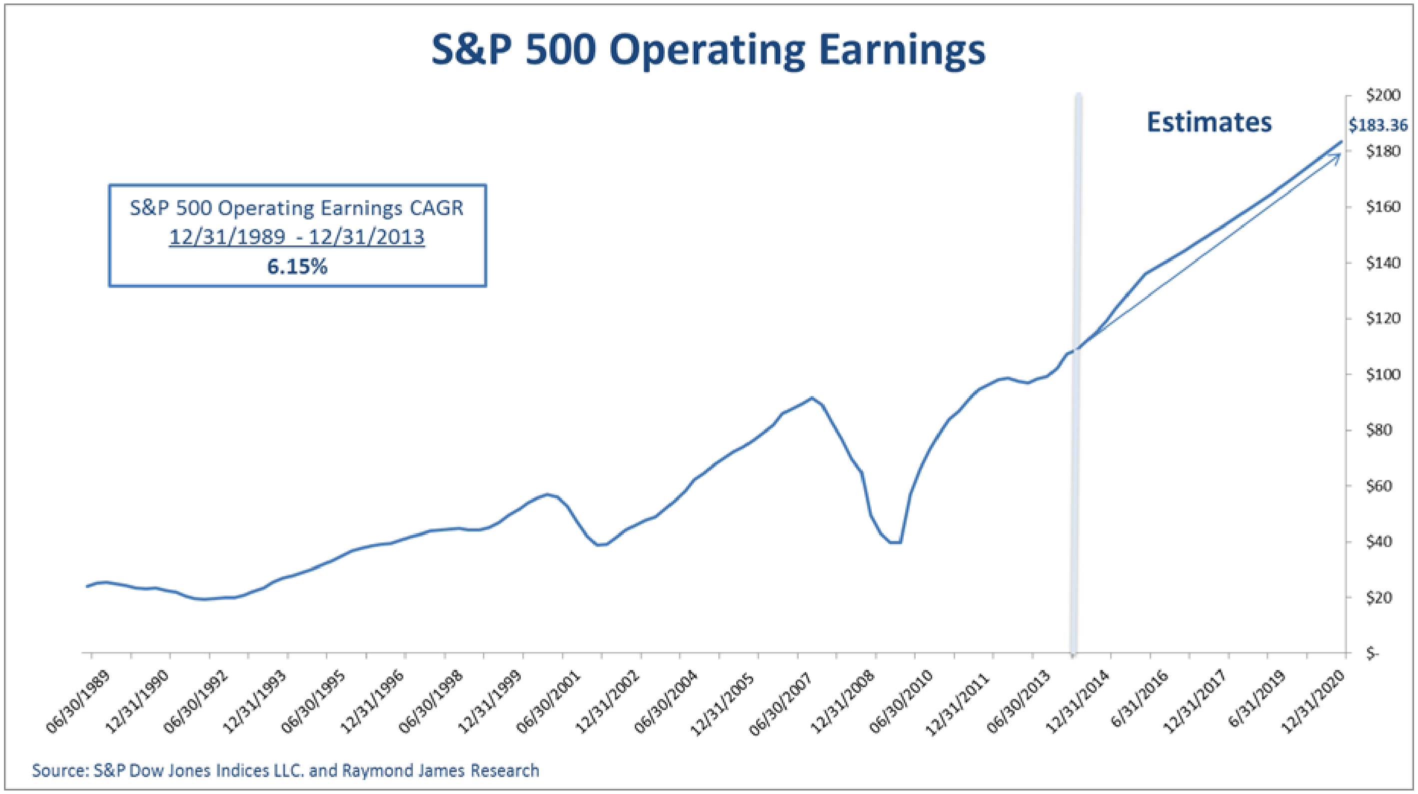
Extrapolating S&P 500 Earnings

Since 1989 bottom-up earnings for the S&P 500 have grown at 6.15% per year. Extrapolating that into 2020 yields an EPS estimate of $183.36 versus last year's $107.



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Using the Historical Mean P/E of 15.5x Earnings Gives us a Target Price for the S&P 500 of 2842. But Of Course One Can Make the Argument That P/Es Should Be Higher.

You Could Use Benjamin Graham's P/E Formula:

P/E = 8.5 + 2G – where 8.5 represents the typical P/E for a no-growth company and where a growing company tends to trade at two times its earnings growth rate.

Therefore:

8.5 + 2 x 6% = 20.5x P/E for a target of 3759 (SPX)

(20.5 x $183.36 = 3759)

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Jeffrey Saut

Or You Could Use the Rule of 20

The S&P 500's P/E should be such that when combined with the inflation rate it sums to 20:

20 = 2% inflation rate + 18x P/E multiple

18 x $183.36 = 3300 S&P 500 target price in 2020

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The Trucking Survey is at a New Reaction High Suggesting the Economy is Doing Better

Source: ISI.

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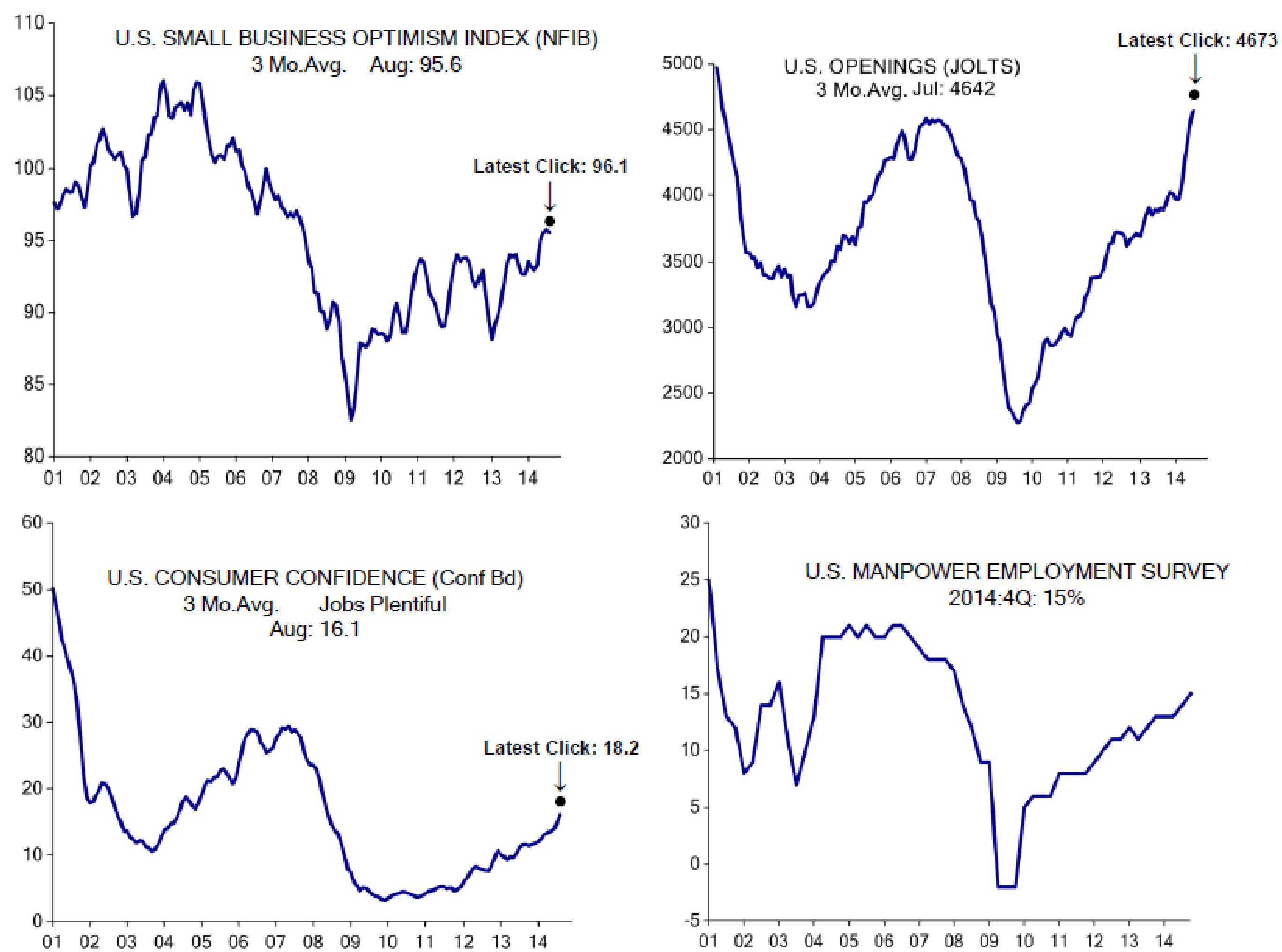
Signs That the Labor Market is Improving



Source: ISI.

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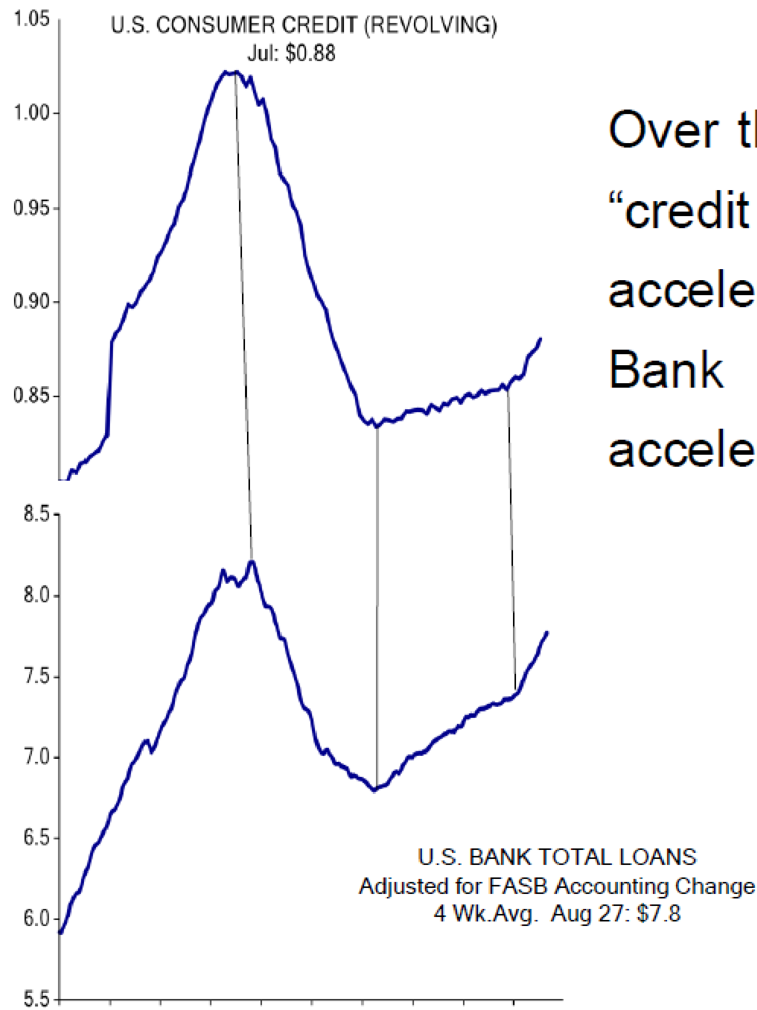
Credit Expansion is Accelerating

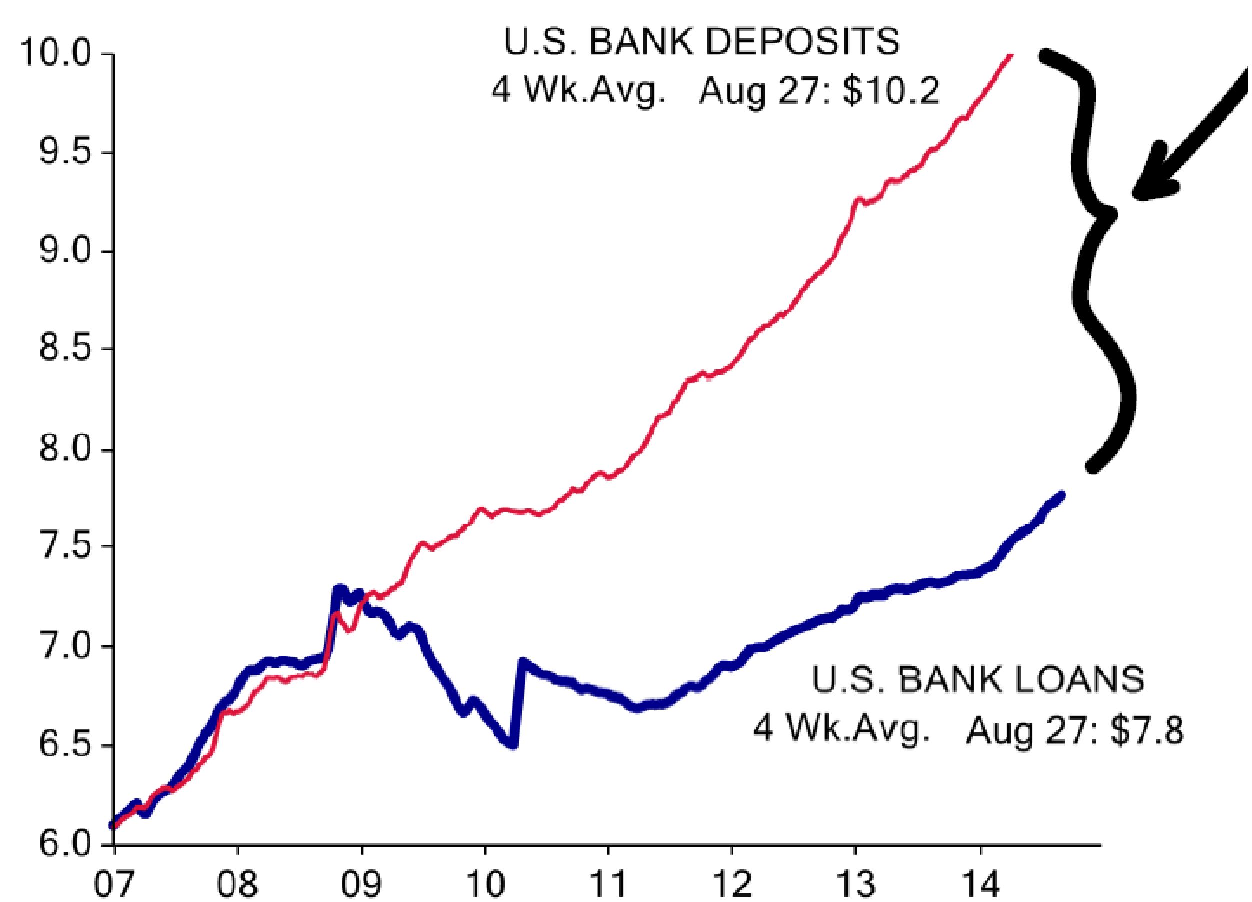


Over the past five months, "credit card" borrowing has accelerated to a +6.0% a.r. Bank loans have accelerated to a +8.4% a.r.

Source: ISI.

Jeffrey Saut

And it has a Lot of Room to Expand Further



Source: ISI.

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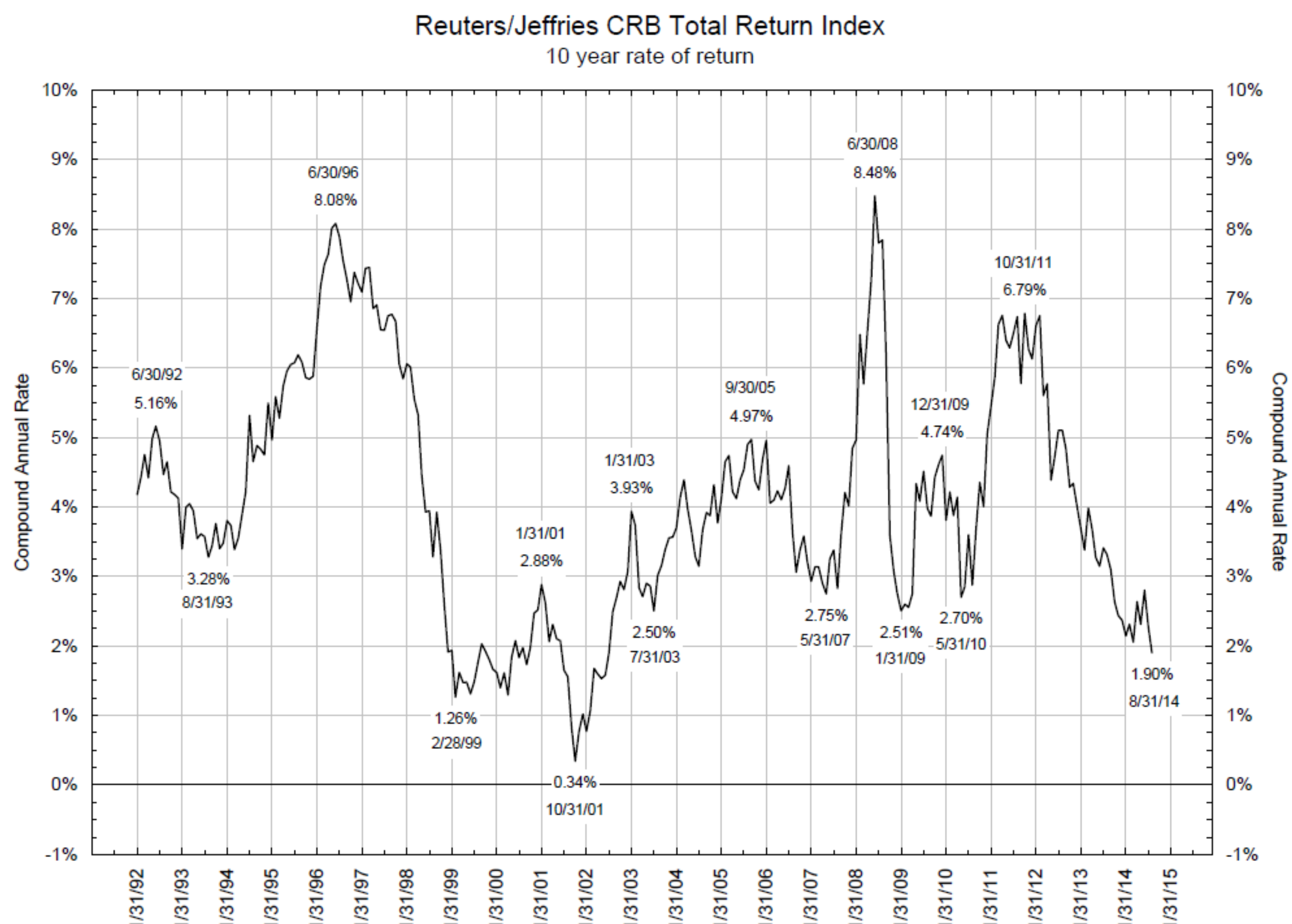
The Stronger U.S. Dollar has Put Downward Pressure on the Commodity Complex Implying Inflation Will Not be a Problem



Source: thechartstore.com.

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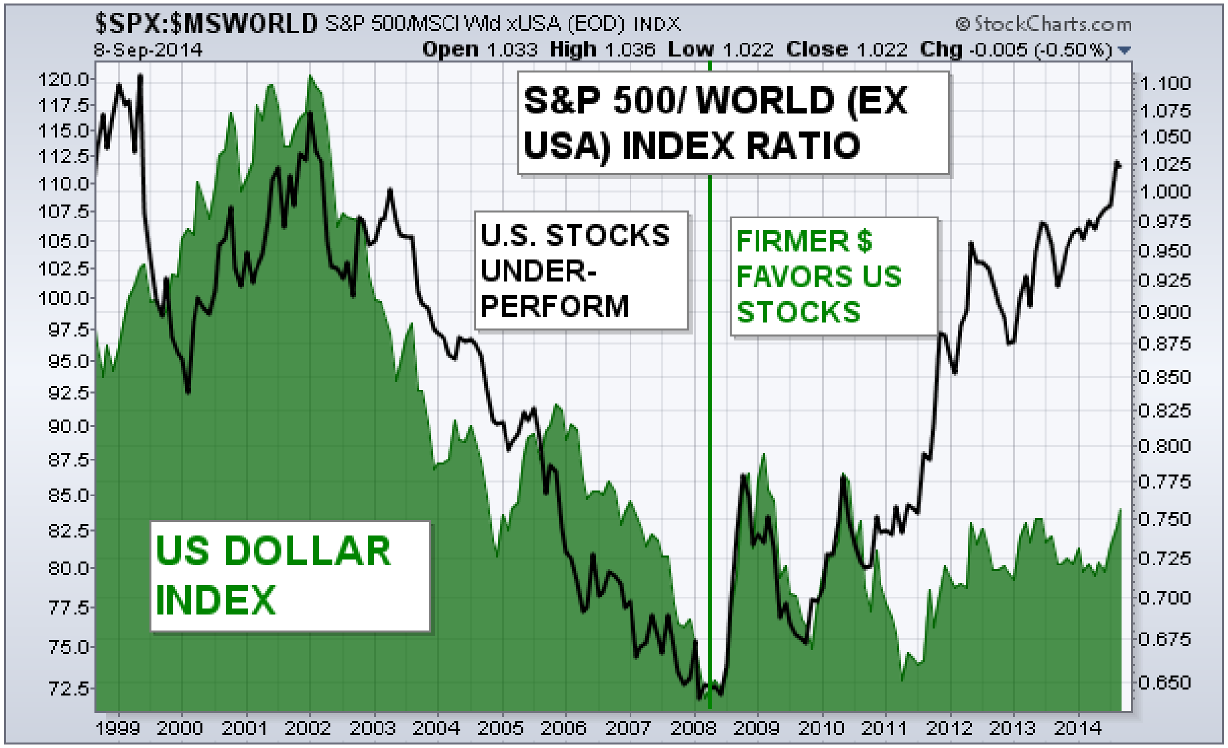
And, a Stronger U.S. Dollar Tends to be Good for Stocks



Jeffrey Saut

I will let Scott Brown and Andrew Adams opine on some of the other points mentioned on the first page of this report. But all you really need to know is that the equity markets do not care about the absolutes of good and bad, but only if things are getting better or worse. And, things are getting better!

"Stay bullish my friends."

Andrew Adams

The Trend is Your Friend

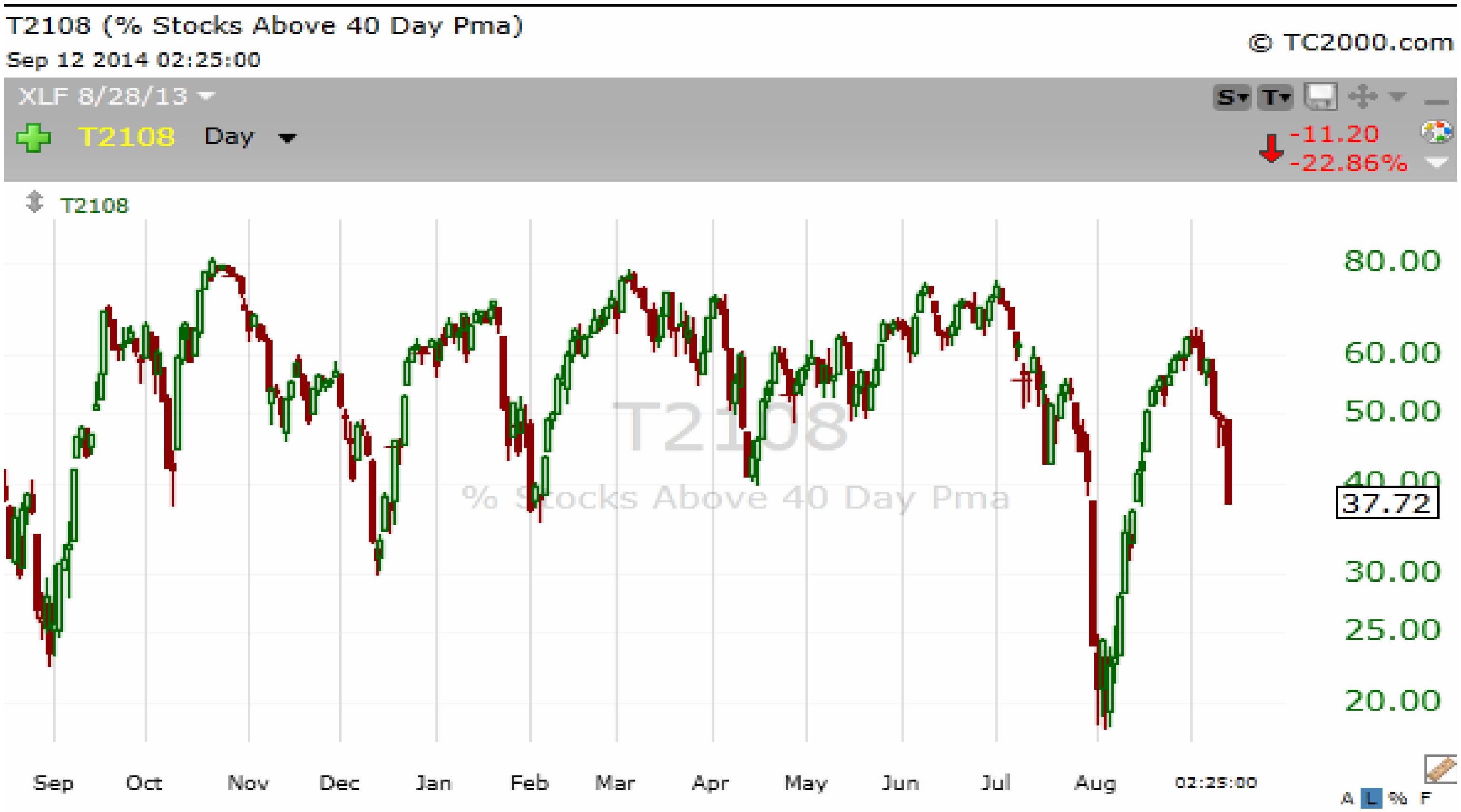
The S&P 500 continues its pattern of higher lows and higher highs that define an up-trend, and would now have to sink below the 1904 mark to break this pattern. It has been consolidating over the past three weeks and now sits right at the key 1980-1985 area that we've mentioned recently, as well as right above the 50-day moving average that is currently around 1973. At this point, several important support areas would have to fall before any structural damage would be done to the market, so until this happens the signs still point to higher prices ahead.

Source: FactSet.

Andrew Adams

Internal Correction

Many investors are still wondering when we are going to get the seemingly inevitable correction or pullback. But perhaps it is possible that we are currently experiencing an internal correction involving much of the overall market while the major averages consolidate. Currently, only about 37% of stocks are trading above their 40-day moving average, which is similar to readings we got near the lows in February of this year and in October and December of last year.



Source: TC2000.

Andrew Adams

Dow Theory Non-Confirmation

While the up-trend in equities is still in effect, one thing to keep an eye on is that the Dow Jones Transportation Average (orange line) has broken out to new highs while the Dow Jones Industrial Average (blue line) has not. This is what's known as a Dow Theory Non-Confirmation. To be a true buy signal, both averages should move above their prior reaction highs, and the closer this happens to each other the better. While we're still a fairly significant distance away from any sort of sell signal, we do want to see the Dow Jones Industrials take out the July high as a sign of support for the ongoing secular bull market.

Source: FactSet.

Andrew Adams

Large-Cap Stocks Still the Place to Be

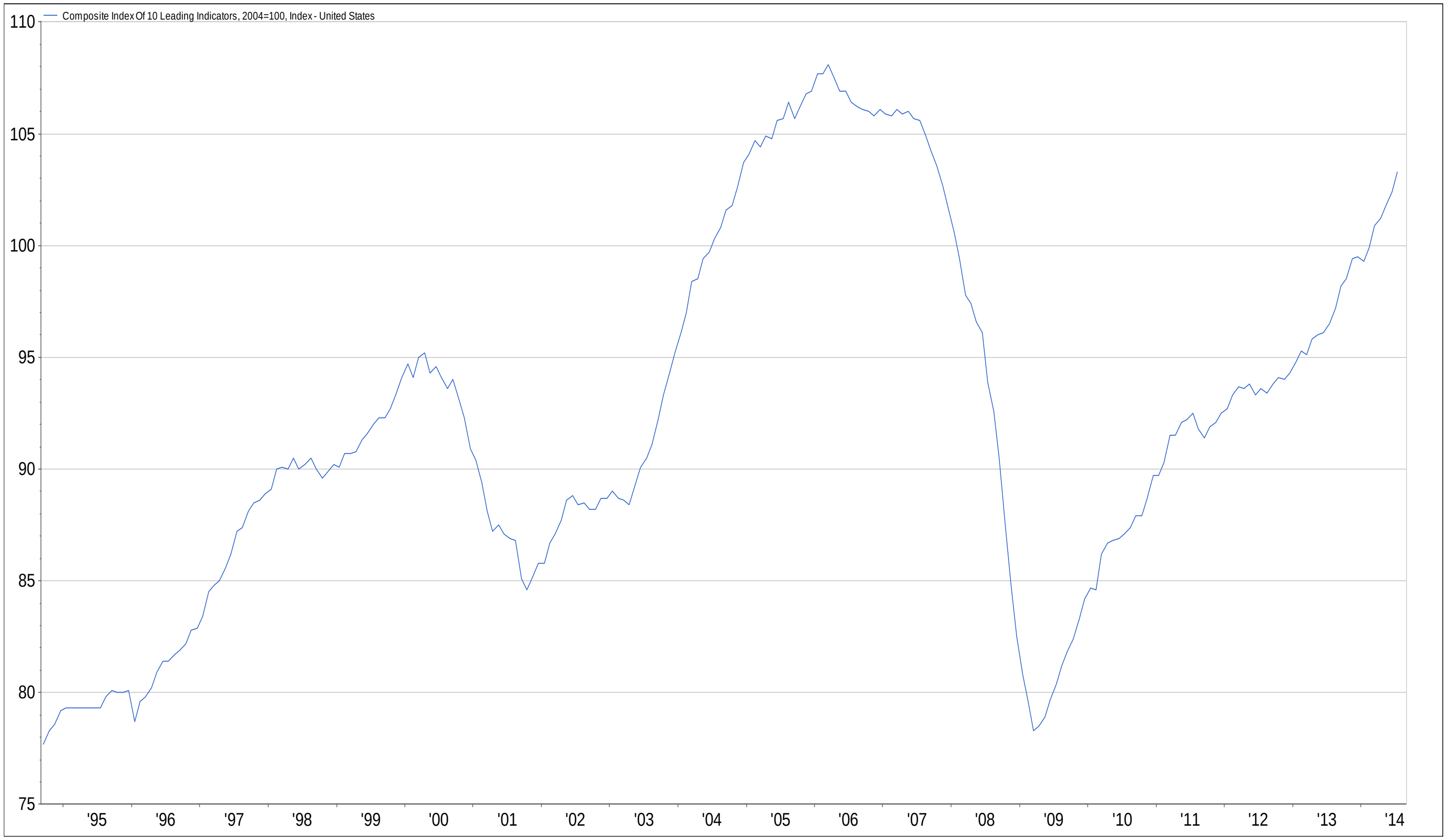
The chart below illustrates the relative strength between the S&P 500 (large capitalization stocks) and the Russell 2000 (small capitalization stocks). When the blue line is going up, large caps are outperforming and when the blue line falls, small caps are the better investment. As of now, the trend in S&P 500 outperformance continues, which means that portfolios should be more heavily allocated to large caps. Only a break of the two lower orange lines in the chart will put this trend in jeopardy.

Source: FactSet.

Andrew Adams

Leading Indicators Still Positive

The Composite Index of 10 Leading Economic Indicators is still trending up and supports that the bull run in stocks is not over. The index topped out in 2006, more than a year before the equity markets did in 2007. And in 2000, the index made its high before the equity market did. So if this pattern continues, as long as the leading indicators remain positive, stocks should not be in major danger.



Source: FactSet.

Andrew Adams

What Goes Up, Must Come Down?

The U.S. dollar has been on a tear and consequently has weighed on the commodities that are priced in dollars (oil, gold, etc.). From its July 1st low to its recent high, the U.S. Dollar Index appreciated around 6% with very little hesitation, and now we must see if it can better its high from July 2013 (top horizontal line) without giving back some of its recent gains. Fundamentally, we are still bullish on the dollar, but given its steep climb it would not be surprising to see at least a sideways consolidation or a mild pullback in the short term that retraces some of the recent move. The key levels on the down side should be around $83.40 (23.6% Fibonacci Retracement; former resistance in 2013) and $82.70 (38.2% Fibonacci Retracement; resistance in 2013 and last month).

Source: FactSet.

Andrew Adams

Breakout in Bond Yields!

The benchmark 10-Year Treasury yield has been stuck in a downward-sloping channel since the beginning of the year, but it may have reached an inflection point after breaking out last week with a greater than 5% gain. While these breakouts will often retrace back to the upper trendline, higher rates should be in our future if this is a true breakout and would be consistent with an improving economy. Of course, higher rates would likely be negative for fixed income investments.

Source: FactSet.

Andrew Adams

Europe Heading Back Down?

Europe has been in the headlines quite a bit recently and not for very positive reasons, so it may come as a surprise to many that the Euro Stoxx 50 Index has actually doubled the return of the S&P 500 since the August bottom. Much of this may have to do with the anticipation of coming stimulus in Europe, but despite performing well over the last month, the Euro Stoxx 50 Index broke the upward-sloping trendline in the chart below last week and may now retreat down to its 50-day moving average. The index has also yet to make it above its June high, so it will be interesting to see if the market believes Europe is doing enough to combat its issues.

Source: FactSet.

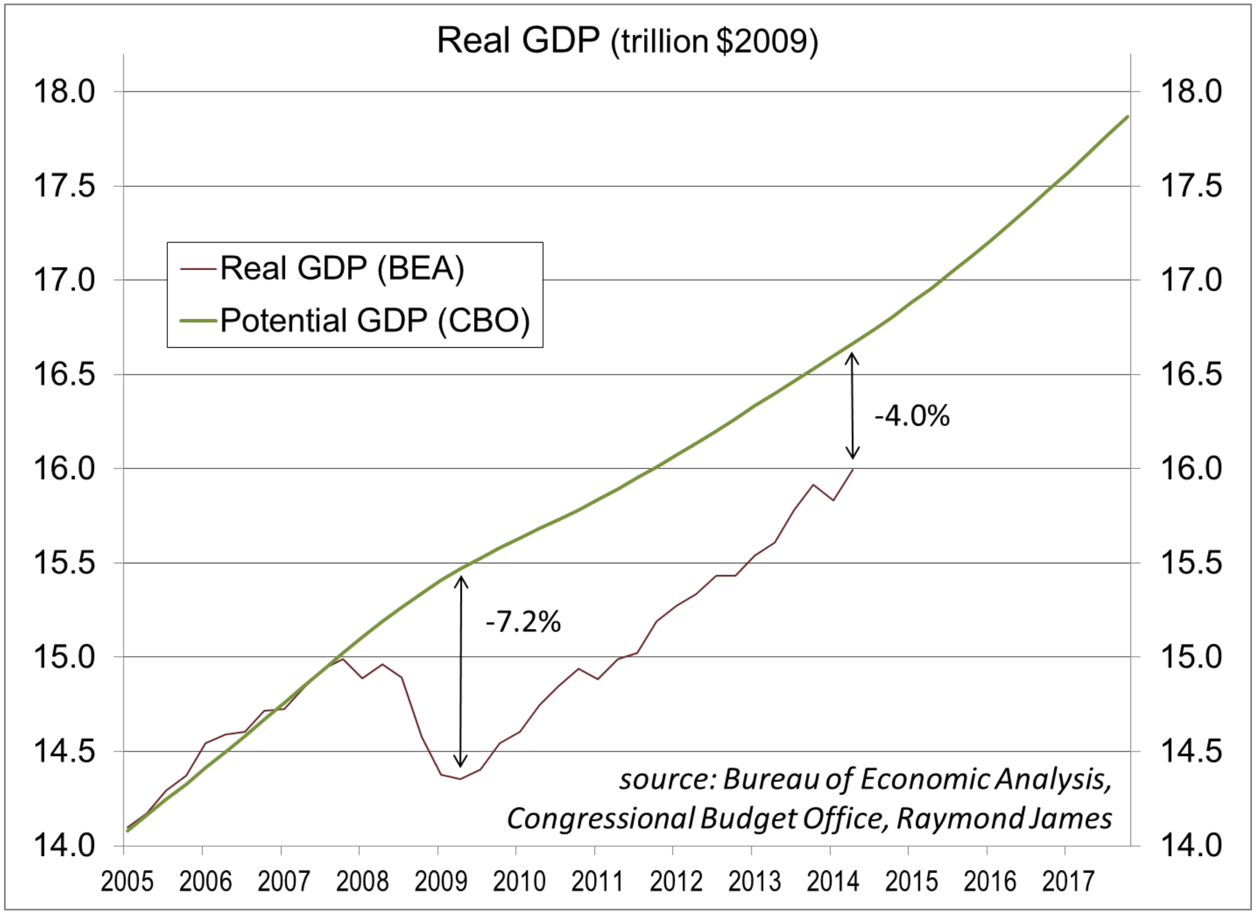
Scott Brown

Key Economic Ideas

- Real GDP rebound sharply in 2Q14, following a very weak 1Q14
- Consumer spending was on a softer trend heading into 3Q14, but picked up in August – Business fixed investment appears relatively brisk – Slower inventories may subtract from 3Q14 GDP
- Labor market conditions have improved, but slack remains
- There is little inflation pressure – consumer price inflation is likely to continue to trend below the Fed's 2% target
- Fed policymakers continue to taper the monthly pace of asset purchases (on track to end in late October) and expect economic conditions to warrant "exceptionally low" short-term interest rates "for a considerable period" after asset purchases end
- At Jackson Hole, Fed Chair Yellen left the monetary policy outlook open, but officials are planning for "policy normalization"
- The dollar should strengthen as the Fed considers tightening and the European Central Banks considers further easing

Scott Brown

While the Economic Recovery has Continued, the Level of Activity Remains Well Below its Potential



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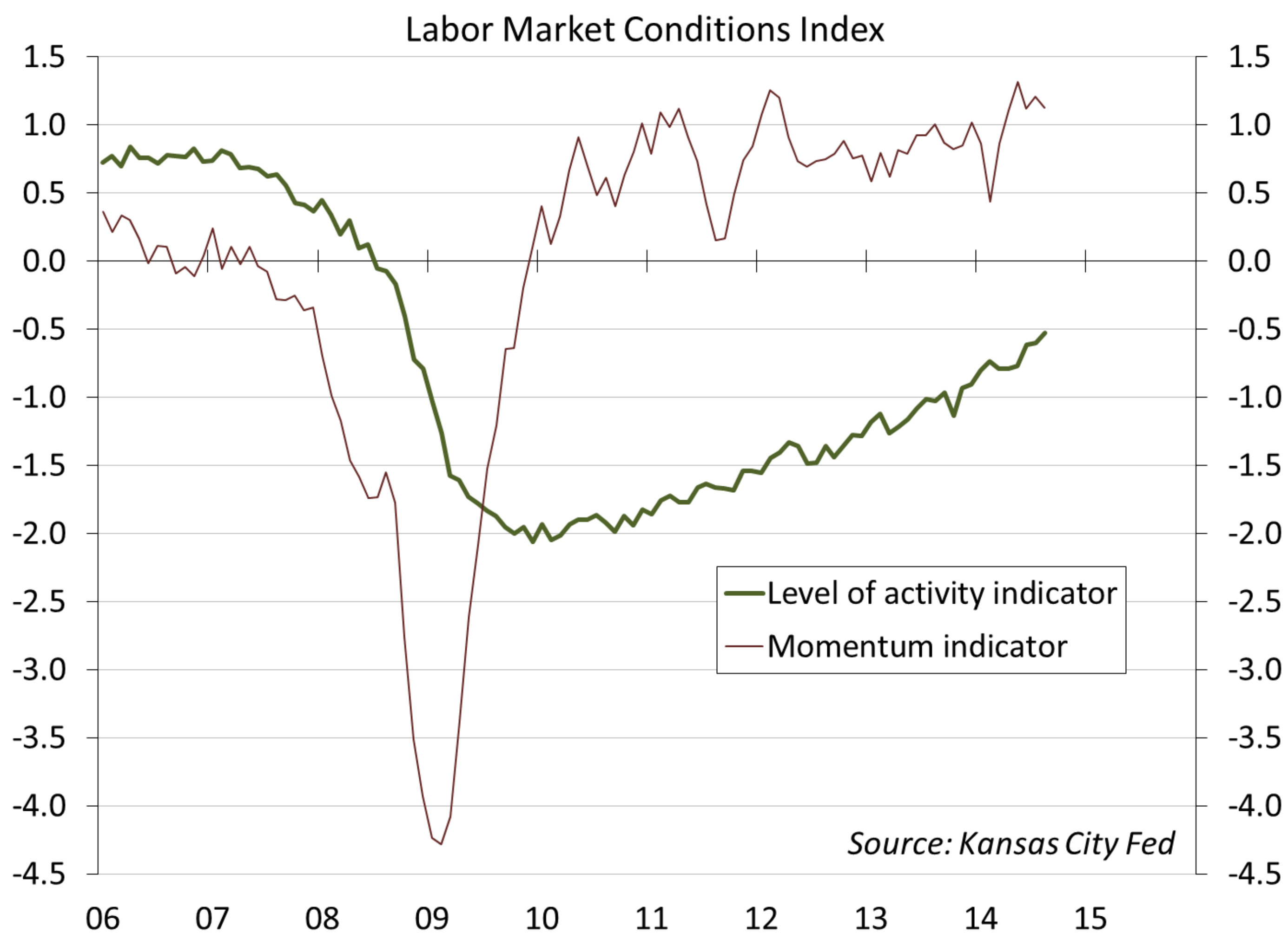
The LMCI, a Composite of 24 Job Market Measures, Shows Good Improvement, but There's Much More to Go



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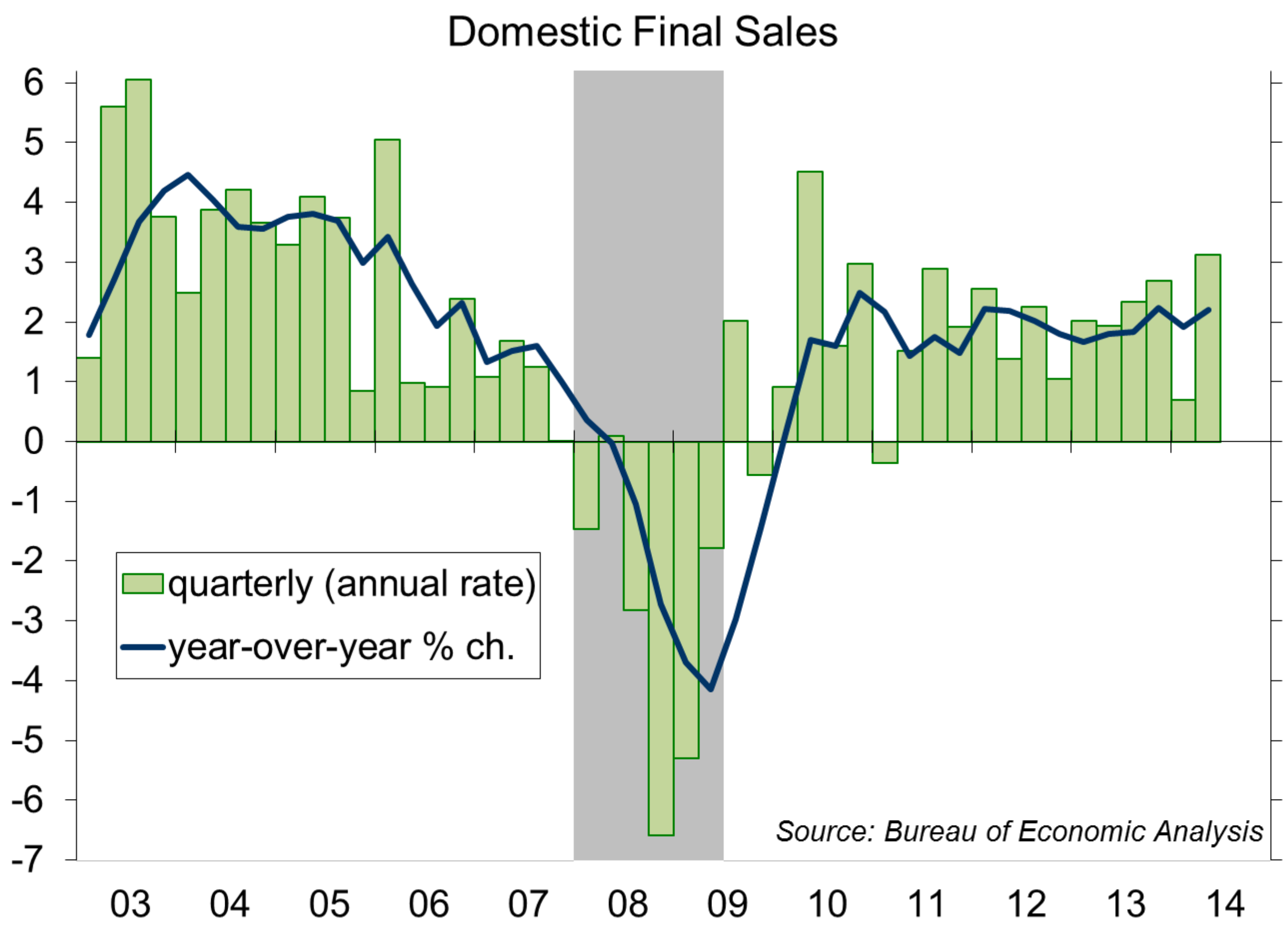
The Trend in Growth of Underlying Domestic Demand Has Been Lackluster to Moderate, but is Expected to Improve



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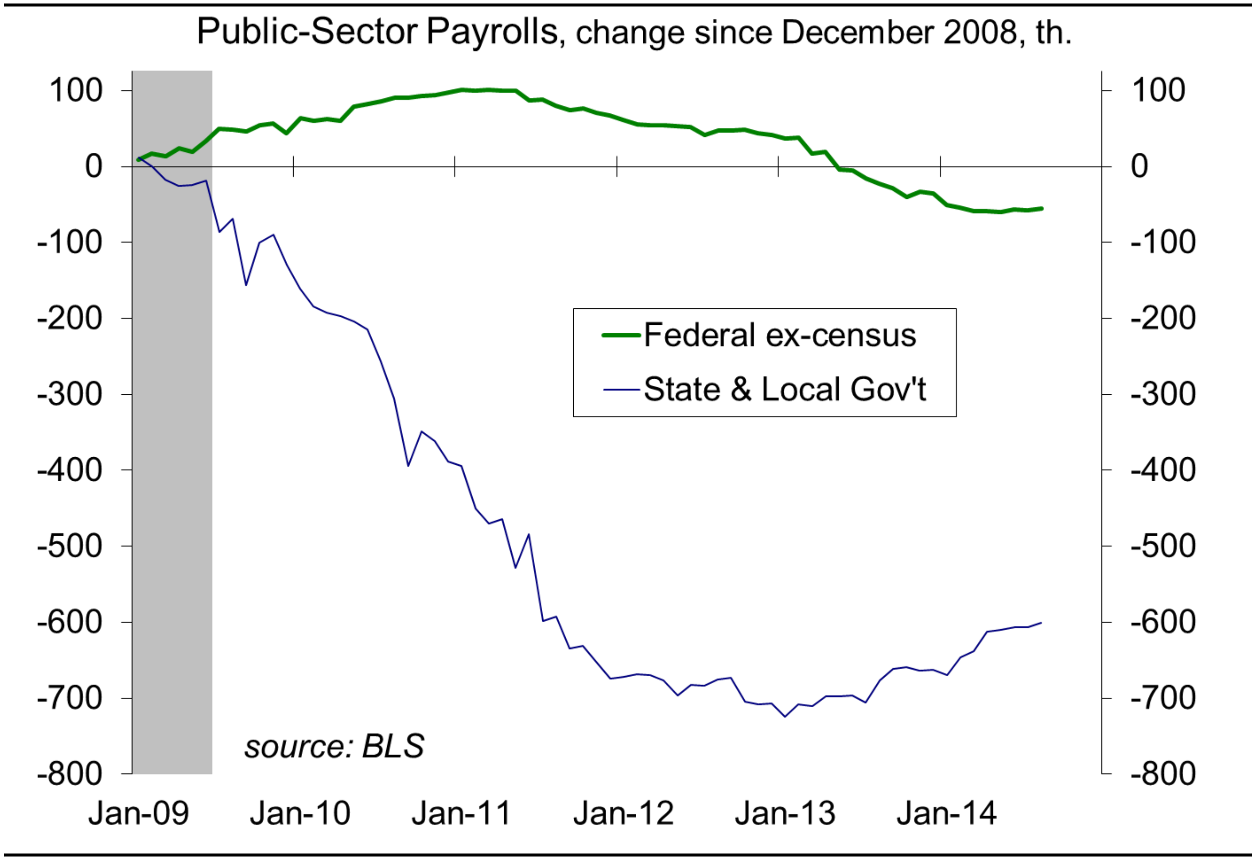
Government is No Longer a Contracting Sector and Will Now Add Somewhat to Overall GDP Growth



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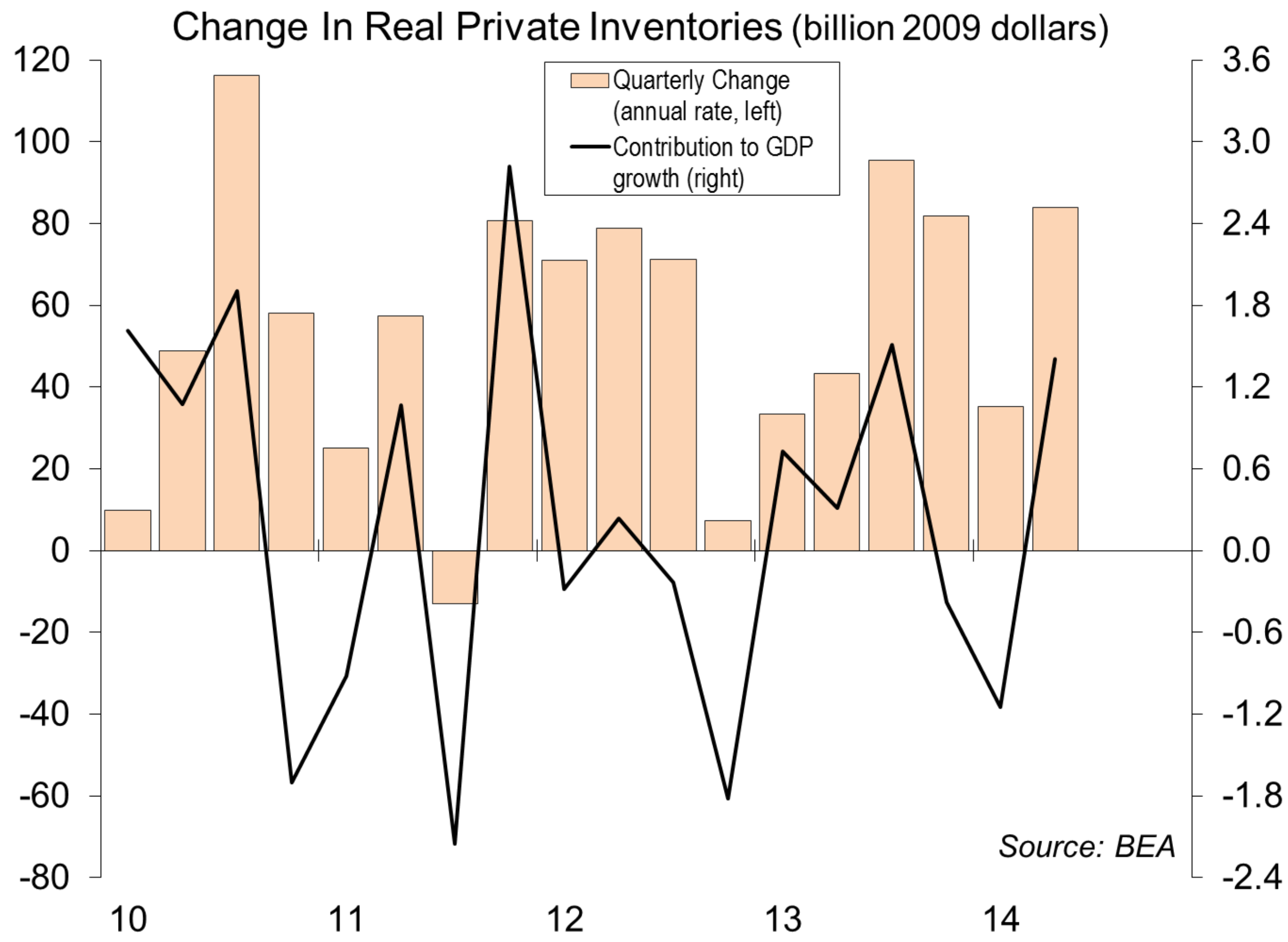
A Slower Pace of Inventory Growth Should Subtract from Real GDP Growth in 3Q14



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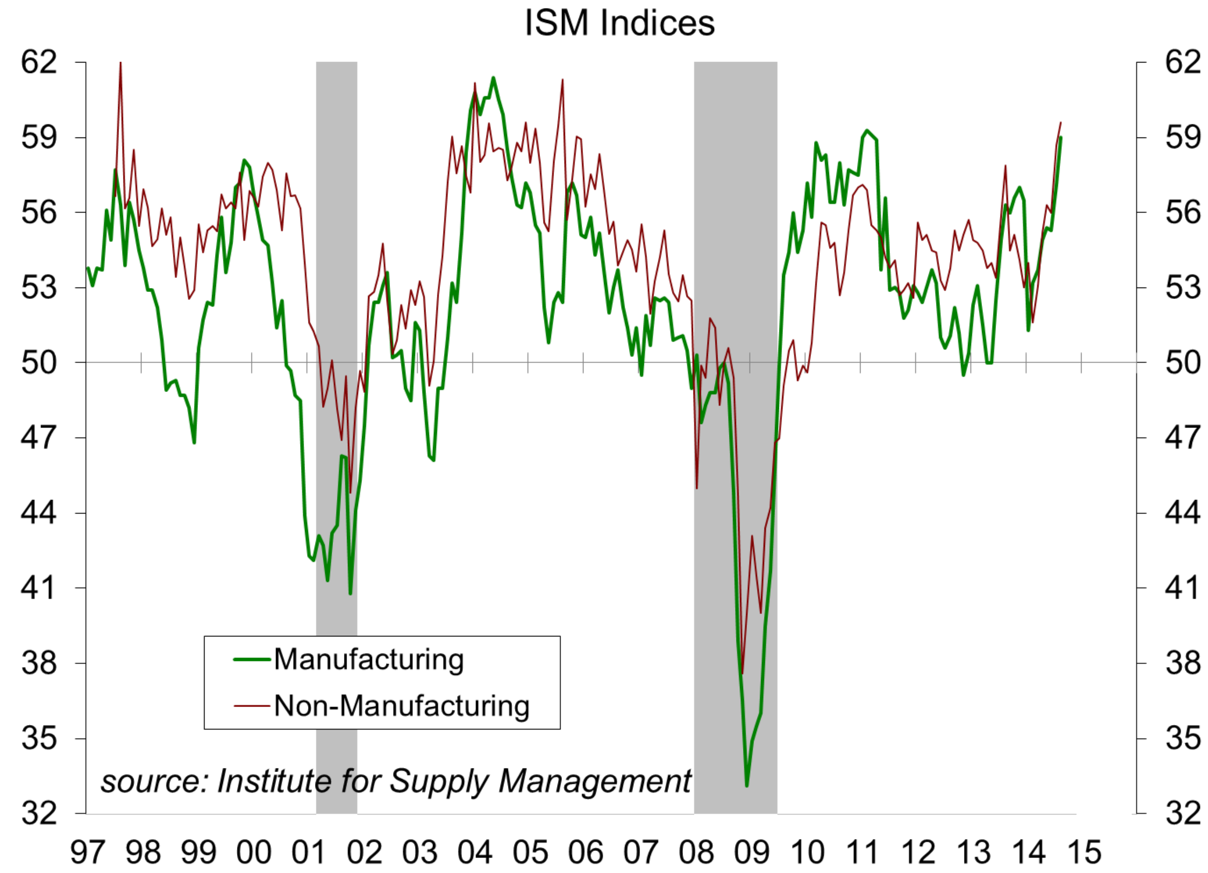
ISM Survey Results Were Strong in August



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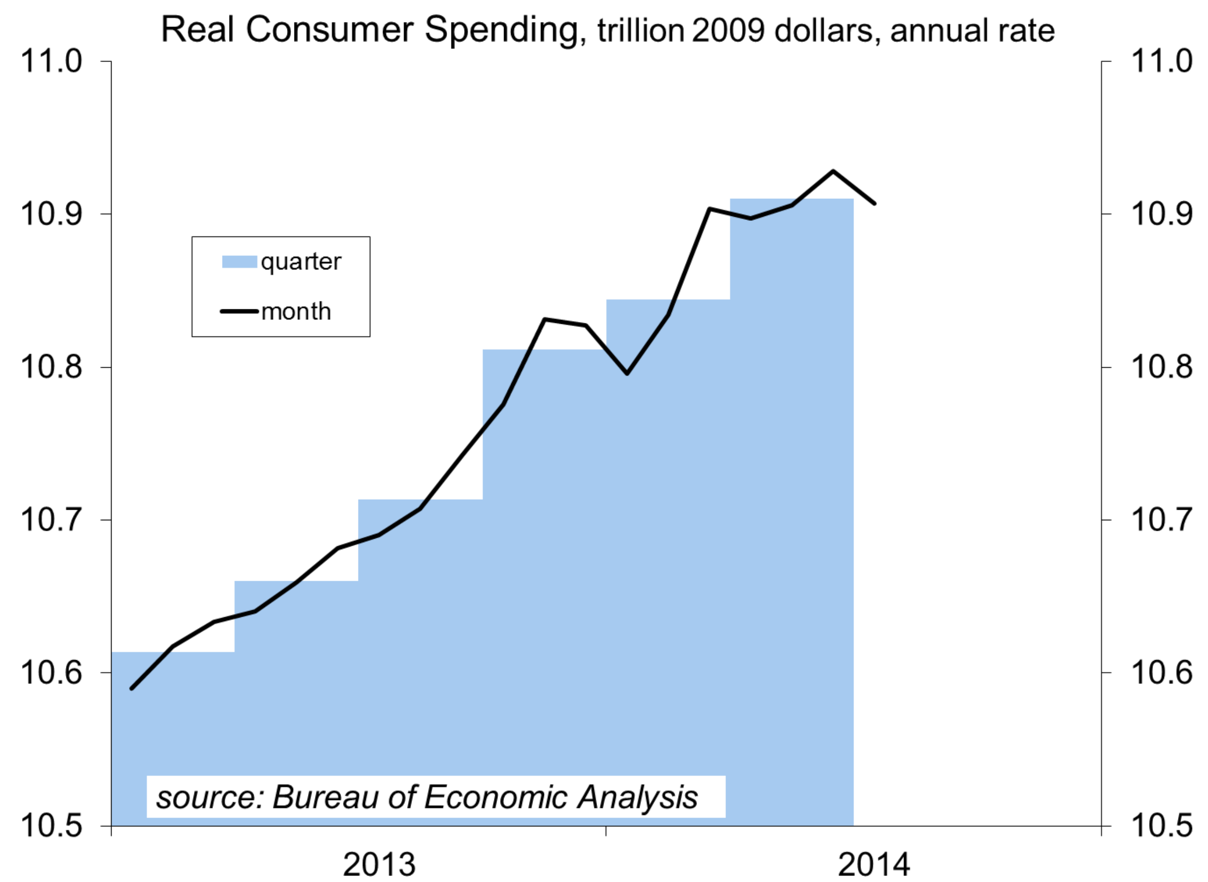
Consumer Spending Slowed into 3Q14



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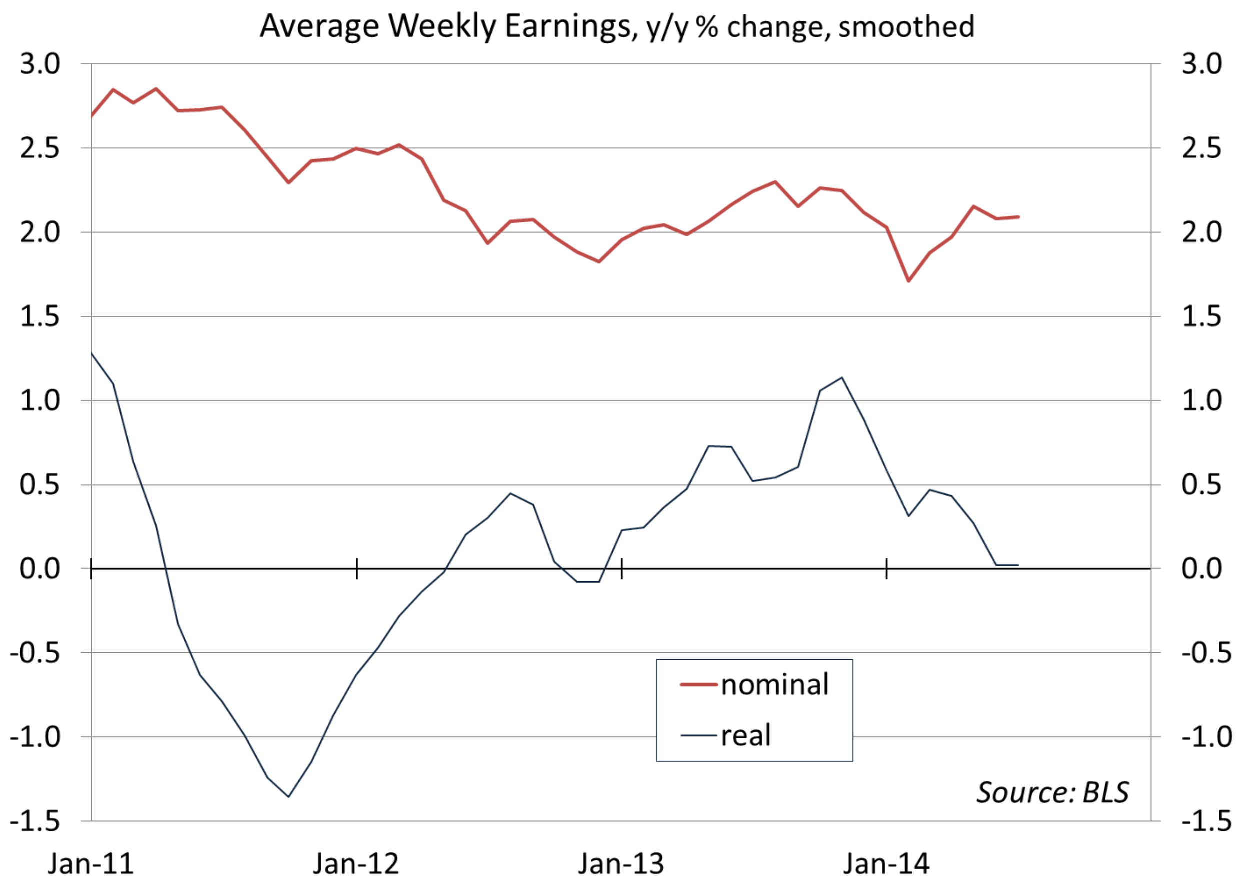
Weak Wage Growth has Been a Restraint



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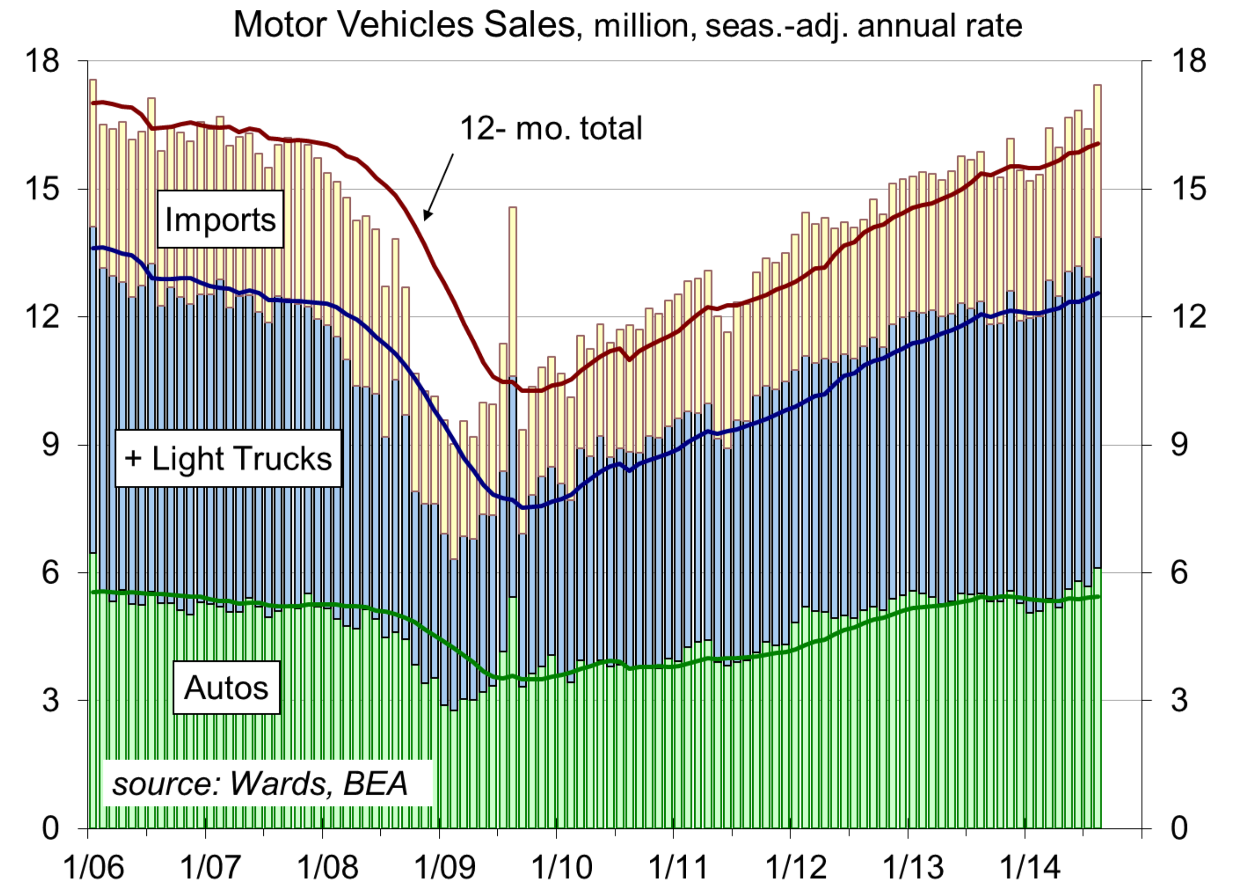
Motor Vehicle Sales Rebounded Sharply in August, the Trend Fueled by Replacement Needs and Easy Credit



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Federal Reserve Policy – Extraordinary Measures

1. **Large-Scale Asset Purchases (LSAP or "QE3")** – monthly purchases ($billion): Tapering is not "on a preset path," but Fed officials expect further reductions "at a measured pace" (-$10 billion at each FOMC meeting). It would take a significant change in the economic outlook to alter that path.

	2013	Dec 18	Jan 29	Mar 19	Apr 30	Jun 18	Jul 30	*Sep 17*	*Oct 29*
Treasuries	45	40	35	30	25	20	*15*	*10*	*0*
MBS	40	35	30	25	20	15	*10*	*5*	*0*
Total	**85**	**75**	**65**	**55**	**45**	**35**	***25***	***15***	***0***

2. **Forward Guidance on Short-Term Interest Rates (July 18)**

"The Committee continues to anticipate, based on its assessment of these factors, that it likely will be appropriate to maintain the current target range for the federal funds rate for a considerable time after the asset purchase program ends... The Committee currently anticipates that, even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the longer run."

Scott Brown

Fed Tools (to Normalize Monetary Policy)

- The **Federal Funds Target Rate** – the overnight lending rate that banks charge each other to borrow overnight
- The **Discount Rate** (alternatively, "the primary credit rate") – the rate the Fed charges banks to borrow short term
- The **Interest on Excess Reserves** (IOER) – the rate that the Fed pays to banks on excess reserves held at the Fed
- **Portfolio Reinvestment** – the Fed currently adds new securities to its portfolio to offset mortgage principal payments and maturing long-term Treasuries/when it stops, the size of the balance sheet will decrease naturally over time
- **Reverse Repos** – the Fed sells, on a short-term basis (usually overnight), securities out of its portfolio (taking reserves out of the banking system)
- **Time Deposits to Depository Institutions** – the Fed issues short-term CDs to banks (taking reserves out of the system)
  - At this point, it looks likely that the Fed will announce a range for the federal funds rate target, with the IOER at the top and the ON RRP at the bottom – portfolio reinvestment may end after the first rate hike

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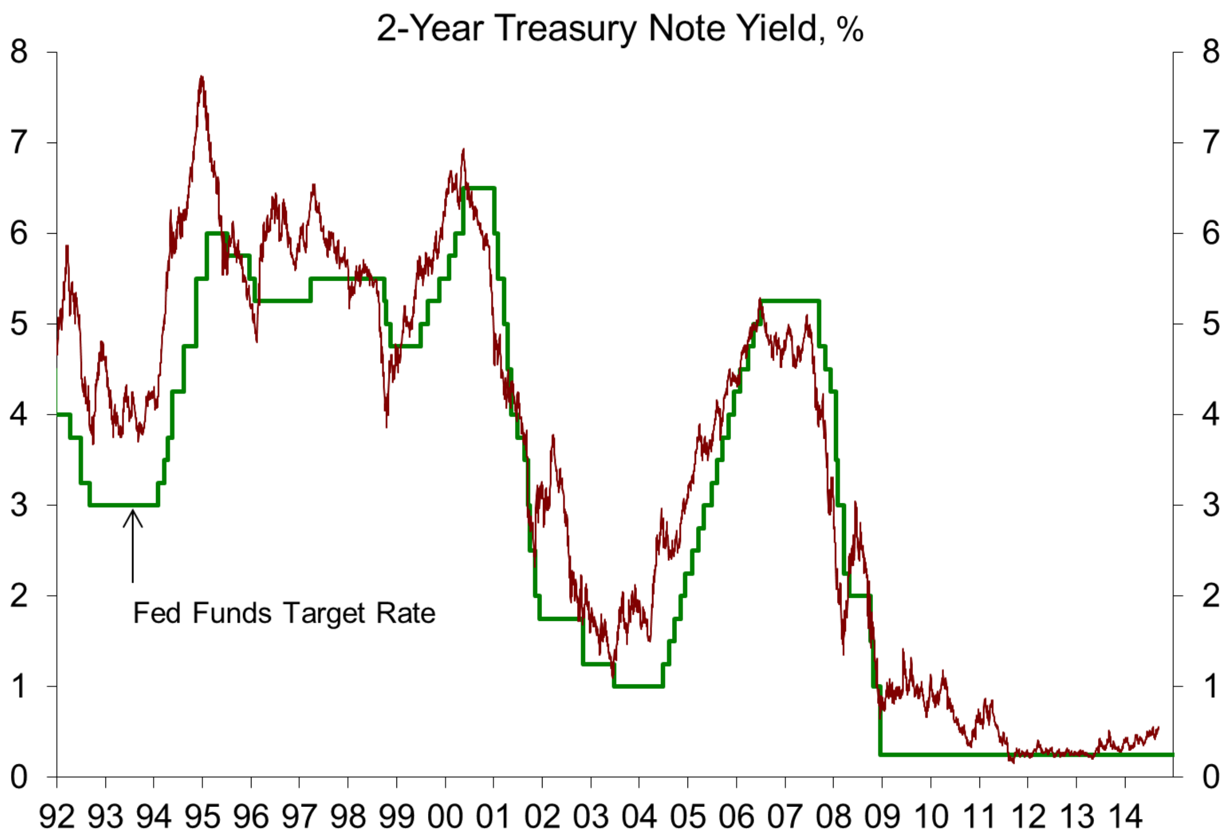
The Two-year Treasury Note Yields Suggest That the Fed is in No Hurry to Raise Short-Term Interest Rates



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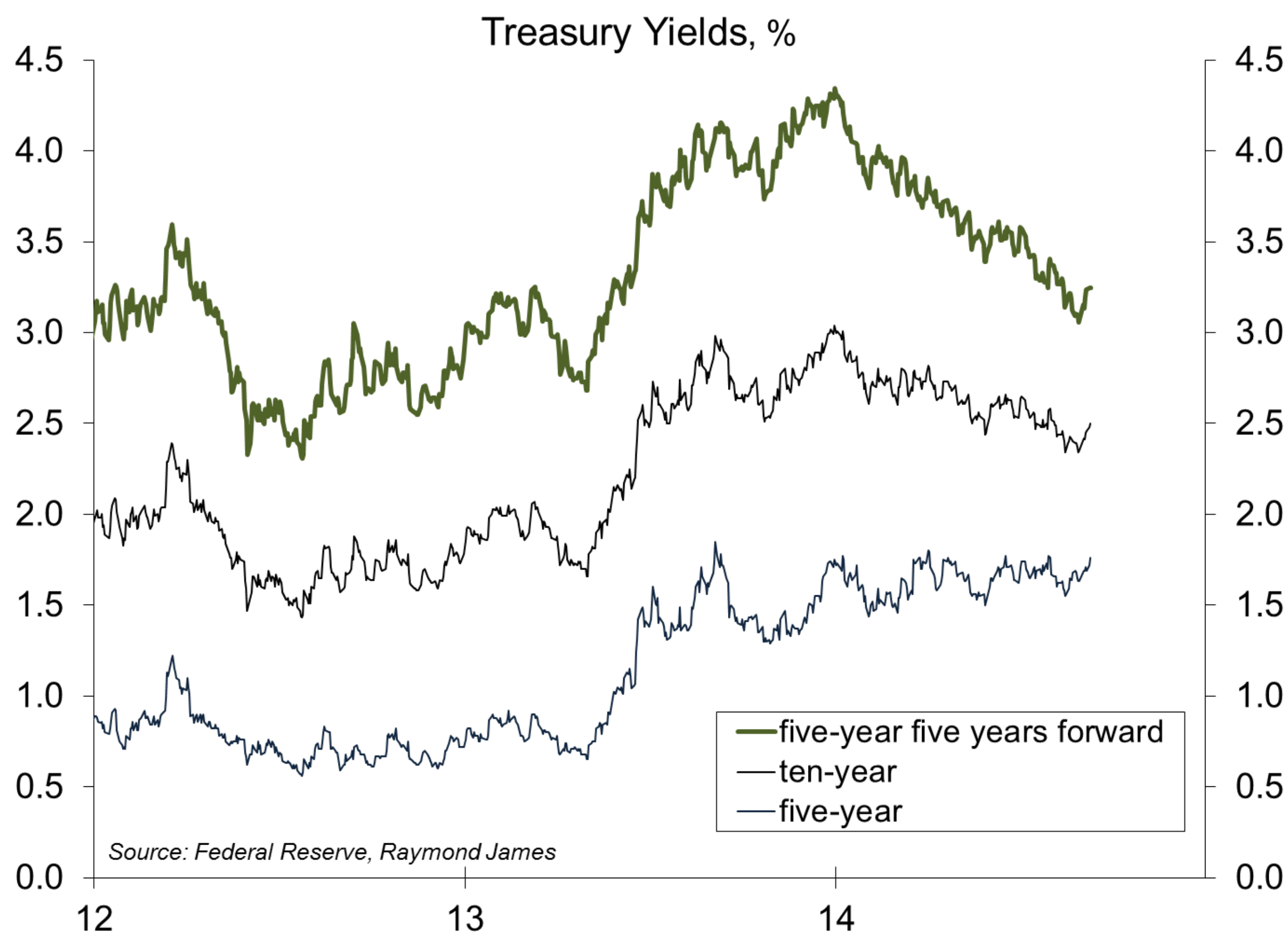
This Year's Decline in the 10-year Treasury Yield Reflects a Decrease in the Implied Five-year Yield Five Years Out



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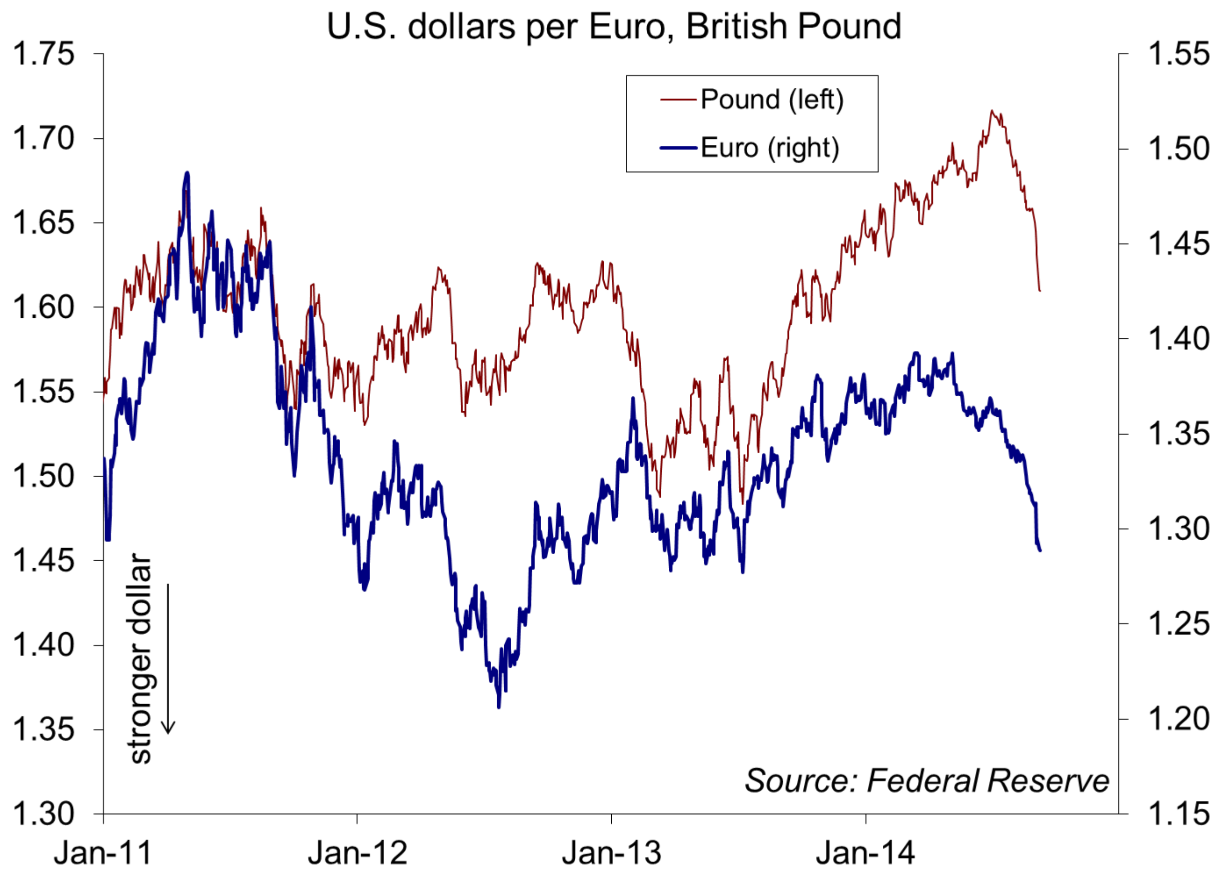
Sterling Hit by the Scottish Independence Referendum, Euro Pressured by Easing ECB Policy



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Interest Rates and Exchange Rates

- **The Fed is expected to begin raising short-term interest rates around the middle of 2015**
  - that could come earlier if the economy strengthens more than anticipated
  - or later if the economy disappoints
  - Fed rate increases are expected to be gradual
- **Long-Term Interest rates**
  - should trend gradually higher as the economy improves
  - and as the Fed gets closed to raising short-term rates
  - inflation is not expected to be a problem
- **Dollar?**
  - an easing ECB and (eventually) tightening Fed implies $ should rise
  - the pound will depend on the Scottish vote for independence
- **Trade Implications**
  - trade decisions don't turn on a dime
  - expect a somewhat wider trade deficit (higher imports, softer growth in exports), which will subtract a little from GDP growth
  - more global capital flows to the U.S.

Scott Brown

Economic Indicators

Economic Indicator	Status	Comments
Growth		The pace of underlying domestic demand should improve, but headline GDP growth figure may be restrained a bit by an inventory correction and a somewhat wider trade deficit.
Employment		Job destruction remains limited. New hiring continues to pick up. However, there is still a large amount of slack in the labor market.
Consumer Spending		After a poor start to the third quarter, spending rebounded in August. However, weak growth in real average wages is a limiting factor.
Business Investment		Capital spending has picked up further in 3Q14, reflecting more optimistic expectations for the economy. Firms remain generally cash rich and borrowing costs are low.
Manufacturing		Mixed across industries. Orders and production have improved and factory employment has begun to pick up, but there's still plenty of excess capacity.
Housing and Construction		Disappointing. The high end of the market is doing well in most areas, but construction costs and higher home prices (amid limited supply) have reduced affordability.
Inflation		The PCE Price Index rose 1.6% over the 12 months ending in July (+1.5% ex-food & energy). The Fed expects inflation to trend gradually toward its 2% goal. There's no appreciable pressure from commodities, production constraints, or labor.
Monetary Policy		The Large-Scale Asset Purchase program (QE3) is expected to end in late October. The Fed is not expected to begin raising short-term interest rates until around the middle of 2015 (and then only gradually).
Long-Term Interest Rates		Long-term interest rates should trend gradually higher as the economy improves and the Fed gets closer to raising short-term interest rates. However, long-term rates are likely to remain a lot lower than was expected at the start of 2014.
Fiscal Policy		Tighter fiscal policy is no longer a significant restraint on overall GDP growth. However, we may see renewed budget/debt ceiling battles on the Hill in the early part of 2015.
The Dollar		A more aggressive stance at the European Central Bank should put some upward pressure on the dollar in the near term.
Rest of the World		Geopolitical tensions and concerns about global growth in general are likely to remain important factors for U.S. investors over the next several months. Global growth is expected to be subpar for the remainder of 2014.

Scott Brown

Key Calendar Dates

- September 17 – Fed Policy Decision, Revised Fed Projections, Yellen press conference
- September 18 – Building Permits, Housing Starts (August)
- September 22 – Existing Home Sales (August)
- September 24 – New Home Sales (August)
- September 25 – Durable Goods Orders (August)
- October 1 – ISM Manufacturing Index (September)
- October 3 – Employment Report (September)
- October 13 – Columbus Day (bond market closed)
- October 29 – Fed Policy Decision, no press conference
- December 17 – Fed Policy Decision, Yellen press conference

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Outperform (MO2) Expected to appreciate and outperform the S&P 500 over the next 12-18 months. For higher yielding and more conservative equities, such as REITs and certain MLPs, an Outperform rating is used for securities where we are comfortable with the relative safety of the dividend and expect a total return modestly exceeding the dividend yield over the next 12-18 months.
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Underperform (MU4) Expected to underperform the S&P 500 or its sector over the next six to 12 months and should be sold.
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Outperform (MO2) The stock is expected to appreciate and outperform the S&P/TSX Composite Index over the next twelve months.
Market Perform (MP3) The stock is expected to perform generally in line with the S&P/TSX Composite Index over the next twelve months and is potentially a source of funds for more highly rated securities.
Underperform (MU4) The stock is expected to underperform the S&P/TSX Composite Index or its sector over the next six to twelve months and should be sold.

Raymond James Latin American rating definitions

Strong Buy (SB1) Expected to appreciate and produce a total return of at least 25.0% over the next twelve months.
Outperform (MO2) Expected to appreciate and produce a total return of between 15.0% and 25.0% over the next twelve months.
Market Perform (MP3) Expected to perform in line with the underlying country index.
Underperform (MU4) Expected to underperform the underlying country index.
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Strong Buy (1) Expected to appreciate, produce a total return of at least 15%, and outperform the Stoxx 600 over the next 6 to 12 months.
Outperform (2) Expected to appreciate and outperform the Stoxx 600 over the next 12 months.
Market Perform (3) Expected to perform generally in line with the Stoxx 600 over the next 12 months.
Underperform (4) Expected to underperform the Stoxx 600 or its sector over the next 6 to 12 months.
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	Coverage Universe Rating Distribution				Investment Banking Distribution			
	RJA	RJL	RJ LatAm	RJEE	RJA	RJL	RJ LatAm	RJEE
Strong Buy and Outperform (Buy)	55%	69%	50%	45%	24%	38%	0%	0%
Market Perform (Hold)	41%	28%	50%	40%	9%	25%	0%	0%
Underperform (Sell)	4%	3%	0%	15%	0%	20%	0%	0%

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Total Return (TR) Lower risk equities possessing dividend yields above that of the S&P 500 and greater stability of principal.

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