Starfox Financial Services, LLC

Market Update

March 2015

MARKET SNAPSHOT	
DJIA	18116
Nasdaq	5011
S&P 500	2104
Comex GOLD	$1190

(closing values March 23, 2015)

CURENT OUTLOOK AND COMMENTARY

Three and a half years of growth in the S&P 500 without a 10% correction. The current rally of more than 1250 days is the 3rd longest period in history without a 10% or greater correction; the 2nd longest ran from 2003 to 2007 (1673 days) ending with the worst bear market in recent memory. Because corrections have a tendency to restore price efficiency, long periods of market expansion without corrections tend to result in corrections of greater magnitude when they do finally occur.

If history is any guide, the markets are due for a correction based on time alone, but other factors appear to indicate a correction is needed to restore price efficiency as well. A long period of highly accommodative Fed policy including QE and zero Fed Funds Rate, as well as, record levels of portfolio leverage being used for speculation and the record pace and volume of corporate stock repurchases may have allowed the market to become significantly mispriced and in need of a correction. A correction would be a shock to yield-hungry investors whose search for yield may have caused them to take too much risk. Tactical investors who have taken advantage of recent market highs to raise cash or have been underweight based on their objective, may benefit greatly from the opportunities presented by a significant correction.

The Fed's Conundrum

Whether investors fear a rate increase or embrace one is unclear. What is clear, is that the uncertainty about if/when the Fed will raise rate has made for a very volatile year so far. Typically, a decision to raise the Federal Funds Rate from zero, would be a confirmation that the macro-economic picture has improved enough to support higher rates. Recent uncertainty centers on changes in Fed language and posture that appear indicate a shift in Fed policy that many feel signals they intend to raise rates this year, while data suggests inflation is far too low to allow a rate increase in the near term.

Their decreasingly dovish tone and recent talk of raising rates introduces a new conundrum for the Fed. The Fed appears ready to increase rates despite economic data that might have previously been used to justify an additional round of QE. With the exception of employment numbers, which have continued to improve, economic data has been weak. Based upon a composite of economic data readings, the prior policy stance would have called for more QE, or rate decreases if not zero bound. (www.zerohedge.com)

The Fed's conundrum—They have been signaling a possible policy change but data is mixed at best

1) The labor market has seen 12 consecutive months of 200k+ job creation– Indicating significant strength in the labor market.
2) Underemployment (U6) still double digits– Too high to ignore.
3) No inflation– Real wages are going nowhere. CPI is nowhere near 2% target
4) Dollar has been soaring– Hurting exports.
5) Import prices are falling– Importing deflation, hurts US producers.
6) 1st Quarter GDP looks soft– Est. 0.3%
7) ECB has just begun massive 18 month QE

Perhaps more than any potential rate increase, the Fed's current language and posture are a significant departure from the monetary policy investors have become accustomed to since the beginning of the financial crisis, representing a significant potential threat to asset prices. Much of the markets climb to new highs has been built on an explicit promise, backed up by actions, from the Fed to support asset prices. If Fed policy continues toward rate hikes without support from economic data confirming strength, the move may be viewed as an end to the Fed's promise to provide price support to financial assets causing a significant correction to occur.

Margin debt is at record highs. The use of margin has fallen steadily over the last 12 months but total margin debt remains very near the record highs of February 2014. The steady decline from the peak could indicate a decreased appetite for speculation and possible problems if the trend continues. As the use of margin has decreased over the past several months, so has the pace of market growth; a trend that appears to validate our belief that the use of borrowed funds to purchase stock has been a contributing factor in pushing the market to new highs. Both the high level of margin debt and the declining pace may have a negative effect on future market values.

Record level of stock repurchases. The volume of stock repurchases that occurred in 2013 was the highest on record, 2014 narrowly missed setting a new record with almost $914 billion in repurchases and 2015 is off to a strong start. Stock repurchase are intended to return capital to shareholders by spending money in a way that makes the stock value go up and shareholders wealthier as a result. A clever little side benefit of stock repurchases is that they inflate the earning per share metric (EPS) and reduce P/E's making stocks appear to be a better value. Repurchases don't actually do anything to improve earnings and can often mask earnings weakness by artificially maintaining stock values even when earnings are falling. The abnormal volume of repurchases over the past several years may have played a role in pushing the markets higher than they might have gone without the price support repurchases provide. As the rate of repurchases slows to a more normal pace, a more accurate valuation will emerge potentially resulting in lower overall market values.

The only thing we can be certain of this year is that the markets (stock and bond) will be more volatile than they have been and the return of volatility may present as much tactical opportunity as it will emotional risk.

***Please contact us if you would like to discuss how our recommendations may apply to your specific situation.**

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