

Awkward Aftershocks

Although the market's third quarter performance was nearly cataclysmic, its gyrations had very little to do with burgeoning fundamentals in the global economic recovery. Or did it?

Equivocation? Contradiction? Not really. Television talking heads and market pundits use a kind-of "grey speech" to voice their opinions about a variety of data. It's commonplace to conflate two situations and call them "causal". Right now, it's popular to attribute market volatility to *global economic instability* and suggest they are the same. Obviously, these issues are much more complex than slogans.

It goes without saying that since mid-summer (S&P 2120) we have been in a rather strident market correction. Ascribing that correction to specific factors (Greece, China, The Federal Reserve Board) is analogous to looking for causality for *any* cyclical event without first looking at quantification corroboration. **In our judgment the markets rose too far and for too long, and too excessively, during the final phase of this rally.**

The reasons for the 5 year rally, and the extraordinary "upside linear spike" which punctuated it, are many, not the least of which facilitated by accommodative monetary policy that allowed hoarding of corporate cash, then to be used for share buybacks and additional non jobs-related endeavors on behalf of their stakeholders. **I have argued enduringly that corporate profits and share price capital appreciation which derive from accounting manipulation or anything but consumer demand (building a better mousetrap) are specious at best and untenable at worst.** Thus, portfolios are now paying the piper for all those excesses of greed. It's as if we created a mini "housing bubble" all over again, except with stocks as the culprit this time. All along, the "wall of worry" we climbed created a schizophrenic sense of anxiety about when it might end juxtaposed against euphoria over an increase in our net worth.... none of which was greeted well when the predictable catalysts came along to bring valuations back to reality.

While metaphysical certitude is never assured, most everyone knew instinctively that the other shoe was going to drop at some point. This is why I cautioned clients that "benchmark high water marks" achieved in their portfolios earlier in the year were not permanent. It is fascinating to observe what we know in hindsight, and what we choose to ignore in the moment.

As an earnings driven investor, I reaffirm our belief that the economy is getting better, selectively, but that those improvements are not widespread amongst all publicly traded equities...nor are they distributed equally amongst all sectors and geographies. In fact, the recovery is quite youthful from a quantitative point of view, and still looking for solid footing after a tumultuous credit crash and commodities-led capitulation. We know, for example, that manufacturing activity and inventory expansion during robust periods tends to mirror public confidence (purchasing), and by that standard alone we are still in for a long slog trying to build top-line revenues and bottom line profitability. We are still waiting for consumers to pick up the slack and "do their part".

In fact, were the market to continue its sell-off, it would only postpone assumptions about a turnaround in consumer confidence. I would not be surprised if this coming holiday shopping season was tepid.

Overview

The Federal Reserve has also been making news recently, saying it will do its best with monetary policy to mirror economic development while also being sensitive to anecdotal emotional constraints. It is a fine tightrope to walk between ensuring growth while maintaining monetary compassion for political and fiscal trends that have been punitive for the less fortunate. Being at the bottom of the interest rate trend line leaves the Fed no choice but to accept that the parabolic curve will migrate upwards whether they like it or not. By their own words in speeches given towards the end of September, the Fed governors are saying this and preparing us for that inevitability. As soon as the market acknowledges that premise, also, I believe some of the volatility in trading will abate.

The Fed really has no choice at this point but to abide by the weight of the statistical, quantitative, fundamental, and market evidence which suggest that the trend is ripe for reversal, and must, in fact, do so to complete a long gestation at the bottom. While it won't be until 2016 that the effects of a rate rise might be felt, any action taken now should have immediate impact to decrease uncertainty within the financial markets. An uptick in interest rates would be a logical, consistent effort towards normalizing the phases of market cyclicity and performance.

It has been a long road back from the aftermath of 2008's credit collapse. The market's third quarter meanderings and volatility have been a good indication of fundamental, technical and psychological discomfort. Negative perceptions drawn from a constant barrage of 24 hour news cycles are morphing market trading sessions into a self fulfilling prophecy of indiscriminate fear and panic. The recovery has been restricted to only a select few categories and sectors. In that regard, the stock markets have become a parable of the distinctions between the "haves" and

the "have-nots", underscoring the gap between the two. **History tells us that when a climate of optimism abounds, the prospects for economic sustainability improve.** We are not there yet.

Much of the criticism for the market's commotion last quarter was attributed to the term "globalization", more specifically difficulties in Greece and China. No doubt that geopolitical disarray certainly contributed to a school of thought that holds "*if China sneezes, the rest of the world catches a cold*". But our analysis subscribes to another way of looking at this chain of events, one which widens the aperture of perception:

We view globalization... the integration of political, monetary, and cultural processes around the globe... as a means to providing commercial solutions and capital gains opportunities for individual investors, corporations, and governments, contributing to capital flow and capital formation during times of insecurity or destabilization. For example, the recognition of South America and Latin America not only as traditional natural resource economies, but as technical leaders in telecommunications, merchant and commercial banking, and manufacturing, positions that region as a logical consideration for our investment allocation. I also expect to see our portfolios overweighted this quarter in Utility and Technology shares on a global scale.

Any aspirational commonalities amongst the globe's diverse economies are more compelling than their differences, and form the basis for profit opportunity and cultural cooperation in finance, infrastructure, natural resources, medicine, agriculture, and ecology.

There is indeed a difference between managing micro and macro investment particulars. But our belief is that, barring war or other exogenous unforeseen influences, there will be profit and growth for equities during the next quarter. Even if wages, core costs, and interest rates were to rise, industrial activity should keep pace with modest demand. We are not naive about the obstacles already in front of us, but will be measuring key components, like jobs growth and credit applications, to confirm our expectations for a market push. As always, consumer activity and confidence holds the key to untangling the market from the vagaries of disruptive unpredictability.

Conclusion

It will take awhile before the after-effects of a wild third quarter are digested and understood. Unfortunately, total return has always been a "*what have you done for me lately*" competition, rather than a more subdued approach of reviewing security of principal, asset allocation, vector direction and long-term macro cycles. There are good people on both sides of that issue, and good reasons, both short term and long term, about why the markets did...and should have....pulled back. However, those explanations don't assuage clients who see their monthly valuation statements decline in consecutive months. As a client myself, I am sympathetic to those anxieties, but must add that global and regional current events over which we have no control play a key role in determining the rising and lowering of the tide. We know unequivocally, however, and I had been writing prolifically, that our proprietary quantitative statistics were indicating an apex of this trend, and that capitulation (decline) was most likely.

I alluded earlier in this missive to the unusually large disparity between sectors that are doing well and those that are struggling to gain traction. An even bigger breach also lies between those investors who feel "successful" and those who feel left behind by the swirl of Wall Street. Our reactions and responses to those two dilemmas might be quite different in the abstract, but frame the essence of the most significant political and moral discussion of our time. **While we on Wall Street, those in the corporate sector, and politicians may spend a lot of time debating integers and X's and O's, let's not forget that there are real people with real issues on the other end of our statistics.**

Even though "speculators" appear overly obsessed by market mini-cycles, it's pretty clear that recovery is a long process (never steady, straight-line, or consistent), and typically requires significant buy-in from political, monetary, corporate, and spiritual quarters.

Zero-sum economics is *not* the key to sustaining the markets. No, this is a game that requires patience and capital commitment. If we can withstand some near-term vulnerability while remaining prudently invested, I have every reason to believe the data is moving in the right direction, towards improvements in wages and standard of living, economic and ecological sustainability, and long term capital gains in the financial markets.

In fact, I would have been more worried had we *not* had the shock of last quarter's demise.

I expect global bourses to continue testing, then re-testing, technical supports during this next quarter while they search for a price and psychological equilibrium which brings into harmony current conditions that mirror both the constraints and the opportunity of the current secular advance. An unusually sharp disparity between *what's real* and *what we perceive* is causing market tension, and only one of these characteristics can be "true" at any given point.

Suggested Balanced Account Asset Allocation Q4, 2015 Equity 55% /Fixed Income 20%/ Cash 25%

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