4th Quarter Playbook

The first three quarters are in the books and the setup for the fourth quarter is as exciting as it gets. I would advise not falling asleep just yet, as the game is just getting started. You will see the lead change between Team Bulls and Team Bears multiple times throughout this next quarter. There will be the occasional turnover and even the potential for a trick play. But, one thing is for certain, the fourth quarter will not lack excitement.

The first drive of the fourth quarter has started with sentiment levels at extreme lows. On September 29th, the Investors Intelligence Bulls & Bears poll registered its lowest reading of the year at 0.70. This number reflects the percentage of bulls to bears. When the indicator is below 1, there are more bears than bulls. The contrarian would sit back and say there is way too much pessimism for the market to continue falling. I would agree with that observation to an extent. The fall from record bullishness to bearishness over such a quick timeframe is nothing short of breath taking. It is the speed at which this has taken place that I do believe we may experience a sharp rally within the next few weeks. In fact, as I write this column the S&P 500 has logged its first 5 day win streak in 2015 and largest 5 day win streak since July 2011 with a 5.59% increase. However, don't be fooled by a rally based on extreme bearish sentiment vs. a rally based on a change to improving fundamentals. The latter is sustainable, while the former is only a temporary change in trend. I suspect this early quarter rally may catch Team Bears by surprise, but I do not believe the drive will eat up too much of the clock. In a desperate attempt to take the lead Team Bulls are overcome by earnings announcements and turn the ball over.

Beginning the week of October 12th, earnings announcements begin to pick up some steam. The bulk of announcements will take place between October 19th and November 6th. Based on current estimates, the S&P 500 operating earnings for the third quarter will come in down 3.34% vs. third quarter earnings in 2014. If the estimates hold true, this will mark the fourth straight quarter of year over year negative earnings growth. As I mentioned in my column last month, the only time the S&P 500 has posted this many quarters of consecutive negative earnings growth was before the recessions in 1990-1991, 2001 and 2007-2009. However, stock prices typically don't react so much to what is reported, but rather what is forecasted. As of September 30th, fourth quarter estimates for the S&P 500 are expected to rise 13.72% vs. fourth quarter earnings in 2014. The consensus reasoning for such an increase in fourth quarter earnings is that the strengthening of the U.S. dollar and falling oil prices will no longer be a headwind. Well, I've got bad news. Just look at the year over year comparisons and you'll clearly see these two factors will most likely remain a headwind throughout the fourth quarter (stronger dollar and weaker oil). Therefore, it is becoming increasingly likely that fourth quarter estimates will be revised down causing Team Bears to maintain a clock eating drive resulting with points on the board.

	Q4'2014 Average Price	Price on 9/30/2015	% Change
U.S. Dollar Index	$88.00	$96.35	+9.49%
Crude Oil	$73.23	$45.09	-38.43%

But, not so fast! The game isn't over yet. Just as the fans are headed for the exits, Team Bulls pull off the unprecedented fumblerooski as the FOMC meet for two scheduled meetings on October 27-28 and December 15-16. For the majority of the year, the consensus expectation was for a rate hike announcement following the September meeting. If you've regularly read this column over the past year, you likely have noticed I don't tend to blindly follow consensus thinking. In January, I stated the following...

"As for 2015, what does the future hold? I've never been big on making market predictions. Part of the reason is we are a bottom up manager, so getting individual companies right is more important than where the S&P 500 is headed over the next year. However, I do believe there is a decent probability volatility will become the buzz word again in 2015, which leads to the first stock market correction (10% or more) in over 2 and a half years. In turn, the Federal Reserve will not increase the Federal Funds rate in 2015 and in fact, may very well re-introduce QE. The wild card in this scenario would be the reaction of the equity market. Do we see much of the same, a swift recovery in equity prices or does the equity market not react to the latest Central Bank intervention? This is a question I suspect will be answered this time one year from now."

Well, I still believe the exact same thing as I did back in January. The Federal Reserve will not raise rates this year or most likely next year for that matter. As macro data points continue to deteriorate, the Federal Reserve find themselves in a bind. They need to hike in order to give them additional ammunition to fight off a future recession. But, they won't hike in the face of a slowing economy. I still contend that the U.S. economy is in the midst of a late cycle slowdown and closer to a recession than most people want to believe. So, you're probably wondering by now where does the fumblerooski come into play? The trick play may be disguised as additional quantitative easing or QE4 for those keeping track at home. Many of you are most likely scoffing at this notion. It surely isn't consensus thinking right now, but it is in the realm of possibilities. It may not come in the form of buying X amount of Treasury and mortgage-backed bonds every month. Instead, as one Federal Reserve member hinted at the last meeting, negative interest rates may be on the way. Granted, this was one individual expressing his or her view, which does not necessarily reflect the view of the Federal Reserve. However, this was the first time negative interest rates have been forecasted by any Federal Reserve member. And, there you have it. The trick play is currently being drawn up in the dirt. The only question now is when to execute the play.

However, the ultimate wild card still remains the same. How will equity markets react to additional monetary easing? This outcome could dictate the ending to 2015 and set up what's to come in 2016. History tells us that the market will rally higher with additional QE. The jury is still out on the actual economic benefit, but at the very least financial assets will perform well - that is if history is any guide. There is the chance investors will finally see through the artificial boosting and manipulation of financial assets and decide to sell. Again, consensus falls on the side of more QE equals a higher stock market. Unfortunately, only time will tell. In the meantime, there is no reason to react to every pump fake the market throws at you. If you haven't done so already, go ahead and devise your game plan. This way you won't be caught offside through every twist and turn of the fourth quarter.

--Billy Little, CFA

"It requires a great deal of boldness and a great deal of caution to make a great fortune, and when you have it, it requires ten times as much skill to keep it." ~ Ralph Waldo Emerson