

On October 1, 2015, the start of the fourth quarter, the Wall Street Journal summarized the previous three months in its headline which read, “Painful Quarter for Markets.” They weren’t wrong, as the S&P fell 6.9%, the NASDAQ, 7.4%, and the Dow Industrials, 7.6%. Commodities like gold, copper, ore, oil, natural gas, wheat, etc. all had a rough three months, along with non-investment grade bonds, whose aggregate yield¹ approached 8% from 6.5%. Markets in developed and emerging economies across the globe all took part in the broad sell-off, some worse than others. These recent events have left investors to question whether another global recession is imminent as the last quarter of 2015 begins. To summarize the next three pages, we do not believe it would be wise to heed the doomsday advice of former Congressman Ron Paul’s commercials or the countless Yahoo! finance articles calling for ‘Dow 5,000’.² To quote the old saying, “Markets have correctly predicted 11 of the last 6 recessions.” We believe it is clear that the U.S. is not at the beginning of an expansion, but it is not at the end of one either.

Every January, Doxa Capital releases a market forecast for the year ahead, estimating earnings and the multiple³ twelve months into the future (while always recognizing that forecasting a short term market multiple is near impossible)³. Through the first nine months, we are pleased to say that not much of a revision is required. In our report, [found here](#), we initially forecasted a target of 2,150 for the S&P 500 on \$125 of aggregate earnings. At the time, most large firms forecasted earnings around \$130, sometimes even higher.⁴ Sweeping negative revisions in September brought those estimates south of \$120, meaning 2015 will have no earnings growth.⁴ The point here isn’t to score who is closer - it is to demonstrate that the consensus estimate has a great track record of overshooting actual numbers. We do not find it probable that corporate earnings retract this year, nor do we see a blockbuster holiday season looming. Our revised estimates exhibit this ‘slow growth’ mentality as we reduce our 2015 earnings target to \$124 (5% y/y growth) and corresponding S&P 500 target to 2,100. We derive our 2,100 target by using a

Global Index Performance, 3rd Quarter - 2015			
Index	Close	Chg	% Chg
Dow Jones			
Industrial Average	16284.7	-1334.8	-7.6
Transportation Average	7785.63	-306.7	-3.8
Nasdaq Stock Market			
Composite	4620.16	-366.7	-7.4
Nasdaq 100	4181.06	-215.7	-4.9
Standard&Poor's			
500 Index	1920.03	-143.1	-6.9
SuperComp 1500	444.16	-34.3	-7.2
Other U.S. Indexes			
Russell 2000	1100.69	-153.3	-12.2
PHLX Gold/Silver	46.25	-16.9	-26.8
CBOE Volatility	24.5	6.3	34.4
JPM Index (U.S. dollar)	96.8	-0.8	-0.8
World			
DJ Global Titans 50 (World)	218.16	-18.3	-7.7
Shenzhen A Shares (China)	1795.36	-782.1	-30.3
Hang Seng (Hong Kong)	20846.3	-5403.7	-20.6
Nikkei 225 (Japan)	17388.15	-2847.6	-14.1
Stoxx Europe 600 (Europe)	347.77	-33.5	-8.8
DAX (Germany)	9660.44	-1284.5	-11.7
FTSE 100 (U.K.)	6061.61	-459.4	-7.0
Sao Paulo Bovespa (Brazil)	45059.34	-8021.5	-15.1

Source: WSJ Market Data Group

¹ Aggregate yield is the stated yield of the Bloomberg USD High Yield Bond Index.

² Multiple = value / earnings or cash flow. Also known as a price/earnings ratio.

³ Due to the volatile nature of markets over the short term, estimating a correct market multiple is sporadic.

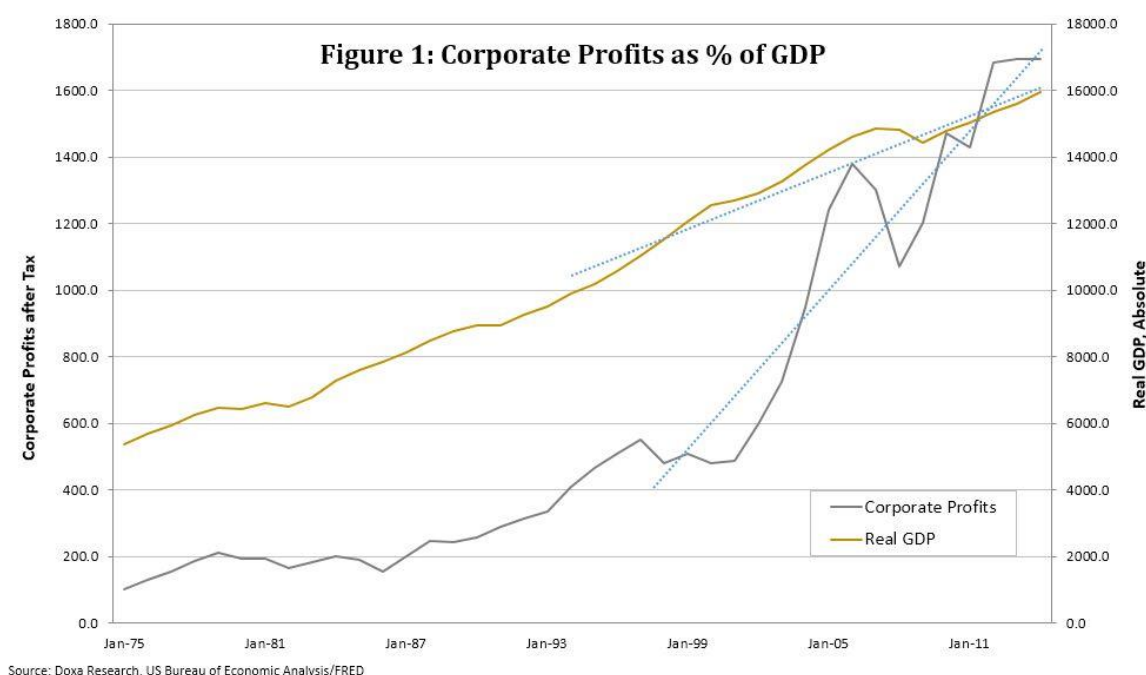
⁴ 2014 aggregate earnings for the S&P 500 Index were \$118.

forward multiple of 15.8, above the long term average of 14.1⁵ and below last year's forward multiple of 16.6.⁶

Slow and not Steady

We have maintained the belief that the US economy is in the normalization stage of the economic cycle (Recession – Recovery – Normalization – Expansion)⁷, which means the expansion is still ahead. Recent market events this summer prompt many to disagree, arguing that the US is headed for more 'quantitative easing' or another recession. While it would appear that an expansion or recession are two drastically different outcomes interpreted from the same economic data, we believe the difference is in the measuring stick, not the conclusion. It just doesn't quite make sense to judge today's world by the logic of 1975.ⁱⁱⁱ Outside of obvious differences, structural changes stemmed from the last decade that have altered the 'normal'.

- 1) **Profit margins will stay high.** Outside of recessionary periods, corporate profit margins have been above average⁸ for two decades. Recently they were even higher, just over 9% the past 4 years. Many people abide by the 'peak margin' theory, which means a company cannot sustain above average margins for a long period of time.⁹ While this is largely true, we believe the 'peak' is higher than originally thought. Notably, some of America's largest companies¹⁰ are tech giants like Apple, Google, or Facebook - all of which have net margins above 21%. In fact, over 20% of the 1500 largest companies in the U.S. have \$0 worth of inventory. In 1975, that was true of less than 5% of the 1500 largest.^{iv} Technology also breeds productivity and efficiency across industries, and both equal higher sustained margins.



⁵ This average is computed over ten years using forward 12 month consensus estimates.

⁶ Please see the attached table 1 for a breakdown of our 2015 estimates.

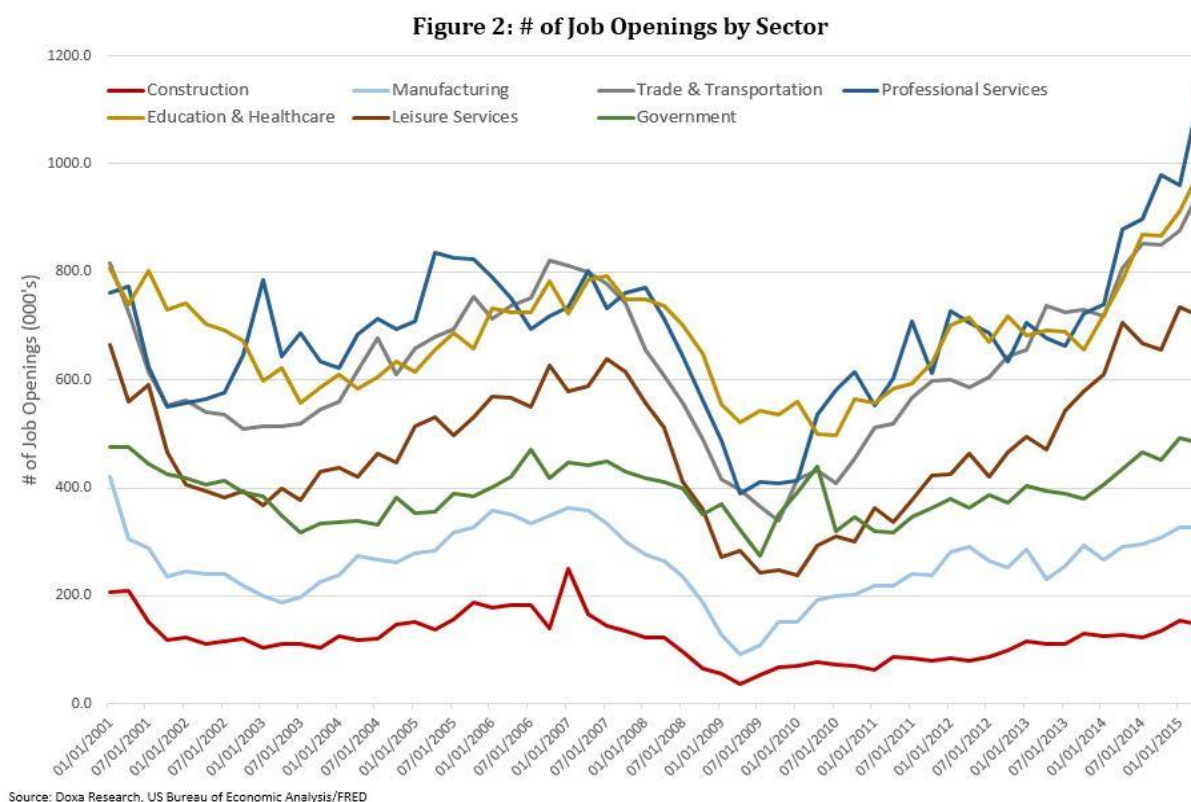
⁷ As defined by Doxa Capital, this cycle is of our opinion, not fact.

⁸ The 10 year net margin average is 9.1%.

⁹ In most cases, multiple compression is simultaneous with margin compression.

¹⁰ Largest is defined by market capitalization.

- 2) **Efficiency over profitability.** From Henry Ford to Steve Jobs¹¹, the idea of business was to create something that someone would pay for that would change the world. The more you created, the more people paid, the more the company profited. Companies like General Electric, Hewlett-Packard, and Sears became behemoths that found growth by serial acquisitions. GE sold dishwashers, business loans, and jet engines – Hewlett-Packard sold printers, software, and desktops – Sears sold insurance, retail goods, and even stocks, all just to name a few. The old way of business was to get bigger, the new way is to get efficient. Corporations aren't hiring the same amount of people they once needed. They aren't purchasing three machines when one will do. They make acquisitions with immediate synergies¹², instead of venturing into new industries. Today, investors reward companies that allocate capital efficiently, so why should we concurrently view slow economic growth as negative? This shift in business mentality will slow absolute growth relative to productivity (figure 1), but negates the idea that earnings will be slowed by a low GDP¹³.
- 3) **The employment landscape has changed.** As discussed in one of our [prior notes](#) on employment and wages, the U.S. is facing structural changes to its labor force. The latest 'jobs report' was described as abysmal because it did not produce 200k+ jobs¹⁴,^v but economic data should not be analyzed independently. When you factor in 13.7% year over year construction growth, 2.25% annualized year over year GDP growth¹⁵, and



¹¹ Roughly defined as 1925-1990.

¹² Synergies occur when two like businesses merge and costs can be reduced because of scale.

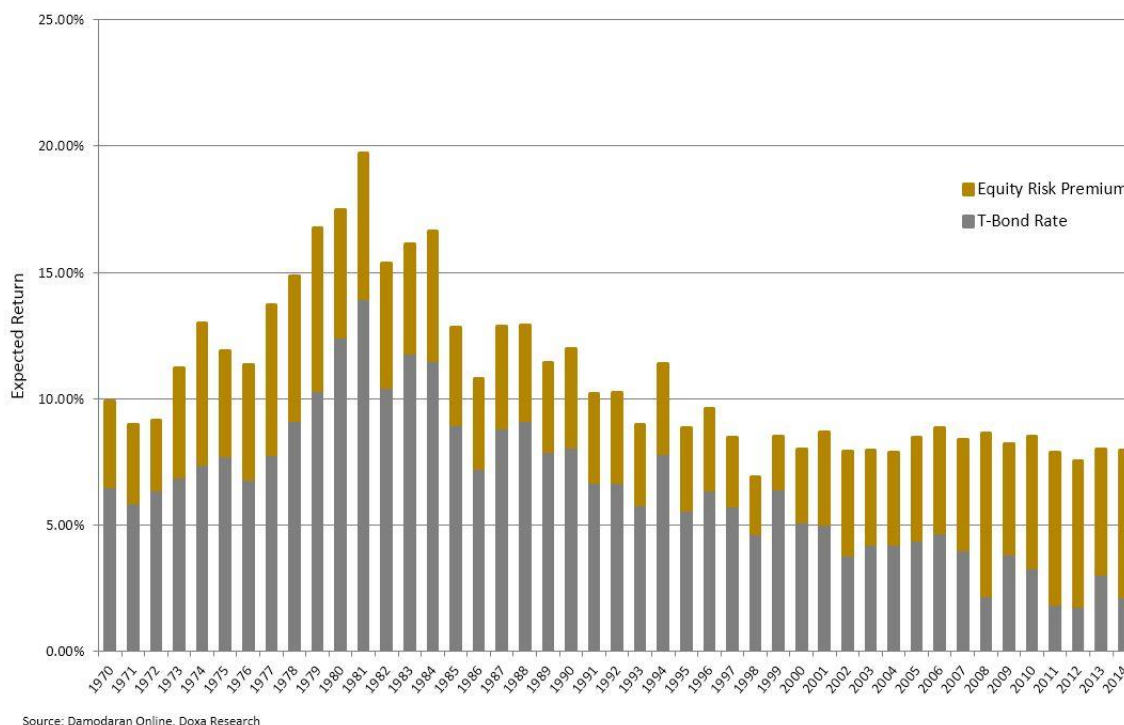
¹³ Low GDP is defined as less than 4% y/y growth.

¹⁴ The October 2 employment situation stated 142,000 jobs were created in September.

¹⁵ For the first six months of 2015, annualized year over year GDP growth was 2.25%.

surging auto sales^{vi} – the lack of job creation is structural, not cyclical. In fact, the unemployment rate for people with a four year college degree is trending near 2.5% with almost 75% participation.^{vii} As mentioned above, companies are focused on efficiency – they need full-time skilled workers (college degree) and substitute technology for non-skilled jobs.¹⁶ Although, it is important to note that these jobs are not disappearing, but instead shifting to other sectors, like professional services or healthcare (figure 2). As this transition continues to unfold, it is inevitable that the U.S. will continue to have job

Figure 3: Equity Risk Premium



Source: Damodaran Online, Doxa Research

openings that unemployed workers simply can't fill (*Note: demographics will also have a defining role going forward: [The Millennials](#)*).

The Interest Rate Dilemma

Interest rates can affect asset prices as much as LeBron James affects the Cleveland Cavaliers. The higher the interest rate → the higher the expected inflation rate → the higher return an investor expects on investments¹⁷. As these variables shift over time, the equity risk premium remains one of the most valuable market valuation metrics. The 'equity risk premium' is the difference in return an investor should receive for taking a risk in stocks (companies) versus government bonds¹⁸. During times of turmoil, like recessions, investors stay away from risk (stocks), making the reward for owning risk (stocks) compared to safe government bonds increase. As shown in figure 3^{viii}, the equity risk premium has been higher than average since 2008, providing us confidence that a material

¹⁶ Skilled labor is defined by the BLS as a job that requires an advance degree. The opposite is true to define non-skilled labor.

¹⁷ Also known as $[E]r$, or expected return.

¹⁸ Assuming U.S. treasury bonds are considering 'risk-free' by investors.

decline¹⁹ in equities is unlikely.^{ix} Going forward, whether interest rates and inflation go up or down, we expect the risk premium to contract back to normal levels, supporting the equity markets.^x

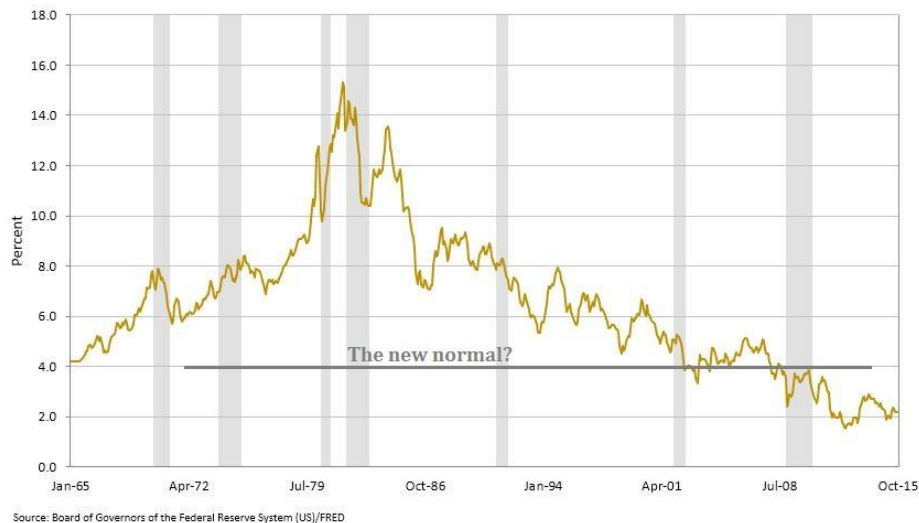
We admit that we missed the ‘no rate rise’ call in September, but it appeared most investors shared our unenthused attitude, as the markets subsequently sold off and bond yields dove toward 2%²⁰. Artificially holding short term rates²¹ low for a long period of time is unprecedented and may carry unintended consequences – but for now, we do not believe there is a problem in delaying the first hike until December. As investors, it is easy to get swept up in the short term, but the Federal Reserve determines monetary policy that they believe is in the best interest of the country over the long term. Another three months and a quarter point rate hike will not deter U.S. economic gains over the long term. Our year end targets that we laid out above actually rely on the FOMC staying true to their higher rate year-end forecast. We believe many positives surround the economy at this stage, and we cannot move forward in the cycle until the normalization process²² begins to take place (figure 4).

To conclude, we have faith in the U.S. economy and financial markets going forward. The end of the cycle does not appear to be upon us, allowing our slow growth forecast to continue on. Inflation growth in areas like rent, entertainment, and certain food items^{xi} shows promise that interest rates will normalize. New construction in residential and non-residential areas^{xii} show resilience of a recovering property market. Structural tailwinds²³ in the labor market provide strength for wage growth and consumer spending. The constant innovation and efficiency across corporations offers confidence that GDP growth can continue. A recession will come as it always does, but we do not believe it is here, yet.²⁴

Chase Lee

Director of Research

Figure 4: 10-Year Treasury Constant Maturity Rate



¹⁹ We define a material decline as 20%+.

²⁰ Quoting the U.S. 10 year note.

²¹ The Federal Reserve only has authority to set the overnight rate, or discount rate.

²² This process would be the retraction of accommodative policies, like manipulating the yield curve lower.

²³ Changing demographics and technology can be defined as structural.

²⁴ Forecasting more than 12 months out is onerous, but as normalization occurs, expansion will follow. The end of the expansion could be estimated around 2018, many things constant.

Table 1: Doxa Capital 2015 Year-end Targets:

Scenario	Probability	2015E EPS	2016E EPS	FPE Multiple	YE2015 Target
Bull	15%	\$128	\$139	17.3x	2400
<i>Growth</i>		8%	9%		
Base	60%	\$124	\$133	15.8x	2100
<i>Growth</i>		5%	7%		
Bear	25%	\$116	\$120	14.5x	1750
<i>Growth</i>		-2%	4%		

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ⁱ Arends, Brett, "Dow 5000? Yes, it could happen", <http://finance.yahoo.com/news/dow-5-000-yes-could-202006267.html>, August 2015

ⁱⁱ Factset Research, "Earnings Insight", August 2015

ⁱⁱⁱ Parker, Adam, & MS Research, "US Equity Strategy – Is Nothing Something?", September 2015

^{iv} Parker, Adam, & MS Research, "US Equity Strategy – Is Nothing Something?", September 2015

^v Bureau of Labor Statistics, "Employment Situation", October 2015

^{vi} BLS & Census Data, August 2015

^{vii} Bureau of Labor Statistics, "Employment Situation", October 2015

^{viii} Data provided by Aswath Damodaran of the Stern School of Business at NYU through Damodaran Online.

^{ix} A material decline in equities is unlikely unless extraneous world events created more fear for investors than the likes of 1979, 2001, and 2008. If this event does not happen, we view it as unlikely the equity risk premium will expand much more than it is currently.

^x With the risk premium elevated to levels seen when only when fear exist (1979, 2001, 2008), we believe that the most likely occurrence is for the risk premium to decline back to average. This decline would send equities higher as the [E]r would decline. If the premium stays elevated and rates stay low, we also believe this provides a hard support for equities. It seems to be unlikely for the risk premium to expand exponentially compared to the 'high fear' times mentioned above, unless a geopolitical event or adverse economic event does cause such fear.

^{xi} Bureau of Labor Statistic, Consumer Price Index Summary, August 2015

^{xii} BLS & Census Data, August 2015

IMPORTANT INFORMATION

The views in this report are subject to change at any time based upon market or other conditions and are current as of the date at the top of the page. While all material is deemed to be reliable, accuracy and completeness cannot be guaranteed. This note is not deemed a solicitation on our part with respect to the purchase or sale of any securities or commodities. Please remember that all investments carry some level of risk, including the potential loss of principal invested. They do not typically grow at an even rate of return and may experience negative growth. As with any type of portfolio structuring, attempting to reduce risk and increase return could, at certain times, unintentionally reduce returns. Keep in mind, like all investing, that multi-asset investing does not assure a profit or protect against loss.

No model or group of models can offer a precise estimate of future returns available from capital markets. We remain cautious that rational analytical techniques cannot predict extremes in financial behavior, such as periods of financial euphoria or investor panic. Our models rest on the assumptions of normal and rational financial behavior. Forecasting models are inherently uncertain, subject to change at any time based on a variety of factors and can be inaccurate. Doxa Capital believes that the utility of this information is highest in evaluating the relative relationships of various components of a globally diversified portfolio. As such, the models may offer insights into the prudence of over or under weighting those components from time to time or under periods of extreme dislocation. The models are explicitly not intended as market timing signals.

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ECONOMIC INDICATORS AND FINANCIAL DEFINITIONS

Inflation – The Consumer Price Index (CPI) NSA (non-seasonally adjusted) measures changes in the price level of a market basket of consumer goods and services purchased by households. This indicator value represents the trailing year over year % change in the CPI index as of last month-end.

Yield - The yield of a bond is inverse to its price: as bond prices increase, bond yields fall. For example, assume that an investor purchases a bond with a 10% annual coupon and a par value of \$1,000. The yield on this bond would be its par value divided by the interest it pays.

Expected Return - the value of a random variable one could expect if the process of finding the random variable could be repeated an infinite number of times. Formally, it gives the measure of the center of the distribution of the variable.

Unemployment – The Bureau of Labor Statistics measures employment and unemployment of all persons over the age of 15 using two different labor force surveys conducted by the United States Census Bureau (within the United States Department of Commerce) and the Bureau of Labor Statistics (within the United States Department of Labor) that gather employment statistics monthly. The data reported here is seasonally adjusted (SA) to account for seasonal gains in employment leading up to Christmas.

GDP / Economic Expansion – GDP (Gross Domestic Product) measures the total market value of a nation's output of goods and services during a specific time period. It is usually measured on a quarterly basis. Current GDP is based on the current prices of the period being measured. Nominal GDP growth refers to GDP growth in nominal prices (unadjusted for price changes). Real GDP growth refers to GDP growth adjusted for price changes. Calculating Real GDP growth allows economists to determine if production increased or decreased, regardless of changes in the purchasing power of the currency.

Recession - A period of temporary economic decline during which trade and industrial activity are reduced, generally identified by a fall in GDP in two successive quarters.

The S&P 500® Index - is a free-float capitalization-weighted index published since 1957 of the prices of 500 large-cap common stocks actively traded in the United States. The stocks included in the S&P 500® are those of large publicly held companies that trade on either of the two largest American stock market exchanges: the New York Stock Exchange and the NASDAQ.

Bloomberg USD High Yield Corporate Bond Index - a rules-based, market-value-weighted index engineered to measure publicly issued non-investment grade USD fixed-rate, taxable and corporate bonds. To be included in the index, a security must have a minimum par amount of \$250 million and have a minimum maturity of 1 year at rebalancing. Emerging market debt is excluded.

Market Volatility (VIX) –CBOE VIX (Chicago Board Options Exchange Volatility Index) measures annualized implied volatility as conveyed by S&P 500 stock index option prices and is quoted in percentage points per annum. For instance, a VIX value of 15 represents an annualized implied volatility of 15% over the next 30 day period. The VIX measures implied volatility, which is a barometer of investor sentiment and market risk.

Aggregate Demand - In macroeconomics, aggregate demand (AD) or domestic final demand (DFD) is the total demand for final goods and services in an economy at a given time. It specifies the amounts of goods and services that will be purchased at all possible price levels.

Aggregate Supply - In economics, aggregate supply (AS) or domestic final supply (DFS) is the total supply of goods and services that firms in a national economy plan on selling during a specific time period. It is the total amount of goods and services that firms are willing and able to sell at a given price level in an economy.

Capital Expenditures (Capex) - A capital expenditure is incurred when a business spends money either to buy fixed assets or to add to the value of an existing fixed asset with a useful life extending beyond the taxable year.

Multiple / Price to Earnings Ratio (P/E) - a ratio for valuing a company that measures its current share price relative to its per-share earnings.

Federal Open Market Committee (FOMC) - The branch of the Federal Reserve Board that determines the direction of monetary policy. The FOMC is composed of the board of governors from different Federal Reserve Banks around the country.

Policy Normalization - Specifically, monetary policy normalization refers to steps to raise the federal funds rate and other short-term interest rates to more normal levels and to reduce the size of the Federal Reserve's securities holdings and to return them mostly to Treasury securities, so as to promote the Federal Reserve's statutory mandate set by Congress.

Commodities – a raw material or primary agricultural product that can be bought and sold, such as copper or coffee.

Developed Economy – countries with high gross domestic product (GDP) per capita and industrialization; countries in which the tertiary and quaternary sectors of industry dominate would thus be described as developed.

Emerging Economies - progressing toward becoming more advanced, usually by means of rapid growth and industrialization. These countries experience an expanding role both in the world economy and on the political frontier.

Quantitative Easing - is a type of monetary policy used by central banks to stimulate the economy when standard monetary policy has become ineffective.

Structural - of or relating to the arrangement of and relations between the parts or elements of a complex whole.

Cyclical - occurring in cycles; recurrent.

Profit Margin / Net Margin - the percentage of revenue left after all expenses have been deducted from sales. The measurement reveals the amount of profit that a business can extract from its total sales. The net sales part of the equation is gross sales minus all sales deductions, such as sales allowances.

Market Capitalization - the total money market value of the shares outstanding of a publicly traded company; it is equal to the share price times the number of shares outstanding.

Productivity - the effectiveness of productive effort, especially in industry, as measured in terms of the rate of output per unit of input.

Overnight Rate / Discount Rate - the interest rate that large banks use to borrow and lend from one another in the overnight market.

Monetary Policy - the process by which the monetary authority of a country controls the supply of money, often targeting an inflation rate or interest rate to ensure price stability and general trust in the currency.