

Opportunities Amid the Market's Cruellest Months: September and October

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Stock market statistics support market lore and drive investors' worst fears. In a nutshell, there's an apparent treacherous intersection between a market overdue for a correction or worse after five plus years of a bull market, with what have historically been the two most difficult months for investors, September and October.

Summary

After 36 months without a 10% down move, markets are overdue for a correction. Such a fall typically happens every 12 months. Given that valuations are no longer cheap, stock prices could easily fall simply because they're overpriced.

September and October have historically been the markets worst performing months, although there is no consensus why. Following an unexplained historical anomaly is not a sound long term investment plan.

Moreover, there are a number of sectors and stocks that have either been overlooked or even despised by the market, and thus offer good value for longer term oriented investors.

Investors are best advised to rebalance to their long term asset allocations, not try to time the market and to add undervalued ideas to their portfolios.

September and October: When Market Ghouls Come Out to Play

The stats are clear: While nearly every month sports an average positive result, September is different, with the average return a disappointing 1.01% since 1928. October is notorious as being the month when several major market crashes have occurred, including the mother of all crashes, October 19, 1987, when the Dow dropped a sickening 22%.

So, why wouldn't an astute investor cash out now, and respect the odds of history?

Quite simply, just because something has usually happened before doesn't mean it will again, especially where no compelling reason for such seasonal market weakness exists. It's no different from being skeptical that there's a greater than 50/50 chance that a coin toss will come out heads even though the last 10 tosses were heads. No theory supports that bet.

It may be even more important to ignore the September/October doomsday pundits when their warnings are so widely accepted. After all, if investors have already sold in anticipation of

a fall, the market is less likely to fall, because the much-feared event has already been discounted in the markets. Markets fall following unexpected events, not expected ones.

Even if you do sell, when do you get back in? Prefer an all-weather balanced portfolio approach, and eschew risky short term trading.

Market Valuations: Not Cheap But Not a Bubble

The stock market is trading at 19 times trailing earnings, a healthy premium over the normal 15.5. However, nearly all pundits agree that what's a reasonable multiple depends somewhat on the valuation of competing asset classes.

The ten year Treasury is trading at just 2.4%, or over 40 times its payout. And that payout is not growing, unlike stocks' earnings. Of course, that begs the question what happens to the market when interest rates rise. That increase would not be helpful from a comparative valuation perspective. Analysts cite the late 1990s as the paradigm of a bubble. Then, stocks traded at nearly 40 times earnings.

A higher valuation can also be justified when earnings growth is superior. This year's S&P earnings could jump 8.1% per analysts' consensus, advancing another 11% in each of the two succeeding years. That outpaces the more normal 6% earnings annual advance, and certainly can justify a higher valuation. Of course, some of the earnings growth is due to stock buybacks, lower debt costs, and other transitory factors.

The upshot is not to jump ship due to the market's current valuation, but certainly stay vigilant should certain sectors or the market become overheated.

Who's Got the Story Right, the Stock Market or the Bond Market?

Low interest rates are a boon to the economy, spurring housing, reducing borrowing costs, and inciting people to be more adventurous with their investments. Indeed, our Federal Reserve can take no small credit for creating the monetary policies that have reduced unemployment, improved the economic outlook, and lifted stock prices to record levels.

Now along the path of renewed prosperity, reduced Federal Reserve bond buying due to the taper and greater borrowing demand should have increased interest rates this year. Instead, they dropped again, down significantly from the ten year US Treasury's near 3% rate at the start of 2014.

Why are investors flocking to bonds? Does the bond market see economic troubles that the stock market is missing?

The bullish case is that the US economy is doing fine and lower rates are simply due to adverse economic conditions abroad. Monetary authorities overseas are reducing interest rates, and capital seeking enhanced returns is flowing Stateside, capping any rate rise here. Further,

reduced Federal Government borrowing needs have diminished the supply of bonds, keeping rates from rising. A longer period of lower rates is an unalloyed benefit.

Nevertheless, close to 50% of the S&P's revenues come in from overseas. The bearish case is if economies abroad are so weak that rates must continue to fall, corporate profits may come under pressure, which ultimately could pressure stock prices here. A rush to invest here from overseas may also cause Dollar appreciation, making our exports less competitive and devaluing repatriated profits.

We do not advise bailing from the market due to this complicated macroeconomic environment.

The Economy and Geopolitics

Other factors may also buffet our stock market. Chief among them are a confluence of ugly geopolitical developments.

The Ukrainian situation raises the specter of a possible shut off of gas to Europe, putting a cloud on the economy of one of our largest trading blocs. The rise of the Islamic State is triggering renewed American military involvement in the Middle East.

War in the Middle East risks reducing oil production. Higher oil prices will act like a global tax. The bullish response, however, is that America is close to energy self-sufficiency on the strength of new horizontal drilling methods.

The bears worry that higher oil prices overseas may yet hurt American corporate profits even if energy costs Stateside are less vulnerable to geopolitics in the Middle East than a generation ago.

If Value Will Win Out, Try These Stocks

Financial stocks provide some of the best values. First, their earnings have been held back by both the low rate environment and the weak economy.

As rates improve, the spread between what they pay for their deposits and what they can charge for their loans should rise. A more robust economy will spur loan demand and make more debt financed projects feasible.

Banks have also been under pressure due to the low trading volumes. A normalized interest rate environment may increase trading, a significant driver of some large banks' profits.

Third, financials is the one sector that has not recovered from the 2008 downturn, leaving many stocks trading at or below book value.

Finally, continued litigation costs have weighed on earnings and sentiment as disputes over accountability for the subprime crises continue. But, that won't be forever and abatement will help restore profitability.

Citigroup, Bank of America, and Goldman Sachs are all poised to benefit from the better times ahead we see for financials.

Higher Interest Rates due to Inflation Will Benefit Energy Stocks

Energy concerns have underperformed as interest rates have moved lower. Wall Street's convinced that deflation, not inflation, is the problem, so hard assets like energy are not in vogue.

At the same time large integrated oil companies have failed to replace adequately their reserves. Part of that is due to the very long dated projects they've undertaken, requiring years for results to show, and part of that is due to lower than expected fossil fuel prices. Absent higher energy prices, many opportunities are not financially viable, and so their resources don't count as reserves.

As a result, valuations on energy companies are cheap, relative to history and relative to the rest of the market. We believe the time to buy inflation protection is when it's on sale.

Because of the perception that the outlook for domestic stocks trumps overseas stocks', foreign energy companies trade at a discount to Stateside ones.

We recommend **Royal Dutch, BP** and French **Total**.