SHOULD JULY'S FIVE DAY SELL OFF SET OFF ALARM BELLS FOR LONG TERM INVESTORS?

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Starting July 20 the S&P 500 fell nearly 3%, declining for five consecutive days. Should longer-term investors be getting nervous? And if not, where are the new buying opportunities being created as risk comes out of the market? **I think the five-day July sell-off in the S&P 500 was caused by two principal factors.** First was the sell-off in Chinese equities, led by selling in Chinese A-shares. Although Chinese equities are still up for the year, the velocity of the 30% sell-off since early June is causing investors agita, in part because Chinese authorities have taken market-intervening measures to stem the slide. If the Chinese government fails to contain or control the selling, this raises larger questions about how well-equipped the government is to rein in larger market dislocations—not just in the stock market but in the real economy, which has been slowing in relative terms for several months. The NBS Manufacturing Purchasing Mangers' Index (PMI) on average has flatlined just above 50 for two years now, signaling only modest expansion in China's manufacturing sector. Chinese imports remain below the trend line average over the past three years, and quarterly gross domestic product (GDP) growth in China has been decelerating since 2011. This economic weakness in China (compared to how fast it used to grow) is impacting the prices of global commodities. West Texas Crude prices fell below $48 a barrel in July, pushing the price of oil down as much as 50% over the past year. Spot gold prices have fallen below $1,100 per ounce, down about 9% this year. Overall commodity prices, as measured by the Thomson Reuters/Core Commodity CRB Index, are hitting multi-year lows. And this weakness is impacting not just commodity prices but the currencies of commodity-exporting nations. The Brazilian real was down 21% year-to-date, pulling the Brazilian stock market down with it.[1] Commodity currencies from Chile and Peru to Australia and New Zealand have fallen between 7% and 15% versus the U.S. dollar. Falling global commodity prices and weaker commodity currencies are signaling, in my view, weaker aggregate demand coming out of China. This could impact global GDP growth and, with it, sales and earnings growth for U.S. multinationals. The second factor, in my opinion, is a growing recognition that as this bull market ages, it can no longer depend on expanding price-to-earnings (P/E) multiples for sending it higher. The S&P 500 has benefitted over the last four years from both expanding P/E ratios and positive trailing 12-month earnings per share growth. That is changing now. Operating earnings per share contracted within the S&P 500 for each of the last two quarters on a quarter-over-quarter basis. So did net margins. These are typically red flags for a bull market that is 72 months old. Moreover, the S&P 500 has gone nearly 1,400 days without a stock price correction of 10% or more—its third-longest streak since World War II.[2] With companies struggling to get through another quarter of lowered earnings expectations, I view the next three months as the most likely period for the U.S. market to correct. An easier year-over-year comparison will emerge in Q4 and Q1, so I do not expect U.S. companies to endure a long profit recession. And at this point, I don't believe there will be an economic recession in 2016. Recent job growth has been too strong and interest rates and oil prices remain too low. A decent GDP report released Thursday, showing 2.3% annualized growth in the second quarter, suggests growth is picking up as we head deeper into 2015.[3] **So where may the opportunities in this sell-off be found?** During this period, it's worth watching the diminishing number of stocks in the S&P Index that are trading above their 200-day moving average. Right now, only about 51% of the names in the index are doing so, which is another cause for concern. On a relative basis, Chinese stocks remain weak; European stocks remain strong. As we see below, when we view year-to-date returns in local currencies, major stock indexes in France, Germany and throughout the eurozone continue, along with Japan, to generate double-digit returns for investors, despite the aforementioned headwinds. Given that a good portion of the stocks in these indexes continue to trade above their 200-day moving averages, I would not be surprised to see investors tilt that way, especially if they have reason to decrease equity weights in the U.S. and emerging markets in the weeks ahead. **Major Stock Index Performance**

Index Name	Region	Year-to-Date Return	1-Year Return	3-Year Return	5-Year Return	Percent of Stocks above 200-Day Moving Average
CAC 40 INDEX	France	18.33%	17.45%	18.44%	10.10%	82.05%
DAX INDEX	Germany	13.23%	14.65%	18.23%	12.23%	80.00%
STOXX Europe 600 Index	Europe	15.37%	16.51%	18.01%	12.32%	76.35%
NIKKEI 225	Japan	17.59%	33.20%	35.75%	18.03%	73.78%
FTSE 100 INDEX	U.K.	1.33%	-0.47%	9.13%	8.07%	62.00%
S&P/ASX 200 INDEX	Australia	5.58%	6.25%	16.61%	10.71%	55.84%
S&P 500 INDEX	S&P 500	1.60%	6.78%	16.74%	15.59%	51.11%
HANG SENG INDEX	Hong Kong	5.46%	2.87%	12.00%	6.57%	28.57%

Source: Bloomberg, as of 7/27/15. Returns are stated in local currency terms. Past performance is not indicative of future results. You cannot invest directly in an index.

For definitions of indexes in the chart, visit our glossary. ***Unless otherwise noted, data source is Bloomberg, as of 7/27/2015.*** [1]Source: Bloomberg, as of 7/27/15. "Brazilian stock market" refers to Bovespa Index in U.S. dollar terms. [2]Source: Wang, Lu ."S&P 500 Propped Up by Just 2 Sectors Shows Bull Market Aging." www.bloomberg.com. July 27, 2015. [3]Source: Bloomberg, as of 7/30/2015.

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DEFINITIONS

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

A-share : shares traded on the Shanghai and Shenzhen stock exchanges. This is contrast to Renminbi B shares which are owned by foreigners who cannot purchase A-shares due to Chinese government restrictions.

Purchasing Managers' Index (PMI) : An indicator of the economic health of the manufacturing sector. The PMI is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. A reading above 50 indicates an expansion of the manufacturing sector compared to the previous month; below 50 represents a contraction while 50 indicates no change.

Gross domestic product (GDP) : The sum total of all goods and services produced across an economy.

Bullish : a position that benefits when asset prices rise.

Trailing 12-month earnings : is the sum of a company's earnings for the previous 12 month.

200-day moving average : Average of the prior 200 days' worth of price values, with an increasing trend indicating relative strength and a decreasing trend indicating relative weakness.

Bovespa Index : a theoretical portfolio of stocks that seeks to serve as a gauge of performance for the Brazilian stock market.