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www.greeninvestment.com | brad@greeninvestment.com
303-747-0500

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Rising rates and Terrorism

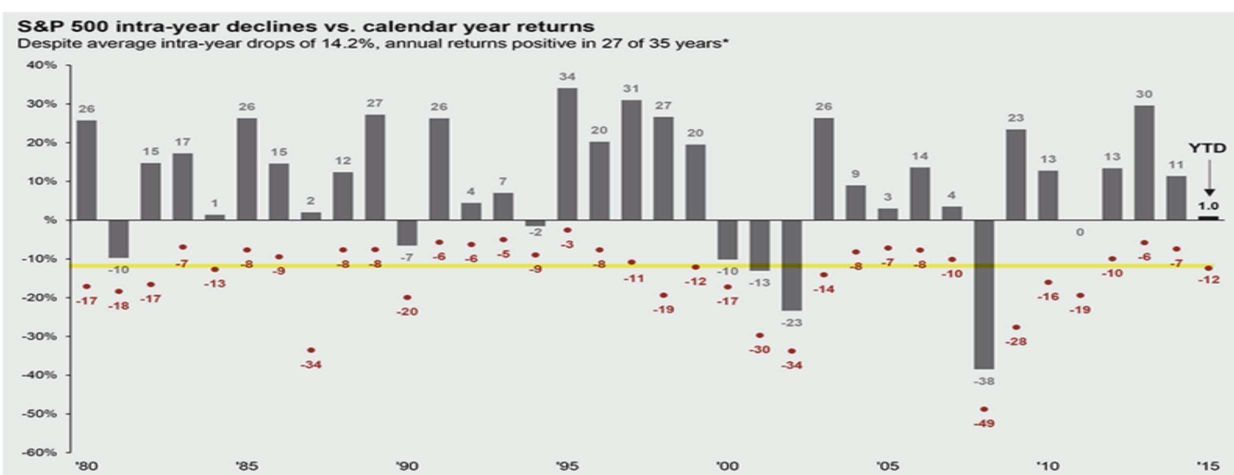
11/24/2015

A few thoughts before we head out to live the life of a ski bum, at least for the next 5 days. I'm continually amazed that ski resorts have bars near the top of the mountains. It's not like anyone can take your keys away and no one in history has ever take the ski lift *down* the mountain…

Markets: The US equity markets have rebounded from the August swoon and we're heading into the strongest six months of the year. It's no secret that equity markets are strong from Thanksgiving to year end with an average return of 2.2% and an 80% positive return since 1990 with the only significant negative return coming from the 2002 recession and bear market.

I really would like to emphasize that the August decline was just 12% peak to trough from the July market high. Since 1980 the average annual intra year market decline is 14%. And even if we weed out the worst years associated with bear markets the decline is still just 10.5%. Intra year declines are normal and it's unrealistic and very expensive (especially tax-wise) to attempt to avoid all of them.

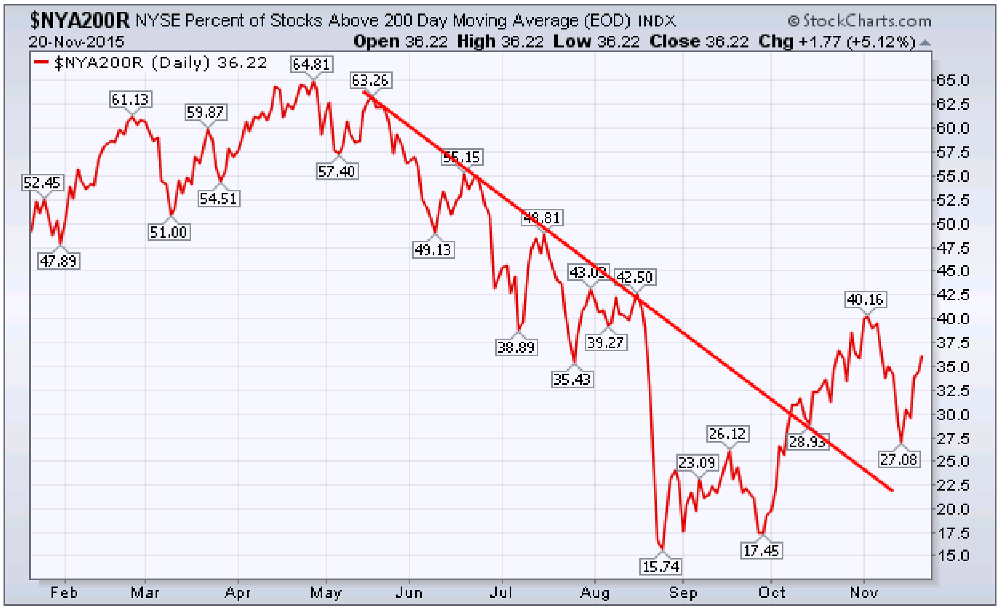
Most importantly we must distinguish the difference between garden variety market pullbacks and those draconian bear markets associated with recessions. I redeployed cash that had in money market accounts back into equities when I became convinced the sell-off was more like the one we experienced in 2011 rather than 2008. As was the case in 2011 there is no immediate concern for a recession but an economic soft patch. However, the fear generated by the sell-off (remember: fear and greed are inverse correlated emotions) that it was very unlikely we'd see prices decline before the August low.



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management.
Returns are based on price index only and do not include dividends. Intra-year drops refers to the largest market drops from a peak to a trough during the year. For illustrative purposes only. *Returns shown are calendar year returns from 1980 to 2014 excluding 2015, which is year-to-date.
Guide to the Markets – U.S. Data are as of October 31, 2015.

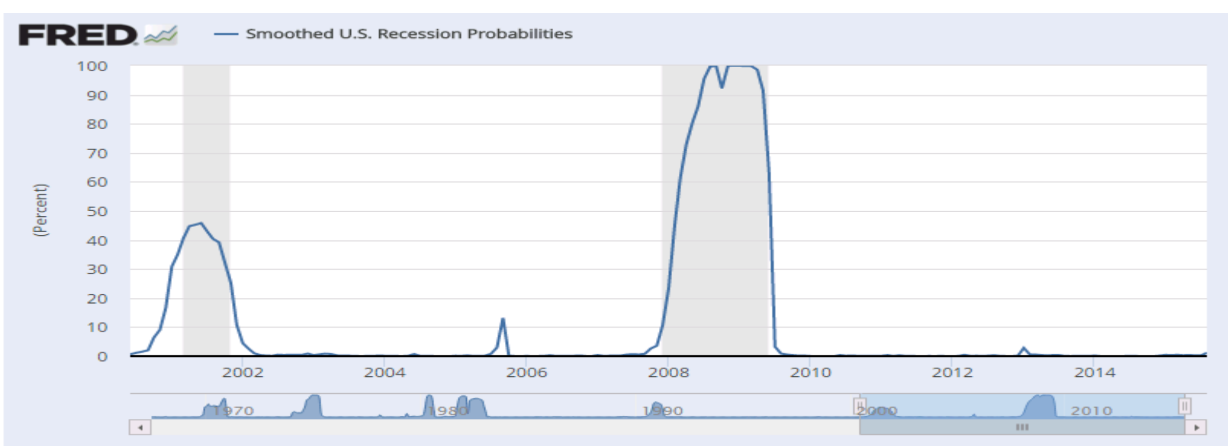
So the trend remains higher and we really do want to be fully invested in equities till the end of the year.

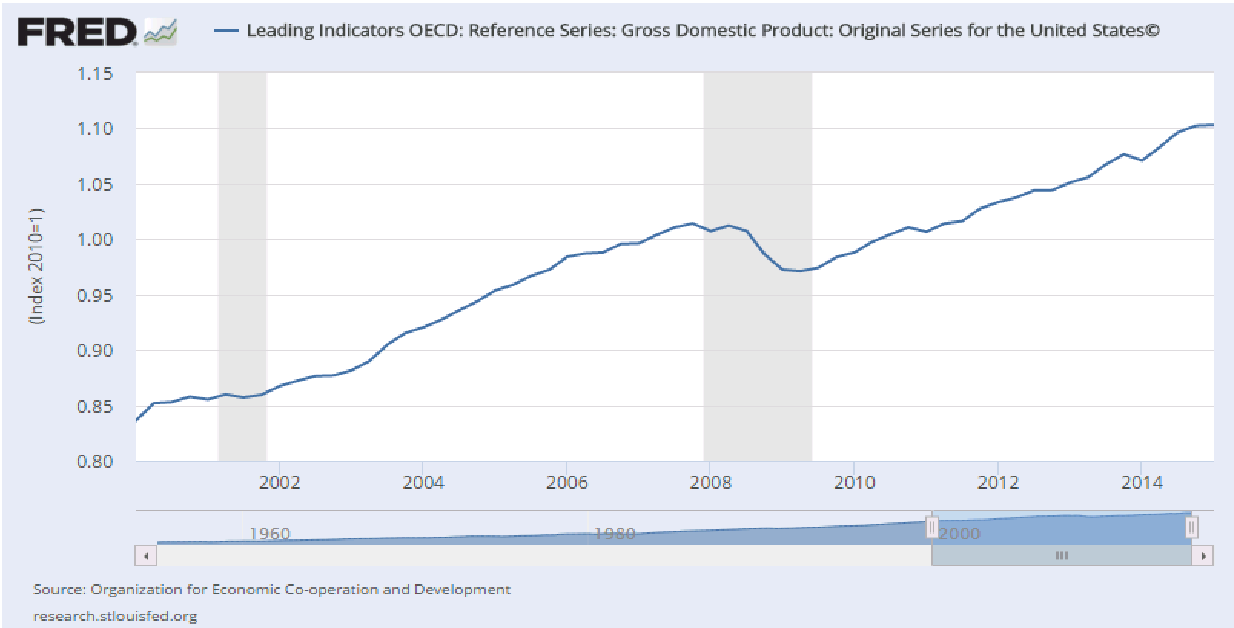
In my July notes I mentioned the declining percentage of stocks above their 200 day moving average. This was one of the primary signals I used to reduce equity exposure. With the August bottom in place and the successful September retest of the lows the percentage of stocks above the 200 dma shows some promise. Further strength in the rising percentage of stocks will increase the odds of breaking the July market high.



The economy: In Q3 US real GDP grew at revised 2.1% annual rate compared to the average pace of 2.3% in the first half of 2015. Slowing does not mean recession, at least not at present. A broad array of US and Global leading indicators indicate that the soft patch that we've been through may be either ending or at least not deteriorating further.

The US economy is currently bifurcated with manufacturing near recession levels but services are growing at a healthy pace. Given that they have 12% and 88% respective weights in the US economy a broad based recession based on manufacturing is very unlikely at present.





While the weak Q3 data doesn't support a rate hike the fantastic November jobs report does support a hike we should finally see a rate hike in December which is one of the most important steps in returning to a normalized interest rate policy.

The beneficiaries of a rate hike in terms of stocks are primarily Financials, especially Banks and Insurance companies. The rate hike is expected to be just .25% with more on the way. But to Financials it means that they'll be able to earn interest on funds presently earning 0% this is why we at present have close to 35% of our holdings in Banks and Insurance companies.

The human toll of terrorist attacks is immeasurable but the financial/investment impact tends to be limited based on history. In the past global markets were more sensitive to changes in economic fundaments and geopolitical events rather than terrorism.

Date	Location	Attack	Weeks to Return to Pre-Attack Level
1/7/2015	Paris, France	Charlie Hebdo shooting	0
12/15/2014	Sydney, Austrailia	Sydney hostage crisis	1
5/24/2014	Brussels, Belgium	Jewish museum shooting	0
4/17/2013	Boston, MA	Boston Marathon bombings	1
9/11/2012	Bengazi, Libya	US Embassy Assault	0
7/22/2011	Oslo, Norway	Bombing and shooting in Utoya	6
7/7/2005	London, UK	Commuter train bombings	0
3/11/2004	Madrid, Spain	Commuter train bombing	3
11/1/2003	Istanbul, Turkey	Bombing at British Consulate and HSBC Bank Headquarters	0
9/11/2001	New York; Washington DC	Airline hijacking attacks WTC, Pentagon	4
11/12/2000	Aden, Yemen	Bombing of USS Cole in port at Aden, Yemen	3
12/24/1999	Indian Airlines	Airline flight IC-814 hijacking	1
8/7/1998	Nairobi, Kenya	US Embassy bombing	12
7/25/1995	Paris, France	Subway bombing at Saint-Michel (first of several)	0
4/19/1995	Oklahoma City, OK	Truck bombing at US federal building	0
3/20/1995	Tokyo, Japan	Sarin Nerve Gas Attack	1
2/26/1993	New York	WTC bombing in underground garage	0
7/20/1990	London, UK	London Stock Exchange bombing	33
12/21/1988	Lockerbie, Scotland	Pan Am Flight 103 bombing	1
12/1/1983	London, UK	Harrod's department store bombing	0
11/23/1983	Beirut, Lebanon	US Marines and French forces barracks bombing	6
3/9/1977	Washington DC	Siege of DC buildings	0
12/29/1975	New York	La Guardia airport bombing	0
1/24/1975	New York, NY	Bombing in Manhattan	0
9/5/1972	Munich Germany	Olympic Bombing	0
		Total Attacks	**25**
		Average Weeks to Return to Pre-Attack Level	**2.9**
		Median Weeks to Return to Pre-Attack Level	**0**
		Attacks on the United States	**11**
		Average Weeks to Return to Pre-Attack Level	**2.4**
		Median Weeks to Return to Pre-Attack Level	**0**

Source: Charles Schwab, Factset & Bloomberg data as of 11/6/2015.

Happy Thanksgiving to everyone

Brad Pappas

Disclosures