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**Stocks presenting a low risk entry point**

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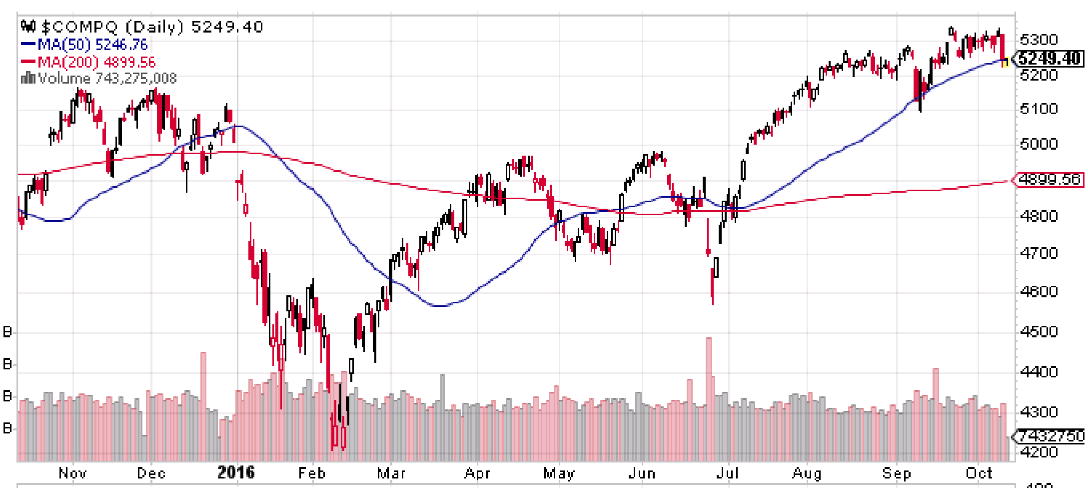
Summary: Stocks, especially those listed on the Nasdaq remain in an uptrend from the June/Brexit low. Growth stocks including Chinese stocks listed primarily on the Nasdaq have been amongst the top performers this year, a trend likely to continue. In July, the Nasdaq Composite Index broke to new all-time highs which signaled a resumption of the bull market that had stalled for close to two years. But since August all markets have been trending sideways as they try to digest the election uncertainty and higher interest rates. On the bright side, the selloff this past week could create enough fear to catapult stocks above the August highs. Plus we are entering quarterly earnings season which could be a catalyst. Earnings and future guidance (just as important) could be enhanced by the improving economy. Economic growth is accelerating once again proving that close call with recession was a soft patch and nothing more.




I've heard from many of you and share your concerns about a potential Trump presidency but after last week DJT's chance of victory are very slim. RealClearPolitics.com lists the odds of a DJT victory at just 14% as of 10/12/16. Almost as important according to Fivethirtyeight.com the odds of the Dems taking control of the Senate are now slightly better than 50% and the trend is moving lock step with HRC's rising poll numbers.

I don't see any reason to extrapolate the risks of a DJT victory. But an HRC presidency creates its own set of investment issues and while the HRC does not have the existential risk of a DJT presidency markets will have to adjust and digest the following, especially if the Dems take control of Congress:

1. Health Care, Financials and Energy will all be under pressure. Since we already factor out much of the Energy industry the potential for increased regulation will be reasons to avoid Health Care and Financials for the coming months.

2. Markets must also digest the potential for increased minimum wages and tax hikes on individuals, investment income and businesses.

3. With the economy rebounding, the Fed will likely raise short term interest rates again by .25 There will be much angst and worry about this which will likely create an excellent entry point for cash we have on the sidelines. In addition, renewed strength is the economy is a very bad omen for bonds and bond proxies like REIT's and Utility stocks – these were the safe haven stocks of the past year and they now are high risk.

Always keep in mind that sizeable market sell-offs are a two sided coin. The decline inevitably sets up the next rally. Rallies are born from sell-offs.

None of these issues are bull market killers. They just need to be factored into market prices since markets are often like polling machines as new information is factored in. September and October are in combination historically the two weakest months of the year. The strongest six months of the year will commence in mid-October.

**Using a simple mean reversion strategy to squeeze returns in a sideways market**

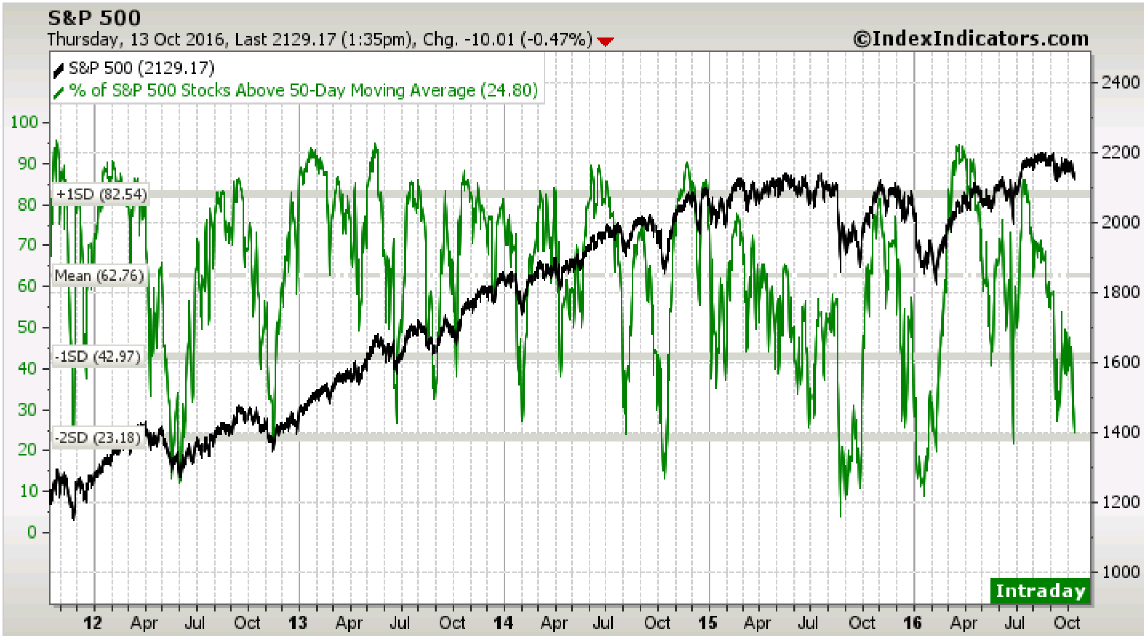
An investor in a slow moving market you'll have 2 or 4 upward market surges a year. This is especially true when the Federal Reserve is no longer providing liquidity or lowering interest rates as they are now. These upward market thrusts almost always come just after a period of weakness, such as right now. The rest of the time the market is either flat-lining or declining which is not ideal for our bottom line.

I was trained and schooled in the common bromide that "markets can't be timed" and that you should be fully invested at all times. This is what the Index funds always preach but there is another contra argument that is valid in 2016 and going forward.

Our current economic expansion is very mature as we will soon enter year 8. It's safe to say that the years of big returns by remaining fully invested are mostly behind us. They'll return once again at some point in the future after the next business cycle bottom aka recession.

But what do we do in the meantime? The strategy is simple as the best ones tend to be. I am using the % of S&P 500 stocks above their 50-day moving average as the benchmark. 42.97% of stocks above their 50-day moving average represents one standard deviation "SD" and a more extreme (and better) 23.18% above constitutes 2 standard deviations. We currently stand at 24.8% which implies we're at a low-risk entry point.

Basically, the strategy is to increase exposure to stocks once we reach the vicinity of 2 SD below the mean (we are there now).




On the flip side we start to reduce stock exposure after the ensuing rally (which we should have sizeable gains) when the % of Nasdaq stocks rises above 1 SD. We could have as much as 40% to 50% in cash once we pass above 1 SD. If the market reaches 1 SD it doesn't necessarily mean it will immediately decline as it could waffle and drift sideways for a bit. But we will know that much of the gains have already occurred.

Using this technique we will actually look forward to inevitable market weakness and take advantage of lower prices. We will only be invested when the probabilities are extremely in our favor, otherwise holding cash is a wise option. Note: As with any system there is always an Achilles Heel. In this case, the stock market must be in the midst of a long term advance without threat of imminent recession. Otherwise, market weakness should not be bought as markets could go a lot lower.

Below are the back-tested results of this strategy* after 100 trading days.

## Summary:

- Over the last 5 years, there have been 6 independent observations where the % of S&P 500 Stocks Above 50-Day Moving Average was below the level of 25.
- After 100 days, the S&P 500 returned an average of 10.54%, with the return being positive in 83% of the observations.
- During the 100 days:
  - Positive returns occured in 100% of the observations. The highest average return of 13.14% occurred after an average of 86.83 days.
  - Negative returns occured in 100% of the observations. The lowest average return of -2.50% occurred after an average of 13.50 days.
- Over 5 years, the total return was 63.26%, while the passive return for the S&P 500 was 77.44%.

## Details:

| Events | | | S&P 500 Performance (100 Days) | | | |
|---|---|---|---|---|---|---|
| Date | Index | Indicator | Lowest Return | Highest Return | 100 Day Returns | Final Return |
| 2011-11-23 | 1161.79 | 23.22 | -0.27%<br>Day 1 Indicator: 22.18 | 22.14%<br>Day 88 Indicator: 82.43 | | 18.52%<br>Day 100 Indicator: 50.42 |
| 2012-05-17 | 1304.86 | 17.15 | -2.06%<br>Day 10 Indicator: 12.34 | 12.33%<br>Day 83 Indicator: 85.98 | | 10.47%<br>Day 100 Indicator: 65.27 |
| 2012-11-14 | 1355.49 | 23.85 | -0.16%<br>Day 1 Indicator: 22.59 | 17.55%<br>Day 100 Indicator: 84.52 | | 17.55%<br>Day 100 Indicator: 84.52 |
| 2014-08-07 | 1909.57 | 24.06 | -2.47%<br>Day 48 Indicator: 14.44 | 9.48%<br>Day 99 Indicator: 85.56 | | 8.94%<br>Day 100 Indicator: 82.01 |
| 2015-08-21 | 1970.89 | 21.76 | -5.24%<br>Day 2 Indicator: 3.97 | 7.05%<br>Day 51 Indicator: 80.96 | | -2.49%<br>Day 100 Indicator: 15.06 |
| 2016-01-14 | 1921.84 | 15.06 | -4.83%<br>Day 19 Indicator: 20.08 | 10.27%<br>Day 100 Indicator: 75.94 | | 10.27%<br>Day 100 Indicator: 75.94 |
| Totals | | | -15.02% | 78.81% | | 63.26% |
| Averages | | | -2.50%<br>SD: 1.98%<br>Day 13.50 Indicator: 15.93<br>SD: 16.72 SD: 6.57 | 13.14%<br>SD: 5.16%<br>Day 86.83 Indicator: 82.57<br>SD: 17.30 SD: 3.44 | | 10.54%<br>SD: 6.89%<br>Day 100 Indicator: 62.20<br>SD: 0.00 SD: 23.98 |

Data from Indexindicators.com

Stock market sell-offs are very tough on the psyche. Nobody wants to see the profits made on the rally to dissipate during a decline. The easy going rising markets are a thing of the past not to be seen for the next few years (they will come back with a new business cycle). So at least we should be realistic and embrace both the rallies and welcome the sell-offs as an opportunity when we hold high amounts of cash.

All the best to everyone,

Brad Pappas

*Does not factor in trading costs or management expenses. And as always there is no guarantee of future success.

International investments are subject to additional risks such as currency fluctuations, political instability and the potential for illiquid markets. Investing in emerging markets can accentuate these risks.

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