

SIEGEL EXPECTS A CORRECTION: WHERE TO POSITION

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I had two interesting conversations on the market last week. First, I heard from Professor Jeremy Siegel, WisdomTree's Senior Investment Strategy Advisor, that he has turned cautious on the market and thinks a stock correction may be coming. I also talked with Neil Azous, founder of Rareview Macro and author of the newsletter Sight Beyond Sight, about his views on the global macro landscape, [disinflation](#), divergence in global central bank policy and its impact on the U.S. dollar (USD) and equity markets. **Siegel Shifting to Cautious Stance** Professor Siegel said he believes it is likely we will see a correction in the market (typically corrections are defined as 10% falls). This is news as he often is characterized as being a "perma-bull." Siegel is concerned about the broad markets breaking down, in particular the small caps measured by the [Russell 2000 Index](#) lagging the performance of the broader markets. In addition, the length of time since a prior correction is cause for concern, and he believes we may be in for a rough market in the next couple of months. Further, there appears to be a fundamental deterioration in earnings—Siegel expects the [S&P 500 Index](#) to barely grow earnings by 1% this year. It is an unassailable fact that falling oil prices coupled with a stronger U.S. dollar have impacted markets. Given strength in the labor data, markets are pricing in higher odds of a September [rate hike](#). This phenomenon and falling earnings are two ingredients that might wear the markets down in the next couple of months. Looking forward, the professor believes earnings should resume their growth in the first quarter of 2016, but markets will likely remain choppy until then. **Stronger USD—Impact on U.S. Marketplace** Azous generally agrees with Siegel on the cautious stance toward U.S. equities. Azous believes that people are more nervous about the U.S. markets than they are excited—the investor community is far less constructive on the markets today. Part of the concern is U.S. dollar strength. He estimates that a 10% appreciation in the dollar can potentially take off 0.5% to 0.6% from U.S. [gross domestic product \(GDP\)](#). Furthermore, sectors such as Energy, Materials and Industrials that typically generate more than 60% of their revenue from overseas could be negatively impacted by a stronger U.S. dollar, and its multiples must undergo a repricing. Azous believes that the [Federal Reserve's \(Fed's\)](#) language and signaling are important for the market directionality heading into year-end. **Repricing of Fed Hike Trajectory** We have not had a rate hike in more than nine years. Azous believes that the markets will reprice the speed of rate moves going forward, and that will underpin equity market performance. For example, comments last week by Dennis P. Lockhart¹ about a possible September rate hike increased the probability for a September hike from 40% to 60%. Additionally, after employment data was released Friday, odds for a September move increased to 75%—a record high in this cycle. Azous believes that what happens the rest of the year in equity markets is highly dependent on Fed trajectory. Observers can assess the Fed's likely reaction function by looking at the recent rate hike cycle. One way is to utilize what Azous calls the "measure pace template," which considers that the Fed has hiked rates 17 times in a row in its latest cycle. History suggests that the Fed has the ability to be a lot more potent than markets might be expecting based on this previous hiking cycle, and this can have material implications for equity markets. **USD Bull Market to Persist** To Azous, the key factor supporting U.S. dollar strength is the divergence in global

central bank policy. Many countries in developed and emerging nations are experiencing [inflation](#) breaking through the lower bounds of their central bank targets, due to lower commodity prices. As a result, many central banks may be forced to further ease their policies as the Fed raises rates. As a result of this policy divergence, the U.S. dollar can strengthen further. **Japan and Europe Outlook** Azous believes Japan is mostly a micro and fundamental story at the moment. The investment community is net [long](#) equities and [short](#) yen. It is important for investors to continue to track inflation- and consumption-related indicators in Japan—both are presently failing—and the Bank of Japan (BOJ) must do more to support growth. Weakness in the Japanese consumption-led recovery can be seen in the recent earnings report from Fast Retailing (which makes up 11% of the [Nikkei 225's](#) total [market cap](#)): Sales declined 1.5% from the year earlier, number of customers declined 6% and online sales declined 1.2%.² Further, inflation is languishing as wage growth stays benign. More recently, the Ministry of Labor in Japan reported that bonuses declined 8.5% in June. Azous believes the BOJ will have to ease policy further between October and early next year to sustain the recovery and that this will help weaken the yen to levels closer to 125-130 jpy per usd in the near future and provide support for the equity markets. Europe positioning: One of Azous' favored regions to invest at the current time is Europe. We did not get to explore this topic in great detail, but given his subdued outlook for the U.S., this could remain one of the more interesting markets to benefit from a continued strengthening of the U.S. dollar that he expects. *Read the Conversations with Professor Siegel Series [here](#).* ¹Dennis P. Lockhart: The 14th president and CEO of the Federal Reserve Bank of Atlanta. ²Source: Earnings report, 7/9/15.

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DEFINITIONS

Disinflation: Term used to describe instances of slowing inflation, different from deflation in that price levels are still increasing overall, just at a slower rate.

Russell 2000 Index: Measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

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.

Rate Hike: refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

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

Federal Reserve: The Federal Reserve System is the central banking system of the United States.

Inflation: Characterized by rising price levels.

Long (or Long Position): The buying of a security such as a stock, commodity or currency, with the expectation that the asset will rise in value, the opposite of Short (or Short Position).

Short (or Short Position): The sale of a borrowed security, commodity or currency with the expectation that the asset will fall in value, the opposite of Long (or Long Position).

Nikkei 225 Stock Average Index: A price-weighted average of 225 top-rated Japanese companies listed in the First Section of the Tokyo Stock Exchange.

Market Capitalization: Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.