CLS's WEEKLY 3

What You Need To Know About the Markets

OCTOBER 24, 2017

1. October marks the anniversary of several infamous crashes.
2. Strong stock market returns have some interesting differences under the surface.
3. Gauging sentiment across asset classes can be constructive.

CLS INVESTMENTS

Market Performance

Equities	LAST WEEK	QTD	YTD '17
Total U.S. Market[1]	+0.83%	+2.21%	+16.43%
Domestic Large-Cap Equity[2]	+0.88%	+2.31%	+16.88%
Domestic Small-Cap Equity[3]	+0.45%	+1.27%	+12.36%
International Equity[4]	-.038%	+1.78%	+23.28%
Developed International Equity[5]	-0.31%	+1.25%	+21.46%
Emerging Market Equity[6]	-0.55%	+3.55%	+32.31%
Fixed Income	**LAST WEEK**	**QTD**	**YTD '17**
U.S. Investment Grade Bonds[7]	-0.45%	-0.13%	+3.01%
Cash Equivalent[8]	+0.02%	+0.06%	+0.61%
Commodities	**LAST WEEK**	**QTD**	**YTD '17**
Commodity[9]	-0.71%	+1.02%	-1.88%

[1]Russell 3000 [2]S&P 500 Index [3]Russell 2000 Index [4]MSCI ACWI ex-U.S. Index [5]MSCI EAFE Index [6]MSCI Emerging Markets Index [7]Bloomberg Barclays Capital U.S. Aggregate Bond Index [8]Bloomberg Barclays Capital 1-3 Month U.S. Treasury Bill Index[9]Bloomberg Commodity Index

As of 10/20/2017

Week in Review

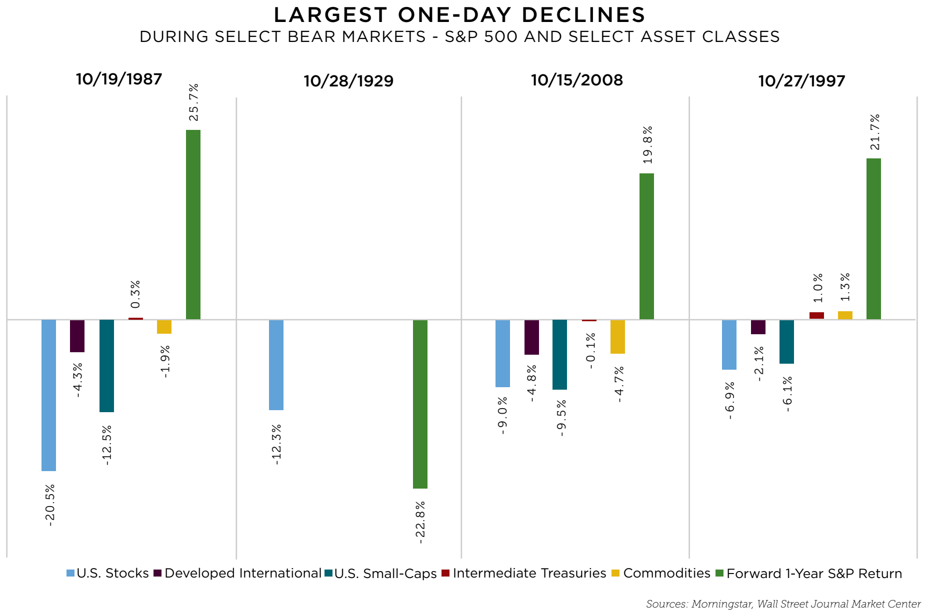
Global stocks closed higher last week, led by domestic large-caps. International stocks closed lower on the week for only the 13th time this year, on track for the fewest weekly declines since 1999. Renewed hope on tax reform and more clarity on the President's next Federal Reserve (Fed) chair contributed to positive sentiment. Earnings season is in full swing, with major financial institutions leading off and reporting solid results. With the exception of General Electric, earnings reports were solid across the board. This week marks one of the busiest of the earnings season, with 189 companies in the S&P 500 reporting.

There was limited economic data last week, however, the Fed released its "Summary of Commentary on Current Economic Conditions," more commonly known as the "Beige Book," ahead of next week's Federal Open Market Committee meeting, pointing to continued strength in the U.S. economy and transitory effects from hurricanes. Bond yields rose last week, and the U.S. dollar continued to climb back from recent lows, dampening returns on commodities.

Not-So-Happy Anniversary

Last week, financial media highlighted the 30-year anniversary of the largest single-day decline in stock market history. Commonly known as "Black Monday," October 19, 1987 saw the Dow Jones Industrial Average (DJIA) fall 508 points, or 22.6%, and the broader S&P 500 Index fall 20.5% (note that today a decline of 508 points would only be a decline of 2.2%! Read more about issues with the DJIA here and here). There were many recollections of loss during that day and stories of some lucky participants who took advantage of the steep decline, today blamed on portfolio insurance (Bloomberg has a great piece from a number of famous investors if you want to read more).

Based on the average daily percentage changes in the market leading up to that day, a decline of 22% equates to a 20 sigma, or 20 standard deviation event. In a normally distributed market, daily returns should fall within two standard deviations of the average 95% of the time. Therefore, a 20 standard deviation event is basically statistically impossible! But, it happened and no statistical model could have possibly come close to predicting it.



Investors can't predict, but they can prepare via diversification, and that's one of the key lessons. The chart above shows the largest single-day declines (headlined by 1987) in major bear markets. Historically, October has been a rough month for the U.S. stock market, as the chart shows, there are many anniversaries of major declines this month. The original Black Monday occurred during the 1929 crash. It wasn't nearly the same size decline, but within two weeks there had been three total daily declines of more than 10%. However, other asset classes saw declines of much less than the S&P 500, and in some cases saw positive returns. Even small-caps, typically higher-beta versions of large-cap S&P 500 stocks, provided a benefit to portfolios in most of the major decline periods. Perhaps most importantly, forward returns following these events were strongly positive in most cases, and much of that recovery came in the days and weeks immediately following.

Stocks YTD: Under the Hood

The stock market has undoubtedly had strong returns this year, both domestically, and more so outside U.S. borders. How strong? There are a few ways to "look under the hood" of the stock market and gauge the major indices' strength. Typically these fall under our behavioral area of analysis. Technical indicators, such as the advance/decline line (A/D) or TICK Index, help us to understand the strength of a rally (or decline), commonly known as market breadth indicators. We'll keep it simpler than that, but still throw out some stats that offer even more reasons to invest abroad.

Only 37 stocks in the Russell 3000 Index (which has been composed of more than 3,200 stocks this year) contributed to half of the index's gain. The FANG (Facebook, Amazon, Netflix, Google) or FAAMG (Facebook, Amazon, Apple, Miscrosoft, Google) companies are large contributors, as are some other blue chip names. Internationally, 113 stocks contributed half the gains, which in percentage terms is over five times more than the companies contributing domestically. Many of those stocks hail from a variety of countries, both developed and emerging. Not to mention, more than 80% of stocks in the index abroad are positive versus just over 60% in the U.S. There are also significantly more stocks domestically that have fallen more than 20% (classic bear market definition).

Overall, through the first three quarters of the year, not only are returns stronger overseas, but there is more durable strength in the recovery abroad. The tech giants may not stop their blistering returns any time soon, but other parts of the market are lagging behind. The bull market in international stocks is real – and supported by lower valuations, improvements in earnings, and strong breadth measures.

	YTD Return	% Postitive	% Above Index Return	Stocks Contributing Half of Gain	% Stocks in Bear Market
Russell 3000 Index TR	13.9%	63.5%	38.6%	37	13.7%
MSCI ACWI ex-USA NR	21.6%	83.5%	43.5%	113	2.8%

Grant Engelbart, CFA, CAIA
Portfolio Manager

Grant Engelbart manages CLS's aggressive mutual funds and several ETF and mutual fund separate account strategies, including CLS's American Funds portfolios. He also leads the alternative broad asset class team and serves on several committees across CLS's parent company, NorthStar Financial Services Group, LLC.

Mr. Engelbart first joined CLS as an intern in 2007. He returned in 2009 and held several roles in trading and investment research prior to accepting the role of Portfolio Manager in 2013. He previously held positions at TD Ameritrade and State Street Corporation.

Mr. Engelbart received his Bachelor of Science degree in Finance from the University of Nebraska at Lincoln. He holds the Chartered Financial Analyst® (CFA) designation, Chartered Alternative Investment Analyst (CAIA) designation, and FINRA Series 65 license. He is a member of the CFA Society of Nebraska and the CAIA Chicago Chapter.

Did you know? Grant invested in his first fund at age 13.

More on Sentiment

We've previously touched on sentiment and its usefulness in two recent *Weekly 3s* (here and here). Last week there were a couple more sentiment reads from common surveys. The Investors Intelligence Survey indicated that 60% of market newsletter writers were bullish on the market, up from 47% in September. Merrill Lynch's Fund Manager Survey also showed cash continues to move into the market, as average cash balances fell to 4.7% - the lowest level since 2015. Broadly, sentiment gauges for U.S. equities continue to look elevated, but not yet at the extreme levels that are most worrisome.

Asset Class/ Commodity	Sentiment Reading
Wheat	26.4
Natural Gas	30.5
Corn	32.6
Sugar	34.0
Silver	36.6
Cocoa	38.2
Soybeans	38.8
Lean Hogs	42.9
Platinum	44.6
U.S. Treasuries	48.3
Copper	49.4
Live Cattle	50.1
U.S. Dollar	51.9
Crude Oil	55.4
Cotton	57.0
Gold	62.5
S&P 500	72.6

Source: Ned Davis Research

Sentiment can be measured for many asset classes, even when survey data isn't available by utilizing positioning (usually in futures contracts). The chart to the right is an aggregation of some of these measures for commodities and broad asset classes. While each reading may rely on different indicators (making comparisons harder), higher levels generally indicate excessive optimism (bearish) and low levels excessive pessimism (bullish). We continue to favor commodities based on a number of measures, with depressed sentiment being among them.

The Russell 3000 Index is an unmanaged index considered representative of the U.S. stock market. The index is composed of the 3,000 largest U.S. stocks. The S&P 500® Index is an unmanaged composite of 500-large capitalization companies. This index is widely used by professional investors as a performance benchmark for large-cap stocks. The Russell 2000® is an index comprised of the 2,000 smallest companies on the Russell 3000 list and offers investors access to small-cap companies. It is a widely recognized indicator of small capitalization company performance. The MSCI All-Countries World Index, excluding U.S. (ACWI ex US) is an index considered representative of stock markets of developed and emerging markets, excluding those of the US. The MSCI EAFE Index is a composite index which tracks performance of international equity securities in 21 developed countries in Europe, Australia, Asia, and the Far East. The MSCI Emerging Markets Index is a composite index which tracks performance of large and mid-cap firms across 21 countries classified as emerging market countries. The Bloomberg Barclay's Capital U.S. Aggregate Bond® Index measures the performance of the total United States investment-grade bond market. The Bloomberg Barclay's Capital 1-3 Month U.S. Treasury Bill® Index includes all publicly issued zero-coupon U.S. Treasury Bills that have a remaining maturity of less than 3 months and more than 1 month, are rated investment grade, and have $250 million or more of outstanding face value. The Bloomberg Commodity Index is made up of exchange-traded futures on physical commodities and represents commodities that are weighted to account for economic significant and market liquidity. An index is an unmanaged group of stocks considered to be representative of different segments of the stock market in general. You cannot invest directly in an index.

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