<u>Monthly Outlook: November, 2015: "The Scourge of Terrorism…"</u>

The brutal events that unfolded last Friday in Paris are yet another reminder of the ***ugly scourge of terrorism in our midst.*** While the lives of many innocents have been lost in wanton fashion, it is hard to predict the sequence of events that lead to such outcomes. Indeed, having lived through September 11, 2001 and many similar events, we are convinced that terrorism is hard to predict and even harder to hedge against.

The sheer numbers are ***mind boggling***: 129 Parisians were gunned down at random and over 350 people were injured, many of them critically. Their only fault was being out at a restaurant or at a concert hall to have a good time on a Friday evening. One reaction could well be to stay at home and not go anywhere at all, but such a response is both childish and parochial: The aim of a terrorist is to strike terror in the hearts and minds of innocent civilians and disrupt life as one knows it.

Another natural response is anger at the authorities for allowing such acts to happen. But in the words of a counter-terrorism official, given ***our "open" society*** and global cultural appeal, we cannot suspect every individual that looks "foreign" of being a terrorist. Indeed, counter terrorism and defending the homeland are very tough tasks, especially since the terrorist only has to succeed once. No one remembers all the saves that a hockey or soccer goalie makes – they only remember the ones they let through!

On to more ***mundane things like the economy***: October's employment report implies a fairly robust labor market. The US economy added 271,000 jobs to ***nonfarm payrolls*** during the month. Revisions to September (-5k) and August (+17k) signaled that the job market was better than originally estimated. Within the private sector, professional and business services added 78k taking the annual total to 664k, outpacing every other slice of the job market. Education and health services came in second with an increase of 57k jobs, followed by trade, transportation, and utilities (+51k) and leisure and hospitality (+41k).

The unemployment rate declined one-tenth to a post-recession low of 5.0%. A broader, more robust measure of unemployment (the U-6 measure) was down two tenths in October to 9.8%. The labor force participation rate held steady at 62.4% and the employment-to-population ratio rose to 59.3%. Average Hourly Earnings posted a gain of four tenths for the month (2.5% year-on-year) suggesting that wages are finally starting to increase at a good pace as well.

The Bureau of Economic Analysis ***pegged third quarter GDP growth at a modest 1.5%*** (quarter-on-quarter seasonally adjusted annual rate) compared to the frenetic second quarter pace of 3.9%. While the headline number failed to beat expectations of 1.7%, the details provided further evidence that the economy is growing at a steady pace. Personal consumption expenditures were up a robust 3.2%, mainly from strong sales of automobiles, and continued strength in the services sector.

Auto sales do remain a ***bright spot for consumer spending***: At an annualized rate well over 18 million units, the consumer appears to be buying cars and light trucks as if they are going out of style! Indeed, lower gasoline prices also seem to have altered the mix of automobiles being bought, with consumers now preferring to buy light trucks and sport utility vehicles more than sedans. We suspect that this trend is likely to continue so long as gasoline prices remain relatively cheap.

The non-manufacturing ISM survey is a compilation of responses from over 300 firms across various sectors of the economy (ex-manufacturing). The latest survey results point to persistent, strong growth in the economy; with the level at 59.1 (a number above 50.0 indicates expansion). Within the report was a solid reading on exports

which flies in the face of a rising US dollar. New orders also posted a positive jump and the employment index was at one of the highest levels in the survey's history.

In terms of manufacturing, the outlook appears mixed: On the one hand, regional surveys and the closely watched national ISM survey indicate the sector continues to struggle with the latest ISM reading at 50.1 (a level below 50.0 signals contraction). On the other hand, the new orders (52.9) and production (52.9) component of the ISM report do suggest a sector that seems to be healthy. We think that the path for manufacturing will be heavily influenced by the Fed's interest rate policy going forward and the international response to this policy shift.

The Federal Open Market Committee of the Federal Reserve does not meet during November, but does have a meeting next month. The market appears to believe that the ***chances of a rate hike in December*** are around 68% - especially after the robust employment statistics for October. Members of the FOMC (including Chairman Janet Yellen) have claimed that every meeting is a "live" meeting, thus confusing market participants further.

We have for long maintained that despite all the speculation about when rate lift-off occurs (we take issue with the very term "lift-off", as if the rate increase is likely to follow the ***path of a fiery rocket!***), what is more important for markets is the pace of rate increase(s) as well as the terminal rate. Rate increases by the FOMC are likely to be slow and gradual, at an unhurried pace as long as the Fed is not forced into increasing the pace of rate increases.

In terms of the latter, the ***so called "dot-plot"*** that is released four times a year by the Federal Reserve (indicating FOMC member's forecasts for a long term Fed Funds Target) does suggest a terminal rate somewhere between 3.0% and 4.0%. As a frame of reference, the terminal rate in 2007 was 5.25% and the terminal rate in 2000 was 6.50%. This suggests that monetary policy is likely to remain quite accommodative well into 2017, perhaps even into 2018.

A quick word on earnings: 460 companies in the S&P500 index have reported earnings so far for 3Q2015. The aggregate share-weighted earnings gain is a -3.4% (compared to expectations of -5.6% going into earnings season). Of these, the 420 non-energy companies posted a ***gain*** in earnings of 3.5% for the quarter. This puts the adjusted earnings per share of the 460 companies at $29.77 per share (annualized at a run rate of $119.08) – which is above consensus.

In addition, 70.2% of these have had positive surprises (=323 companies), while 7.8% (or 36 of them) met expectations and 22.0% (or 101 companies) failed to meet expectations. Relative to the numbers for 3Q2014, these figures are not that different – suggesting that companies continue to post positive surprises, not as a result of better revenue growth, but more as a result of cost-cutting. ***This trend bears watching (pun intended!)***, as there does appear to be a theoretical limit beyond which cost-cutting becomes counterproductive.

Farther afield, ***GDP data out of Europe*** (+1.5% quarter-on-quarter, seasonally adjusted annual rate) implies an economy that might finally be coming out of its funk – egged on by quantitative easing by the European Central Bank. Mario Draghi, the ECB President, has gone on record to suggest that the ECB Governing Council might be looking to increase the amount of quantitative easing if the data warrants it. However, in complete contrast, Japanese GDP fell during the third quarter by -0.8% (also q/q, saar) with business spending also contracting.

In summary, despite the ugly scourge of terrorism amidst us, life must go on, hard though it might be. We do believe in the ***eternal optimism of the human spirit*** and the indefatigable decency of the human race to continue to prosper and make progress despite such setbacks.

This report was prepared by

Suresh Raghavan, CFA, and Clark Blackman III, CFA, CPA/PFS
MBR Financial
2000 West Loop South, Suite 1510
Houston, TX 77027

www.mbrfinancial.com

For further information please contact us at
Voice: 832.667.8787
Fax: 281.974.2108
Email: contactus@mbrfinancial.com

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