MCM MONTGOMERY CAPITAL MANAGEMENT

CAPITAL WATCH

Fall 2015 | Volume 1 | Issue 3

UP TO THE MINUTE

Over the last quarter, volatility has returned to the markets – in a major way! We don't expect that to change anytime soon, and here's why, in our view.

From any reasonable valuation perspective, the stock market has been overpriced for some time. Even the correction of 2008-09 did not bring valuation measures (like Price to Earnings ratios) into line. As a result, the stock market remains in a long-term correction phase. These unrealistic valuation levels are creating tremendous headwinds that would have taken their toll sooner if the Federal Reserve had not acted to stimulate prices with quantitative easing and zero interest rates.

Currently major stock market barometers, like the S&P 500, are below the average of the last 200 days. That's not surprising given the recent declines. But significant fluctuations in stock prices often happen when prices are below their 200 day average, so watch out.

Indeed a recent study shows that since 1928, the S&P 500 has moved 2% or more on 1,488 occasions, and 65% of those moves were when the price was below its 200 day average. Simply put, markets are nervous, and nervous markets do not need "good reasons" to fall.

There is something of a self-fulfilling prophecy to this – the equity markets are dominated by large players and hedge funds. Should prices decline, selling from hedge fund redemptions can further depress stock values, creating more sales. Here's what we are watching:

- **The Federal Reserve –** Many expected the Fed to raise interest rates in September, but they did not. Now the watchers are expecting a rate hike in October or December. While a small increase in interest rates is not significant, it would show a clear change in monetary policy from easing to tightening. But what if the Fed's next move is another injection of money into the economy?
- **China –** While many economists are eyeing China's economy, we are more concerned with currency fluctuations behind the scenes. China's yuan has been pegged to the dollar for some time, but the dollar's strength has made things difficult for Chinese exporters. China's response was to change the peg, which effectively devalued their currency. This back and forth will continue and could impact a number of emerging markets. Brazil is evidence of that.

Further, China is lobbying the IMF to have the yuan included in its Special Drawing Rights (SDRs). Signs point to 2016 and is an invitation for China to join the world's major economic powers. Today we do not generally monitor SDRs, but when there is a major liquidity crisis in the financial markets, SDRs are what the IMF brings to the rescue. If China is a player in the next SDR-based rescue, expect significant currency disruptions.

- **Oil and Commodities –** Absolutely nothing looks positive in the commodities sector right now. Oil cannot find a bottom, and industrial commodity prices just keep falling. While we like paying less at the pump, the ramifications of this global deflation are widespread. Commodity-based economies are stuck in a cycle of having to devalue currencies to keep their exports competitive. Meanwhile the global slowdown and shrinking prices reduce revenues putting even more pressure on the currency. Our primary concern here is debt-related, so we are watching to see whether this could spill-over into sovereign debt defaults.

Because the markets are so fluid, we'll keep you updated on our blog at **www.MontgomeryCap.com**.

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ON THE CLOCK:

CHANGES TO COLLEGE FINANCIAL AID

For parents (and grandparents) of college-bound children, you'll want to learn about upcoming changes to the FAFSA, the federal financial aid form schools use to determine need-based aid.

Beginning in 2016, the form will be available in October of each year, instead of waiting until the following January 1. This change is intended to give families more time to complete the form and to better align with the college admissions timeline.

This has ramifications. Applicants will now have to report income from an entire year earlier, meaning the October 2016 FAFSA, which is for the school year starting in the fall of 2017, will require family income data from 2015.

Your 2015 income will therefore be used for both the January 2016 FAFSA and the October 2016 FAFSA. So if you can take steps now to reduce your income in 2015, it will give you twice as much benefit!

We've prepared a special report on these and other upcoming FAFSA amendments. **If you'd like a copy, please email jcwest@montgomerycap.com or call 757-597-9525.**

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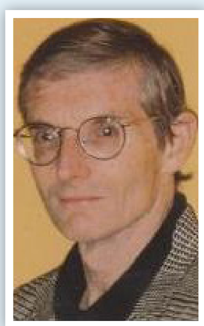

One of the few "regular" pieces Paul composed was "A Date Which Will Live in Infamy," based on the significance of the Autumnal Equinox. Given the close proximity of the equinox this year to the lunar eclipse, we thought it would be fun to take a look back:

"The legendary trader W.D. Gann reportedly claimed that capital and commodity markets tend to top on or around September 22nd more often than on any other day of the year. There is no apparent economic logic behind this reported observation, but the notion might very well have a certain appeal to astrologers, inasmuch as September 22nd happens to be the usual date of the Autumnal Equinox…Apparently this concept is so ancient it pre-dates even the oldest Mesopotamian culture. Initially, we never took such notions seriously…But such an attitude misses the point: Cycles are supposed to tell us, ex ante, when disturbances will occur – not, ex post facto, why they did occur. These cycles are not market specific; they are instead, cycles in the state of function of the human nervous system."

UNIVERSAL ECONOMICS, SEPTEMBER 13, 2013