GKV Capital Management

Market Update

August 23, 2015

Analysis of Recent Equity Market Weakness

Last week was terrible for the equities markets. Not just in the U.S., but stock markets globally sold off sharply. After moving sideways though the first half of 2015 the major indices are all now in negative territory. As of Friday's close the Dow Jones Industrial Average is down 7.7% year-to-date, the S&P 500 is off 4.3% and the NASDAQ, which was up nicely earlier this year, is down 0.6%. In one week all of the gains for the year were wiped out. For the week, the NASDAQ lost 7.5%, the S&P 500 lost 5.8% and the Dow gave up 5.8%.

As we have discussed in our last several quarterly newsletters, we have viewed the market as being over valued for some time relative to likely realistic earnings. The S&P 500 jumped 29.6% in 2013 on the expectation that sales and earnings would accelerate in near future. Instead, earnings have showed little growth and the combined headwinds of a slowdown in China, an energy supply glut wreaking havoc in that sector and the prospect of rising interest rates have further dampened expectations. Corporate earnings grew a paltry 5.3% in 2014 over 2013 and the forecast for 2015 over 2014 now calls for a 1.0% **decline**.

	2012	**2013**	**2014**	**2015***
S&P 500 EPS	$96.82	$107.30	$113.01	$111.89
EPS y/y growth	*0%*	*11%*	*5%*	*-1%*
S&P 500 Index	1426.19	1848.36	2058.9	1970.89
Index y/y return	*13%*	*30%*	*11%*	*-4%*
Trailing P/E	**14.7x**	**17.2x**	**18.2x**	**17.6x**

* 2015 based on full year 2015 EPS estimates and index price 8/21/2015

Since the recession in 2008, every decline in the market has been short lived and investors with the nerve to "buy on the dip" have been rewarded. We believe this time is different. The sky is not falling, however, fundamentals and the optimism for the typical post-recession growth acceleration are fading quickly. An increasing sentiment of skepticism among investment professionals seems to be moving more in-line with our cautious view of earnings.

Despite our concerned view regarding future earnings we remained fully invested through the end of June 2015. Investor sentiment has stayed positive despite weakening fundamentals and in hindsight we were too cautious in 2014. Our investment thesis this year has been that although the fundamentals are weak, U.S. economic data has been mostly positive and investor optimism will be enough to result in slight gains in the major indices for 2015.

Since the close of the June quarter the positive optimism has clearly weakened against the headwinds of China, the energy glut, rising rates, and a lack of sales growth. These events are forcing investment professionals to take a closer look at the far too optimistic earnings growth estimates for 2015 and 2016. In anticipation of a downward revision in corporate earnings expectations by the investment community we began reducing equity positions and raising cash in early July and accelerated our reduction in equities in August through the end of last week. Firm wide our cash is now 20% of assets, up from 2% on June 30th. Equities have been reduced to 37% of assets under management from 55%.

The coming weeks will be interesting. We fully expect to see a bounce after the overly sharp correction last week. Optimism remains significant and while earnings are lackluster, U.S. economic activity is on a positive trajectory. Many investors will likely view the selloff as an opportunity to once again "buy on the dip". Our exposure to stocks remains significant, but we are less optimistic. If earnings really do fail to grow, a case can be made that the S&P 500 could fall as much as another 15% more before appearing "cheap". With no earnings growth, the S&P could trade closer to the 15 times trailing earnings as the market did in 2012. At $112 or so in earnings, 15 times results in 1,680 on the S&P 500 index, or 15% below Friday's close. We don't want to suggest that this is where the market is headed, but it is certainly the negative possibility. The bullish case would be that earnings will accelerate and that the $131.46 estimate for 2016 is possible. If earnings growth accelerates then a 17 times forward multiple is expensive but possible resulting in 2,227 for the S&P 500, or 13% higher than Fridays close. The most likely scenario between now and year end will be something in between these parameters, but our cautious bias is that earnings projections will continue to be revised downward and it is more probable that 2015 will end with the major stock indices in negative territory.

We have decided that the weakness in earnings is significant enough to reduce exposure and we risk once again being too conservative. Our investment philosophy is to try to protect assets first and second maximize returns. The bond market is up 1.1% through Friday despite the specter of rising interest rates and we will continue to collect coupon yield in the months to come. The cash that has been raised we will deploy as opportunities present themselves in both stocks and bonds. If the correction continues we will look for suitable entry points to redeploy capital when valuations appear attractive. In the mean time we may reduce equities further to protect against losses.

Please don't hesitate to contact us if you have any concerns or questions.

Southern California
125 Auburn Ct.
Suite 200
Westlake Village, CA 91362

Northern California
2950 Buskirk Ave.
Suite 300
Walnut Creek, CA 94597

Phone: 805-497-2616
Fax: 805-379-3216
E-mail: greg@gkvcapital.com