DORSEY WRIGHT & ASSOCIATES

Manager Insights

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Third Quarter Review

Stocks continued their charge upward in the third quarter. The broad U.S. equity market (as measured by the S&P 500 Total Return Index) was up about 4.5% for the quarter bringing its year-to-date performance to a solid 14.2%. International equity markets have performed even better than domestic markets. Developed Markets stocks (as measured by the MSCI EAFE Total Return Index) were up 5.5% for the quarter, and 20.5% so far this year. The best spot for equities this year has been Emerging Markets. The MSCI Emerging Markets Total Return Index has risen 28.1% so far this year, and was up slightly over 8% in the third quarter alone. While bonds have lagged the strong performance of equity markets so far this year, they have delivered positive performance. The one trouble spot has been commodity markets. Some areas of the commodity markets, such as industrial and precious metals, have done well; however energy has performed poorly, and that has dragged down the performance of broad commodity indexes so far this year.

This year, one of the big market stories has been the lack of volatility. Pullbacks have been incredibly shallow as the market has been grinding upward this year. As of the end of the quarter, it had been about 10 months since the S&P 500 had experienced a 3% drawdown or larger. This is the second longest streak on record! Needless to say, investors have been aggressively buying any and all shallow corrections so far this year. Market volatility as measured by VIX is also near historical lows. The CBOE Volatility Index (VIX) measures market expectations of near-term volatility by looking at options on the S&P 500. VIX finished the third quarter at about 9.5, which is one of the lowest readings since the index began in 1990.

The lack of volatility is puzzling considering current events. Tensions with North Korea are high and seem to be escalating. We also had several major natural disasters over the summer. Finally, Washington seems to be having trouble passing a lot of the legislation they had promised to pass. Any one of these events would have caused major market moves just a couple of years ago. Investor sentiment has definitely changed. Investors are taking news in stride and have been willing to buy weakness to extend trends. This is a very welcome development, and our strategies have responded well to this new regime.

The economy has been doing well so far this year. Second quarter GDP was revised upward to 3.1%, which is a healthy number. The index of leading economic indicators has also been moving higher in a nice uptrend so things look positive heading in to the last three months of the year. That said, we would not be surprised to see some of the economic indicators experience some weakness as a direct result of the hurricanes, and then see them bump up higher later in the year as the rebuilding process takes hold. The good news is people are expecting this to happen so it will most likely not be a shock to capital markets if we get some softness in economic numbers over the next few weeks.

One thing we believe flew under the radar at the end of the quarter was the resurgence of small cap stocks. The Russell 2000 Total Return Index was up 6.24% for the month of September versus 2.06% for the S&P 500 TR. Micro caps, which are even smaller than small caps, did even better finishing the month up 8.15%. This is a welcome development as returns this year have been dominated by a few mega cap stocks. We believe a small cap rally would broaden out the leadership and provide more opportunities for our strategies to find leadership. This is a trend that may become very important as we head in to year end.

The extremely low volatility is bringing more investors back to stocks, and making investors less fearful of equities. These are both good things for momentum, which is performing well this year. If you have any questions about our strategies please let us know.