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Will the Bull Stumble and Then Run?



Here we are again in October, the month that's brought over 50% of the worst one day declines in history. The crash of 1929, Black Tuesday, and the crash of 1987, Black Monday, were two very memorable times. October, on the positive side, is also known as a bear killer month because several bear markets have met their demise during this month.

The first day of this October was a rather interesting day as the S&P 500 declined 1.3%. We believe that decline is good news as it increases the odds that the market will rise for the remainder of the year. October has started with a decline of 1% or more 13 times and the S&P 500 has ended the year higher 12 of the 13 times. The exception was during the Depression year of 1931.

October saw declines of 1.5% in the S&P 500 which is not earth shattering as that index has *advanced* 1.13% for the recent quarter and 8.12% for the year. **More concerning is the action of smaller-cap stocks as measured by the Russell 2000 index.** That index *declined* by 5.61% in October, is *down* 4.12 % for the year, and is *down* 10.2% from the peak it set in March. Almost 50% of small-cap stocks in the NASDAQ Index are *down* 20% or more and almost one-third are down over 30% from their recent highs. **Are small-cap stocks the canary in the coal mine?** Could this be the start of the next bear market as small-cap stocks usually get hit first as risk comes off the table?

The above notwithstanding, the S&P 500 has made a new high 33 times this year while the Dow Jones has achieved a new high 18 times. Both indices eked out small gains for the recent quarter.

The big news for the third quarter was the strength of the dollar which gained 7.7%. Except for the third quarter of 2008, *Continued on page 2*

SUMMARY

While the current bull market is getting a bit long in tooth, there are several encouraging items to help us believe that it will continue, **albeit with an overdue correction on the near horizon.** Since 1941 the average gain in the fourth quarter of a mid-term election year has been 7.41%. There have only been four other times since 1941 that the S&P 500 was up more than 8.2% going into the fourth quarter during a mid-term election year and the fourth quarter averaged a gain of 7.72%.

According to Sam Stovall of S&P Capital IQ, it does not matter who wins or loses in the mid-term; the coming bounce is apolitical. Since World War II, the S&P 500 has gained an average of 15.3% from October 31st, just before the election, to the following April 30th or six months out. He also points out that from 1945 to 2010 the market has risen 100% of the time from October 31st of the mid-term year to October 31st of the following year.

He says, "There are so many people who don't like this market! And because so many dislike it, we're likely to have a surprise to the upside."

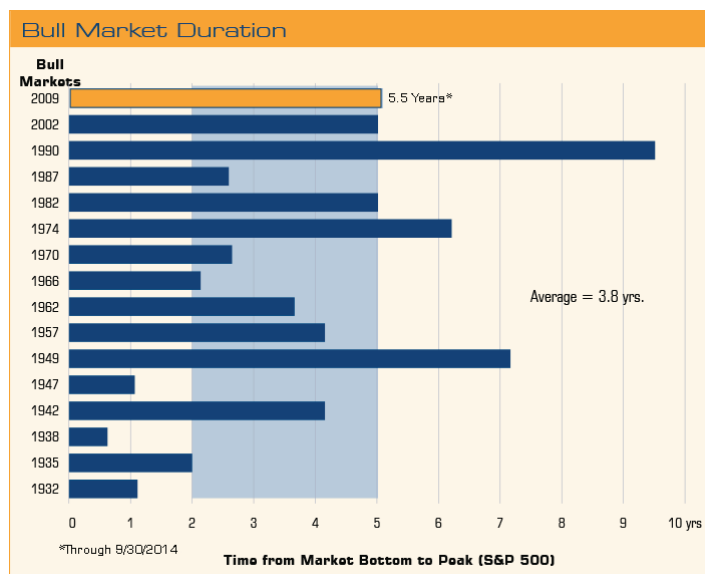
In eight of the past nine mid-term election cycles (six months from Oct 31 to April 30) bonds also enjoyed a bounce returning 6.5% total return. What does this portend for higher interest rates? If bonds are going to move higher in price, we believe interest rates will not go up.

when the global financial system seemed to be faltering, this was the largest quarterly gain for the dollar since 1992. Dollar strength is one reason that the price of oil is declining. The U.S. economy is why the dollar is strong. While the U.S. economy is not setting the world on fire, gross domestic product is expected to rise by 2.1% this year. Economic growth will, at some point, cause the Federal Reserve to raise interest rates (but read the blog from Tony Soslow later in this newsletter). The rest of the world economies are lackluster at best, as Europe faces recession with German industrial production sliding, to downright nasty at worst, with Japan contracting two out of the last three quarters. The U.S. is the one really bright spot; hence a favorable dollar.

But we have to be careful what we wish for. Too strong a dollar will not be good for all. Companies in the S&P 500 get almost one-third of their revenues abroad and these revenues are worth less when the dollar is strong. A strong dollar makes our exports more expensive and could cause U.S. manufacturers to cut cost of products sold outside the U.S. to stay competitive. That would threaten record profit margins. A strong dollar could bring down the price of oil too far which also is not in our best interest. The U.S. is becoming energy independent due to new extraction methods for oil and natural gas. The economics do not work if the price of oil becomes too low to support that effort.

Back to the question of the day; “Will the Bull Stumble and Then Run?”

The current bull market is now the fourth longest since 1929



Source: InvestTech Research

and is now 5.5 years old. It has surpassed the bull market of 1982 to 1987 and the one from 2002 to 2007. These bull markets were just over five years old when they expired.

And, as we know, they both expired in very big ways.

The bull market from 1982 to 1987 ended on Black Monday when the Dow Jones *declined* 22.6% on October 19th. The secular bull market then resumed but ended in 2000 in what was to become at the time the most devastating bear market since 1929.

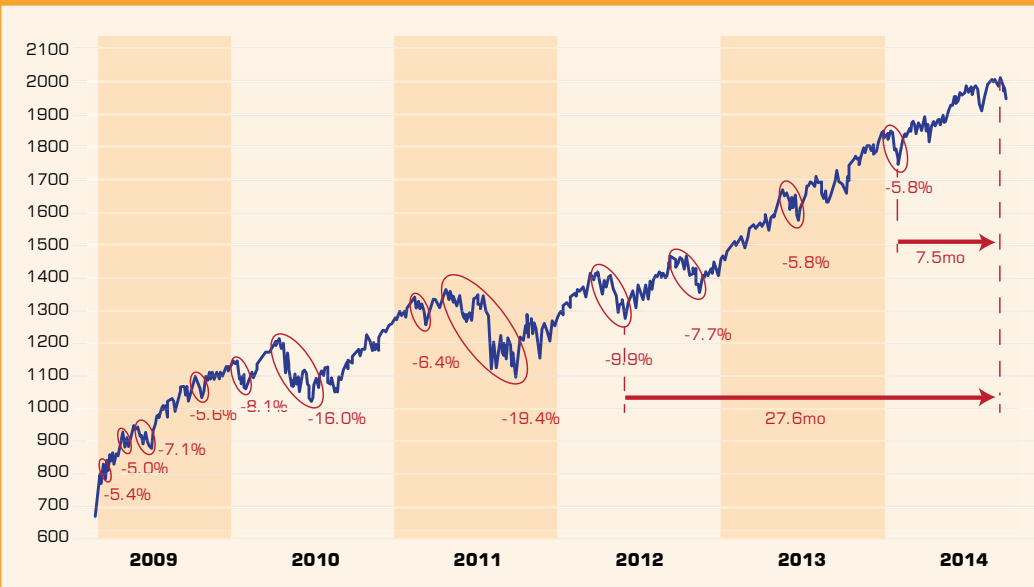
The bull market of 2002 to 2007 ended and thus began the devastating bear market of 2007 to 2009 which was to surpass the prior bear market and become, by far, the second most devastating bear market of the 20th century. Our current bull market began at the bottom of that bear market in March of 2009 and hence its age.

All bull markets end, sadly, when a bear market begins. The only question is how devastating will the coming bear market be? **By all measures we should have had a bear market (defined as a decline of at least 20%) during this year as the average decline in a mid-term election year for the past 85 years has been 21.7%.** But our “Eveready” bull market has stubbornly refused to decline even to a modest degree, at least not yet.

The chart at top right (again from James Stack and InvestTech Research) shows that there have been 12 corrections (defined as a decline of 5% or more) since this bull market began. Many more corrections occurred early on as the bull market was not quite believed but far fewer occurred recently as everyone has become a believer. **But we are way overdue for a decent correction of 10% or more.** As shown in the chart, it has been 7.5 months since a 5% correction and 27.6 since a 10% correction.

The chart at right shows the typical four year Presidential Election Cycle which includes the average decline of 21.7% mentioned before. As of October 3, the correction has been all of 4%. So don't be surprised to see something bigger come along. **In our opinion, this will not be a bad thing as history shows that the rally from the low in this year, the mid-term election year, to the high next year has averaged 48% over the past 85 years.**

2009 - 2014 Bull Market Corrections
S&P 500



Source: Investech Research

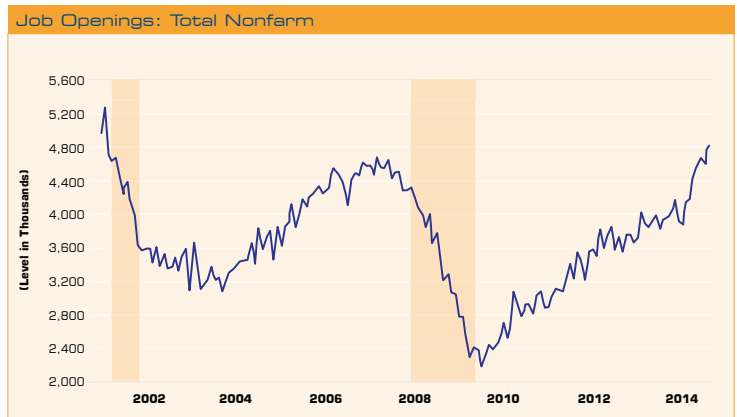
its aftermath. But monetary policy has undoubtedly fueled the bull market that we are enjoying today. But will that continue? As you know, the monetary stimulus that has been in place for quite some time is due to come to an end this month as the Fed does the final taper and stops buying assets. The question remains: "When will the Fed abandon the almost zero interest rate policy that it has maintained since December 2008?"

The chart below shows the availability of new jobs in the nonfarm sector and is believed to be a key chart that our Federal Reserve Chair utilizes in her work. **This shows that the number of job openings**

is the highest in 13 years. Couple this chart with the most recent jobs report of 248,000 increase in nonfarm payrolls and a 5.9% unemployment rate and the specter of increasing interest rates looks to be a definite possibility sooner rather than later.

THE FED & INTEREST RATES

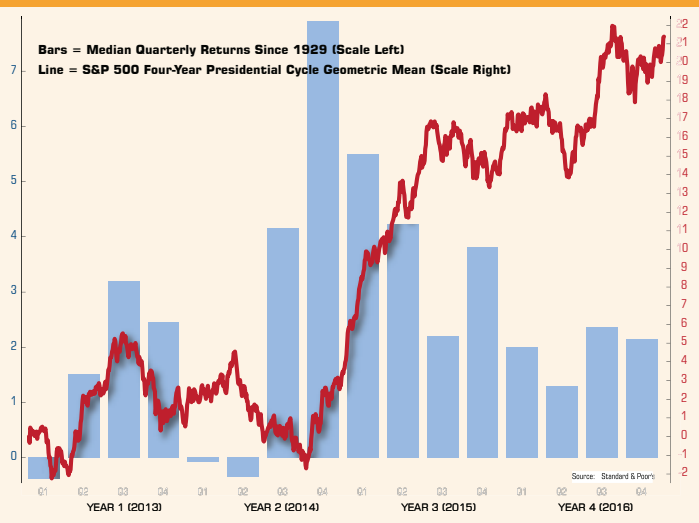
Another memorable event that occurred during the month of October was on October 6, 1979 when the then Federal Reserve Chairman, Paul Volcker made the "Whatever it takes" pledge to support the U.S. economy. Since then monetary policy has been relied upon to shepherd world economies through thick and thin. You might also say that monetary policy has caused massive disruptions such as the housing bubble and



Source: U.S. Department of Labor: Bureau of Labor Statistics

However, one of our Senior Portfolio Managers, Tony Soslow, CFA, who manages several of our individual stock portfolios, posted a blog that goes against the conventional thought about raising rates. That blog is on the following page.

S&P 500 Four-Year Presidential Cycle (1929 - 2013)



Source: Ned Davis Research

SIX REASONS WHY THE END OF QUANTITATIVE EASING MAY NOT LEAD TO HIGHER INTEREST RATES



Debunking Conventional Wisdom

QE is ending! Oh no! Telegraphed by the Fed, the lengthy monetary expansion plan known as Quantitative Easing is scheduled to end this month as the final \$15 billion of monthly purchases of Treasury notes and mortgage securities occurs.

While the incremental liquidity has certainly provided stimulus to long term asset prices over the last five plus years, I believe there are six reasons why the end to QE may not directly translate into meaningfully higher interest rates.

- The last two times the Fed ended QE (2010 and 2011), 10 year Treasury yields fell as anticipated economic growth declined.
- Stifled by slow economic growth, many European

countries' short term rates are now negative and thus represent little threat of leading our rates higher.

- Now at a four year high, the U.S. dollar has suppressed commodity inflation and will likely keep a lid on U.S. export growth.
- With roughly 6% unemployment and low labor participation rates, labor markets remain balanced and wage growth subdued.
- With a strong economy and higher tax rates, 2014's Treasury deficit should decline to just \$660 billion, the lowest since 2008 — representing a small supply of debt issuance for the market to absorb.
- Over the last five years, whenever the Fed's Five Year Forward Breakeven Inflation Rate dropped to 2.20% or below, the Fed initiated a new round of quantitative easing. At just 2.15% and dropping, Yellen and team are probably on the verge of re-upping their stimulus policies.

Taken together — low inflation, low foreign rates, slow foreign economic growth, low labor participation rates, a strong dollar and the likelihood of the Fed coming back to the party would all support a near zero interest rate policy.

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The S&P 500 measures the performance of the 500 leading companies in leading industries of the U.S. economy, capturing 75% of U.S. equities.

The Dow Jones Industrial Average is a stock market index that shows how 30 large publicly owned companies based in the U.S. have traded during a standard trading session in the stock market.

The Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index.

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