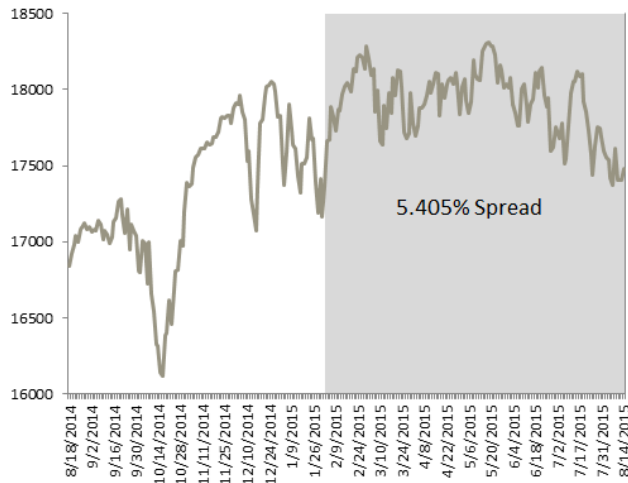




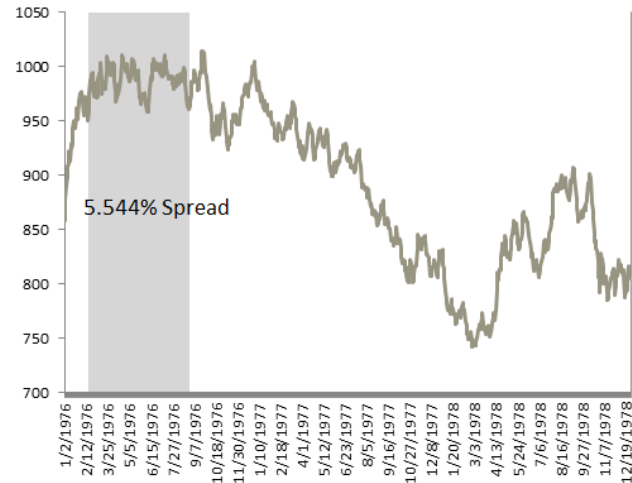
Its late in the summer, things have slowed down but there is plenty about which to worry. The Fed is set to raise rates, growth is blah, China is devaluing and Brazil is embroiled in a corruption scandal. What could go wrong?

Market Spread Over 135 Sessions is Tightest In Last 115 Years!!

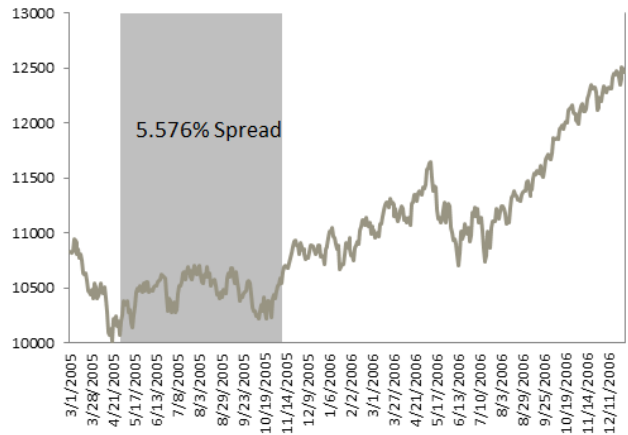
Dow During the Current Period (Through 8.14)



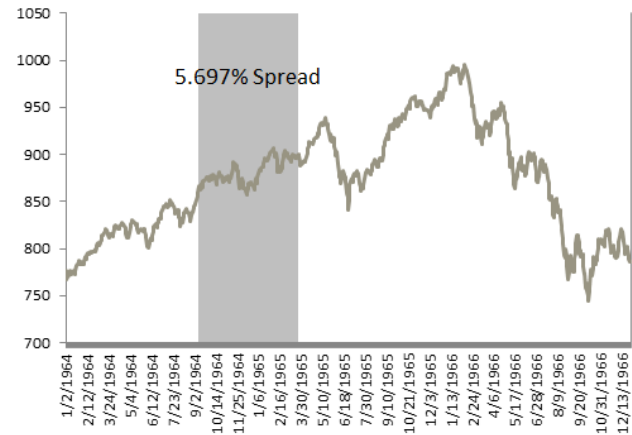
1976 Episode



2005 Episode



1964/1965 Episode

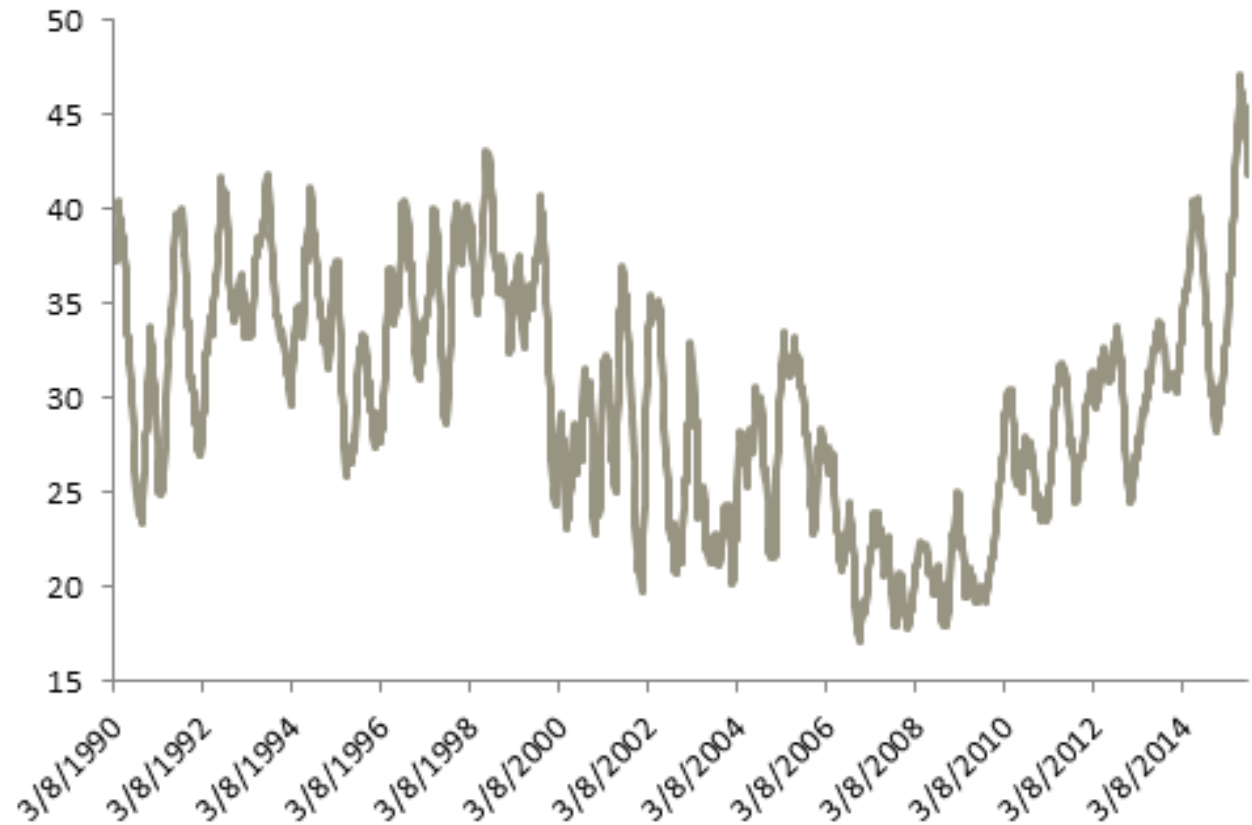


Source: BTIG LLC

With No Direction, Obviously People are “Neutral”

10 Week Moving Average AAI Neutral Readings

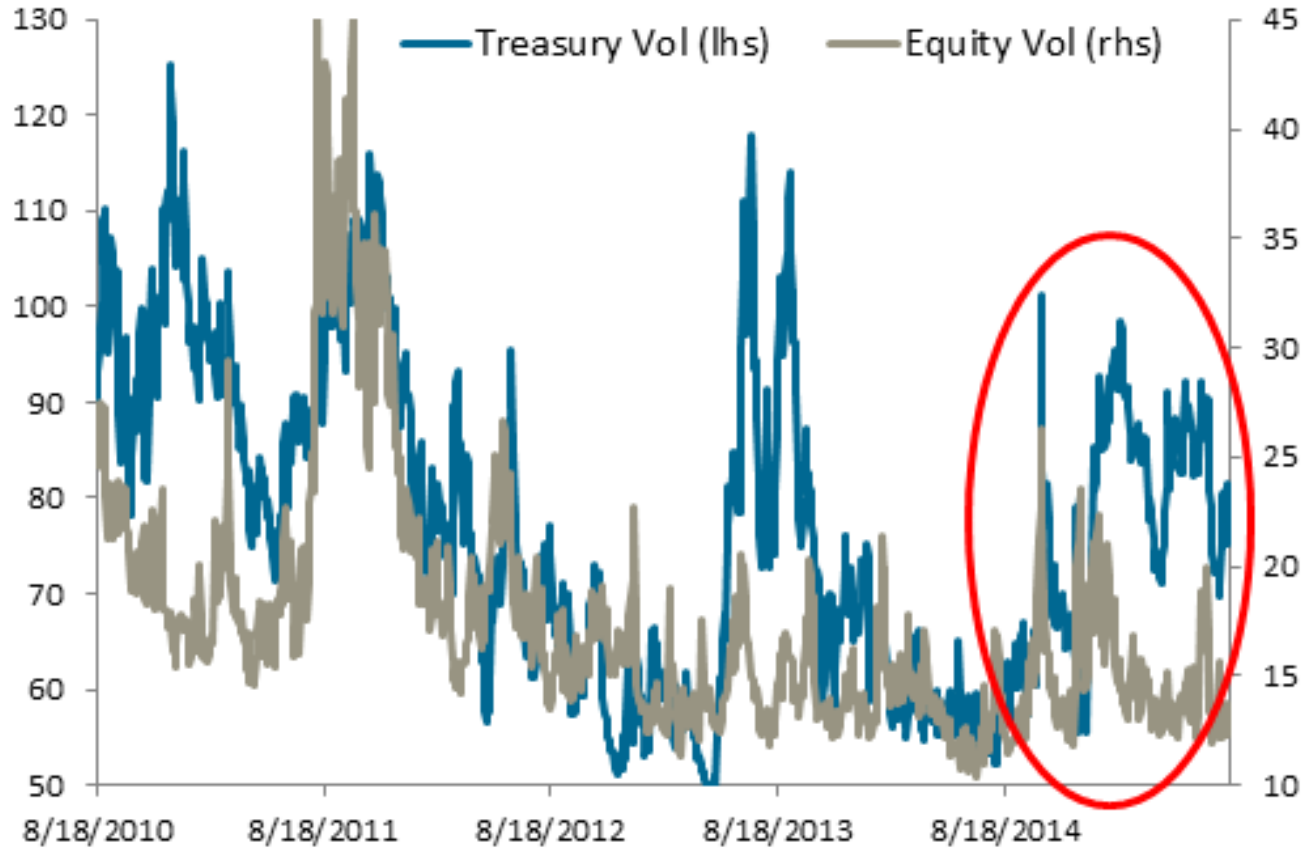
- The S&P 500 has crossed its 50 DMA on more than 30 occasions this year.
- We believe this to be the most number of times in modern history the index has done so.



Source: AAI, BTIG LLC

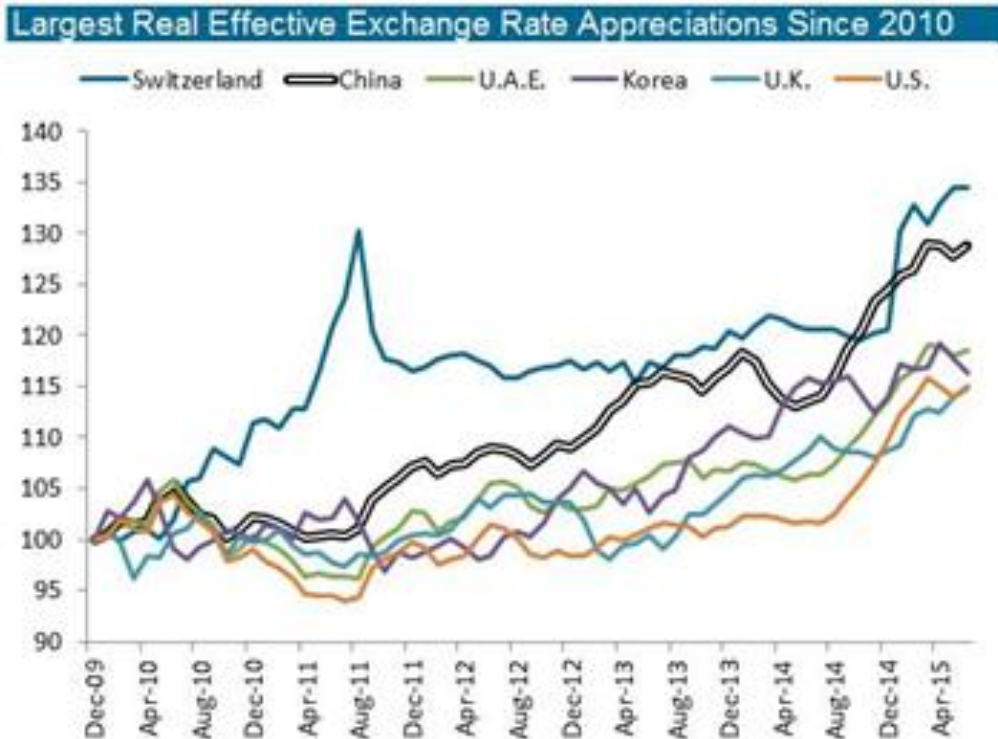
But While Equity Vol is Restrained, Treasury Volatility....

Treasury v. Equity Vol



Source: ML, CBOE, BTIG LLC

Why Didn't China Devalue Earlier?

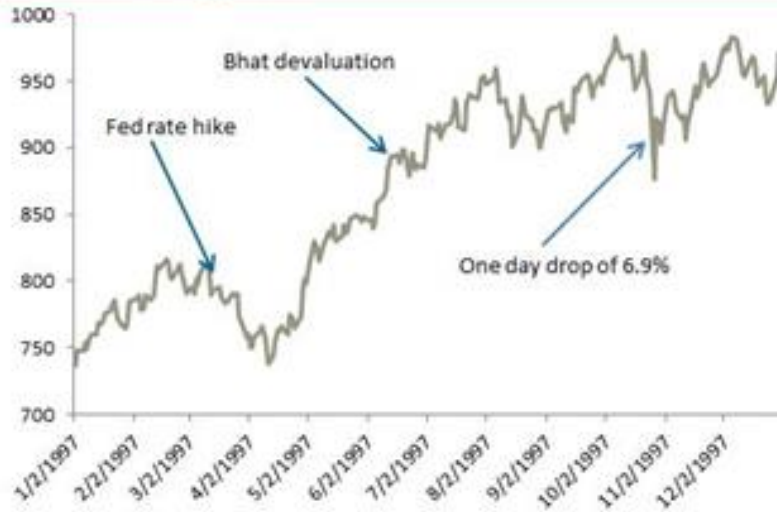


Source: BIS, BTIG LLC

- Over the last few years, China's economy has slowed and its stock market has imploded.
- Yet its currency has shown no meaningful deterioration as a result.
- In fact, the Yuan has experience one of the most pronounced REER appreciations of all major economies.
- It's reasonable to wonder why they didn't do something like this *sooner*.

The Last Period of Dollar Strength

S&P 500 During 1997



Source: BTIG LLC

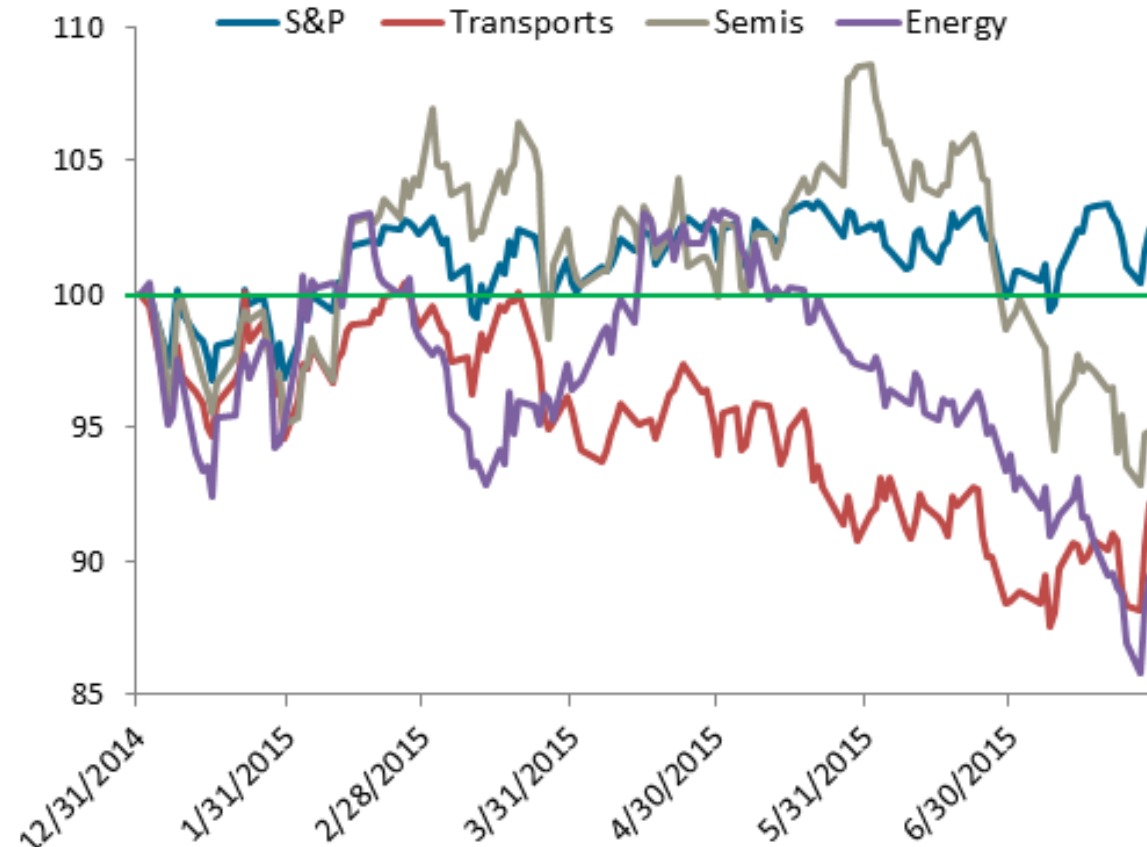
MSCI EM: 1995-1999



Source: MSCI, BTIG LLC

Several Sectors are Worrying Clients...

Beneath the Hood Though...



Source: BTIG LLC

% of Stocks Over 200 DMA Moving Lower Still

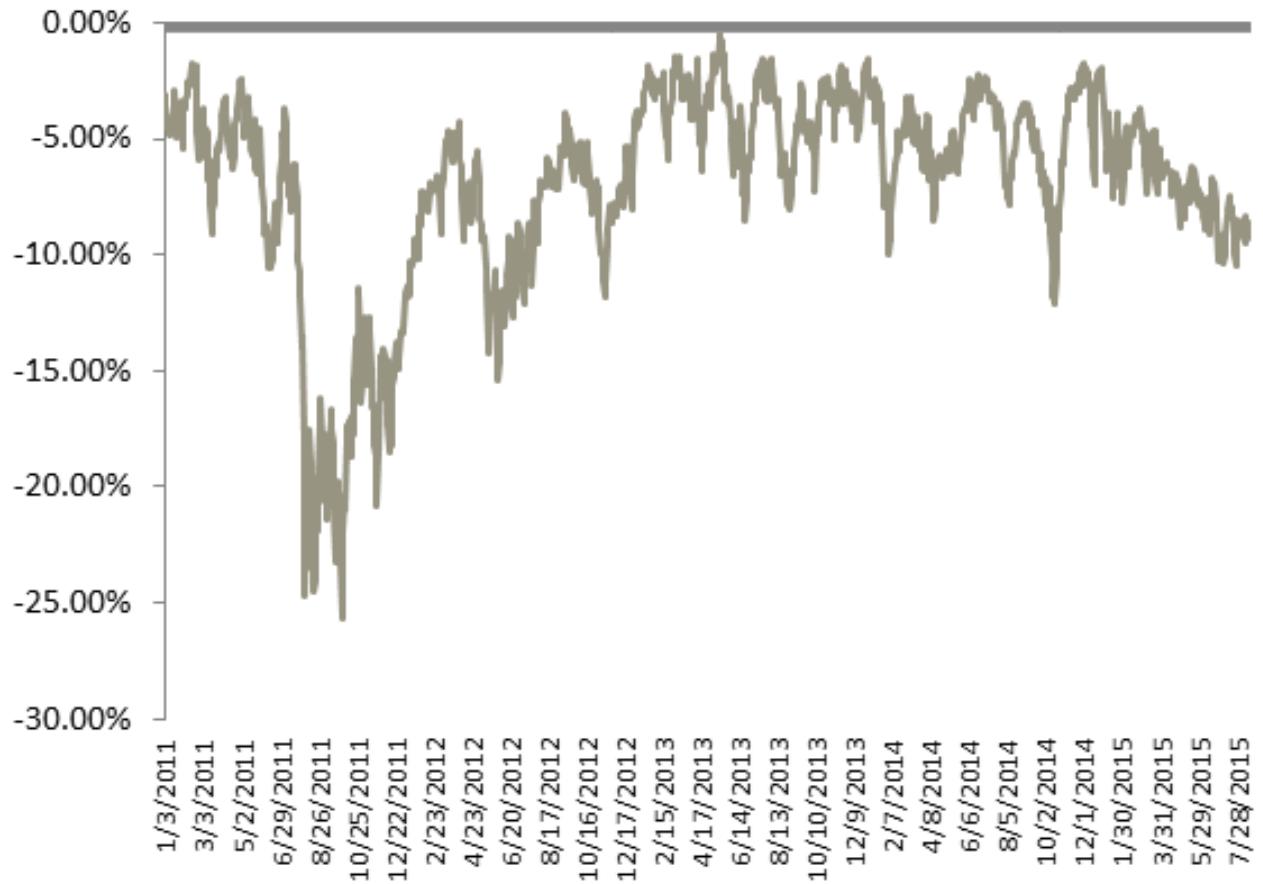
Fewer and Fewer Stocks Participating



Source: BTIG LLC

Median S&P 500 Stock Down Nearly 10%

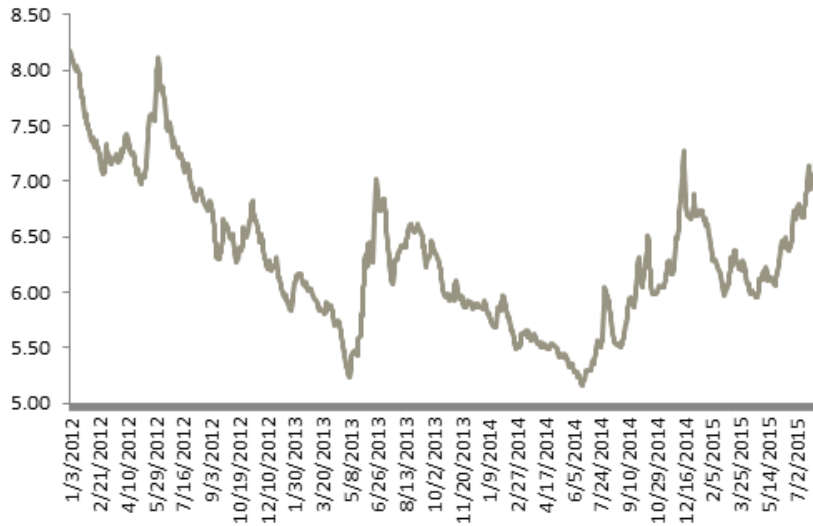
Median S&P 500 Stock In Relation to 52 Week High



Source: BTIG LLC

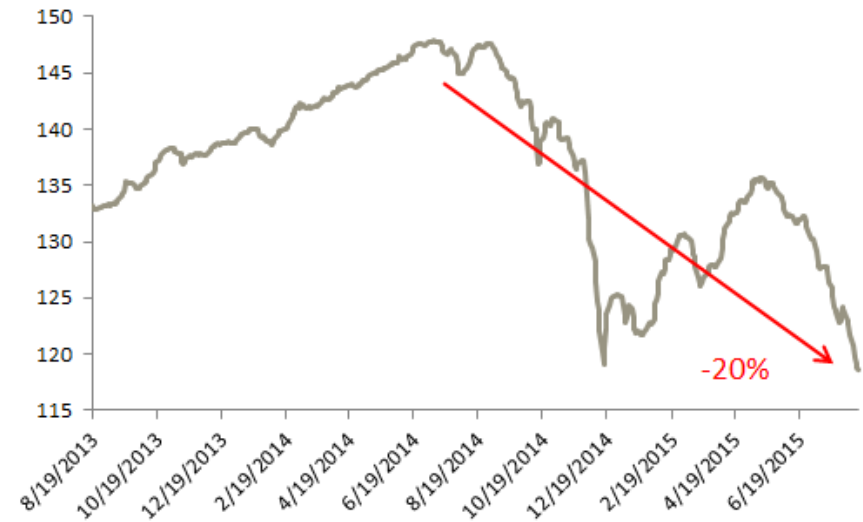
Then There's High Yield....

HY Effective Yields



Source: ML, BTIG LLC

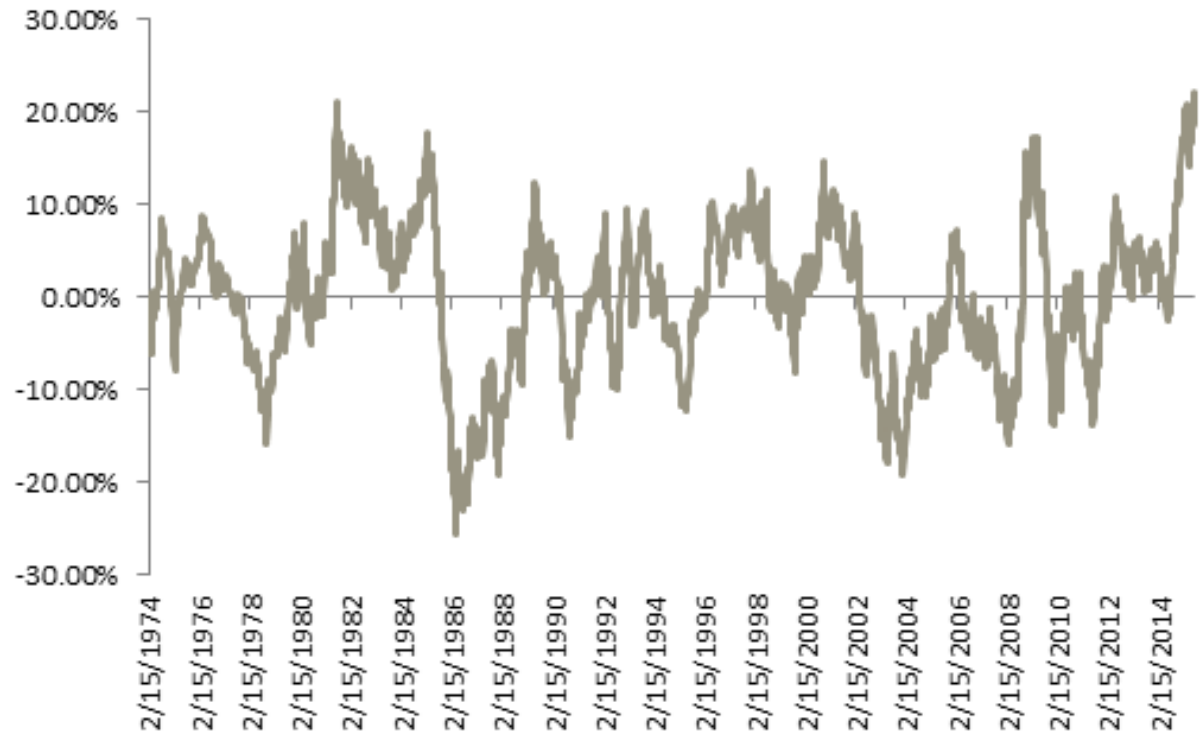
Bloomberg High Yield Energy Bond Index



Source: Bloomberg, BTIG LLC

...And the Dollar

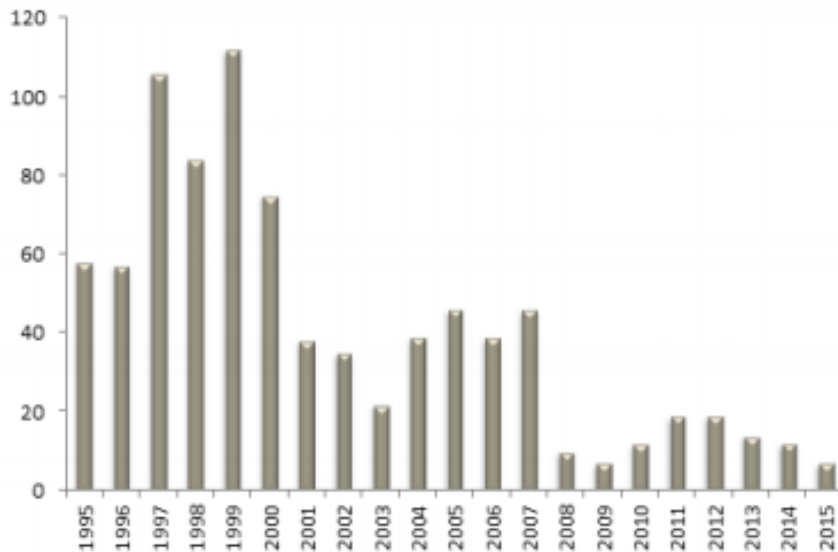
58 Week Change in Trade Weighted Dollar



Source: Federal Reserve, BTIG LLC

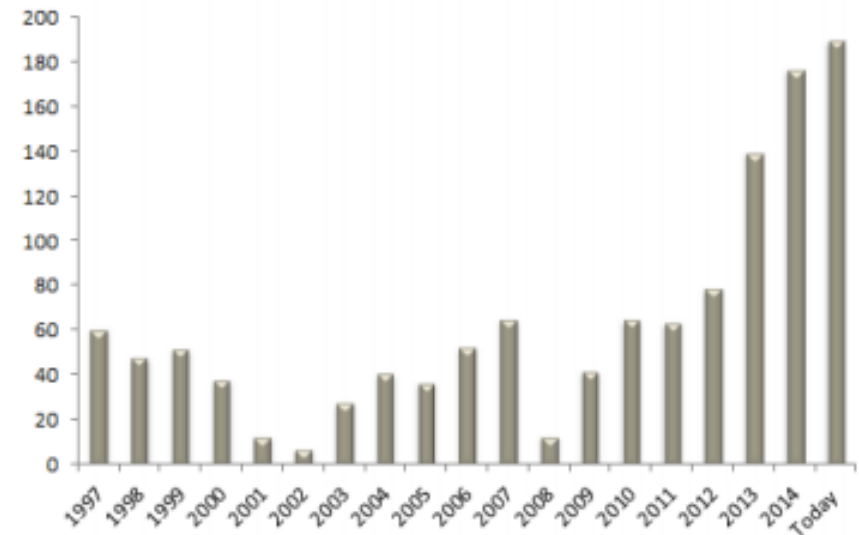
But Where's the Volume?

S&P 500 Announced Stock Splits by Year



Source: Bloomberg, BTIG LLC

Number of S&P 500 Companies Valued \$80 or More



Source: BTIG LLC

- Stocks splits in the late 1990s were a major reason why, despite the huge run up in the stock market, just 10% of stocks in the S&P 500 were trading north of \$80.
- At the end of 2008, close to the bear market's end, just 2.6% of stocks were trading north of \$80.
- Today, roughly 40% of the S&P 500 trades above \$80 per share. Liquidity and volumes suffer as a result.

Ex-Energy, Earnings Season Was Pretty Good

S&P 500 Earnings Season Thus Far					
	Reported	Total	% Change	Sector EPS	% of Total
Discretionary	62	84	9.2%	\$3.30	11.0%
Staples	27	38	1.9%	\$2.52	8.4%
Energy	41	41	-56.0%	\$1.51	5.0%
Financials	87	86	3.7%	\$6.47	21.5%
Health Care	51	55	13.1%	\$4.58	15.2%
Industrials	62	65	-2.1%	\$3.16	10.5%
Tech	54	66	4.3%	\$5.73	19.1%
Materials	27	29	5.8%	\$1.04	3.5%
Telecom	5	6	11.1%	\$0.94	3.1%
Utilities	26	30	5.3%	\$0.82	2.7%
Total	442	500	-1.9%	\$30.07	

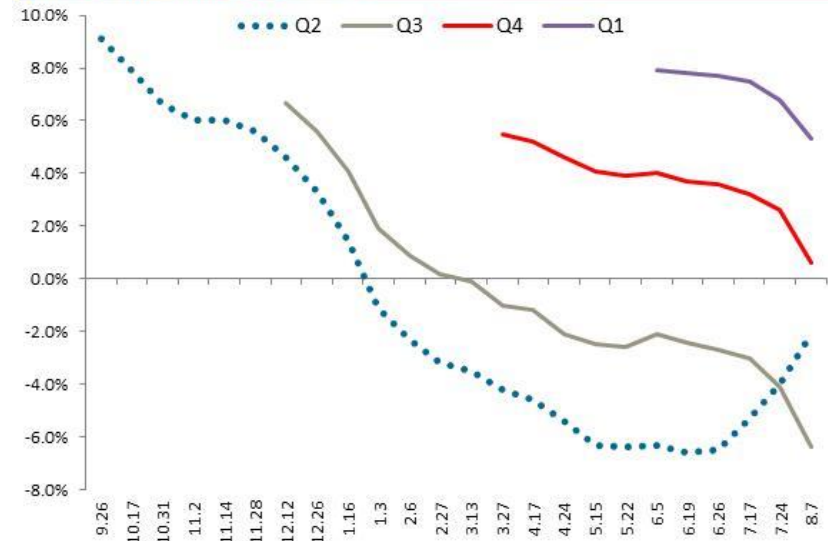
Source: Company Reports, Bloomberg, BTIG LLC

S&P 500 Sales Season Thus Far					
	Reported	Total	Sales Beat	Sales Misses	YOY % Chg
Discretionary	62	84	38	21	1.7%
Staples	27	37	11	14	-3.2%
Energy	41	41	1	40	-33.1%
Financials	87	88	55	26	1.5%
Health Care	51	55	40	11	8.1%
Industrials	62	65	25	36	-3.0%
Tech	54	66	29	23	4.0%
Materials	27	29	9	17	10.2%
Telecom	5	5	4	1	2.4%
Utilities	26	30	6	19	-4.2%

Total **442** **500** **218** **208** **-4.9%**

Source: Company Reports, Bloomberg, BTIG LLC estimates

Expected Earnings Evolution



Source: Factset, Bloomberg, BTIG LLC

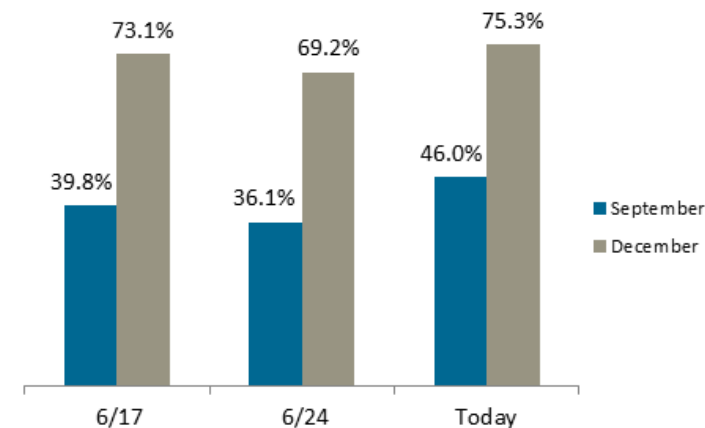
We Think Bond Market “Mispricing” the Fed...If They Hike in September

10 Year Yield Reflecting Rate Hike Expectations



Source: BTIG LLC

Rate Hike Odds On the Way Back Up



Source: BTIG LLC

- A guiding metric for us these last few years is the relationship between how far away the market prices a rate hike and the 10-year yield.
- Today’s spread, if the Fed does hike in the fall, is unusually wide—suggesting further yield increases (no, we don’t think yields “should” be 3.5%).
- We’re told by some, “This can’t happen,” for a number of reasons:
 - Deleveraging, Dodd-Frank and global risk aversion.
- We agree but would remind clients that yields rose by 140 bps in 2013 during the “taper tantrum.”
- How high rates can go is a much more interesting debate. Answer: not much higher.

Rates Appear Likely to Rise

Yellen: If the economy evolves as we expect, economic conditions likely would make it appropriate at some point this year to raise the federal funds rate target, thereby beginning to normalize the stance of monetary policy.

Mester: I think the economy is recovered. I think the fundamentals are good. And I think we don't really need to be at a zero interest rate...The economy could sustain some minor increases in interest rates over the rest of the year.

Williams: My own forecast would be having us raise rates two times this year.

George: We would be wise to act modestly but act now

Rosengren: Were the U.S. economy to unfold as I and other policymakers expected in our June forecasts, beginning the policy normalization process later this year might be appropriate.

Powell: My own forecast calls for liftoff in September and for an additional increase in December

Rates Appear Likely to Rise (II) – Don't Wait for Wages



“If we did see wage growth pick up that would be at least a symptom that inflation would move up over time” however such wage growth isn't “a precondition to raising rates.” – Chair Yellen, March 18th

“Obviously, rising wages are healthy for the economy. They're a positive sign for the recovery and the country. **But looking at patterns in prior recessions and the history of monetary policy, they're not an indicator of overall inflation one way or another.** That means that I'm not surprised by their slowness to rebound and I'd be disinclined to lose sleep were they to rebound sharply—at least inasmuch as relates to their contribution to inflation.” – SF Fed President Williams, May 26th



Rates Appear Likely to Rise (III) – The Importance of “Some”

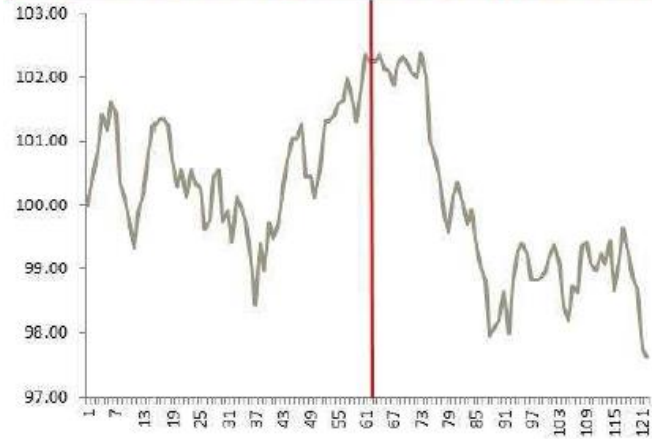
international developments. The Committee anticipates that it will be appropriate to raise the target range for the federal funds rate when it has seen further improvement in the labor market and is reasonably confident that inflation will move back to its 2 percent objective over the medium term.

international developments. The Committee anticipates that it will be appropriate to raise the target range for the federal funds rate when it has seen **some** further improvement in the labor market and is reasonably confident that inflation will move back to its 2 percent objective over the medium term.

In June, the Fed wanted to see further improvement but in July, only “some” further improvement was necessary. We view this as an “upgrade” and if things continue to progress along current trajectory, we believe the Fed is going to raise rates in September.

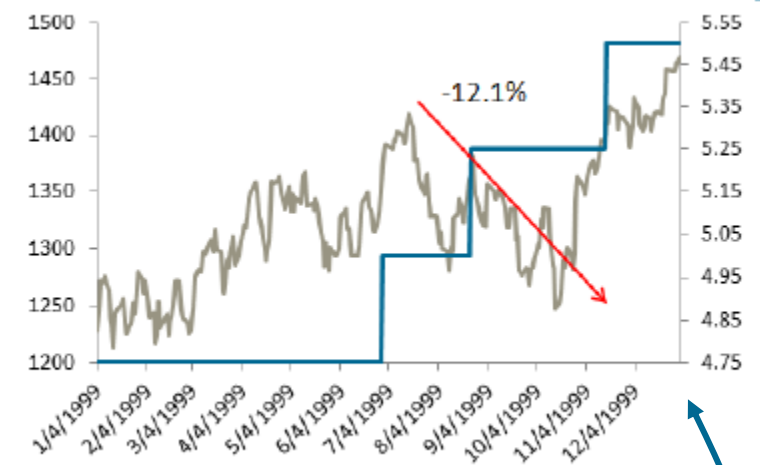
It's Only 25 bps! Everyone Knows it's Coming!

Sixty Sessions Before and After Last Three First Rate Hikes



Source: BTIG LLC estimates

S&P 500 and the 1999 Rate Hike

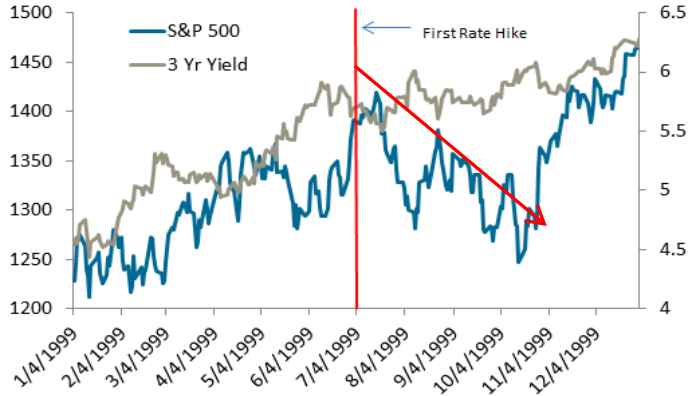


Source: BTIG LLC

- It is commonly said that “equities rally into a rate hike and decline afterwards.” That is largely true, but the specifics are more uncertain. 2004 was *not* a rally into a hike. Taking the last three hikes, equities are only modestly higher into the hike.
- Further, while this rate hike might be well known and well followed, even the exceedingly bullish 1990s environment was not immune from a market pullback.

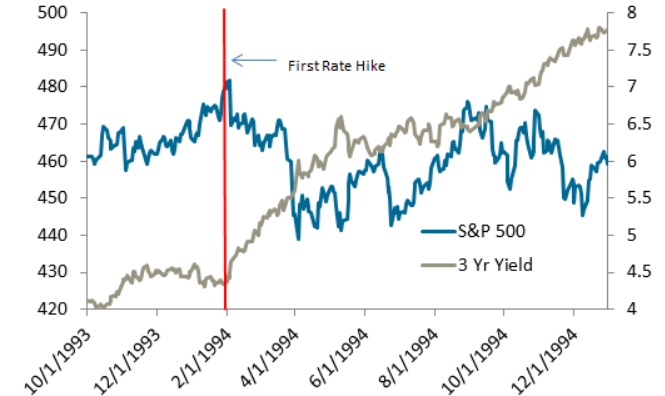
Graphical Evidence: Each Episode Different

S&P 500, Yields and the 1999 Tightening Campaign



Source: BTIG LLC

S&P 500, Yields and the 1994 Tightening Campaign



Source: BTIG LLC

S&P 500, Yields and the 2004 Tightening Campaign



Source: BTIG LLC

S&P 500, Yields and the First Hike in 1983



Source: BTIG LLC

What People Said Then

Following the 1999 Hike- NY Times: *“many analysts had expected the Federal Reserve to raise rates by another quarter-point at its next meeting in August, and they were caught off guard by the central bank's suggestion today that there was no consensus on the need for another increase to slow the economy's growth. That suggestion, in the form of a shift to a neutral stance from a stance toward higher rates, was taken as a green light by investors on Wall Street, who rapidly bid up stock and bond prices in the belief that higher rates were less likely this summer.*

Following the 2004 hike- NY Times: *“The Fed's statement was a relief for many on Wall Street.... It also appears to be good news for President Bush...any rate increases are likely to be mild.... Because Mr. Greenspan and other top officials had telegraphed their intentions months in advance, yields on long-term Treasury securities...actually declined slightly after the Fed's announcement....*

- *This was exactly what they had advertised, and I think the markets were reassured*
- *I think the Fed had to lay the groundwork because of the very ugly experience of 1994, when they did not prepare the groundwork*
- *They think they will be able to move in this gradual, measured way*

Poor Performance is More than Three Hikes

- Going back to the 1960s, equities tend to perform poorly in the wake of rate hikes.
 - PE's contract by a median of 7.6%.
- Yes, *cycles* lend themselves to strong performance: Fed tightened by 425 bps during the last cycle, and the stock market rose by over 100% during its entire run.
- As telegraphed as the Fed now is, we stick to the script calling for difficult performance through 2015 as investors digest this reality.

The S&P 500 and Rate Hikes: A Long History of Tough Times

	S&P 500 GAAP PE Ratios			S&P 500 Price Performance	
	3 Mons Before	Date Of	3 Months After	3 Mons Before	3 Months After
11/20/1967	17.8	17.3	17.2	-3.3	-0.9
12/18/1968	17.9	18.5	18.3	5.1	-7.7
7/16/1971	19.8	18.6	18.3	-42	-1.3
1/15/1973	17.6	18.4	17.4	9.7	-5.4
8/30/1977	9.6	9.2	9	0.1	-1.6
9/26/1980	7.8	8.6	8.5	8.7	8.1
4/9/1984	12	10.2	9.6	-8	-1.3
9/4/1987	20.5	20	18.1	7.3	-29.3
2/4/1994	22.4	21.5	20.7	2.7	-3.9
6/30/1999	33.9	33.5	31.2	5.5	-6.6
6/30/2004	21.6	20.3	19.8	1.2	-2.3

Source: Bloomberg, Federal Reserve, BTIG LLC estimates (Discount rate changes used prior to 1990)

What Sectors Have Done What?

Major Equity Sector Performance Before and After Three Most Recent Tightening Cycles

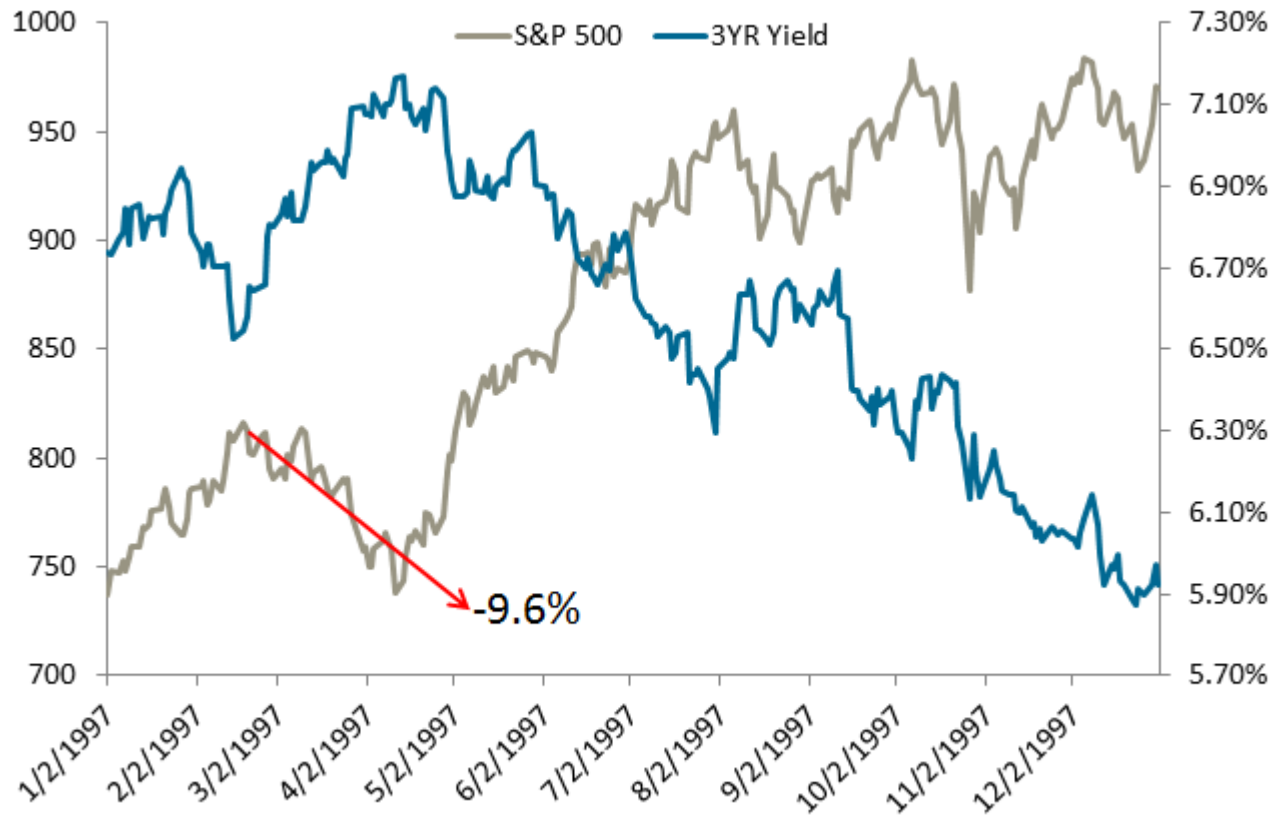
1994	80 Days Before	Three Months After	1999	80 Days Before	Three Months After	2004	80 Days Before	Three Months After
Materials	16.2%	-5.4%	Materials	21.7%	-8.6%	Industrials	5.3%	-0.5%
Industrials	9.2%	-5.6%	Energy	17.9%	-1.7%	Energy	4.2%	10.4%
Tech	6.6%	-0.7%	Tech	13.8%	4.9%	Tech	-0.4%	-10.0%
Health Care	3.5%	-3.8%	Industrials	12.0%	-5.2%	Materials	-1.2%	3.0%
Discretionary	3.5%	-5.0%	Utilities	8.4%	-5.9%	Staples	-1.5%	-6.1%
S&P 500	0.6%	-3.9%	Telecom	8.2%	-7.7%	S&P 500	-1.8%	-2.3%
Staples	0.1%	-2.2%	S&P 500	5.4%	-6.6%	Discretionary	-2.5%	-1.4%
Energy	-2.4%	-3.9%	Financials	2.2%	-15.5%	Health Care	-3.3%	-5.7%
Financials	-7.3%	-1.6%	Discretionary	1.8%	-8.7%	Utilities	-3.3%	5.7%
Telecom	-10.2%	-1.9%	Staples	-4.3%	-12.9%	Telecom	-5.8%	5.5%
Utilities	-10.6%	-9.2%	Health Care	-9.2%	-10.5%	Financials	-6.1%	-0.2%

Source: BTIG LLC estimates

- Over the last twenty years, there have been just three tightening campaigns: 1994, 1999 and 2004. Three is hardly a statistically significant sample size, and differences in market makeup make extrapolating one period to the next a fruitless endeavor.
- For instance, Utilities, an area thought to be one to which investors would not want exposure if the Fed tightens, was the second best sector three months after the Fed tightened in summer 2004. Telecom was third!
- Following a hike, discretionary is probably closest to “the worst” sector while tech and energy appear closest to “the best.”

What About One and Done?

One and Done in 1997 Didn't Stop a Decline



Source: BTIG LLC

Bull Markets Don't Die of Old Age...

- Bull markets don't die of old age...and even if they did, the current rally is “younger” than six other rallies in the last 100 years.
- Excesses, overvaluation and interest rates kill equity rallies.
- With interest rates still at exceptionally low levels and inflation rates benign, we still believe the current bull market has room to run.
- With valuations at current levels though, we are less excited about forward returns.

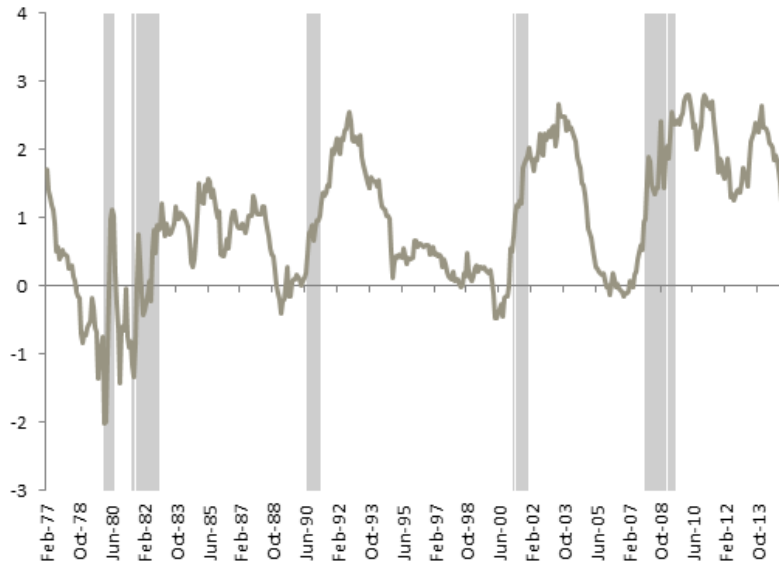
Historical Bull Market Duration

<u>Bull</u>	<u>Length</u>	<u>Bull</u>	<u>Length</u>
1921	2013	1982	1273
1934	662	1987	692
1942	1031	1990	836
1953	651	1994	1083
1957	559	1998	347
1962	924	2002	1258
1970	669	2009	541
1974	456	2011	918

Source: BTIG LLC

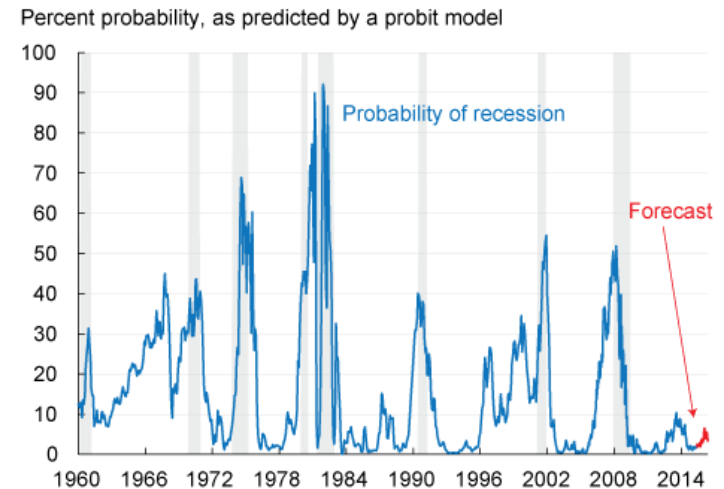
...Recessions and Inflation Kill Bull Markets

2s10s Yield Curve; No Recession Yet



Source: BTIG LLC

Recession Probability from Yield Curve

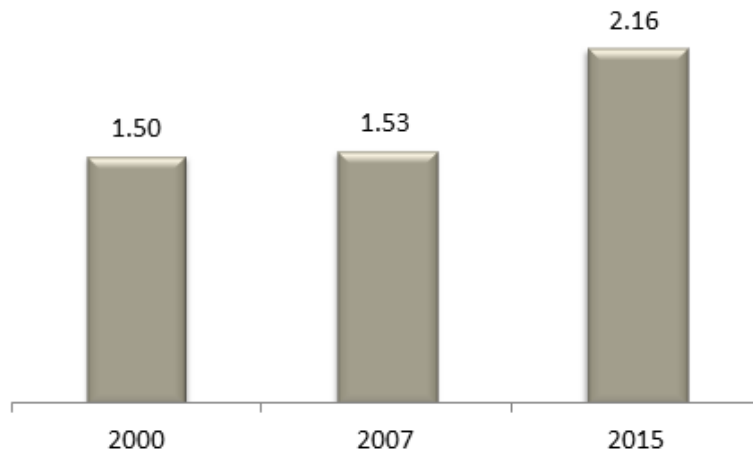


Source: Board of Governors of the Federal Reserve System; NBER; authors' calculations.

- The Yield Curve remains a prime recession indicator, and it suggests the odds of a recession in the coming six months are less than 5%. Further, recoveries associated with low inflation pressure, such as the current episode, tend to last longer than high inflation recoveries.

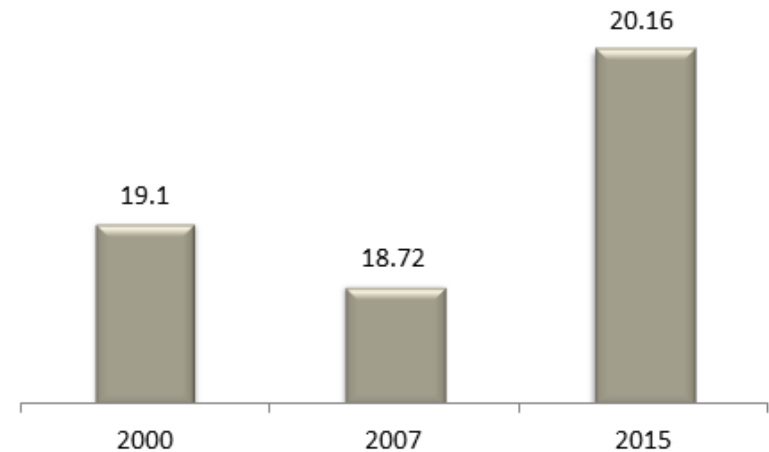
Regardless, Things Aren't "Cheap"

Median P/S Ratio for S&P 500 Stocks



Source: BTIG LLC estimates

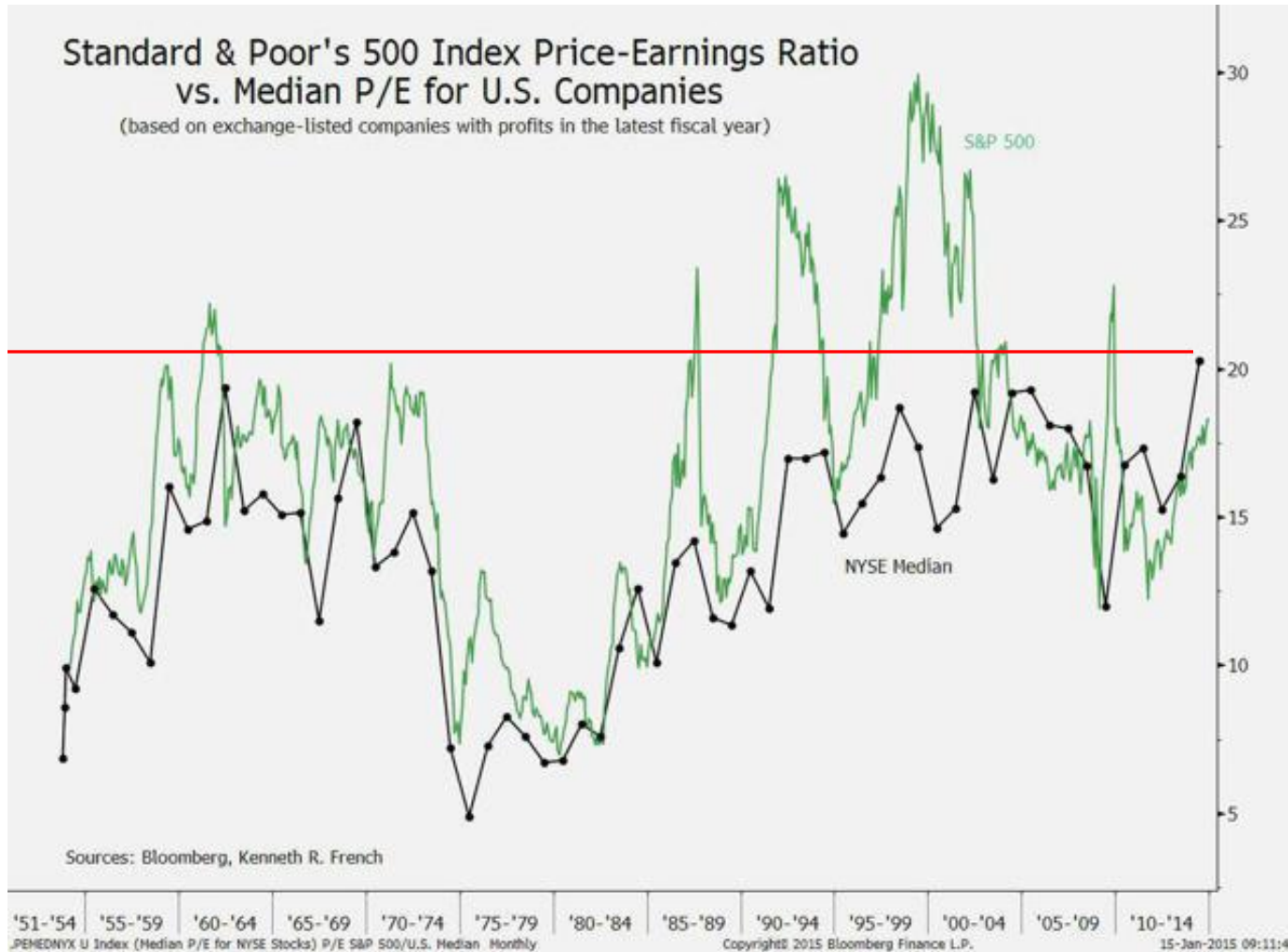
Median P/E Ratio for S&P 500 Stocks



Source: BTIG LLC estimates

- The S&P 500's PE ratio isn't screamingly expensive, but neither is it attractive. It's on the high side of fair value. On the other hand, the median stock's P/S ratio is higher than it's been in quite some time.
- The median stock's P/E ratio is higher today than at either the 2007 or 2000 peaks. This of course means little in terms of predicting near-term performance (valuation is a useful guide to longer-term returns, but virtually useless in terms of timing), but it does suggest investor hesitancy is warranted.

Expressed Another Way



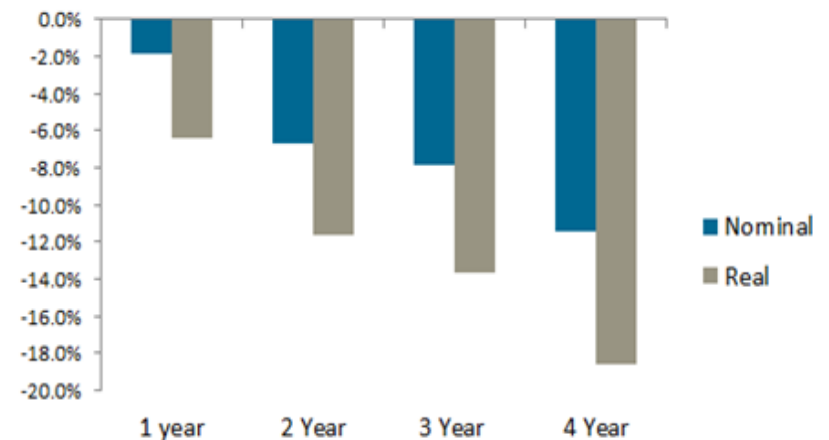
The CAPE is a Terrible Market Timing Tool, But...

10 Year Cyclically Adjusted PE Ratio



Source: Shiller, BTIG LLC

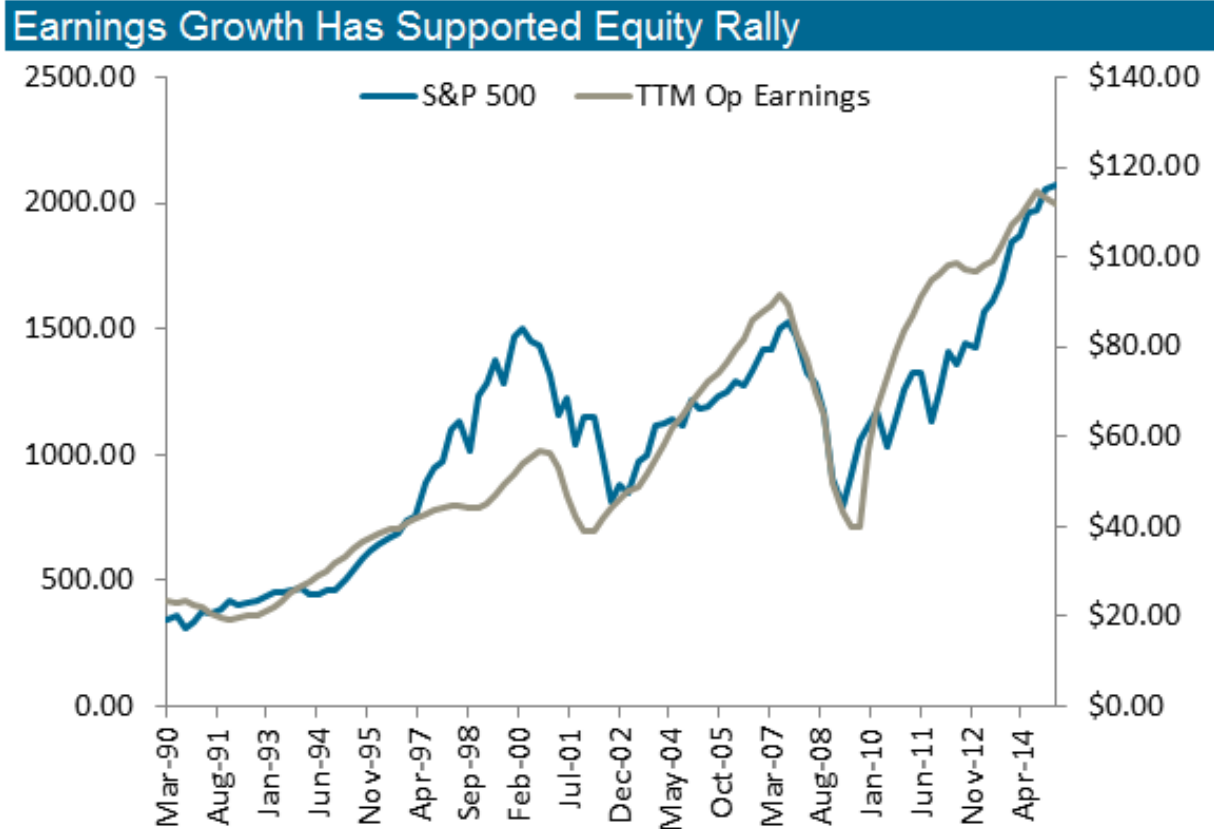
Avg Returns When Shiller PE is Higher Than Today



Source: Shiller, BTIG LLC

- The expansion in PE multiples has brought back to the fore the Shiller Cyclically Adjusted PE Ratio (CAPE). Several clients have asked where this measure stands, and so we present the nearby two charts. At 27.9x, the CAPE is higher than all but 4.2% of months dating back to the late 1800s. The few episodes where higher valuations were realized are *all* concentrated around the 1929 and 2000 equity peaks. As such, the chart showing realized forward returns should hardly be surprising.

Bubble? What Bubble?

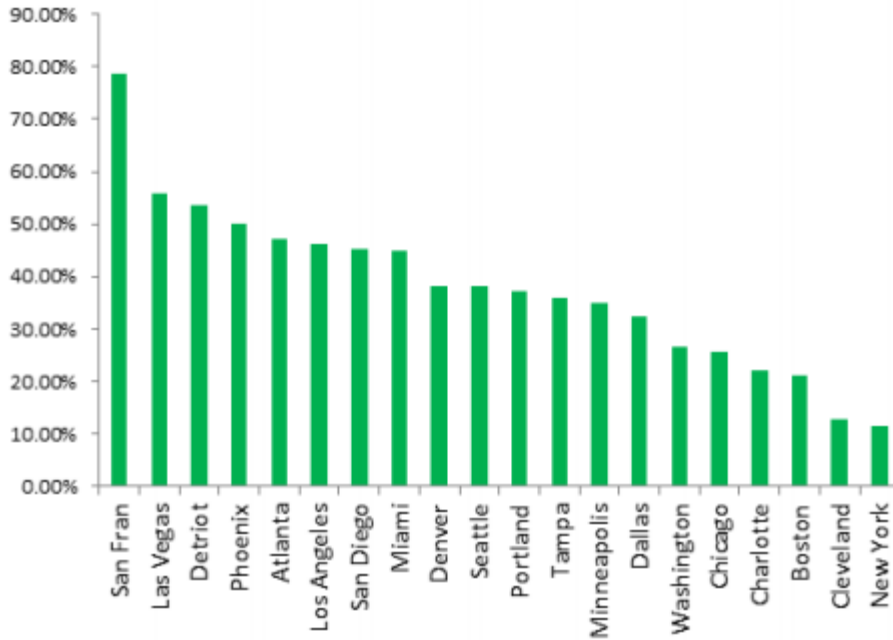


Source: S&P, BTIG LLC

- Earnings growth has largely supported equity prices.
- In fact, the S&P 500 is up 162% from the end of March 2009 while TTM earnings are up 157%.
- That doesn't sound like a bubble to us.

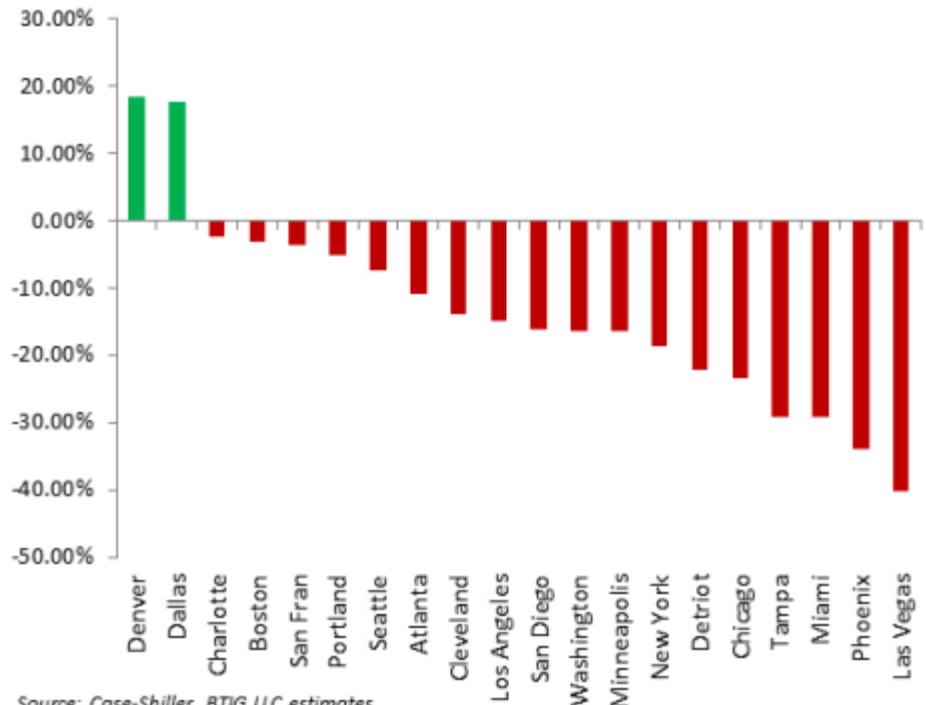
If Housing's in a Bubble, It's a Smaller One Than 2006

Case Shiller Home Prices Bounce From Low Price



Source: Case-Shiller, BTIG LLC estimates

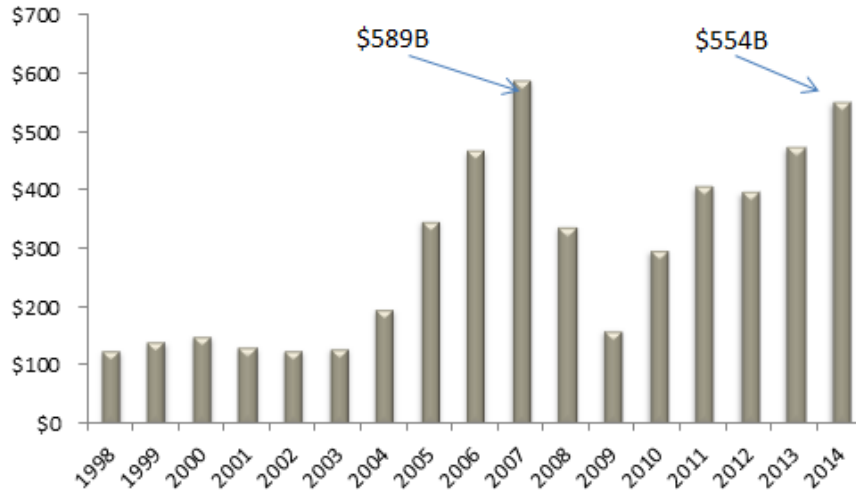
Case Shiller Home Prices From Peak



Source: Case-Shiller, BTIG LLC estimates

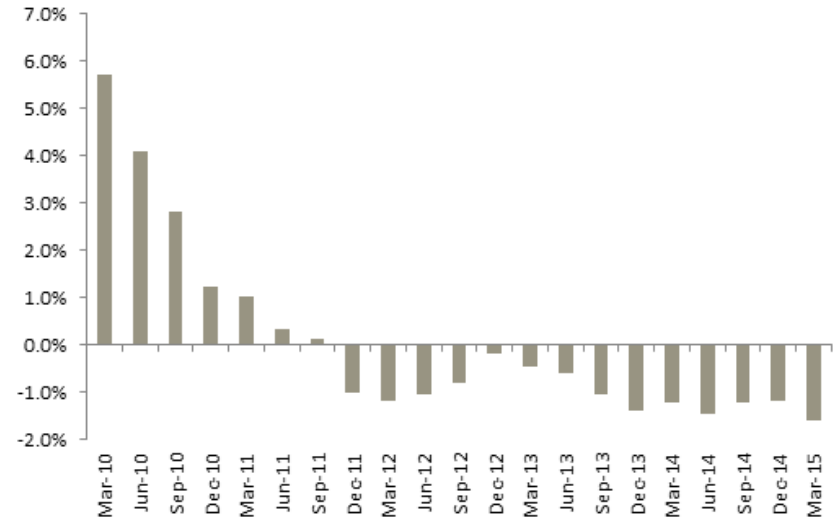
Yes, But Financial Engineering

2014's Buyback Level Was Just Short of a Record



Source: S&P, BTIG LLC

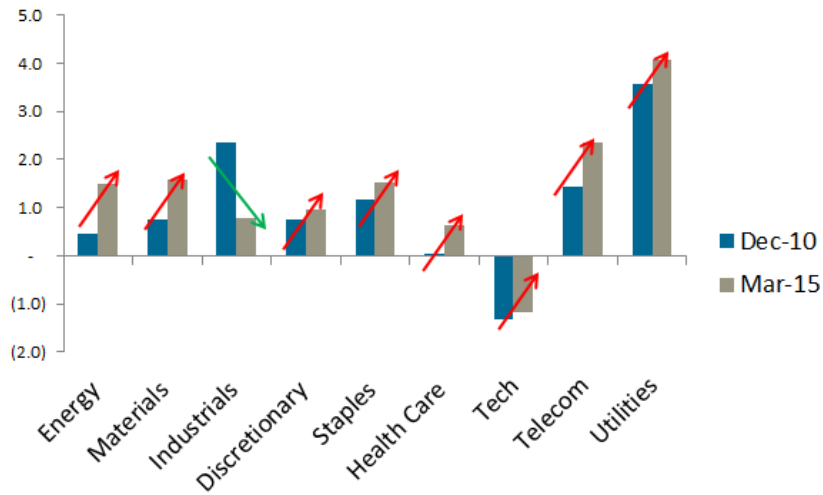
YOY Change in S&P 500 Equity Float (Current Constituents)



Source: BTIG LLC estimates

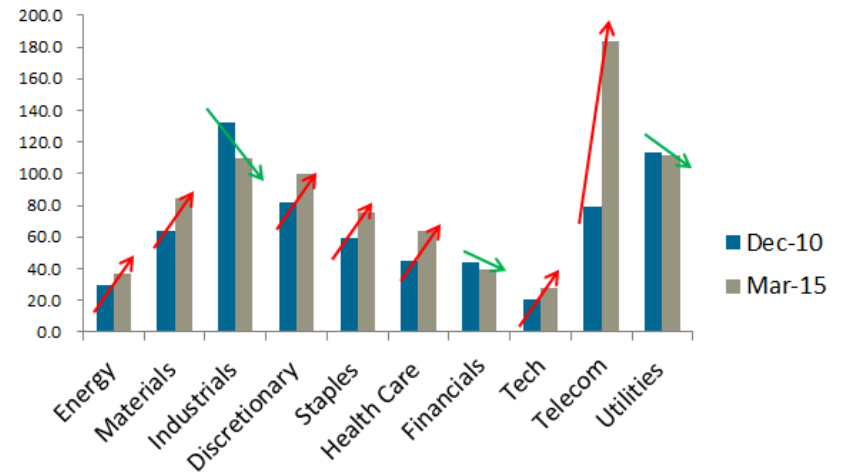
Yes, But Financial Engineering (II)

S&P 500 Sector Net Debt / EBITDA



Source: Factset, Bloomberg, BTIG LLC

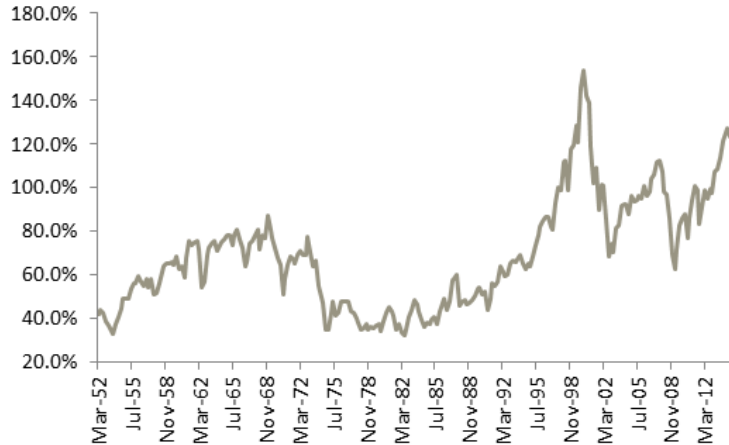
S&P 500 Sector LT Debt / Total Equity



Source: Factset, Bloomberg, BTIG LLC

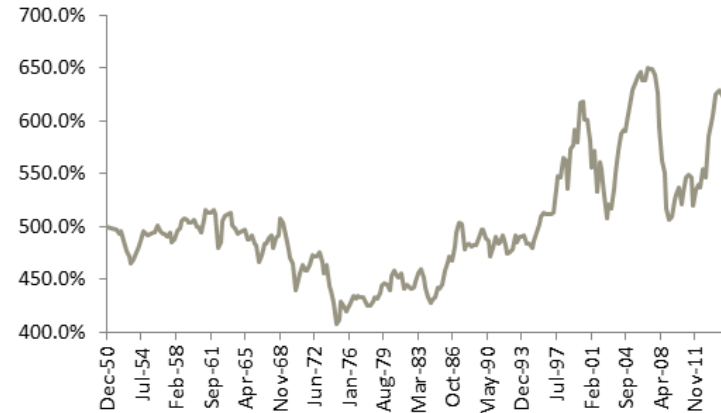
What Worries Us Longer Term?

U.S. Market Cap to GDP Ratio



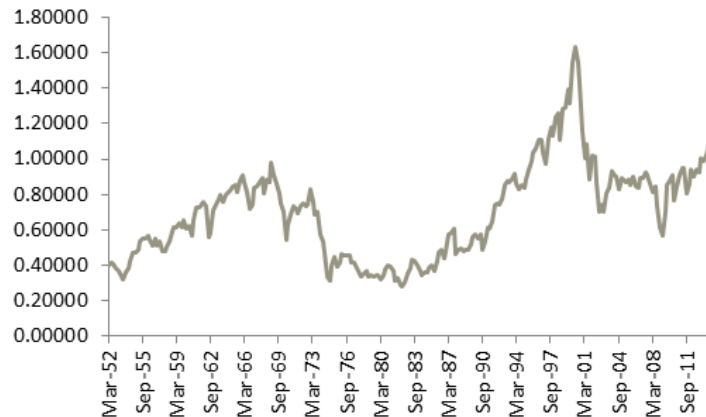
Source: Federal Reserve, BTIG LLC

Household Net Worth as % of Disposable Income



Source: Federal Reserve, BTIG LLC

Value of Corporate Equities to Replacement Value (Tobin's Q)



Source: Federal Reserve, BTIG LLC

- Market cap to GDP was once cited by Warren Buffet as being his favorite indicator of “excess” and its reached levels only once exceeded in the post war era.
- Low interest rates and the associated rise in asset values of all stripes has lifted household net worth (\$82.9T v. \$54.9T in March '09) but since disposable incomes haven't risen, the ratio of the two now stands at the levels only matched in “bubble” periods.
- Tobin's Q tells a similar story; relative to net worth or replacement cost, equities are “rich.”

Additional Information Available Upon Request

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