Quarterly Commentary 2015 | Q3

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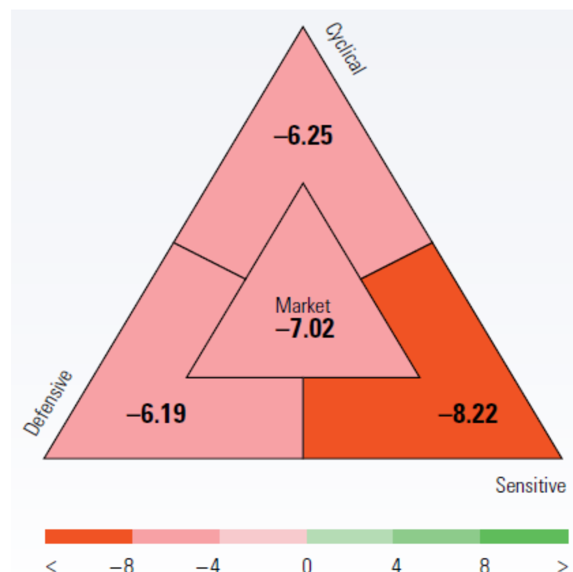
"The stock market is filled with individuals who know the price of everything, but the value of nothing." -Phillip Fisher-

Much as we have been expecting, volatility gripped the equity markets through much of August and September. The downward swings were largely attributable to a sense of fear and uncertainty. Although significant declines in valuation are always a concern, the longer-term investor can today look back and characterize the period as a bump in the road. The investor with a shorter-term perspective may have grown overly concerned and locked in losses.

Since the third quarter drew to a close, we have seen some stability return to the equity markets and the downward pressure appears to have subsided, much to the relief of many investors. The greatest concern may be that the markets are not so much rising on fundamentals, but on the expectation that the Federal Reserve may keep the punch bowl at the table a while longer.

One of the catalysts which drove markets down in August and early September was a widely held belief the Fed would raise interest rates at their September 16th meeting. Investors grappled with the potential impact on the economy, corporations, and investment markets. Since the Fed has been actively priming the pump since the start of the Great Recession, many investors are fearful of the side effects brought on by a hike in interest rates.



Morningstar Supersector Delta (for illustration purposes only.)

However, much to almost everyone's surprise, the Fed's decision's not to raise rates at their September meeting did not calm markets, but ignited even more concern. Investors were confused and began to wonder what key pieces of data they were missing; what did the Fed know that they did not. When uncertainty pervades market psyche, there is typically only one response—reduce exposure by trimming positions, literally taking some money off the table.

One such element of uncertainty hinged on the true health of the Chinese economy. The Chinese government had already acted to devalue the country's sovereign currency, to increase China's competitiveness in the world market. Signs of a continuing slowdown haunted investors, particularly given the Chinese government's relative predisposition for a lack of transparency.

A second reason for unease was the falling price of crude oil. Rising fuel prices are often seen as

a sign of a healthy economy. Falling prices are associated with a weaker economic outlook, due to a decrease in demand. As a result, there is often a relatively strong correlation between equity and fuel markets.

Sector	Quarter	1-Year	3-Year
Cyclical	**–6.25**	**2.97**	**14.65**
Basic Materials	–16.93	–18.97	2.44
Consumer Cyclical	–4.08	10.36	17.41
Financial Services	–7.25	1.65	16.91
Real Estate	0.30	7.35	8.14
Sensitive	**–8.22**	**–7.38**	**8.69**
Communication Svs	–5.43	0.32	10.36
Energy	–18.71	–31.66	–4.05
Industrials	–7.43	–2.53	13.88
Technology	–5.21	0.14	11.64
Defensive	**–6.19**	**6.82**	**16.38**
Consumer Defensive	–0.76	7.41	13.11
Health Care	–11.22	6.80	20.90
Utilities	4.75	5.97	10.07

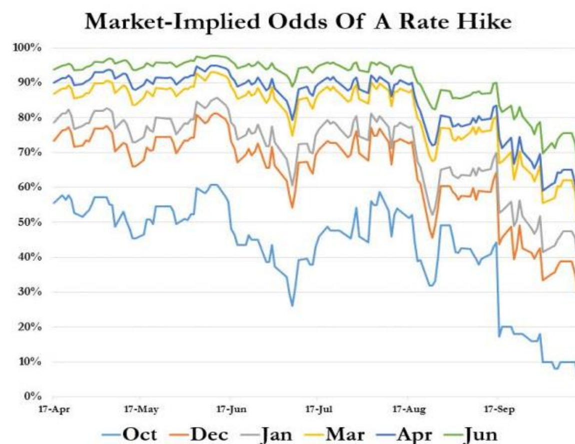
The lingering risk of deflation in the Eurozone provided yet another catalyst for market tension. Although the European Central Bank has established a program of highly accommodative monetary policy for Eurozone countries, member nations once again reported anemic growth in the third quarter. Continued weakness among the European countries caused the U.S. dollar to strengthen, and prompted investors to worry that profits earned overseas by U.S. multinational corporations would be diluted if not eliminated.

The news, however, was not all bleak. The Federal Reserve Open Market Committee indicated that economic activity "is expanding at a moderate pace". It also noted that "house-hold spending and business fixed investment have been increasingly moderately" and that "the housing sector has improved further." Perhaps most encouraging, the committee observed that the "labor market indicators show that underutilization of labor resources has diminished."

The Bureau of Economic Analysis also revised its GDP estimate upward from 3.7% to 3.9% for the second quarter. Many economists classified the revision as high-quality, signifying that the contributing factors are indicative of positive economic momentum.

As the fourth quarter began, investor confidence gained traction in the midst of a general consensus that the Fed would stay at the table a while longer, given the murkiness of the global economy. Many investors and economists have now coalesced around the idea that we will not face the specter of a rate hike until March of next year, even though a few members of the Fed's Board are continuing to espouse the possibility of a hike before the end of the year.

From the standpoint of many academics, pundits and market watchers, the Fed now has a serious credibility problem. Most economists and investment professionals do not believe the Fed will move to hike rates before the end of the year. From the perspective of many investors though, the desire to own equities appears to be back, thanks in large part to the Fed's continued accommodation and the chance to avoid the unknown—at least for a while longer.



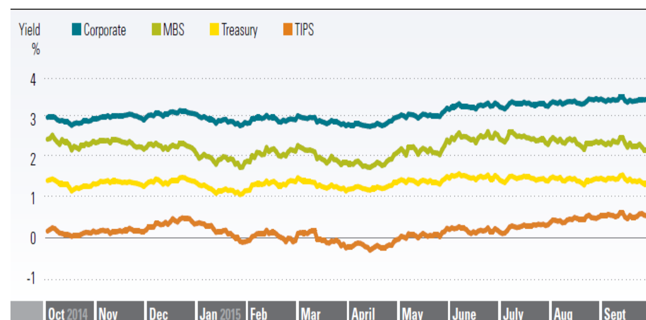
A Brief Retrospective on Bonds…

While declining interest rates boosted many bond returns, an aversion to risk widened credit spreads, pressuring returns in the corporate bond market. The culprit was a heightened fear of default in the energy, metals and mining sectors, as plunging oil and commodity prices weighed.

Treasury Inflation-Protected Securities (TIPS) suffered a similar fate. As inflation and inflation-expectations subsided, demand for these bonds waned.

The story was similar in Europe. Sovereign bonds logged gains in the face of declining interest rates, but corporate bonds struggled in the wake of widening spreads.

US Bond Indexes: Average Yields



Looking Forward…

An investor who may have gotten too concerned by the recent wave of volatility may have liquidated investment positions, accepted permanent loss of capital, and not participated in the current rally. For these very reasons, we have repeatedly stressed the need for a long-term perspective.

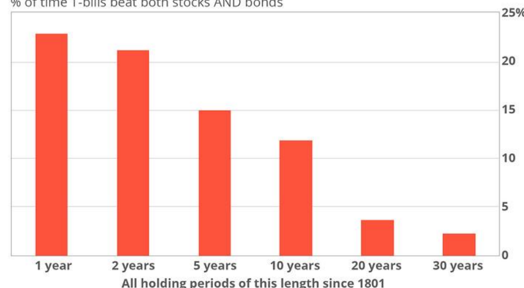
Once when asked what stocks would do, legendary investor, Warren Buffett, quipped that they will go up or down. Such movement has been synonymous with equity market activity since the inception of trading.

But much of Mr. Buffett's fortune is attributable to his ability to weather the storm, to adopt a long term perspective and to in many ways be greedy when others are fearful. To paraphrase, when shares of a position you own are depressed, don't despair and sell, rather buy more.

While it is highly unlikely that any of us will ever amass a fraction of his fortune, there is an important lesson to be learned. He was able to adopt his winning approach by employing a barbell strategy. His investments were on one end, while the funds needed for near-term operations were on the other. The assets needed to service current commitments remained in cash. He was not reliant on his long-term investment to produce an immediate return to meet short-term obligations.

Don't count cash out

% of time T-bills beat both stocks AND bonds



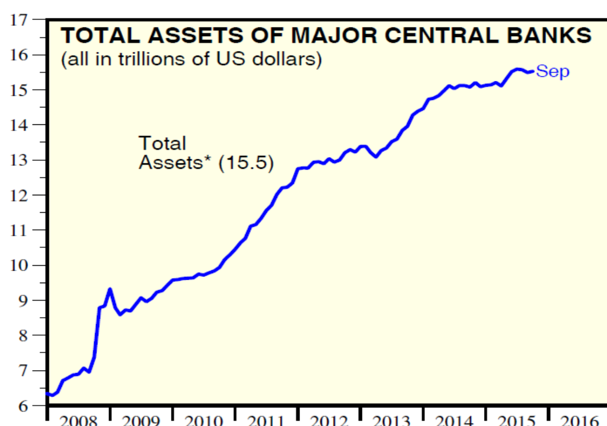
Source: Jeremy Siegel, Hulbert Financial Digest

When we recommend this approach to our clients, we frequently refer to it as the bucket strategy. Simply fill the bucket with the liquid cash needed to meet current commitments and allow your investment policy the time required to develop, mature and produce the desired results.

While we are very pleased to see the stability that has returned to the equity markets, we anticipate

some periods of volatility in the coming quarters. There are many reasons for concern in our increasingly inter-connected global economy, but there are also many reasons for optimism—declining un-employment, a board spectrum of corporations that are beating revenue and earnings-per-share estimates, a relatively strong housing market, and stable consumer confidence.

Perhaps the greatest concern is the deep reliance on central banks around the world to maintain an almost unwavering commitment to highly accommodative monetary policy. News of additional stimulus sends stocks up. Any perceived expectation of tightening can instigate a downward spiral.



Also disturbing is the fact that many companies are using the ultra-low interest rate environment to boost share prices by buying back stock, as opposed to investing for future growth. In such situations, companies may not foresee any growth in demand for their products and services. Economically, such a trend does nothing to stimulate job or wage growth.

Generating additional concern is the overall health of the global economy. While the U.S. still dominates international markets, it is important that other countries also do well and thrive. Much of the revenue of our domestic corporations is generated outside our borders. Other countries provide markets for the goods and services we produce. In our increasingly inter-connected economy, if one established-economy falters, the effects will literally be felt around the world.

While we remain cautiously optimistic, we acknowledge that there are many forces at work which could undermine what has been a long and slow economic recovery. These forces could at times erode investor confidence and disrupt markets. Most importantly, we recognize that every investor's situation is unique; although we encourage clients to take a long-term perspective, some have the ability to withstand volatility for a period of time, others do not.

If you have questions, comments, or feel that your position has changed and your portfolio no longer reflects your risk tolerance, investment objectives and time horizon, we would welcome a call. As always, we appreciate the opportunity to be of service.

Sincerely,
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