Quarterly Update & Economic Commentary—September 30, 2015

Quarter in Review

The third quarter proved to be a difficult quarter for equity investments. Many of the broad equity benchmarks suffered their worst losses in four years. The S&P 500 Total Return (TR) dropped 6.44 percent, the S&P MidCap 600 TR lost 8.5 percent and the S&P SmallCap 600 TR lost 9.27 percent. The worst performing sectors for the S&P 500 were energy (-17.41 percent), materials (-16.90 percent) and health care (-10.67 percent). The only sector to post a positive return for the quarter was the utilities sector which finished up by 5.40 percent and on an annual basis, the consumer discretionary sector is the only sector to be in positive territory which is up by 4.08 percent. For the quarter, international equities, both developed and emerging, underperformed domestic equities. The MSCI EAFE, which represents developed international equities, fell 10.23 percent; emerging markets stocks, represented by the MSCI Emerging Markets index, fell 17.90 percent.

Investment grade fixed income had a stellar quarter compared to the dismal performance in the equity markets. The Barclays US Aggregate Bond Index was positive for the quarter by 1.23 percent. Lower quality bonds performed more like equities; the Barclays US Corporate High Yield bond index lost 4.86 percent during the quarter and is now negative by 2.45 percent for the year. Accounting for differences in maturity, longer dated bonds outperformed shorter dated bonds as a result of rates falling after the Fed announced that it would not raise interest rates at the September Federal Reserve meeting. Higher quality bonds outperformed lower quality bonds as investors flocked into safer assets.

Commodity prices declined during the quarter, led by the continued decline in the price of oil and other energy resources. Spot prices of crude oil fell by 24.18 percent for the quarter; they are down 15.36 percent for the year and have lost more than 50 percent in the last 12 months. Gold, despite its reputation as a safe haven, fell 4.83 percent for the quarter and has lost 5.82 percent for the year.

The headlines for the quarter centered on the correction in the equity markets and the Federal Reserve's decision to keep the Fed Funds rate between 0 and 0.25 percent.

The correction — defined by a decline of ten percent or more — was the first since 2011. The instability in the equity markets was initially sparked by the extreme volatility seen in the Chinese stock market. Corrections are never easy for investors, but they are common occurrences. In fact, seeing consecutive years without a ten percent decline is an anomaly by historical standards.

The bigger news during the quarter was the Fed's decision to not raise the benchmark rate in September, despite overall encouraging signals from the U.S. economy. The Fed's mandate is to focus on the domestic economy and to promote maximum employment, stable prices and moderate long-term interest rates, though interestingly it cited global economic conditions as one of the reasons they elected to keep the status quo. With an improving labor market and moderate inflation (ex-food and energy), many expected the Fed to commit to raising rates. By electing to punt on a rate increase, the Fed created greater uncertainty around the timing and swiftness of future increases.

Although there remains slack in the labor market, the jobs picture in the U.S. continues to improve. The headline unemployment rate is at 5.1 percent and is expected to fall below five percent soon. In addition to the declining unemployment rate, the recent Job Openings Labor Turnover Survey (JOLTS) indicated that the labor markets are improving. The survey showed job openings were at a series high, 5.8 million, on the last day of July. The "quits" rate, indicative of employee confidence to quit and find a better opportunity elsewhere, continues to be stable; overall this rate has increased since the end of the recession. One of the areas of concern in the labor market is the increasing level of job layoffs; however, it is difficult to tell if this is a result of the economy or other outside issues. As an example, the computer sector is seeing a large percentage of layoffs, but this is a result of outdated technology and not an economic slow-down. Layoffs are prominent in the energy sector, which has been impacted by low oil prices and multinational companies which are affected by a stronger dollar and struggling economies outside of the U.S.

Inflation indicators are another measure that Fed officials watch when making monetary policy decisions. The Fed targets a two percent long-term growth rate in prices. Headline Consumer Price Index (CPI) is currently at 0.2 percent, well off the Fed's target; however, Core CPI, which excludes food and energy prices, is much closer to two percent at 1.8 percent. Falling food and energy prices has brought down inflation measurements but the cheaper prices are inflationary because it puts more discretionary income in the consumers' pocket which can be spent on other goods and services.

The growth of the U.S. economy remains stable. The second quarter annualized growth rate was 3.9 percent which is higher than the normalized rate which is around 2.5 percent. A two or three percent economy is not a robust economy but slow growth is sustainable growth. The housing market has been a positive for the economy. Rising rents and low inventory levels are pushing home prices higher and encouraging builders to continue building new homes. Total vehicle sales have been another positive contributor to the economy; the seasonally adjusted annual rate of light vehicle sales reached over 18 million vehicles, a level not reached since January of 2006.

The U.S. economy is ahead of many other recovering developed economies. Europe, which started their quantitative easing after the U.S., is showing signs of stabilization. GDP is growing at an annualized pace above one percent. The unemployment rate has fallen to 11 percent, still alarmingly high but it is trending lower. In a sign of improving consumer confidence and financial conditions, banks are reporting an uptick in loan demand. Europe is far from a strong economy right now, but it has made significant progress since its financial crisis.

Global economic factors continue to cause problems for emerging markets. Many emerging market countries have debt issued in U.S. dollars, resulting in more expensive interest payments as the U.S. dollar has strengthened in recent quarters. In addition to the burden of the rising interest payments, many emerging market countries that export significant amounts of commodities like oil have seen revenues decline along with prices. The double whammy of low energy prices and a stronger dollar have hurt countries like Brazil the most. In U.S. dollar terms, Brazil's market has fallen 33 percent for the quarter and is off almost 40 percent year-to-date. The concerns surrounding emerging markets have resulted in significant capital outflows from these countries. Russia's increasing belligerence abroad and Brazil's seemingly endless political corruption cause additional concern for investors.

A Look at the Numbers

Name	3rd Quarter Performance	YTD Performance
DJ Industrial Average TR USD	-6.98	-6.95
S&P 500 TR USD	-6.44	-5.29
S&P MidCap 400 TR	-8.50	-4.66
S&P SmallCap 600 TR USD	-9.27	-5.49
NASDAQ Composite TR USD	-7.09	-1.61
MSCI EAFE NR USD	-10.23	-5.28
Barclays US Agg Bond TR USD	1.23	1.13
Wilshire US REIT TR USD	2.88	-3.01
IA SBBI US 30 Day TBill TR USD	0.00	0.01

Forecast in Brief

The U.S. equity markets will need a strong fourth quarter to keep from posting a negative return for the first time in years. The S&P 500 TR has not finished negative for a calendar year since the 37 percent drop in 2008. Small cap domestic equities, as measured by the Russell 2000 Index, have not finished negative since 2011 when they lost 4.18 percent.

We feel that the Fed missed an opportunity to raise rates in September and created more uncertainty around when they will hike rates and at what pace. Chair Yellen has said that she expects the first hike to occur in 2015, but that the decision will remain "data dependent." The Fed meets again at the end of October and during the middle of December. It is unlikely that the Fed will move in October since there is a lack of economic data released between the September and October meeting. December seems more probable, but it comes with its own concerns. Many money managers are required to disclose their holdings as of quarter-end; as a result they want their portfolios positioned in a manner that is consistent with current market conditions. By the Fed making a decision to raise rates so close to quarter and year end, there is concern that the trading that will ensue as a result of the portfolio positioning would cause short-term volatility and market instability. This concern gaining the attention of many Fed officials.

We believe the Fed's zero interest rate policy is an appropriate "emergency measure" for an economy that is on life support. Although our economy does not show signs of runaway growth, it is strong enough to handle a gradual return towards normalized interest rates. The longer the Fed waits to begin raising rates, the less control they will have over the pace at which the increase occurs. Additionally, the Fed would like rates to be higher before the next recession hits so that they have a tool to promote economic expansion.

We expect economic data coming out of the U.S. to continue to show improvement with a few exceptions. The GDP growth for the third quarter will likely be low, with some analysts calling for a reading below one percent. This is a significant decline off of the 3.9 percent reading for the second quarter. The expected decline will likely be due to lower net exports and inventory build-up from the second quarter. Despite the lower quarterly reading, the economy will still register an annual growth rate between two and three percent. The fourth quarter should provide a good gauge on the confidence and strength of the consumer as holiday shopping ramps up.

Year-over-year corporate earnings of companies in the S&P 500 are expected to decline for the second consecutive quarter. If earnings do decline for the second quarter this would be the first time that we have seen consecutive earnings declines since 2009. Revenues, which are harder to manipulate than earnings, have also been struggling. The third quarter is expected to be the third straight quarter of negative revenue growth, year-over-year—the first three quarter stretch since 2009. Companies that have struggled the most are either in the energy sector or have a majority of sales outside of the U.S. According to Factset, companies in the S&P 500 excluding energy companies that generate more than 50 percent of their revenue inside the U.S. are expected to see earnings growth of 8.8 percent and revenue growth of 5.3 percent. Managers and analysts tend to downplay earnings expectations prior to the announcement so as to "beat the expectations." Guidance has been unusually positive heading into this quarter's earnings season, which may be an indication of surprises to the upside.

The fourth quarter will bring us another quarter closer to the 2016 presidential election. The Republican Party has already lost two candidates and the field should continue to shrink. On the Democratic side it looks like it will be a three person race with the possibility of one or two joining soon. Even though the election is a year away, investors are paying attention to what some candidates are saying, as an example a tweet by Democratic contender Hillary Clinton about steep drug prices is believed to have caused the biotechnology index to fall eight percent in a week in September.

We will continue to monitor economies abroad to gain insight on the strength of the global economy. Japan may increase its already robust quantitative easing program to battle the re-emerging threat of deflation. The European Central Bank may increase the rate of its own quantitative easing program as well to help Europe's weak recovery.

As the second largest economy in the world, China is important to global growth. Though there is little doubt that China's economy is slowing, it is still growing at an annualized pace of 6.8 percent. China is in the middle of transition from an export-driven economy to one that is led by its own consumer. The Chinese stock market may continue to be volatile, but it has shown little correlation to China's economic strength in the past. The consensus is still out on China's market in the near future. Our conversations with our numerous and diverse investment resources have been mixed: some are bullish, some are bearish and some believe that there are opportunities but you need to be selective.

Broadly speaking, emerging market countries have struggled as a result of a strengthening dollar and lower energy prices. If the Fed decides to raise rates the dollar will continue to strengthen and hurt many of these countries. We believe that there are many emerging market companies that offer attractive valuations and the opportunity for strong long-term returns, but investors need to buckle in for a wild ride. The past headwinds are expected to persist and cause continued volatility.

Over the short-term, the equity markets both domestic and abroad have not delivered the type of return that investors like. Big market swings are good reminders that investing requires risk and could result in losing money. For investors with a longer time horizon, the volatility should have little to no influence on investment decisions. Additionally, market pullbacks could represent a buying opportunity for long-term investors to purchase stocks on sale. Generally speaking, investors are usually paid for their ability and willingness to take risks in the form of higher average returns over a long time period. Investors who are appropriately positioned in a more aggressive asset allocation should remember the strong returns earned during the six years leading into 2015. Investors who maintained a fully diversified portfolio, owning both equities and fixed income, performed very well relative to the broad equity markets.

We continue to stress how important it is for clients to understand the risk profile of their asset allocation and make sure it is appropriate for their situation. If anything in your financial situation has changed, please let us know so that we can determine whether a change in your portfolio is necessary.

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