Economic & Market Commentary

The lackluster and calm stretch of financial market performance that we had experienced for the first half of the year gave way to a succession of violent swings during the third quarter, as virtually all financial assets experienced large increases in volatility. The surprise move by the Chinese to devalue their currency, increased aggressiveness in their monetary policy and a sharp decline in their equity markets, coupled with the surprising inaction on the part of the Federal Reserve to raise interest rates destroyed whatever euphoria investors had, and volatility returned with a vengeance. The result was the shedding of risky assets as investors questioned the future path of worldwide growth. U.S. stocks were down 7 - 10%, with smaller capitalization issues suffering the most. International markets suffered more, particularly those in Latin America and Asia. The only asset class that produced a positive return was fixed income, with bonds barely above water. Most managed money did even worse, according to *Morningstar.* They reckon that the average domestic equity portfolio was down close to 8%, with mid and small cap portfolios down 9% and 11% respectively. International funds averaged down 10%, with Chinese equity-oriented funds down 21%. It was a difficult quarter with few places to find safety. Only four of the ten S&P sectors outperformed the average for the quarter, with only one generating a positive return (Utilities). Likewise, for the nine months, only four sectors outperformed, with the Consumer Discretionary sector generating only a fractionally positive return. We have talked before about the narrow performance of the equity markets, and once again it is a factor, and underscores the masking of good business performance by weak stock performance.

So, the quarter brought the highly advertised and long awaited “correction” in the equity markets (a decline of 10% or more). For five days in August we suffered a gut wrenching decline in stock prices of 12%. According to *Yardeni Research*, there have been 29 stock market declines of 10% or more since 1950, but very few took place in five days or less. The last correction we experienced was in the summer of 2011, during the uproar over the downgrading of the U.S. credit rating, a potential default, weak domestic economic reports and the European financial crisis. All of these factors cast doubt on the sustainability of global growth, and raised the specter of another global deflationary wave. So, in a sense we were overdue, as the intervening period marked the third longest streak without a correction on record. Earlier this year, we withstood many alarm bells without a major market reaction. Neither the potential interest hikes by the Fed, intermittent soft domestic economic data, nor Greek and Puerto Rican financial crises, had a significant impact on our markets. The primary catalyst for the recent sell-off has been China, the world’s second largest economy. That country’s unexpected move to devalue its currency, its collapsing equity markets, and its aggressive monetary policy moves sent shock waves through the global financial markets. The fear was that the country’s economy was in worse shape than thought, and that Chinese central policy makers could no longer control the situation. This, coupled with the inaction on the part of the Fed regarding raising rates, raised the question of the sustainability of global growth, and fears of another global deflationary wave.

There is little transparency when it comes to knowing what is happening in the Chinese economy. Virtually all professional China watchers agree that economic prognostications about China are, at best, a shot in the dark. We know that the Chinese economy is slowing. This is not new news. The hope is that the slowdown will result in a soft landing (growth decelerating from 7-8% to 4-5%), rather than a hard landing. The anecdotal evidence so far supports this view. While the investment sector (est. at 45% of China's GDP) has slowed dramatically, the consumer and service sectors (est. at 40% of GDP) have picked up. This is a transition that the Chinese economy must make to sustain future growth. China also has a huge debt load, which has risen from seven trillion dollars in 2007 to an estimated twenty eight trillion dollars in 2014. This is about 280% of GDP, larger than the U.S. or Germany. History tells us that extreme debt levels are the cause of most financial crises. The latest move to devalue the currency (RMB), altered monetary policy by the People's Bank of China (PBOC), coupled with the massive sell-off in Chinese stock markets, all convey an unsettling impression. To date, capital flight from China, away from a devalued RMB, has not been significant. To counter that possibility we know that China has massive hard currency reserves (estimated at $3 – $4 trillion) which can go a long way toward preventing calamity. In addition China is a huge consumer of commodities. Their economy consumes 40-50% of the world's output of most industrial commodities and 20-30% of many of the soft commodities. Clearly this will back up on economies that produce those goods, which are primarily other emerging market countries.

All of this begs the question of what impact these Chinese and emerging market (EM) events will have on the U.S. and the rest of the world's growth prospects. Thanks to BCA Research we can assemble some facts that will enable us to make some judgements about this question. Imports for internal consumption (just under 80% of total imports) to China and other Asian EM represent about 7.5% of global GDP, while U.S. and European Union (EU) imports account for 3% and 2.5% respectively. BCA includes Asian EM economies because of their proximity to and close involvement with China. These imports by China and their close EM neighbors account for 35% of global imports, while the U.S. and EU are 15% and 12% of global totals. Finally, U.S. exports to the vulnerable Chinese and EM economies account for only 2.5% of U.S. GDP, whereas exports from Germany and Japan are 5% and 6% of their respective GDP. Clearly China and their EM partners are important to world trade, more so than the U.S. and the EU. A slowing China should, therefore, have a dampening effect on world trade, which should impact others more than the U.S. If China can avoid a hard landing the impact on our economic prospects should be small. China has the tools to prevent a calamitous event, and their leaders know that economic crisis can lead to social crisis which can lead to political crisis, all of which they will seek to avoid. We think China can get through this rough period without a drastic decline in economic activity and without major impact on other economies. All of this underscores what we have written for some time, which is that we continue to be in a period of subdued, below trend, global growth, which we expect will last for several more years. In keeping with this theme, the IMF recently reduced their estimate of global growth for the next year from 3.3% to 3.0%.

In contrast to China, our economy is moving along about as expected, so we have no change in our expectation. Second quarter GDP was recently revised upward (from +2.3% to +3.9%), which lends support to our view of modest growth. Countering that has been the September jobs report, which at 150,000 additions was below expectations, as was the recent manufacturing ISM indicator which was weaker than expected. The flash estimate for August trade also contained some crosscurrents. Exports have continued to decline, partially a result of the dollar strength, while imports did the same (lower oil value and price no doubt played a role here). Given our earlier comments, this trend bears watching. In spite of all these crosscurrents we see no signs of impending recession, and we are comfortable with our long held view of modest growth in the U.S.

As far as our markets are concerned, we can say with some certainty that high volatility is here to stay. As we said earlier we had not had a "correction" since 2011 and were overdue. Our equity market was not stretched, but at 17-18X earnings was certainly not cheap. The peak to trough decline took about two multiples of earnings off that valuation. Since the quarter's end, we have had a rebound in stocks for the first week of the new quarter. Earnings season is once again upon us, and the expectation is for aggregate reports to be below a year ago. This is largely due to a severe decline in energy earnings; excluding that sector, earnings should be up modestly. With profit margins at record levels and the many global crosscurrents mentioned earlier, we expect future guidance to be muted. Our equity portfolios are conservatively positioned with a bias toward domestically oriented companies. We expect volatility to be with us for some time, but we do not see the recent equity market decline as a precursor to a bear market. As a result, we look to take advantage of market volatility to add to stocks we believe are significantly undervalued, with an emphasis on those that are less exposed to the many global crosscurrents mentioned earlier.

The bond market posted solid returns for the third quarter. In contrast to the second quarter which saw a broad-based increase in rates, the third quarter saw rates fall across the yield curve. Increasing concerns about slower worldwide growth and continuing strength of the US dollar contributed to downward pressure on Treasury yields. The yield curve flattened as the move at the short end of the curve was minor, while the long end suffered more. In terms of the overall market, the Barclays U.S. Aggregate Bond Index generated a 1.23% return for the quarter and a 1.13% return Year-to-Date (YTD).

We wrote last time that we thought the Federal Reserve's first tightening, or raising of the Fed Funds rate target, would come late in the year. Speeches by several Fed governors over the course of the summer, the strong showing of second quarter GDP and improvements in the labor market persuaded us to shift the odds to a September move. In doing so, we neglected one of the basic tenets of the bond market, "Watch what the Fed does, not what it says". When the Fed failed to move at its September meeting, market reaction was forceful. The two year Treasury yield fell 13 basis points in one day, its biggest one day decline since December 2010. Expectations of the first tightening by year end, as priced by Fed Funds futures contracts, fell from 64% on September 16th, the day before the decision was announced, to 43% on September 17th, the day the decision was announced. As of this writing, in early October, odds of a tightening by year end have fallen to 33%. The Fed could surprise the market again. We think the Fed could start to raise rates in December. This would start the long process of normalizing interest rates and restore some of the credibility that the dithering on tightening has taken away.

In this environment we don't want to expose the portfolios to more interest rate risk than we feel is warranted. Therefore, we are maintaining a defensive strategy with durations of about 90% - 95% of our target. We are positioned with most of our interest rate exposure using the five to ten year part of the curve and have moved to a more pronounced barbell strategy. A barbell strategy involves holding a mix of securities with short maturities and longer maturity securities that are less affected by changes in the Fed Funds target.

In our last commentary, we opined that Treasury Inflation Protected Securities or TIPS were an attractive alternative to nominal Treasuries. This was based on the breakeven rate being low by historic standards (the breakeven rate is the point at which you are indifferent to owning a TIP, whose principal adjusts with the CPI, or a nominal that is completely exposed to inflationary pressures). Current dollar strength has pushed the breakeven rate even lower. So, we are holding our allocation to TIPS with an eye on exiting if the breakeven rate moves back toward its historic norm or deflationary pressures return.

Agencies are instrumental in our barbell strategy, in spite of a meager return. We prefer to add bullet Agencies with less than one year to maturity, as a highly liquid cash equivalent in order to generate a small yield advantage over that available in short Treasuries. We will continue to add callable Agencies opportunistically.

We maintained our overweight allocation to corporate bonds that we established earlier in the year, in spite of underperformance to date. We like the 7 to 10 year part of the curve as we see it representing the best value and have opportunistic holdings in long corporate bonds in credits we expect to benefit from M&A activity. We continue to prefer issuers with the ability to raise prices or those engaged in ongoing balance sheet repair. And, as always, we tend to avoid those companies that issue debt in order to pay dividends or buy back shares.

Mortgages outperformed the benchmark for both the quarter and the year to date. They delivered a positive return in large part because of the short duration or interest rate sensitivity of the product. While mortgage spreads, like credit spreads, have widened relative to Treasuries for most of the year, the move has been muted. Much of the return of mortgages has been income. Mortgages are up 1.61% this year. The income component is up 2.63%. Negative price action and pay downs have subtracted more than 1% this year. We'd be leery of increased pay down activity if rates stay low or go lower. We held our mortgages position constant over the quarter and would look at additional spread widening as an opportunity to add to mortgages. We expect to use Collateralized Mortgage Obligations (CMOs) carved from high quality Fannie Mae and Ginnie Mae mortgages with yields comparable to corporate debt. We like structured paper priced below par ($100) designed to be less interest rate sensitive in the face of rising interest rates.

A common question in the bond market today is, what is credit telling us? The next question is often, are we heading into a recession? Corporate bonds are thought to lead the markets. In several instances over the past 15 years, changes in corporate spreads over Treasuries have correctly led changes in direction of the S&P 500. The lead time has typically been between 5-10 months. So what is credit telling us now? Credit is telling us that, after a period of balance sheet repair and support from the Federal Reserve, it's time to take a breather and become more selective in the credits that you own. Old relationships, for example, spreads of energy-related companies relative to the overall market, have broken down and may offer opportunity. Is credit telling us that the cycle has turned? Probably not. Credit cycles usually don't turn until the Fed has tightened at least twice and bank lending standards have become more restrictive. As we discussed above, the first tightening might come this year though the market has 2016 as the expected liftoff date. Lending standards continue to loosen albeit at a declining pace. Is credit telling us we are heading for a recession? We don't think so. While spreads have moved back to levels usually associated with recessions, much of the movement can be traced back to energy company spreads which have historically traded at a lower level than the overall market and now traded much higher. As a final word here, bond professionals get concerned when the yield curve inverts. For example, when the difference between the thirty year and two year Treasury is negative, the onset of a recession is feared. On September 30, this measure stood at a positive 2.22%, well above its twenty year average.

Municipal returns were strong, 1.65%, in the third quarter and have offered investors 1.77% YTD. Investment grade municipals were largely immune to the volatility experienced by holders of the debt of Puerto Rico as AA - rated bonds performed the best over the last three months. The situation in Puerto Rico is still unfolding and the resolution regarding the treatment of the bonds is uncertain. We would not be a buyer at this time. In general, yields on municipal bonds rival those of Treasuries and offer good relative value. We favor AAA and AA-rated securities specifically in those states and municipalities not dependent on oil revenues. We also like revenue bonds where the coupon and principal are backed by a lien against a payment stream from a toll road or ticket sales, for example.