# Market Commentary
# Q3 2015

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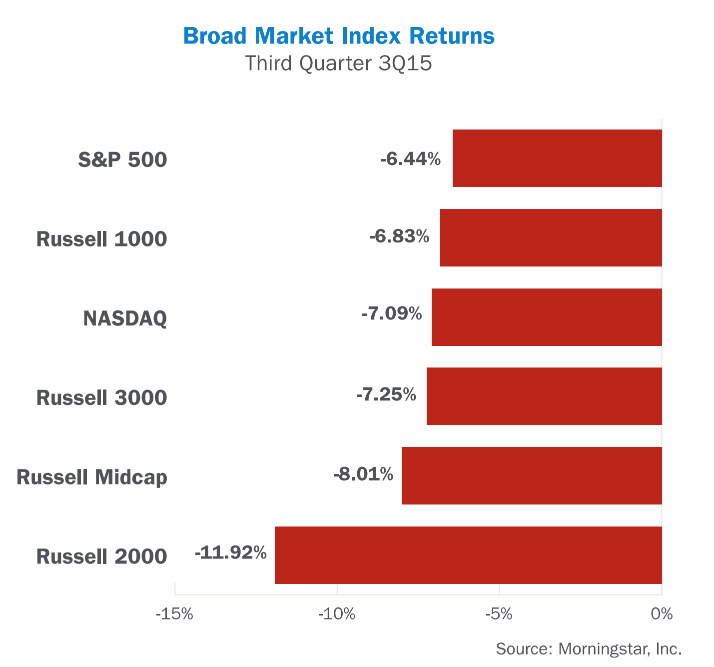
A sharp drop in the market in late August marked the first correction for the U.S. stock market since 2011. While we saw a continued upswing in the market the first part of the quarter, concerns about China's economy as well as the devaluation of the yuan currency helped trigger the sharp drops in the global equity markets. Market corrections are never fun, but we all must understand that they are common. Given the length of time since the last correction in 2011, a market correction has been widely expected. Overall, all areas of the equity market finished significantly down for the quarter.

## The Economy

The domestic economic landscape remained on a slight uptrend in the third quarter of 2015, characterized by steady but unremarkable growth. The U.S. economy faced significant challenges from global economies and financial market distress. The Bureau of Labor Statistics raised its second estimate of second quarter 2015 gross domestic product (GDP) to +3.9%, above both the prior estimate of +3.7% and the first quarter's +0.6% reading. The positive rebound, driven primarily by consumer spending, occurred despite a continued fall in energy prices. Employment was strong, with an average of about 221,000 jobs added each month. The unemployment rate declined to 5.1%.




The global situation was less upbeat, as both developed and emerging economies sputtered. September saw consumer prices decline in the Eurozone, the first time that has occurred since the European Central Bank (ECB) initiated its asset-purchase program earlier this year. The decline sparked fears that the region would devolve into a deflationary cycle, and investors called on the ECB to step up its stimulus measures. The region also must determine how best to handle effectively the influx of Syrian refugees and their impact on the economy.

In China, growth continued to be moderate, which, along with the country's currency devaluation and significant drop in stock prices, created considerable concern for market participants. Emerging-market economies again reeled as commodity prices suffered their worst quarterly decline in almost seven years.

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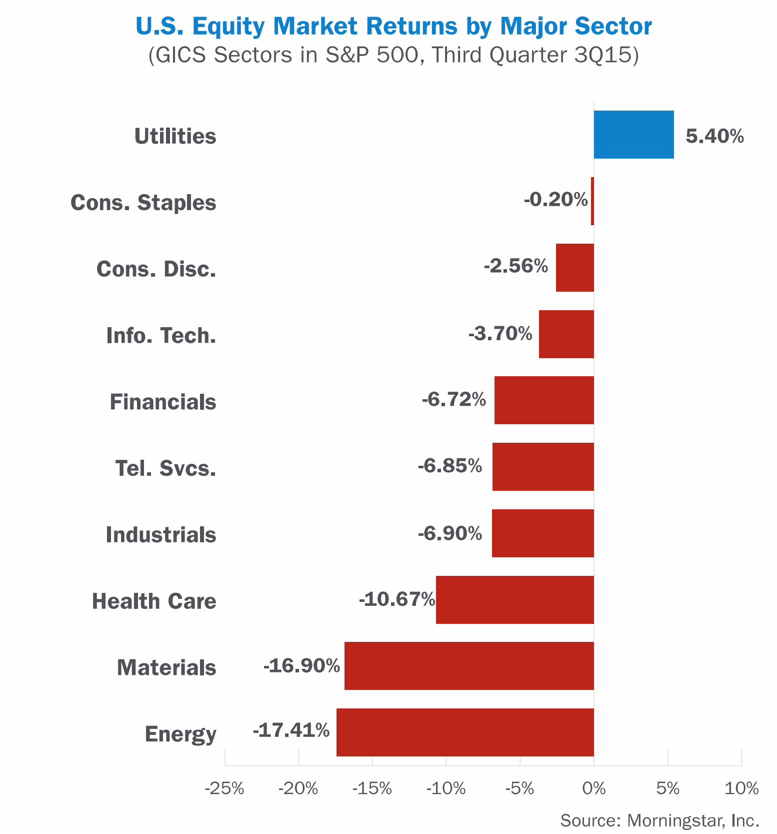
The Federal Open Market Committee (FOMC) did not make any changes to its interest rate guidance at its September meeting, choosing not to begin the rate liftoff. Concerns about China's problems and resulting financial market distress, coupled with low inflation, likely swayed the Committee. In addition, the FOMC slightly lowered its economic outlook, but most analysts still expect it will begin normalizing rates before year-end; however, a growing number of analysts assume the severity of global economic issues may delay the initial rise in rates until sometime in 2016.

## Highlights

### GDP

The Bureau of Economic Analysis released the second estimate of the second quarter 2015 real GDP, a seasonally adjusted annualized rate of +3.92%. This was up from the prior quarter's +0.6% annualized growth, and was an increase from the prior +3.7% growth estimate. The results were an indication of the economy's strength, although analysts caution that a buildup of inventories may be a negative harbinger for third-quarter results. But, the growth was encouraging, particularly following the lackluster numbers posted last quarter, so many economists continue to look for ongoing expansion soon. (One complication may be China's economic downturn and its global implications.) Consumer spending was the primary growth driver, and investment, trade, and government spending each made modest contributions. Corporate profits jumped by +3.5% (not annualized) after a -5.8% decline in the prior quarter. Low energy prices kept inflation in check in the second and third quarters.



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### LABOR MARKETS

Employment, on average, was stronger than in the second quarter, and the uptrend remains intact. Employers added 173,000 jobs during August, although below consensus expectations. The three-month moving average was 221,000, slightly higher than the average for the period ending in May, but below the levels of each of the prior two months. The August unemployment rate was 5.1%, below May's 5.5%, and also a post-recession low. Average hourly earnings increased 2.2% in the past 12 months, a reasonable growth rate, but not so rapid as to create inflation concerns. Analysts expect average employment gains of 200,000 through the end of the year, and many projections anticipate average monthly additions of 250,000 in 2016.

### HOUSING

Portions of the housing segment recovered well: existing-home sales for August (the latest monthly data available) advanced at an annualized rate of 5.31 million units, down about -4.8% from July's 5.58 million-unit rate, but still up more than +6% from August 2014. The inventory of existing homes loosened somewhat to about 5.2 months of supply. Existing-home prices in August declined slightly from May, but rose by about +5.1% from year-ago levels. The Housing Market Index (HMI), a measure of new homebuilding activity based on surveys from the National Association of Home Builders (NAHB), ended the quarter at 62, up slightly from the prior quarter's reading of 60—the highest level in the last decade. The rise was broad-based regionally, with all regional indexes at least maintaining levels from the prior month. Analysts have stated that the housing industry is in its best shape in years. Although the prospect of higher interest rates may dampen future growth somewhat, the underlying strength should allow the housing recovery to continue well into 2016.

### FED

The FOMC ended its September meeting with no changes to its interest rate policy. Despite this widely anticipated decision, some analysts had expected the FOMC to initiate the liftoff of interest rate normalization at this meeting. The Committee's statement noted that recent global economic- and financial-market developments potentially could result in a slowdown of economic activity, causing inflation to drop below its target level of 2%. The FOMC's economic-projections release lowered the median estimate of 2016 real GDP to 2.3% from 2.5% in the June release. Most economic analysts expect the FOMC will begin raising rates sometime in 2015, as delaying action risks accelerating and overheating the economy, thereby offsetting the advantages that a rate hike can provide.

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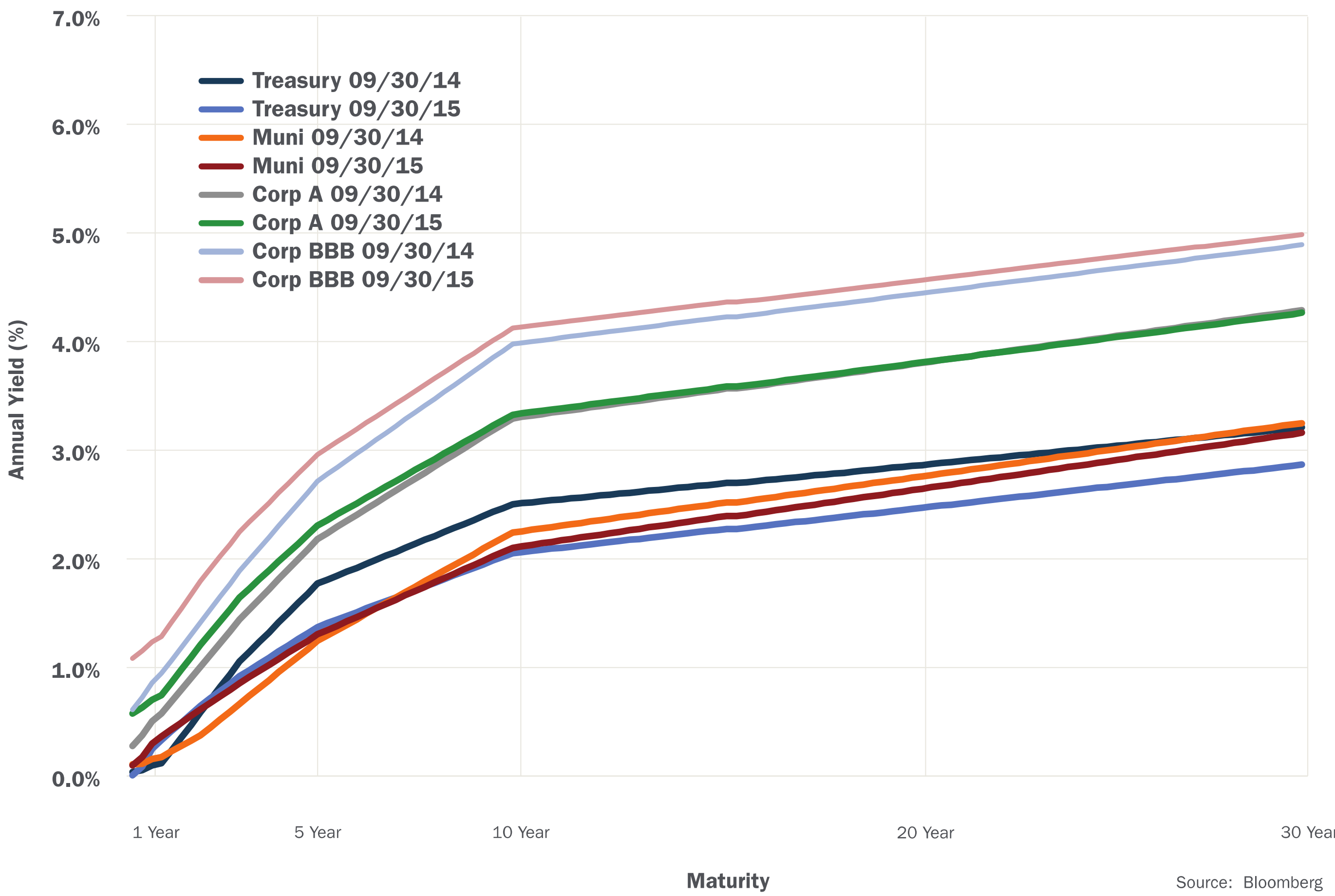
## Interest Rates

Fixed-income securities were buffeted by several issues this period, including anticipation of potential FOMC action on interest rates, fallout from China's stock market decline, the subsequent currency

U.S. Treasury, Muni, and Corporate 30-Year Yield Curves




Source: Bloomberg

devaluation by its policymakers, and a global slowdown in economic growth. Earlier this year, the economic trajectory resulted in consensus among analysts and market participants that the FOMC would raise rates at its September meeting. As the summer progressed, however, it became less certain that liftoff would occur that soon, given questions about China's growth, the continued decline in commodity markets, and the distress in U.S. equity markets. In the end, the FOMC postponed a rate increase, and the consensus now is that rate normalization will begin sometime in the fourth quarter.

Fixed-income securities generally posted positive, but modest, total returns. The Barclays Treasury 5-7 Year Index gained +2.27%, and the Barclays U.S Corporate 5-10 Year Index advanced +0.88% . High yield

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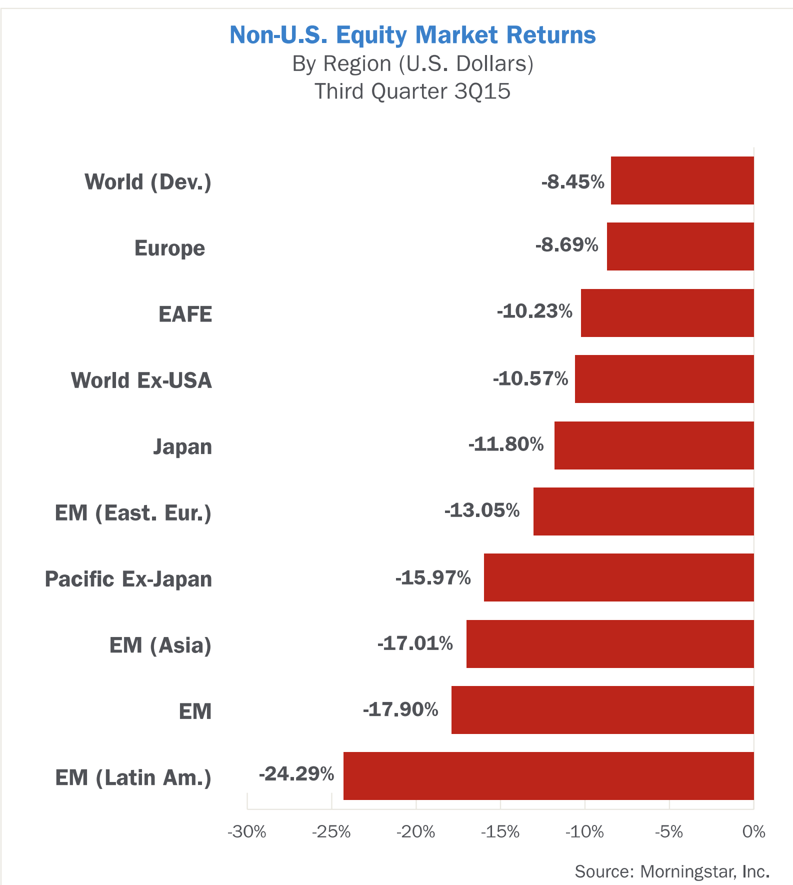
securities performed very poorly, and, along with emerging-market debt, constituted one of the only major fixed-income segments to post negative returns, shedding -4.86%. The Barclays Municipal Bond Index was one of the best performing fixed-income asset classes, gaining +1.65%. Non-U.S. fixed-income also fared well, as the Barclays Global Aggregate ex-U.S. Index posted a +0.64% return. However, the index still has a negative year-to-date return. Emerging-market debt suffered from the drop in commodities prices, and the JPM EMBI Global Index gave back -2.04%.

## Equity Markets

This period was a tale of two environments. In the first half of the quarter, equity prices continued to trend higher, in part due to steady, if not robust, domestic economic growth. In addition, investors seemed to shrug off the early declines in China's stock market and to acclimate to the idea that the FOMC would begin to normalize interest rates at its September meeting. However, it was an entirely different story in the quarter's second half. Markets perceived China's August 11 yuan devaluation as a sign that its economy needed more support than originally believed, and that the bursting of the Chinese stock bubble may eventually affect global markets. The S&P 500 Index finished the quarter with a loss of -6.44%, and is now down -5.29% on a year-to-date basis. It was the index's first negative quarterly return since the fourth quarter of 2012, and marked the most severe quarterly decline in four years.




The ten primary economic sectors generated significant disparities in performance, putting sector selection at a premium for active managers. The interest-rate–sensitive utilities sector, the only sector to generate positive returns, posted a gain of +5.40%. Consumer staples and consumer discretionary also fared well on a relative basis, with losses

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of -0.20% and -2.56%, respectively. The energy and materials sectors were by far the poorest performers during the quarter, declining -17.41% and -16.90%, respectively.

The Russell 1000 Index of large capitalization stocks generated a -6.83% total return. Within the large-cap segment, growth stocks outperformed value stocks. Small-capitalization stocks, as represented by the Russell 2000 Index, performed very poorly relative to large caps, ending with a total return of -11.92%. On an annualized basis, small caps now lag behind large caps by almost 3% over the past five years. Unlike the situation in large caps, however, value significantly outperformed growth within the small-cap universe. The Nasdaq Composite, dominated by information technology stocks, also slid during the third quarter, ending down -7.09%. The Dow Jones Industrial Average of 30 large industrial companies declined -6.98% during the quarter.

Real Estate Investment Trusts (REITs) bucked the general equity market trend, as interest rates dropped slightly. The DJ US Select REIT Index managed a gain of +3.09%. Commodities resumed their freefall, and the Bloomberg Commodity Index plunged -14.47% for the third quarter. The index is down approximately -26% over the past 12 months, and has declined at an annualized rate of more than -16% for the past three years.

International stocks suffered severely compared to U.S. equities, as investors continue to be nervous about the halting economic recovery in the Eurozone. The ECB began its asset-purchase program earlier in the year to provide stimulus to the flagging economy; however, deflation is a continuing concern: consumer prices in the region fell in September for the first time since the stimulus program was launched. Investors now are calling for the ECB to step up its asset purchases to stem any further slide. As a result, European stock indices were hit hard: the MSCI ACWI ex-USA Index, which measures performance of world markets outside the U.S., dropped -12.10% in the third quarter, again driven by both developed and emerging markets. The MSCI EAFE Index of developed markets stocks sank by -10.23% during the same period. Regional performance was very weak, and every region declined. Latin America and China were the poorest relative performers: the MSCI China and MSCI EM Eastern Europe indices suffered losses of -23.18% and -13.05%, respectively. Emerging-markets performance also was extremely weak, keyed in part by the ongoing decline in commodity prices. The MSCI Emerging Markets Index posted a loss of -17.90%.

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## Looking Forward

Although equity markets recently have given back some of the gains accumulated over the past few years, and the economies of China and Japan continue to struggle, economists generally remain optimistic about U.S. economic prospects. China's slowing economy does not surprise economists, since the Chinese government has been lowering growth forecasts for some time, as it attempts to transition the economy to a more consumer-driven model from one driven by exports. Analysts also fault Chinese policymakers for mismanaging this transition by appearing to encourage the run-up in stock prices to bubble levels. Positives for the U.S. economy include gains in employment, one of the key criteria the FOMC considers in its decision about when to begin normalizing interest rates. Some economists estimate the economy will achieve full employment sometime in the third quarter of 2016. In addition, although the rise in the U.S. dollar has caused manufacturing to suffer, manufacturing employment remains robust. Inflation, one of the primary metrics the FOMC considers—along with employment—in its decision on when to raise rates, remains fairly low, and may be a key reason the committee didn't move to raise them in September. But, wage growth is rising steadily, and current low inflation is a function of declining oil prices and the rising dollar, effects that many deem to be temporary. The continued positive trends in the housing segment also bode well for U.S. growth.

Since the end of the quarter, we have seen the market rebound some, and on 10/8/2015 the DOW closed above 17,000 for the first time since August; however, we are likely not done with the volatility. We feel it is important to remember that the market goes through cycles. Corrections as well as market crashes are normal occurrences in the market. As we mentioned earlier, it has been four years since the market corrected. A market correction is generally a drop of 10% or more from the 52-week high.

Additionally, we have not seen a market drop of over 20% since the financial crisis in 2007. Currently, we are not only seeing significant swings on a daily or weekly basis, we are also seeing some huge swings within a day. Where we go over the next few months is anyone's guess. While the market may have bottomed out from the recent correction, it is also equally likely that we will continue to see more volatility.

*Gratitude makes sense of our past, brings peace for today, and creates a vision for tomorrow*
-- Melody Beattie

We want to wish everyone a wonderful holiday season.