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INSIGHTS

A QUARTERLY NEWSLETTER BRINGING YOU FINANCIAL INSIGHTS

2015 Q3 Insights: "Flying at Low Altitude"

The dearth of volatility in the first half of the year gave way in Q3 as the bottom fell out of most stock indices worldwide. Fuelled by major retrenchments in the Brazilian and Shanghai stock indices (losing 34% and 29% respectively), the Emerging Markets (EM) index shed nearly one-fifth (losing 17.90%) of its value. In turn, EM woes spilled over into Developed Markets, with Japan, Germany, and the U.S. all posting significant losses (the 6.44% loss in the S&P 500 was the single largest quarterly loss in four years). All-in-all, global equity (as measured by the MSCI All Country World Index) lost 9.45% for the quarter and experienced a loss of 6.66% over the trailing twelve-month (TTM) period.

Why the sudden bout of renewed volatility and downward price pressure? Markets quickly started losing ground in mid-August, soon after China devalued their currency. While it's true that a free-floating currency is beneficial in the long run, investors viewed the devaluation of the Yuan as a clear sign of increased economic weakness coming from the world's second largest economy. Even though a weaker Chinese economy is by no means a surprise, market jitters nevertheless spread across the globe—and quickly. On August 18th, the S&P 500 hovered near 2100. Just four trading days later, the index had fallen to 1867—an 11% drop in less than a week.

	NOTABLE SECTORS	Q3	TTM*
STOCKS	*GLOBAL EQUITY*	*-9.45*	*-6.66*
	U.S. Large Cap (S&P 500)	*-6.44*	*-0.61*
	U.S. Small Cap (Russell 2000)	*-11.92*	*1.25*
	International Developed Markets	*-10.23*	*-8.66*
	International Emerging Markets	*-17.90*	*-19.28*
BONDS	*GLOBAL BONDS*	*0.85*	*-3.26*
	U.S. Aggregate (High Quality)	*1.23*	*2.94*
	U.S. High Yield (Low Quality)	*-4.86*	*-3.43*
	International Aggregate	*0.64*	*-7.67*
	Emerging Market Debt (USD)	*-2.39*	*-1.43*
ALTS	*Gold*	*-4.83*	*-7.96*
	Commodities	*-14.47*	*-25.99*
	Master Limited Partnerships	*-22.10*	*-39.19*
	Real Estate	*2.06*	*9.47*
CASH	*Inflation*	*-0.06*	*0.19*
	Cash (3-month T-bills)	*0.01*	*0.02*
	U.S. Dollar Index	*0.66*	*10.71*

**Trailing Twelve Months*

Markets settled and slowly began to regain lost ground until September 17th when the Federal Reserve seemingly confirmed the global slowdown by not only maintaining short-term rates at zero but by also explicitly referencing the Chinese turmoil as a key driver of our emergency monetary policy (a factor which, by the way, is not in the Fed's dual mandate of domestic price stability/inflation and domestic job growth). With the Fed ostensibly moving the goalposts, uncertain investors hit the sell button driving stocks lower heading into the final days of the quarter.

Slower economic growth worldwide also pushed down yields. The 10-Year Treasury bond, which was yielding 2.34% at the start of the quarter, lost nearly 30 basis points to finish at 2.06%. In fact, these two themes (slower growth and lower yields) permeated all asset classes—investments tied to global growth lost ground, and those

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directly tied to Chinese growth suffered the most. Meanwhile, income-oriented investments outperformed as the hunt for yield continued.

EQUITY: Although down for the quarter, the S&P 500 fared better than other global indices as U.S. stocks were perceived as a relative safe haven. Within the U.S., Growth stocks once again bested Value stocks (for the 6th quarter in a row) and Large Caps bested their Small Cap brethren for the first time this year. The negative impact of the Chinese slowdown on commodities could also be felt here at home, with U.S. sectors tied to Materials and Energy leading the decline. Meanwhile, as one would expect during a stock market correction, dividend-focused defensive areas of the market outperformed as did Consumer Staples and Utilities.

ALTERNATIVE ASSETS: The diversified Commodity Index (Oil, Precious Metals, Base Metals, Agriculture, etc.) was down 14.47% in Q3 with Copper down 10.22% and Crude Oil dropping 24.18%. Master Limited Partnerships involved in the transportation of Crude Oil (losing 22.10%) sold off in sympathy. In keeping with the *"flight to dividends"* theme, dividend-oriented Real Estate served as a rare bright spot, with the sector posting a 2.06% quarterly gain.

FIXED INCOME: The U.S. Aggregate Bond index reversed its second quarter 1.68% loss with a 1.23% gain in Q3. But not all bonds posted gains, and those tied to our aforementioned themes particularly lagged. The U.S. High Yield sector (filled with smaller distressed energy companies) lost 4.86% in Q3: its worst quarterly loss since Q3 of 2011. Emerging Market Local Debt (losing 8.68%) was the worst performing bond sector as the result of two strong headwinds—widening credit spreads (as seen in high yield) and weakening local currencies (as seen in Brazil's Real losing 18% versus the U.S. Dollar). Again, defensive sectors outperformed with Long-Term Treasuries posting a 5.34% gain.

OUTLOOK: The title of this Insights ("*Flying at Low Altitude*") is an important reminder that we are not living in normal times. Generally, an aircraft and its passengers are more susceptible to turbulence (and probably more fearful) while flying at low altitudes. At higher altitudes the air is considerably smoother – small bumps and turbulence don't elicit passenger fear. Economic cycles are no different. When U.S. Gross Domestic Product (GDP) was consistently growing at 3%-5% annually, temporary blips of lower growth weren't met with much concern as the economy was still comfortably growing. However, today's lower altitude economy is struggling to post growth in excess of 2%. Any economic turbulence (as was seen in Q3) causes quite a stir as the stock market inevitably tries to correct downward and price in any possibility of recession. But in fact, history shows that a 10% correction is not necessarily a harbinger of economic contraction. If it were, then since 1983 ***the stock market has priced in 13 of the last 3 recessions!*** Corrections are normal. They're a fundamental part of the cyclical nature of markets. And by no means are they necessarily indicative of bad things to come.

To reiterate our recent Tailwinds piece, *investors are forced to trade the market they have—not the one they want. Alas, we all must play the hand we've been dealt. If equity investors could dream, we would wish for extremely low interest rates, readily available credit, strong corporate balance sheets, low commodity and energy costs, low inflation, strong job gains, solid retail sales and a robust housing market. Oh yes—and low valuations. Unfortunately when this nirvana takes hold, the good news is usually already priced into the market resulting in stock valuations so high that any subsequent investment would actually be quite risky. Fortunately it appears that over these last few months of 2015, the hand being dealt may actually be an investor's dream.*

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