Investment Strategists for
Successful Families

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Thank you for reading GreenThought$. It is our privilege to provide you with our insight on current financial market events and our outlook on topics relevant to you.

Third Quarter 2015 Economic and Market Update

The U.S. stock market just ended its worst quarter in 4 years. Major indexes, including Dow Industrials, S&P 500, and NASDAQ were all down around 7%. Certain sectors fared far worse. Healthcare was down over 10% with biotech stocks dropping 16% in just the last 2 weeks in September. Concerns about the effect of low oil prices pressured the Master Limited Partnerships (MLP) space, with the MLP index down 18%. While the index of U.S. bond prices, the Barclay's Aggregate, saw a gain of 1.3%, certain sectors like high yield bonds dropped as much as 5%. So there were very few safe havens, not many places to hide.

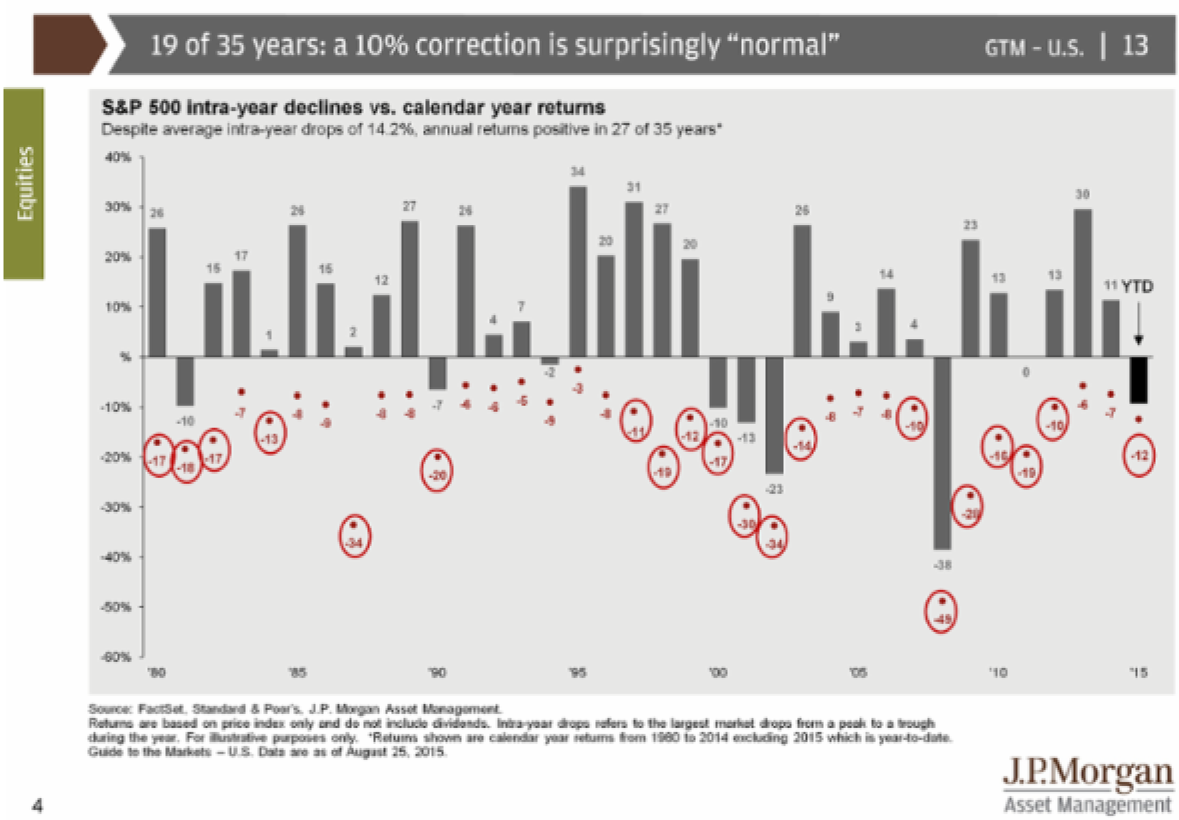
Factors weighing on the markets have not changed since our mid-quarter update of July. Not only didn't the Federal Reserve raise rates in September as many had hoped (as an increase may have signaled confidence in the economy), Chairwoman Janet Yellen's press conference led many to believe a rate increase later in the year may be in doubt. Financial markets don't like uncertainties, hence the increased volatility and swings in prices of securities worldwide.

The situation in China remains unclear, with people claiming to be knowledgeable about the situation offering opinions ranging from the economy is doing just fine to a "hard landing" is inevitable. We had previously discussed whether the Chinese devaluing their currency could lead to a currency war and there is no further clarity on that point.

The debate continues about the decline in oil prices, and whether the cause is an oversupply, or global demand slowing, which would be a drag on company earnings. One obvious factor contributing to oversupply is that with many energy companies in poor financial condition, and many oil producing countries facing recessions, lower oil prices are forcing them to continue pumping as much oil as they can to maintain their revenues. While the declines are good for the consumers (we all like to pay less for gas at the pump), these are not necessarily good news for the global economy at large. Energy companies are a major component of many stock indices, plus the energy sector significantly contributes to the employment in oil producing regions.

So, are there any reasons for investors to be optimistic? First, while the third quarter of the year frequently is the worst, the last quarter of the year historically tends to be the best for the financial markets. Also, the negative factors we've just discussed have mainly been known to market participants for some time. Markets are discounting mechanisms, so the current stock and bond prices may already reflect much of these bad news. Earnings that companies will be reporting shortly are not expected to be good, so any upside surprises, especially among the market leaders, could provide a lift to the entire market. Investor sentiment is negative, which can act as a contrary indicator because retail investors often invest with their emotions which make them most negative at market bottoms, just as they are most euphoric at market tops. Lastly, the extreme sell off in some market sectors has created valuations that are much more favorable than just a few weeks ago.

Let's take a deep breath and look around. While the recent market volatility, coupled with uncertainty from the Fed, has resulted in a significant pull-back, this is by no means unusual, as per the chart below from an August J.P. Morgan newsletter. At that time the S&P 500 had dropped 12%. The key takeaways from this are that pullbacks are normal. In fact, there was a 10% correction in 19 of the 35 years shown. Even with those corrections the S&P 500 achieved a positive calendar return in almost 80% of the years shown.



What does this all means for your portfolios? While financial markets' drawdowns like the one we've just experienced are unpleasant for everyone, the investment team at Emerald is always looking to exploit opportunities presented by such events. This includes making new investments, or adding to investments in sectors that we feel overreacted to investors' fears. We also look for situations where it makes sense to "harvest" losses for tax purposes by either exiting a sector altogether or staying in the sector and just changing managers. As also mentioned in our last newsletter, this may be an opportune time to rebalance your portfolios, by selling some of the past winners and reinvesting the proceeds in the beaten down sectors or regions.

We welcome the chance to share our thoughts on the economy and the financial markets with you. We hope to talk with you very soon.

Sincerely,

The Emerald Team

About Emerald

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