Market Update & Portfolio Commentary

August 2015

MARKET UPDATE

In recent days, global capital markets have experienced a sharp spike in volatility and most equity markets around the world have declined more than 10% from recent peaks (and some more than 20%). It has been nearly four years since investors have experienced comparable levels of volatility in global capital markets and many are asking if the current bull market has reached its conclusion.

During periods of heightened market volatility, it is crucial for investors to maintain discipline and to critically assess the underlying causes of market uncertainty through in-depth research in order to make informed decisions. Market corrections are a normal (and usually healthy) part of investing as they generally help to keep prices in line with fundamentals over the long term. The most prudent course of action is typically to stay the course and to avoid attempting to time markets during these normal market corrections that are often accentuated by heightened investor emotion. However, there have historically been exceptional periods of unsustainable market valuations (e.g. the U.S. technology bubble of 2000) and severe economic stress (e.g. the financial crisis of 2008) that have called for greater caution than a normal market correction.

Based on our analysis, we do not believe the current market sell-off is one of these exceptional periods and as such have maintained our positioning as we continue to feel that discipline and patience are warranted. We also anticipate the current stock market correction will prove healthy and provide equity markets an opportunity to consolidate after the strong gains generated in recent years, especially in the U.S. The basis for this view is that the current period of capital market volatility appears to be driven by three core factors that are not unexpected and that we do not feel threaten the global economic recovery: signs of stress in China, declining global commodity prices, and uncertainty over when the Federal Reserve will raise interest rates.

- **CHINA -** As the second largest economy in the world, China is closely monitored by investors as a harbinger for global growth. In recent years, growth levels in the Chinese economy have been slowing as the country attempts to transition from an export and investment led growth model to one driven by domestic consumption. Despite this deceleration in growth levels, the CSI 300 Index, a broad measure of the Chinese equity market, had more than doubled in value between November 2014 and June 2015. As a result, Chinese equity markets appeared extremely overvalued heading into the summer and many investors became concerned about a bubble forming in the Chinese stock market. Not surprisingly, the CSI 300 Index has declined by nearly 40% since June, which has nearly erased the strong gains generated in Chinese stocks in late 2014 and early 2015 (Bloomberg). China has further shaken global markets in recent weeks by allowing its currency, the renminbi, to depreciate against a basket of major global currencies after a multi-year period of gradual appreciation. While the recent currency depreciation caught many investors by surprise, we expect the impact to be felt much more strongly in the Asian region than in the U.S. or Europe.

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- **COMMODITIES** – Commodity markets have struggled in recent years due to a combination of subdued global growth and low levels of inflation around the world. Over the past year, the general malaise in commodity markets has turned into broad-based declines, especially in the energy sector. The catalyst for the recent collapse in oil prices has been twofold: increased global supply due to production increases in the U.S. and Middle East and slowing demand in the midst of a slowdown in China. We expect commodity markets and countries that are dependent on commodity exports to continue to struggle in this environment. However, we also continue to expect countries in the developed world that are significant consumers of energy, including the U.S., Europe, and Japan, to ultimately benefit from lower energy prices through increased domestic consumption.

- **FEDERAL RESERVE** – The Federal Reserve (FED) has been an important player in U.S. capital markets in recent years through a combination of quantitative easing and maintaining short term interest rates near zero. However, the FED has indicated that they are likely to raise short term interest rates in the coming months as the U.S. economy has continued to strengthen. In recent weeks, both equity and fixed income markets have seen increased volatility in response to uncertainty over the timing of interest rate increases and the potential impact on the U.S. and global economy. In our view, the FED is still likely to raise interest rates by a small amount in the fourth quarter but will likely do so at a very slow pace over the course of the coming years. We do not expect that the gradual increases in short term interest rates that we anticipate will derail the U.S. economic recovery as the FED is likely to remain highly cautious in implementing this policy change.

PORTFOLIO COMMENTARY

The Investment Committee at Freedom Capital Management Strategies® is continually monitoring the complex financial world in an effort to prudently manage the balance of risk and opportunity for our clients. We remain confident that our active investment strategy, with risk management at its core, is well positioned to navigate ever-changing capital markets in an effort to provide our clients a path to achieving their financial goals and dreams.

As we assess the global opportunity set in the midst of current market volatility, we remain constructive on both the U.S. and Europe, which is where we maintain the significant majority of our exposure. We maintain minimal exposure to emerging markets due to the uncertainties described above. We also remain conservatively positioned in our fixed income allocations, especially in relation to interest rate risk, as we continue to find the risk/reward in bonds unfavorable given the suppressed levels of yields globally.

- **United States** – The U.S. economy remains a beacon of strength relative to the rest of the world. The economy continues to grow at a slow, steady pace, and we continue to see notable improvement in both the labor and housing markets, which we expect to continue supporting domestic consumption. Further, inflation remains subdued, which we anticipate will allow the Federal Reserve to maintain its accommodative monetary position for longer. Going forward, we will be monitoring corporate earnings closely as profit margins remain near record highs. The decline in commodity prices is likely to prove a short term headwind to corporate earnings, but we expect a positive long term effect for U.S. consumers that should be supportive of U.S. equity markets.

- **Europe –** Europe appears to remain in the very early stages of recovery after a prolonged recession. We expect that the impact of the European Central Bank's version of quantitative easing, which was implemented in January, will have a positive impact on the European economy and capital markets in the coming quarters and years. European economic indicators have already begun to improve from very weak levels and corporate earnings expectations have been revised upwards in recent months. Further, as a significant net importer of energy, we expect European consumers and businesses to begin to benefit from the impact of lower commodity prices. We will continue to monitor European economic and corporate earnings data for indications that the challenges facing the developing world may begin to threaten the nascent European recovery, which we do not anticipate happening at this time.

- **Emerging Markets –** We remain concerned about the challenging macroeconomic conditions facing emerging markets, especially China, in the near term and have maintained minimal exposure to developing nation equity and fixed income markets for some time. We will continue to closely monitor the situation in emerging markets for possible contagion risk that has the potential to negatively impact economic conditions in the U.S. and Europe. We currently feel that this contagion risk remains contained. On the other hand, we will also be evaluating emerging markets in the coming months for potential opportunities to increase exposure at more attractive valuation levels after the sharp sell-off in recent weeks may present a compelling entry point.

- **Fixed Income** – Global interest rates remain at historically low levels and have declined further in the midst of the recent flight to safety in response to heightened equity market volatility. We continue to feel that the opportunity set in bonds remains limited due to suppressed yields around the globe, which has resulted in bonds trading at expensive valuations. We continue to maintain a significant majority of our fixed income allocation in the U.S. where the economy appears stronger and yields are relatively higher than its developed international peers. Further, we maintain a conservative posture in relation to interest rate risk in an effort to manage future volatility should interest rates begin to rise from these levels.

- **Commodities** – We anticipate continued pressure on global commodity prices, especially the energy sector, due to increased global supply and slowing demand, especially from China. Based on this view, we continue to maintain minimal exposures to commodities and to countries heavily reliant on commodity exports, especially in the emerging world.

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RISK MITIGATION

The proprietary risk mitigation overlays available through Freedom Capital Management Strategies®, Risk Assist and Principal Guard, are designed to provide an additional layer of protection to investors through a systematic hedging process constructed to reduce the risk of catastrophic loss in an investor's portfolio. These dynamic hedging strategies are managed through an algorithm-based process that seeks to reduce risk during periods of heightened market volatility at the potential opportunity cost of not fully participating in the potential gains generated on the upside. These hedging decisions happen automatically and are not driven by the Investment Committee's outlook. For investors uncomfortable with the volatility typically associated with investing in capital markets, Risk Assist and Principal Guard offer strategies that are designed to dampen volatility for investors.

In recent days, both Risk Assist and Principal Guard have triggered modest hedges in an effort to protect investor portfolios in response to the elevated levels of market volatility. These hedging overlay strategies are positioned to respond to the dynamic market conditions that we are currently experiencing, and additional hedging activity will occur should market conditions continue to deteriorate.