



Quarterly Commentary – October 2015

Fed Seeks to Sooth Market Shaken by Chinese Turmoil

My Dear Client:

The third quarter marked a tipping point for many investors, both literally and figuratively. Investors received a jolt in third quarter as a series of announcements out of China sent U.S. stock indexes to the largest percentage declines and the most volatility since 2011. By the end of the third quarter most major equity benchmarks had fallen into negative territory for the 2014. Accompanying this broad and steep selloff in equities during the quarter were further declines in commodity prices, especially oil and copper. Throughout the quarter, members of the Federal Reserve Board hinted that they were paying attention to market action leading to the announcement in September by Fed Chair Dr. Yellen that short term rates would remain unchanged.



Third Quarter Review

Questions and uncertainty about China the timing of an interest rate hike in the U.S. and the decline in oil prices driven by Saudi Arabia have been weighing on markets for the past 3 quarters. However, what changed during the quarter (the proverbial tipping point) was investors' realization of the potential ramifications of these developments. We saw sentiment shift significantly regarding risk assets, and China's bumpy transition from an export-driven to a consumer-driven economy may signal the beginning of the end of the Chinese productivity growth phase. One aspect of China's transition toward a consumer-driven economy the surprise action to devalue its currency added to investor angst and amplified stock market volatility. As did the extraordinary government interventions, such as blocking large stock holders from selling for six months for a large chunk of the wider Chinese population uses the stock market as a form of gambling. Some like Jeffrey Gundlach founder of Doubleline Capital Management have recently argued that the amount of Chinese margin debt (which grew 5-fold from mid 2014 until this past spring's crash) and its trajectory are eerily reminiscent of 1929 US market action. Gundlach compared the massive gain in the Shanghai index and the subsequent crash earlier this year to the U.S. stock market movement in 1929 at the start of the Great Depression. (Doomsday prophets are nothing new. Remember to stay focused on your plan.)

While this last comparison may be extreme, clearly there were two dominant market views that arose this quarter. a) That stock prices were at the mercy of the short-term "noise," investor emotions and a "sell-first-ask-questions-later" mindset; basically ignoring that longer term, asset prices typically are driven by underlying fundamentals of earnings, growth, valuation, inflation and interest rates. b) The crisis has woken up many people to the serious problem of a Chinese credit bubble and the likelihood that the country's economic growth will continue to slow and thus may underscore much deeper growth trends for the global economy if the biggest driver is no longer growing as fast.



I will simply say this is not a real capitalist market, a restriction on large stockholders could happen only in a state capitalist system, and we should be mindful that Beijing engineering outcomes for 1.4B people to drive growth for our entire global economy is a pretty scary proposition.

U.S. Equity Market

During the period, the broad U.S. equity market as measured by the Russell 3000® Index declined 7.3% and the large-cap focused S&P 500® Index declined 6.4%. Large-capitalization stocks fared better than mid- and small-cap stocks. Style-wise, large- and mid-capitalization growth-oriented stocks continued the yearlong trend of outperforming their value-oriented counterparts, while small-cap value stocks outpaced their growth-oriented brethren. Of the 10 economic sectors within the S&P 500 Index only one sector Utilities posted a gain which is somewhat expected move if equity investors sought perceived safe & stable investments. Conversely, the Energy and Materials sectors, two sectors impacted by the steep decline in commodity prices, posted the biggest losses. Now may be the time to search for opportunities at these lower values.



Largely due to developments overseas, non-U.S. equity markets posted bigger declines than the U.S. equity market. Non-U.S. developed equity markets, as measured by the MSCI EAFE (Europe, Australasia and Far East) Index (net of taxes), returned -10.2% during the third quarter. Emerging equity markets, as measured by the MSCI Emerging Markets Index (net of taxes), fared worse than developed markets, returning -17.9%. Although China dominated headlines and had a more pervasive impact on the global landscape and investor psyches, developments in Greece also continued to weigh on non-U.S. equity markets (particularly the Euro-zone) during the third quarter. During the period, Greece received a bailout just in time to avoid a default on debt payments, and then held another snap election that, ultimately, re-elected its Prime Minister and allayed investor concerns in the short term about a potential Greek exit from the Euro-zone. Due to the significant problems clearly evident in China's equity markets Greece was somewhat ignored. China's economic slowdown has major implications for emerging markets economies that see big red as their major trade partner. Also slowing growth in China exacerbating the same dilemma other parts of the world has always been a catalyst for geopolitical instability.

U.S. Fixed Income

In contrast to equity markets, most areas of the U.S. fixed income market posted gains during third quarter. Investor risk aversion and anxieties about global growth, and financial market declines amplified volatility, bolstered buying of U.S. Treasuries (securities that many investors viewed as less risky), and sending yields lower. (Bond prices and yields move in opposite directions.) In addition, the Federal Reserve opted against raising short-term interest rates at its September 17th meeting. The U.S. fixed income market, as measured by the Barclays U.S. Aggregate Bond Index, rose 1.2% during the quarter.



U.S. Treasury

Similar to the relatively volatile equity market, U.S. Treasury yield levels have experienced dramatic volatility in recent periods. The yield on the 10-year Treasury note ended the quarter at 2.06%, down from 2.35% at the end of the second quarter. Despite hitting a high of 2.50% and a low of 1.68% during the year, the 10-year Treasury yield ended the third (and yet investors continue to pour money into the US) quarter down slightly from the level at which it began 2015. It should also be noted that US unemployment rate for the period was 5.1% and inflation continues to be reported as tepid.

Looking Ahead

The devaluating of the Yuan and the continuing struggles of economies like Brazil will increase divergence in global monetary policies and push nations to further engage in currency devaluations and interest rate cuts in efforts to boost growth. Growth in the U.S. is generally improving, U.S. corporate balance sheets remain strong, merger and acquisition activity has been robust and is expected to continue. **Yet** the biggest driver of the equity market has and continues to be accommodative monetary policy. That even a *hint* to normalizing monetary policy sends markets into gyrations must give you pause to all assertions that economies, markets, and nations are fully healed from 2008. My capital market expectations have remained mostly unchanged from last quarter. Perhaps a Europe that does not fall apart completely, as well as other non-US nations that are neither extremely oil and commodity dependent nor have major fiscal imbalances could be interesting investment opportunities. Rebalancing some excess cash to potential beaten down areas of one's asset allocation is prudent. I would still affirm patience in selectively seeking cheap assets: in illiquid investment opportunities, un-loved energy options, burgeoning distressed options, global/international/emerging markets, and credit investments away from high-yield (for now).

It remains my view that well-diversified portfolios, active risk and portfolio management, and a long-term perspective are among the keys to successfully achieving investment goals. As always, if you have any concerns, questions, or general thoughts about your portfolio or any other matter, please never hesitate to contact me.

Enjoy the beauty of Fall.

Appreciatively,

Walid L. Petiri

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Sources: Barclays Capital, MSCI Barra, Russell Investments, Standard & Poors, Reuters, Federal Reserve Board