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<u>Potential for Market Rebound</u>
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Since 2011, the U.S. equity market has been on an upward trajectory with only a few minor bumps along the way. Over the last ten months the rate of forward progress decelerated and the market moved into a broad sideways trading range. On August 20th the stock market broke out of its 10-month trading range with a decisive move to the downside. In a five-day stretch the Dow Jones Index declined by 10.5%. There were a number of factors contributing to the recent sell-off including:

1. Economic weakness in China, leading to concerns about a global slowdown;
2. Falling oil and commodity prices creating to concerns about deflation;
3. Technical deterioration for chart and model driven investors;
4. Widening credit spreads for higher yielding borrowers;
5. Deteriorating earnings and growth expectations for many companies;
6. Debate about the timing of Fed tightening;
7. Concern that the six-year stock market rally is getting long in the tooth;

From the stock market high on May 19 to the September 29 low, the Dow declined 12.3%.

Chart 1 – DJI – Is the current decline more like 2007 or 2011?

This market decline lasted into quarter end, resulting in the worst quarterly performance since 2011. In terms of market measures, The Dow Jones Industrial Index was down 7.8% for the quarter, and the index of foreign stock markets was down 12.6% and emerging markets were down 17.9%. Even bond performance was disappointing as investment grade bonds significantly underperformed government debt. Overall, balanced portfolios suffered quarterly losses not seen in quite a while.

Thankfully, the U.S. and foreign stock markets have rallied over 5% since the beginning of the new quarter. While we are hopeful that this bounce will last into the year-end, we remain skeptical about the effect of commodity weakness on foreign and emerging markets. We believe a more U.S. centric position is warranted at this time.

Upcoming Market Positives

From the lows of September 29, the stock market has almost cut the year's losses in half, by rebounding over 5% in five days. This recovery has increased market confidence and created optimism for the near future. Factors contributing to the rebound include:

- The recent weak payroll employment data was uncharacteristically good for the market. Our interpretation is that the market cares more about certainty than uncertainty. By reducing the prospects of a Fed tightening in 2015, the stock market removed a negative from the outlook which enables investors to make decisions with greater certainty.

- Bearish investor sentiment has reached extraordinarily high levels in a short period of time. In addition, asset allocation funds are heavily underweighted in both U.S. and emerging market equities. In the past, this combination has been a contrarian indicator. Therefore, equities should be in better position to move somewhat higher going forward.

- The end of the summer doldrums! October, November and December are historically strong for the market.

- Holiday spending is expected to be strong with an increase of 2-3% over last year. Low unemployment and record-low gasoline prices are putting more money in consumers' pockets.

- There is hope that commodity and energy markets are showing signs of bottoming.

The Earnings Outlook

Earnings for the third-quarter of 2015 are estimated to decline by 5.1%. Back-to-back quarterly earnings declines have not occurred since 2009. It is anticipated that earnings will be substantially lower on a year-over-year basis for energy (-64%), materials (-13.7%), and industrial (-5.9%) companies. Positive growth sectors include Telecom, Consumer Discretionary, Health Care and Financials. I expect to hear the following themes from management:

- Continued strong revenue growth in the U.S., Europe is improving and China is mixed;
- The strong dollar has hurt foreign sourced earnings;
- Profit margins are under pressure;
- The impact of lower energy costs is good or bad, depending upon the sector.

I expect that the third and fourth quarters of 2015 will show continued poor overall revenue and earnings growth. However, many companies remain optimistic that 2016 will be a year of improvement in both metrics of corporate performance. Current projections suggest that revenues will grow in excess of 5% in 2016 and earnings growth should exceed 8% as the drag from the energy and materials sectors dissipates.

Fed Policy Makers Missed Their Opportunity to Raise Rates

To the surprise of many, Jane Yellen, Chairwoman of the Federal Reserve, chose not to raise interest rates at the September meeting. She spoke about the need to respond to a global economic slowdown; very unusual language for the Fed. With the subsequent announcement of weak jobs data, it is unlikely that the Fed will have an opportunity to move interest rates higher until well into 2016, if at all. The inability to raise rates has eliminated a short-term concern for both the stock and bond markets and has propelled a rally in most financial markets. While the Fed's inaction has helped markets, it has created a general loss of credibility as well, as they are now deemed too sensitive to market conditions.

Prospects for 2015 are Reflected in Portfolio Allocations

My goal is to have the core stock and bond portfolios fully equipped to ride through any meaningful market correction and to participate in an upside rally.

However, as with most stock corrections, the question is always "Will there be more and how much?" Needless to say, nobody has the answer. While I remain optimistic for the intermediate and long-term, the recent rebound has created cause for concern and I am taking the following actions:

1. Reducing all account equity allocations to modestly below their long-term target levels;
2. Paring exposure to emerging markets and small-cap equities as these will be the most volatile in the current environment;
3. Decreasing credit-spread risk in the bond allocation of portfolios;
4. Extending bond maturities as there appears to be little risk of higher inflation for the foreseeable future;
5. Holding some cash on the side for future buying opportunities.

For you, the investor, the correct course of action is to remain patient and not get distracted by the news media and their fearmongering strategies. Your long-term goals are aligned with a fully-invested equity portfolio. While volatility is normal, it is no fun to live through it. As for tomorrow, nobody can predict when the market will go down or up. You just have to ride it out.

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