The Ten Themes of 3Q 2015

The third quarter of 2015 was marked by a sharp rise in volatility that saw global stock indices fall by their widest margins in over four years. Decelerating economic growth in overseas markets, particularly in China, appears to be the leading trigger to recent declines.

The increased global market turbulence even altered our own Federal Reserve's plan to begin raising short-term interest rates. Many Fed critics lashed out at the central bank for not having the courage to raise rates. However, the reality is with global growth slowing and commodity prices deflating, raising U.S. interest rates could have the effect of intensifying this slowdown.

The Fed has another challenge when it comes to raising interest rates. Other central banks around the world are loosening monetary policy and adding further stimulative measures, so raising interest rates could trigger a sharp rise in the U.S. dollar. A rising dollar seems like a positive, but it would likely hurt sales (and ultimately profits) of large multinational companies.

In our view, the 3Q 2015 selloff in stocks was justified as prices have reset lower to reflect less growth. The good news is we believe stocks have now become less risky and that there are more values in the market today than there were six months ago. As we enter into the final 3 months of the year we will see how it all unfolds. In the meantime, here are the ten themes we believe impacted financial markets the most from July 1, 2015 to September 30, 2015.

1. A Grexit that never happened
2. Better earnings, but weak sales
3. Financially engineered earnings
4. Chinese stock bubble burst
5. Lower oil prices
6. Currency War
7. Global stock selloff
8. Better U.S. growth
9. Lower for longer
10. International stock market performance

Grexit

A Grexit is a combination of the words "Greece" and "exit." It was one of our ten themes of the 1Q 2015 and it remained a major theme of the 2Q 2015 period. As the books closed on June 30th, investor expectations around the world began to come to grips with the increased chance that Greece would either leave or get kicked out of the 19 country Eurozone. It never happened. Investors quickly lost focus on Greece during the 3Q 2015 period as other factors arose. However, the situation has not been permanently resolved in Greece, and at some point, it could be revisited again by the markets.

Better earnings, but weak sales

While 71% of companies in the S&P 500 beat their 2Q 2015 earnings per share (EPS) estimates, only 49% topped their 2Q 2015 sales estimates. This compares to 60% of companies topping sales estimates, on average, over the prior twelve quarters. This statistic on sales has many market bears claiming that earnings per share data is coming in better than anticipated only because companies are engaging in financial engineering.

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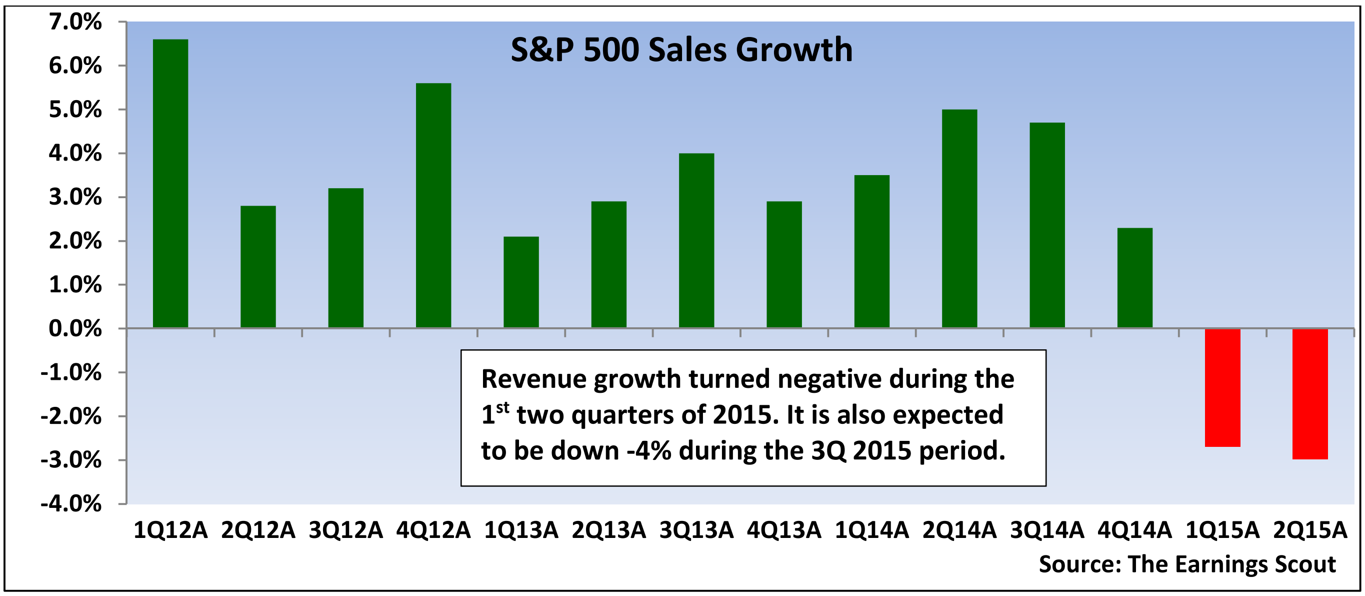
A 1st half 2015 revenue recession



Financially Engineered Earnings

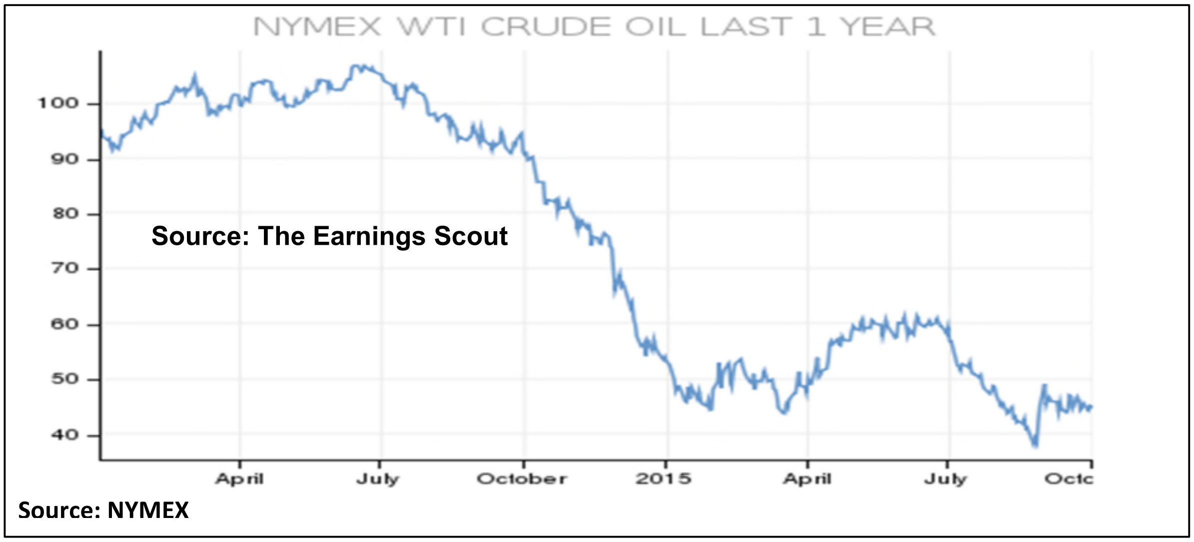
Market bears have highlighted that recent earnings trends are not sustainable because companies have been engaging in financial engineering. By that, they mean companies have been borrowing at low interest rates (thanks to the Fed) to buy back their shares, which provides an immediate boost to EPS figures. In addition, some companies are using excess cash to buy other companies as a way to grow through acquisition and not organically. Based on our review and analysis of share buy backs, M&A activity and other metrics, the bears have a valid argument and we reiterate our view that it will remain difficult for stocks to sustain a rally without companies seeing their top-line sales improve.

Chinese Stock Bubble Burst

From the beginning of the year until June 12, 2015, Chinese stocks, as measured by the Shanghai composite were up +59.72%. At first, when Chinese stocks began to rally in 2014, there was justification for the run-up based on improving economic expectations and depressed prices. However, by this summer, the valuations on many Chinese stocks were not reflective of economic reality as is often the case in manic phases of bull markets. When bubbles burst, it is not pretty and typically painful to smaller investors who often get into the game way too late. Given that China is now the #2 economy in the world, its pain has spread across the world, and rightfully so, as many countries do business with and in China.

Lower oil prices

Crude oil prices have been almost impossible to predict. For example, in the middle of 2014 when WTI crude oil was over $107 a barrel, many on Wall Street were forecasting increased geopolitical risks would spike prices to over $125. Instead, prices plummeted all the way down to $45 by March 2015. However, in the 2Q 2015, oil prices began to stabilize and then rise up to $60 a barrel. This brought the oil bulls back out and many re-upped their forecasts to at least the $70 range. Then, as global growth slowed and supplies remained high, oil prices plummeted again this summer. The most recent move downward was swift and sharp and will have major implications for overall corporate profits and capital spending plans into 2016 for the Energy sector.



Currency War

In early August 2015, the People's Bank of China, roiled global financial markets when it announced it would devalue the Yuan in a move to boost the country's exports. By lowering the value of their currency, China's products become less expensive in other countries around the globe with higher currency value. Other central banks can also be accused of trying to devalue their currencies to make the price of their services and goods cheaper too. Of course, no central bank will admit to intentionally devaluing its currency, but actions do speak louder than words. In mid-March of this year, our own Fed employed this strategy when Janet Yellen stopped the U.S. dollar's rise by hinting she would keep interest rates lower for longer.

Global stock selloff

The U.S. stock market was relatively calm during the second quarter. However, the bond market, which is normally more stable, was not. We have long learned nothing moves the stock market more than the bond market. Therefore, the bond market's volatility in the 2Q 2015 period turned out to be a great barometer of the 3Q 2015 turbulence in global stock markets. For the quarter ended September 30, 2015, the MSCI Developed International index, which is heavily exposed to European and Japanese companies, lost -9.72%. The MSCI Emerging Market index fared even worse declining -17.26% over the last three months. Comparatively, U.S. stocks, as measured by the S&P 500 index, only dropped -6.94% during the 3Q 2015 period.

Asset Class	*3Q 2015 Return	*2015 YTD Return
S&P 500 Index	-6.94%	-6.74%
MSCI Developed International Index	-9.72%	-5.79%
MSCI Emerging Market Index	-17.26%	-16.57%

*Price change through September 30, 2015

Source: Bloomberg

Better U.S. growth

One reason why U.S. stocks did not fare as poorly as international stocks during the 3Q 2015 is that so many of the issues in the current marketplace are occurring overseas, and in particular in China. Japan is still trying to deal with its own issues and even Europe is struggling to see its economy re-inflate despite the European Central Bank's best attempts to pump up the economy. Most domestic U.S. economic indicators were positive during the quarter. However, as we already mentioned, overall, the companies the make up the S&P 500 had weak sales. We do not want you to confuse U.S. corporate sales as being purely domestic though since most companies have gone abroad over the past several decades to find better growth opportunities. Thus, as international economies cool off, some of the companies that have outperformed in the last three months are the ones with less international exposure.

The key question going forward is, will the slowing global growth begin to adversely impact the U.S., or can an improving U.S help save the global economy? In our view, a stronger U.S. is always a good thing, however, many U.S. corporations have a high exposure to international markets. This makes it difficult for these companies to escape without seeing their future growth impacted from the slowing international economies.

U.S. looks good on a relative basis

Lower for longer

At the beginning of this year, the general consensus on Wall Street was that the first Fed interest rate hike of 0.25% was going to occur in June 2015. Janet Yellen squashed those expectations in mid-March when she mentioned the rapid rise in the value of the U.S. dollar. She knew raising rates, as other central banks were cutting them and pushing forward more stimulative initiatives, could be very damaging to large U.S. multinational companies.

During the 2Q 2015 period, the markets moved their expectations for a June 2015 rate hike out to the 3Q 2015 period. Specifically, the general consensus among Wall Street economists and strategists was that the Fed would lift rates by 0.25% at its September 2015 meeting. However, those expectations lowered after the People's Bank of China devalued its currency in early August.

Quite simply, the People's Bank of China, and other global central banks have made it much more challenging for the Fed to hike interest rates, especially as global growth has cooled off. As such, interest rate hikes keep getting pushed out into the future and ZIRP (i.e. zero interest rate policy) is looking more and more like the roach motel, where you can check in, but not check out. Just look at Japan, where interest rates have been near zero for over two decades and growth has been subpar almost the entire time.

Date	Implied Probability Fed leaves rates unchanged	Implied Probability of a 0.25% interest rate hike
October 28, 2015	97.7%	2.3%
December 16, 2015	67.4%	31.9%
January 27, 2016	57.8%	37.0%
March 16, 2016	46.6%	41.0%

Source: Chicago Mercantile Exchange

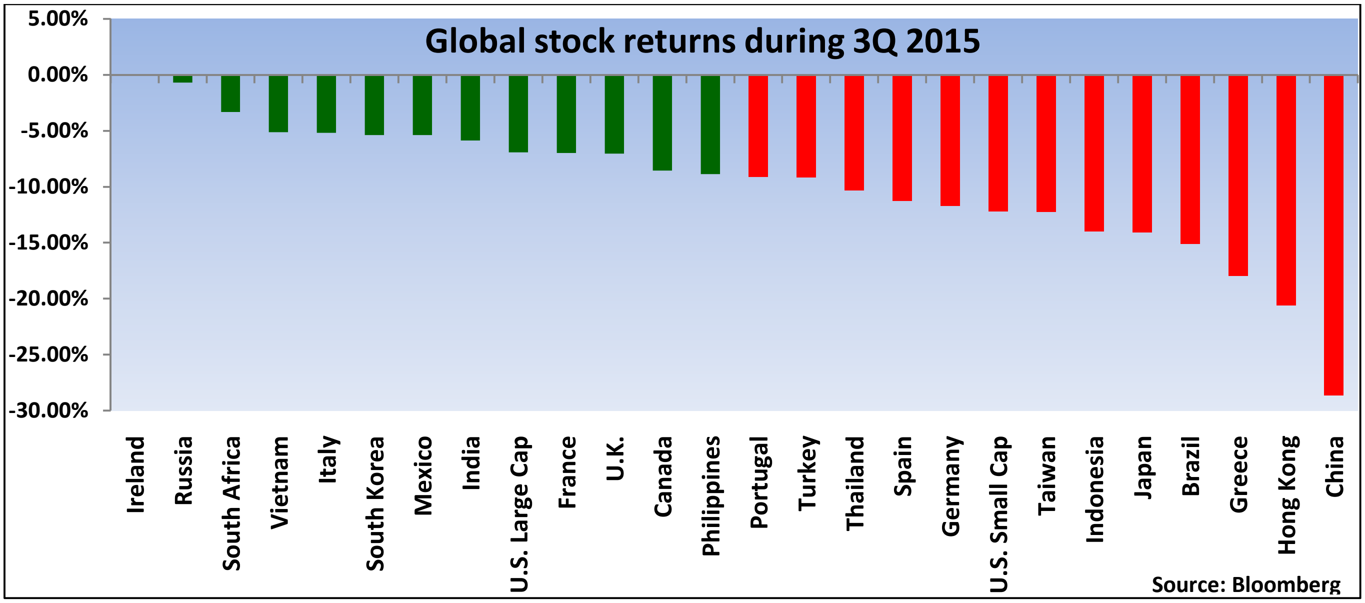
*Implied probabilities are provided by the CME based on 30 day Fed Funds Futures pricing

Global Stock Market Performance during 3Q 2015

Country	*3Q 2015 Return	July Return	August Return	September Return	YTD Return
Ireland	0.04%	5.64%	-1.64%	-3.72%	18.05%
Russia	-0.70%	0.87%	3.84%	-5.20%	17.64%
South Africa	-3.32%	0.48%	-4.00%	0.23%	0.64%
Vietnam	-5.13%	4.72%	-9.07%	-0.37%	3.12%
Italy	-5.19%	4.80%	-6.78%	-2.95%	12.01%
South Korea	-5.37%	-2.12%	-4.37%	1.10%	2.47%
Mexico	-5.37%	-0.67%	-2.30%	-2.49%	-1.19%
India	-5.87%	1.19%	-6.51%	-0.49%	-4.89%
U.S. Large Cap	-6.94%	1.97%	-6.26%	-2.64%	-6.74%
France	-6.99%	6.10%	-8.45%	-4.25%	4.27%
U.K.	-7.04%	2.69%	-6.70%	-2.98%	-7.68%
Canada	-8.56%	-0.58%	-4.21%	-3.98%	-9.06%
Philippines	-8.86%	-0.19%	-5.98%	-2.89%	-4.66%
Portugal	-9.09%	2.95%	-7.95%	-4.06%	5.17%
Turkey	-9.16%	-2.49%	-5.69%	-1.22%	-14.05%
Thailand	-10.34%	-4.28%	-4.01%	-2.42%	-9.93%
Spain	-11.23%	3.82%	-8.24%	-6.81%	-7.00%
Germany	-11.74%	3.33%	-9.28%	-5.84%	-1.48%
U.S. Small Cap	-12.22%	-1.22%	-6.40%	-5.07%	-8.63%
Taiwan	-12.25%	-7.05%	-5.66%	0.08%	-12.10%
Indonesia	-13.98%	-2.20%	-6.10%	-6.34%	-19.19%
Japan	-14.07%	1.73%	-8.23%	-7.95%	-0.36%
Brazil	-15.11%	-4.17%	-8.33%	-3.36%	-9.89%
Greece	-17.97%	0.00%	-21.73%	4.81%	-20.82%
Hong Kong	-20.59%	-6.15%	-12.04%	-3.80%	-11.69%
China	-28.63%	-14.34%	-12.49%	-4.78%	-5.62%

*Price change through September 30, 2015

Source: Bloomberg



Conclusion

As we start the last three months of 2015, our overall view on financial markets is relatively unchanged. We are optimistic that the worst of the negative earnings estimate revisions for corporate America, in terms of magnitude downward, are over. We are also pleased to see stock prices become much more reflective of their true underlying earnings power. However, we remain cautious given weak top-line sales figures reported by major corporations. In other words, it is great that earnings have held up well versus expectations, but a large part of that is coming from cost cutting, share buy backs and some creative pro forma adjustments. Until top-line sales rebound, markets may struggle to sustain a rally until investors get proof business is actually growing as opposed to just being financially engineered.

While we take great pride in our measurement and understanding of all the economic and earnings data, it is impossible for us to know every major market factor in advance. Because of this we continue to apply our fundamental beliefs that risk and return are related, markets are efficient over time, profitability matters and diversification is key. These fundamental beliefs continue to be the core of our short term and long term investment approach.

We hope you found this information useful, and encourage you to approach us with any questions you may have. We look forward to our next conversation.

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