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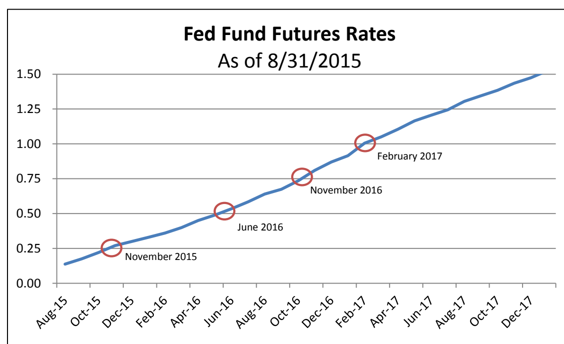
August 2015 Market Review

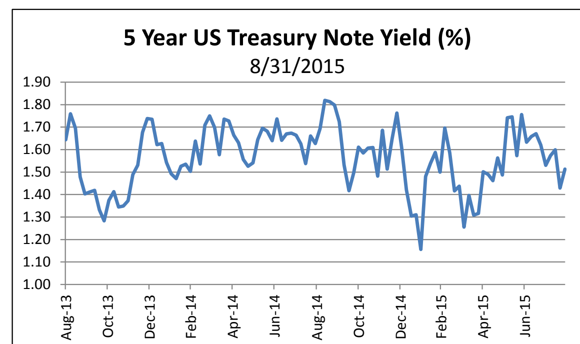
Market Summary:

Market Summary - August 31, 2015					
		Index Returns			
Index	**Yield**	**Aug-15**	**QTD**	**YTD**	**1 Year**
Stock Market Indices					
S&P 500		-6.03%	-4.06%	-2.88%	0.47%
DOW Jones Avg.		-6.20%	-5.70%	-5.68%	-1.00%
NASDAQ Composite		-6.70%	-4.01%	1.74%	5.65%
FTSE 100 (England)		-5.88%	-3.28%	-1.83%	-4.74%
EURO STOXX (Europe)		-8.27%	-3.93%	9.19%	9.78%
Nikkei 225 (Japan)		-8.18%	-6.59%	9.25%	24.51%
Shanghai Composite (China)		-12.46%	-24.35%	0.55%	47.03%
EEM (Emerging Markets)		-8.84%	-14.59%	-13.23%	-23.28%
Bond Market					
Barclays Aggregate	2.41%	-0.14%	0.55%	0.45%	1.56%
Merrill 1-5 Year G/C	1.17%	-0.03%	0.16%	1.11%	1.40%
US Treasuries	1.53%	0.06%	1.00%	0.88%	2.52%
Agency Bonds	1.38%	0.02%	0.44%	1.04%	1.99%
Corporate Bonds	3.46%	-0.67%	-0.14%	-0.59%	-0.42%
Corporate AA	2.75%	-0.38%	0.41%	0.01%	1.21%
Corporate A	3.00%	-0.33%	0.37%	-0.08%	0.73%
Corporate BBB	4.08%	-1.07%	-0.77%	-1.22%	-1.95%
High Yield Corporates	7.39%	-1.76%	-2.37%	0.07%	-3.07%
US MBS Index	2.48%	0.09%	0.73%	0.94%	2.60%
1-5 Year Muni	1.09%	0.08%	0.45%	0.79%	0.69%
Merrill Full Muni Index	2.47%	0.22%	1.01%	1.12%	2.61%
International Bonds	0.83%	-0.32%	1.06%	0.14%	3.16%

- Fixed Income markets have retained mostly positive returns this quarter and year to date, including the mixed returns during August.
- US economic growth continued slow and steady. However evidence of slowing global growth, China in particular, significantly increased the risk of a broader global slowdown.
- The markets have been preoccupied with the size and timing of the next shift in interest rates by the Federal Reserve, subject to employment and inflation in the US.
- Equity markets fell significantly and Corporate Bond spreads continued to widen, as "risk" assets declined in absolute and relative terms.
- Higher rated corporate holdings performed better than lower rated and high yield corporate names.
- US Treasuries again outperformed other sectors in the Fixed Income and Capital Markets during August in a flight to quality. Bonds with longer maturities outperformed shorter maturity securities.
- International bond markets had performed well as a result of a tentative deal with Greece, but global economic concerns still present a headwind for markets and rates rose in peripheral countries. Brazil bond credit ratings were recently downgraded, and Puerto Rico is on the verge of default.

The financial markets continue to be preoccupied by a potential hike in rates by the Federal Reserve. We feel that it is time to move on from that discussion. Any move by the Fed will largely be for posture and not significant enough to have a meaningful impact on the economy or markets in the intermediate term. A material move in Fed Funds in a short time would significantly jeopardize the currently fragile economic momentum that continues to recover from the 2013 taper tantrum. Furthermore, the market is currently





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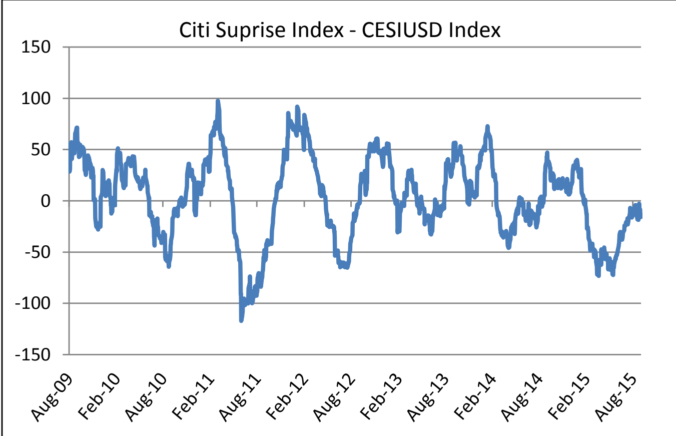
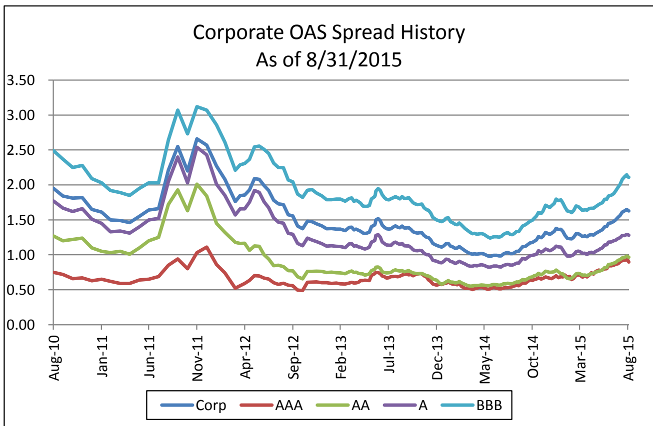
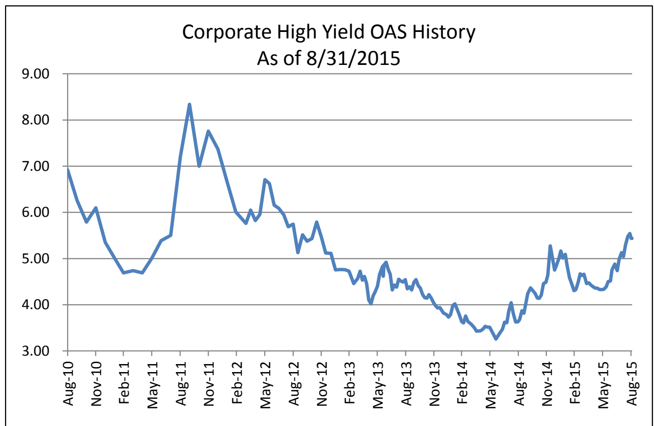
pricing in as much as we will likely see over the course of the next year. Markets pushed out expectations for a rise in the Federal Funds rate from September toward the end of 2015 and into 2016.

Recent revelations about the slowing of the world's second largest economy – China – sent ripples across the globe with concern about the impact to the already fragile global growth environment. Furthermore, the European Central Bank recently reduced growth and inflation estimates for Europe, and reinforced its commitment to monetary stimulus – low rates and bond purchases. The Fed by the way has also continued to reduce estimates of growth and inflation. Overall, economic data have continued to show moderate growth and low inflation, and certainly lower than expectations. The "Citi surprise index" tracks the pace of economic activity relative to market expectations. Interest rates continue to rise and fall with each piece of new economic data that may influence the Fed's decision, however the 5 year Treasury note yield has not broken a 0.50% range since the taper tantrum of 2013. In fact, its yield is within 0.10% of where it was two years ago today. In the markets, it has been a good strategy to be fully invested and earning income as we have been suggesting.



Meanwhile, the true fundamental conditions relative to more robust expectations have not been lost on "risk assets". Heretofore financial assets have been the primary beneficiary of easy US and Global monetary policy. More recently, stock markets in developed and emerging markets have staged significant corrections. It is important to recognize that credit spreads in the fixed income market, including investment grade and high yield, have been widening since mid-year, presaging the move in other risk assets. Corporate BBB rated securities now provide about 2% incremental income relative to US Treasury notes, and High Yield almost 6% incremental income over the risk free rate.





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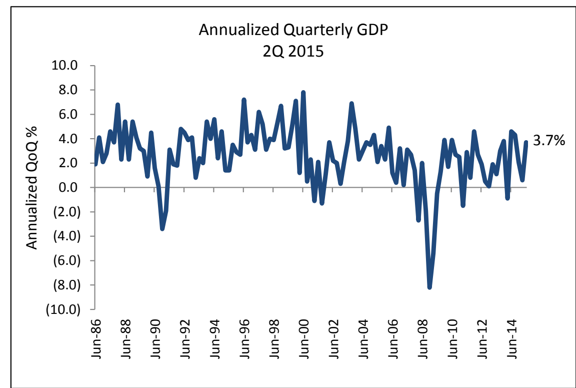
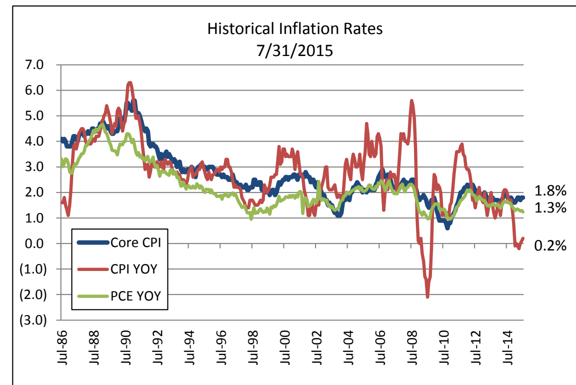
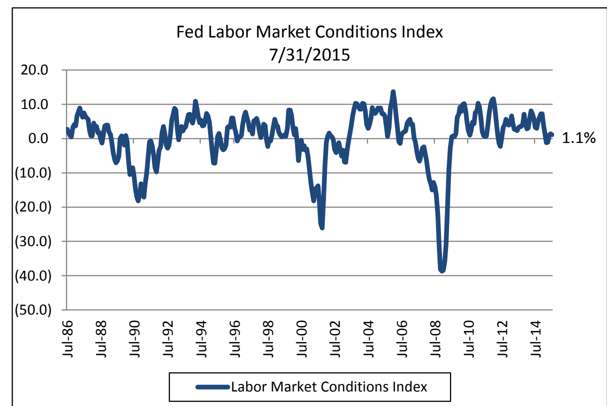
Again, equity markets had reached new highs as financial assets have been the primary beneficiary of ZIRP (zero interest rate policy) maintained around the globe. While the US economy has bounced in the second quarter, the significant majority of US economic data has been moderate at best and still below expectations. There continues to be a lack of capital spending and investment, consumption is moderate and inflation remains low. There continued to be a significant decline in commodity prices – not just oil. Also, regular but modest employment gains and moderate wage gains have led to continued moderate consumer behavior. All of this has contributed to a low inflation environment from a cost push or demand pull perspective, that gives reason for interest rates to remain in a lower rate range and has tempered expectations of a significant shift in monetary policy. This year, Fed members have reduced their expectations of how high and fast interest rate policy will change. Much of it will depend on continued progress in the labor markets, and the implications for further growth and inflation.



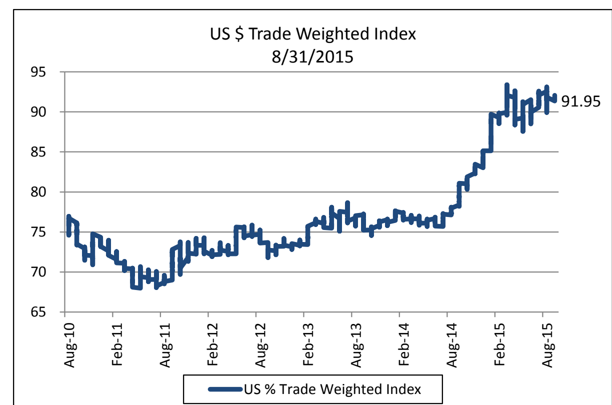


Despite the moderate pace of US economic growth, it remains among the stronger economies in the world. Central banks around the world are also maintaining ZIRP or even negative interest rate policy to stimulate their economies. The significant impact of which has resulted in a stronger US Dollar, presenting another headwind for the US through reduced exports and reduced corporate earnings for multi-national corporations that translate their earnings back to dollars.

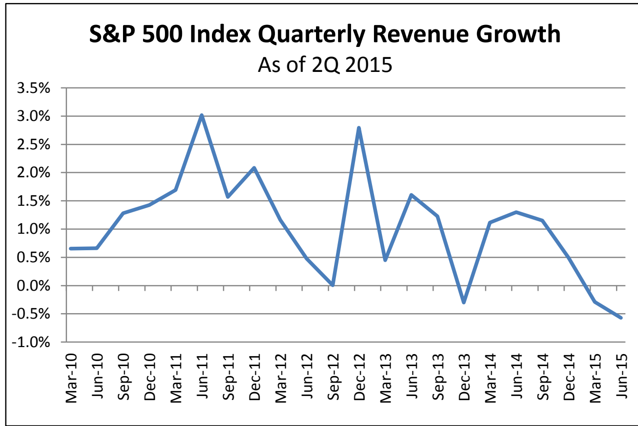


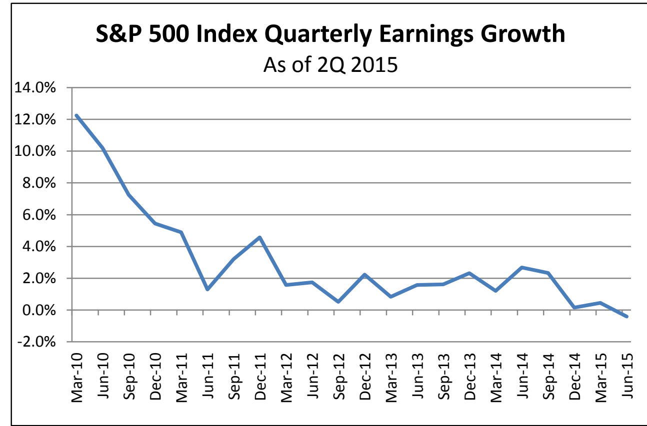
In addition to the economic fundamentals, Global headwinds include the Greece financial conditions and implications for the rest of Europe, European economic growth, slowing economic growth in China, the economic impact of commodities on Canada, Australia and emerging markets, and geopolitical risks such as Russia and the Middle East.

A recent developing issue that will likely grow in importance is the immigration issues in Europe due to other geopolitical issues. This is likely to place further burdens on already struggling economies.



As expected, this earnings season has brought with it a tempered top line revenue growth for corporate America with a subdued outlook going forward. Together with global events and reduced liquidity in the markets, risk premiums on corporate bonds and other "risk" securities have widened by the most in some time. Equity markets have corrected somewhat. Meanwhile, risk premiums on safer securities with little credit risk such as agency mortgage backed securities have remained narrow, in fact tightened – perhaps justifiably so.





The entirety of this environment has continued to give us comfort in remaining fully invested in a well-diversified portfolio as we feel interest rates will not rise significantly. If they do, it would risk what momentum the economy is currently holding on to. We feel the US economy is still trying to recover from the interruption caused by the 2013 taper tantrum. If the Fed does act, it will be minimal and over the medium term will not generate enough negative price action to offset the income of a fully invested fixed income portfolio. Furthermore, a properly diversified portfolio that includes deeper credit securities and longer term interest rate exposure should provide higher income and reduced principal volatility if properly balanced.

We continue to advocate a fully invested, well balanced portfolio depending on investment objectives and time horizons. An allocation to equities and fixed income, where appropriate, in the right balance will provide a reduced level of volatility no matter what market conditions present, and will provide the opportunity to continue to earn income, dividends, and potential appreciation while preserving capital.

Reflecting the environment described above, we have recently shifted our Fixed Income strategy to include a higher allocation to corporate bonds. While the economic environment is not robust, many corporations have improved their balance sheets over the recent years. Economic conditions, while challenging, do not present an environment of broad based credit default. We will see some increased levels of default in the energy sector for example, however we look forward to taking advantage of when higher quality assets become opportunities as a result of the baby getting thrown out with the bathwater.

Please feel free to contact us with any follow up questions or discussion in greater detail. We generate a full "chartbook" and discussion on a quarterly basis that provides a deeper discussion.

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