Investment Update

Third Quarter 2015

While the first half of the year had produced modest positive returns in many market indices, the third quarter brought volatility and steep declines starting in mid-August. Three key events occurred over the course of the quarter that drove stock market performance.

July saw the Greek debt situation resolved for the time being when their government agreed to terms on yet another bailout. Concerns over the possibility of a Greek exit from the euro and the resulting dislocations have been at or near the forefront on investors' minds for five years. Having some resolution, even if not permanent, is a distinct positive.

Equity Markets (Total Returns)	3rd Qtr	Y-T-D	1-Year
Dow Jones Industrials	-7.6%	-8.6%	-4.4%
S&P 500	-6.9%	-6.7%	-2.6%
S&P Mid-Cap	-8.5%	-4.7%	1.4%
S&P Small-Cap	-9.3%	-5.5%	3.8%
MSCI All-Country World	-8.1%	-3.8%	-0.9%
MSCI Foreign Developed Markets	-8.9%	-0.6%	1.2%
MSCI Foreign Emerging Markets	-12.0%	-6.9%	-6.8%
US Bond Markets (Total Returns)	**3rd Qtr**	**Y-T-D**	**1-Year**
Barclays US Gov't/Credit Intermetidate	1.0%	1.8%	2.7%
Barclays US Gov't/Credit Long	2.2%	-2.4%	3.1%
Barclays Municipal Intermediate	1.7%	2.0%	2.9%

However, in August the Chinese devalued its currency the yuan. This surprise move heightened fears that their economy continues to slow, and also that economic metrics calculated by China perhaps chronically overstate its health. While the US exports very little to China, as the second largest economy behind ours, it has the ability to boost or drag down the global economy. Shortly after the devaluation, the S&P 500 dropped 10% over just five trading sessions, leaving it down 12.4% from an all-time high in May.

In September, the Fed decided not to raise interest rates despite having laid the groundwork with rhetoric throughout the year that they would, which many felt somewhat undermined its credibility. Weakening foreign economies and implicitly the aforementioned market action in August were cited. These concerns are well outside of its dual mandate to focus on domestic inflation and employment, but US monetary policy has become increasingly intertwined with the global economy.

While our economy is seemingly ready for a return to higher, normalized interest rates, it is hardly overheating, and inflation has consistently been below the Fed's 2% target. Given that many foreign central banks are several steps behind ours in combating economic stagnation and possible deflation, an increase in our interest rates relative to those in the rest of the world would likely continue to push the dollar up on top of gains over the last year in anticipation of such a move. A stronger dollar against other major currencies reduces the cost of imports to American consumer and companies, and all things being equal, reduces the price of commodities as most are priced in the dollar world-wide, both of which materially reduce domestic inflation.

The source of the Fed's recent concerns is that a strong dollar also effectively exports that deflationary pressure to countries whose currencies are closely linked to the dollar (i.e. China, where the yuan has been actively linked to the dollar), or whose economies are export-dependent. Many emerging markets in particular are heavy exporters of commodities and thus have struggled with this dynamic as well as softening demand.

At the most fundamental level, higher interest rates are not good for stocks. All other things being equal, as the value of an investment is derived from the present value of its future cash flows which in turn is reduced by discounting them with higher interest rates. Nonetheless, investors have spent the last six years worrying about the strength of the US economy as it has struggled to "liftoff", so as discussed in the past, increases in interest rates should be looked at as a signal that it is headed in a direction that is positive for stocks. Perhaps only in the aftermath of a recession as severe as the one precipitated by the housing market collapse, and the resulting long period of artificially low rates would that fundamental relationship between rates and stocks be overshadowed. On balance, we expect interest rates to go up periodically but not significantly over the next couple of years. While technically representing a tightening of monetary policy, we do not think the initial increases will have much negative impact on economic growth and will not be a long-term headwind for the US stock market.

At the market's highs earlier this year, the forward P/E of the stocks in the S&P 500 was about 17x which we did not feel was overly expensive at the time given low interest rates and the then current outlook. While uncomfortable, the recent stock market declines have not been accompanied by poor corporate earnings outside of commodity-producing companies, so the forward P/E is now about 15x. Despite the good news on the Greek front, a chronic concern for some time, this is perhaps not entirely an uncalled for reduction in value given the increased uncertainty about the rest of the world. Over the last few years there have been other such sudden drops in the market, but they have usually been followed by nearly as sudden returns to previous levels. This time, while stocks are on the whole a better value than they were a few months ago, we do not think that a sharp rebound will necessarily occur until the Fed finally increases rates and more confidence can be had about China's economy stabilizing.