Financial Market Commentary

August 21, 2015

Thank Goodness it's Almost Saturday

Typically we look forward to Friday as it represents the end of the work week and the beginning of relaxation. However in the case of this week, I make the assumption that T.G.I.F. includes Friday and given the market volatility prevalent this week, Friday has been a continuation of the trend and I would just assume see Friday come to an end and move to a day where markets are closed such as Saturday. This level of market volatility quickly harkens memories of the recession of 2008. And while this week's volatility has been significant, the chart below shows just how far we have come since.

Chart 1

With that reality check in mind, let's look at the commonly cited reasons for this week's action and analyze the potential for this to result in a prolonged economic downturn:

1. **Low Volume:** While risk markets have moved swiftly down, it has happened while many market participants are "enjoying" time with their families on vacation. It is much easier to push the market around when there are not as many traders. And while this could be a contributing factor to the downturn, it is hardly something that we would consider to have the potential to cause a prolonged slowdown in the economy.
2. **Fed Uncertainty:** The Federal Reserve released minutes this past Wednesday from their last meeting and the text continued to signal uncertainty with the timing of the first rate hike. Many still consider September to be the month for the first rate increase while others believe it is (or should be) further into the future. Uncertainty causes short term skittishness. However to have a prolonged effect on the economy, one would need to believe that the first increase (whenever it happens) is the beginning of a prolonged and aggressive rate tightening campaign. Janet Yellen for her entire history has been a dove, meaning she will err on the side of not choking off a recovery versus being overly aggressive in attacking inflation. There are simply no signs of core or headline inflation which makes it highly improbable that the Fed under Yellen will undergo an aggressive rate hike campaign. With this said we believe that

uncertainty surrounding the timing of the first rate increase does not have the potential to cause a significant effect on the economy and a corresponding correction in the market.

3. **Emerging Markets:** The term emerging market is broad and includes many different countries that are not yet considered developed. The current concern has been more squarely focused on one country in particular and that is China. China's growth has faltered from consistent double digits to mid-single digits. The concern is that a slowdown in the second largest economy on the planet will be a catalyst for a larger global slowdown. In reality, China has historically been a larger manufacturer and exporter than importer and consumption-based economy. It is this transition that seems to be more of a factor in the slowdown than a core economic cause for concern. In fact when this long-term transition finally occurs, there is the potential to create one of the largest catalysts for growth that the global economy has ever seen. With all of that said, while the slowdown in growth is a concern, there is still economic growth in China and we do not believe that the slowdown will have a large scale impact on global growth.

Ultimately, long term trends in markets are based on core economic growth. As many of you have seen from our marketing presentation, there have been two examples of bubbles bursting in the last twenty-five years. When bubbles burst (tech bubble and real estate bubble), economic growth dies and markets crash. So what we are most interested in determining when managing money for long-term investors is, are the factors in place that can cause a bubble to burst and a prolonged economic downturn. Let me be clear that at this point we do not see any such signs of a bubble bursting or what we call a "red year event." So when managing portfolios we have to be equally sure we don't react to the fervor of short term market volatility as knee-jerk reactions can cause investors to be easily whipsawed. Currently the S&P 500 is about 6% off of its all-time high. When I look back over the last five plus years since the recovery from 2008, I see more than ten such instances of market falling 6% or more and all of them were followed by more significant moves back up. Three of the downward moves were more than 10% and two of them approached 20%, but all would have been mistakes to sell into. Portfolio diversification tempers these downward moves. Asset classes like gold and bonds have been positive return contributors over the past week. Risk-based asset classes like high yield debt and preferred stocks have only seen a small portion of the downward move that stocks have. U.S. stocks have performed better than international stocks and we are weighted more heavily in the U.S. than international markets. All of these core allocation decisions may hamper our portfolios from seeing every bit of upside in a raging bull market, but more importantly, they significantly protect portfolios on the downside.

As always we will continue to monitor economic conditions and Fed policy to gauge the best course of action. We appreciate the confidence you have placed in us and will continue to work diligently to manage our clients through this volatile time.

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