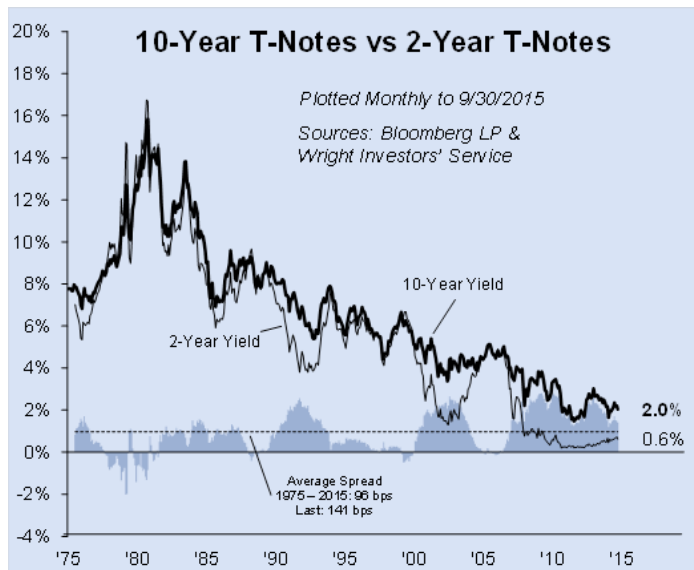
Quarterly Investment Report

October 2015

***SUMMARY**: The third quarter was one of the worst quarters for global stocks in several years, as concerns about international economic growth, chiefly emanating from China, and worries about how an impending interest rate increase might affect a suddenly flagging U.S. economy, worried investors. China markets, as well as those heavily dependent on them, were the worst performers, falling by double-digit percentages. Most of the damage was done in August, after China devalued its currency, but equities continued to lose ground in September. But bonds had positive returns, as investors sought their relative safety. While Federal Reserve officials, led by Chair Janet Yellen, declared that rate liftoff was "likely" to begin before the end of the year, recent economic indicators, especially September's disappointing employment report, may delay that move well into next year.*

Global stocks had some of their worst returns in four years in the third quarter, as the selloff that started in August, triggered by concerns about China's growth – and by extension, the global economy at large – continued into September. In the U.S., the Dow Jones Industrial Average lost an even 7% in Q3, including dividends, after falling 1.4% in September, while the S&P 500 fell 6.4% following last month's 2.5% drop. NASDAQ had the biggest loss for the month at 3.2% on the way to a 7.1% quarterly loss. Year to date, the Dow is down by the same 7%, while the S&P is off 5.3% and NASDAQ down a relatively modest 1.6%. Small-cap stocks did even worse, as the S&P 600 small cap index dropped 9.3% (3.5% in September) and the Russell 2000 sank 11.9% (4.9% last month). Year to date, those two indexes are down a respective 5.5% and 7.7%.



Utilities were the only sector in the S&P 500 to have positive returns in the quarter, rising along with fixed-income securities. The sector gained 5.4% in Q3, with a little more than half of the gain coming last month. Consumer staples were the next best performing category, returning negative 0.2%. But otherwise no sector was spared. Energy stocks were once again the worst performers, losing 17.4%, bringing their YTD return to negative 21.3%, as the price of crude oil plunged another 24.2% in the quarter, ending the month at about $45 a barrel. Materials stocks lost nearly 17% in the quarter, while health care stocks fell almost 11%. Year to date, only one sector in the S&P 500 has had positive returns: consumer discretionary stocks, which are up 4.1%.

Foreign stocks

Yet U.S. stocks outperformed their foreign counterparts, and by a fairly wide margin at that. The MSCI Europe ex U.K. index, which tracks mostly countries in the euro currency

Global Investment Returns In U.S. Dollars	Q3 2015		Trailing 12 Months	
	Stocks	Bonds	Stocks	Bonds
U.S.	**-6.9%**	**1.2%**	**-1.2%**	**2.9%**
Canada	-14.1%	-5.9%	-23.9%	-11.9%
Mexico	-12.0%	-3.4%	-24.0%	-2.9%
Japan	**-11.8%**	**3.0%**	**-2.2%**	**-6.2%**
Pacific ex Japan	-16.0%	-9.2%	-16.8%	-16.1%
Australia	-15.3%	-6.2%	-21.1%	-13.3%
China	-22.7%	-0.4%	-5.0%	5.3%
Hong Kong	-16.2%	N/A	-3.3%	N/A
Europe	**-8.7%**	**1.9%**	**-9.3%**	**-9.3%**
France	-6.4%	-1.1%	-7.7%	-11.3%
Germany	-10.9%	1.9%	-9.3%	-8.6%
Italy	-4.4%	2.4%	-9.3%	-8.4%
Netherlands	-8.9%	1.9%	-2.0%	-8.8%
Spain	-11.1%	1.2%	-20.6%	N/A
Switzerland	-7.0%	-3.6%	-3.8%	1.5%
U.K.	-10.0%	-1.2%	-12.1%	0.2%
World	**-8.4%**	**0.9%**	**-5.1%**	**-3.3%**
World ex U.S.	-10.6%	0.6%	-10.1%	-7.7%

Sources: MSCI Stock & Barclays Bond Indexes as of 9/30/2015

zone, fell more than 8% in U.S. dollar terms. Germany's DAX index fell nearly 12%, while U.K. stocks lost an even 10%.

But no major market got hit harder than China's. As measured by the MSCI China index, Chinese stocks plunged 23% in U.S. dollar terms, as the country's main Shanghai composite index dropped nearly 28% and Hong Kong stocks fell almost 20%. The global selloff in stocks basically started after China devalued its currency in August, a signal that the government had finally acknowledged that the country's economy was a lot weaker than it had been willing to admit. That set off alarms about the pace of global growth in general, since China is an outsize buyer of commodities and a major trade partner with Japan, the U.S., Europe and many developing countries in Asia.

Markets most dependent on trade with China fell the most. The MSCI emerging markets index lost nearly 18% in U.S. dollar terms, while the Pacific ex Japan index lost 16%. Japanese stocks fell almost 12% in dollar terms. Australia's ASX 200 index lost 7% in the quarter and is down 11% over the past two months; the country is heavily dependent on selling its metals and other commodities to China. Indian stocks got off fairly lightly, with the Sensex index losing 6% in Q3. But concerns about India's economy – now growing faster than China's – prompted that country's central bank on September 29 to lower interest rates for the fourth time this year in order to sustain growth.

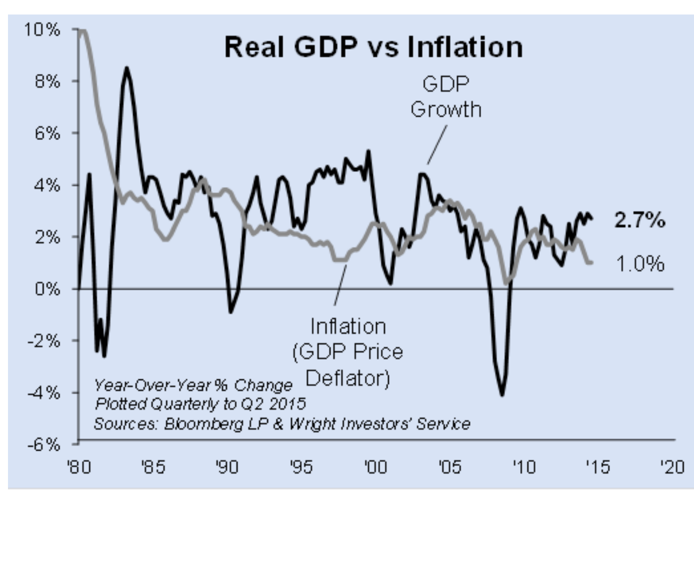
Bonds

Bonds proved to be a safe haven from the volatility in stocks, posting mostly positive returns in the third quarter. The Barclays U.S. Bond Market Aggregate returned 1.2% in the quarter after gaining 0.7% in September. The index, which is heavily weighted with U.S. government bonds, has returned 1.1% so far this year. The yield on the benchmark 10-year T-note ended the quarter at 2.04%, down 31 basis points for the quarter and 18 bps for the month, but fell below 2% in early October after the September U.S. jobs report was released. But high-yield bonds, which tend to trade like stocks, had negative returns, losing nearly 5% in the quarter, with about half of the loss coming in September. Many energy projects, begun when crude oil prices were about double what they are now, were financed with debt, and investors are worried that many of these issues will default as the price of crude continues to try to find a bottom.

European sovereign bonds also did well. The yield on the benchmark 10-year German bund dropped 18 bps to end the quarter at 0.59%, while yields on comparable Italian and Spanish government bonds plunged 58 and 41 bps, respectively. The somnolent euro zone economy has kept interest rates low. Sovereign bonds got a further boost after the European Central Bank announced changes to its quantitative-easing sovereign bond purchase program to try to spur inflation and thus economic growth. The ECB said it will now buy up to a third of each country's individual bond issues, up from 25% previously. Then ECB President Mario Draghi said the bank was prepared to continue buying bonds past the current September 2016 deadline if it had to. Since March, the ECB has been buying €60 billion (about $68 billion) a month in bonds, so far without much to show for the effort.

U.S. Economy

Reports covering the third quarter provided evidence that maybe the U.S. economy isn't quite as strong as the Federal Reserve would like to give it the confidence to start raising interest rates this year. Second quarter GDP growth was revised slightly higher to a 3.9% annual rate from 3.6% previously, largely due to an uptick in consumer spending. And the Fed's "Beige Book" covering the first half of Q3 was fairly upbeat, reporting that "economic activity continued expand-



ing across most regions and sectors." But other indicators have been less than robust. The Chicago Fed's national activity index fell back into negative territory in August after a slight positive reading in July; the index was negative six of the eight months through August. Durable goods orders for August fell 2%, reversing the previous month's 1.9% increase. Ex transportation, orders were unchanged and below expectations.

Leading indicators rose 0.1% in August, up from the prior month's no change but half as strong as expectations. Industrial production fell 0.4%, also below expectations and the sixth decline in the past eight months. Likewise, August factory orders fell 1.7%, worse than forecast. The one bright spot was construction spending, which rose 0.7% in August, driven once again by residential housing. Moving into September, the Institute for Supply Management's manufacturing index fell nearly a point to 50.2, just above the line indicating contraction. It was the index's third straight decline and its weakest reading since May 2013.

Consumer spending activity remains fairly consistent, if not exactly buoyant. Retail sales rose a modest 0.2% in August, slightly below expectations and down from July's upwardly revised 0.7% increase. Consumer spending, a broader category than retail sales, rose a better-than-expected 0.4%, matching the previous month's increase, but personal income rose a weaker-than-forecast 0.3%, down from July's upwardly revised 0.5% gain. That uneven performance, plus some renewed concern about the direction of the economy, may explain the wide divergence in consumer confidence readings. The Conference Board's consumer confidence index rose to 103 in September from 101.3 a month earlier. But the University of Michigan's consumer sentiment index ended September at 87.2, its lowest level in nearly a year and a sharp drop off from August.

Autos and Housing

The two most vibrant sectors of the economy remain consumer-driven, namely auto sales and housing, but the latter sector is starting to show signs of a correction. According to Autodata, annualized vehicle sales hit a 10-year high of 18.17 million, well above forecasts of 17.6 million. Most carmakers registered double-digit increases. The industry is on target for its best sales year since 2000.

But housing indicators have been a little bumpier. New home sales rose nearly 6% in August to an annual rate of 552,000, the highest rate since February 2008 and well above forecasts. But that was offset by a nearly 5% decline in existing home sales to an annual rate of 5.31 million, although that was coming off the best sales pace since 2007. Housing starts fell 3% in August to an annual rate of 1.126 million, with declines in both single-family and multifamily sectors. But building permits rose 3.5% to 1.17 million; permits for one-family homes rose nearly 3% to 699,000, the highest since 2008. The National Association of Realtors' pending home sales index fell 1.4% in August to 109.4, just its second decline this year. Lawrence Yun, the group's chief economist, noted that sales "have leveled off since mid-summer, with buyers being bounded by rising prices and few available and affordable properties within their budget."

Indeed, home prices may have started to hit a wall following steady price increases over the past few years, largely driven by limited inventories of properties available for sale. The widely watched S&P/Case-Shiller 20-city home price index fell 0.2% in July from the prior month, its third straight monthly decline, although it was up 5% compared to a year earlier. But price increases haven't benefited all homeowners, according to two recent reports, with home prices actually falling in many areas of the country. Zillow said its national home value index rose 3.3% in August to $180,800, but noted that fully 28% of homes are now worth less than a year ago. Similarly, a report from Weiss Residential Research that analyzed nearly 100 million homes found that the number of homes losing value on a monthly basis has more than tripled in the past year. Nearly a quarter of homes have lost value over the last year, compared to less than 8% in 2014, the report said. At the same time, the number of homes rising in value has dropped to 57% from 65%. Fed Chair Janet Yellen made a passing comment after the Fed's September monetary policy meeting about the housing market, which she said "remains very depressed," although she added that "demand for housing should be there and should materialize as the job market improves and income growth improves."

The correction in stock prices, and now possibly one in housing as well, certainly bode ill for consumer wealth and the economy at large. The surge in these two assets has been the biggest contributor to the restoration of consumer balance sheets – and moods – since the end of the Great Recession. Should these two indicators continue to move southward, they could have negative consequences for consumer spending, which continues to be the main driver of economic growth.

Investment Outlook

It's clear that the Fed is still not comfortable raising interest rates for the first time in nearly 10 years, and the economy's recent performance probably doesn't give it any additional level of confidence. The Fed elected at its September FOMC meeting to continue to wait and see how the economy and inflation progress before it decides to start liftoff. But the Fed clearly has concerns beyond U.S. shores. In her press conference after the meeting, Yellen said that although "an argument can be made for a rise in interest rates at this time," the Fed decided to stand pat "in light of the heightened uncertainties abroad" and the prospect of low inflation for a longer time. Indeed, inflation remains virtually nonexistent. Consumer prices fell 0.1% in August, pulled down by lower energy prices, while the producer price index was unchanged.

Yellen did offer that a "great majority" of Fed members still expect to raise rates at some point this year, adding that a move this month "remains a possibility." However, the number of members who said they expect to raise rates this year fell to 13, down from 15 in June. A week later, Yellen said in a speech that the Fed was "likely" to start raising interest rates before the end of the year. "Most of my colleagues and I anticipate that it will likely be appropriate to raise the target range of the federal-funds rate sometime later this year and to continue boosting short-term rates at a gradual pace thereafter," she said.

However, September's nonfarm payrolls report was so disappointing that Yellen and her colleagues may be forced to rethink that possibility. The Labor Department said payrolls rose a weak 142,000 last month, more than 60,000 below median expectations and nearly 40,000 below even the most pessimistic forecast. To add insult to injury, Labor revised the previous two months' figures lower by a total of 59,000 jobs. But there was even more bad news in the report. Average hourly earnings were flat, while the labor participation rate fell to a nearly 40-year low of 62.4%. The unemployment rate, however, did hold steady at 5.1%. While that figure may be at a level that the Fed deems to be full employment, and therefore a reason to feel confident enough to raise rates, the rest of the report can hardly give it confidence to pull the trigger on a rate hike soon.

The Fed's zero-percent interest rate policy has certainly been a boon to asset prices over the past six years, but it's not clear how much longer it can continue to work its magic. In our view, the Fed may be doing more harm than good by continually teasing the markets that rate liftoff is imminent, only to pull back the rug at the slightest sign of a problem, either here or abroad. Now it appears that the central bank may have lost the opportunity to raise rates, since the dismal jobs report – released just a week after Yellen said again that a rate rise this year is "likely" – makes that even more unlikely. If we add in the possibility of more negative news from outside the U.S. – either China, Greece or somewhere else – then the probability that the Fed won't start raising rates until sometime next year, not 2015, increases. Added to this uncertainty is the prospect of yet another U.S. government shutdown and debt ceiling. While Congress did avert any immediate crisis, it only pushed back the problem to later in the year, when it will have to resolve the issue yet again. The financial markets, then, will continue to climb the proverbial wall of worry, as they always have. That's why Wright continues to advise clients to hold a conservative portfolio of well diversified stocks and bonds, including both domestic and foreign securities.

The U.S. Economy 2013–2016

		% Change In			End of Period Rates	
		Real GDP*	PCE Core Deflator*	Profits from Operations#	90-Day T-Bills	10-Tear T-Notes
2013	Q1	1.9%	1.7%	5.5%	0.1%	1.8%
	Q2	1.1%	1.2%	5.4%	0.0%	2.5%
	Q3	3.0%	1.4%	5.8%	0.0%	2.6%
	Q4	3.8%	1.7%	6.9%	0.1%	3.0%
2014	Q1	-0.9%	1.4%	7.2%	0.0%	2.7%
	Q2	4.6%	2.0%	8.7%	0.0%	2.5%
	Q3	4.3%	1.4%	9.4%	0.0%	2.5%
	Q4	2.1%	1.0%	6.6%	0.0%	2.2%
2015	Q1	0.6%	1.0%	5.6%	0.0%	1.9%
	Q2	3.9%	1.9%	2.4%	0.0%	2.4%
	Q3 e	2.4%	1.3%	-0.5%	0.0%	2.0%
	Q4 e	2.7%	1.5%	1.0%	0.6%	2.4%
2016	Q1 e	2.6%	1.7%	2.9%	0.8%	2.6%
	Q2 e	2.7%	1.7%	6.9%	1.1%	2.7%
	Q3 e	2.7%	1.8%	11.9%	1.4%	2.9%
	Q4 e	2.6%	1.8%	13.6%	1.6%	3.0%

e: Bloomberg Consensus Estimates; *: Annual Rates; #: Year-Over-Year Change in S&P500 EPS
Sources Bloomberg LP, Wright Investors' Service

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