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2015 Third Quarter Review
"Greece Who?"

At the end of last quarter we marveled at how much attention the predicament in Greece was getting while the problems in China largely went ignored. Well, no more. The Chinese shocked the investment world by posting slower growth statistics and launching a surprise devaluation of their currency, while also becoming the focus of Janet Yellen's and the Federal Reserve Board's highly scrutinized excuses for not raising interest rates yet again. It was a fundamental change in the Fed's focus, which presumably consists primarily of a mandate concerning domestic employment and inflation rates. Many investors found it sobering that the U.S. Federal Reserve Board was afraid to raise interest rates by ¼ percent 7 years into an economic recovery because the economy still appears to be so fragile. Others saw a reason to continue to "run and gun" with a central bank that would continue to provide "accommodation" every time the market hit a downdraft. Whatever the interpretation, the bad news is that stocks had their worst quarter in 4 years. The good news is that the sharp rally since the close of the 3rd quarter has produced the best start to October in as many years. And Greece has been relegated to the back pages of the news.

At the end of September, the Dow Jones Industrials had fallen almost 9% for the year and the S&P was down almost 7%. Bonds recovered some of the ground they lost in the first half and finished down only a fraction of a percent. What was most jarring was the fact that major stock indices lost more than 12% to 13% of their value between July 20th and August 24th when the selling climaxed. Stocks had not experienced a 10% correction in years and this one happened quickly. A second wave of selling near the end of September appears to have been a successful "retest" of the lows established on August 24th. After that second wave of selling, the equities markets have rallied sharply. However, those results will be included in the fourth quarter performance numbers.

The economic weakness in China hurt all markets, but especially those having to do with any commodities like oil, metals, or agricultural products. Since China is the world's workshop, less demand for raw materials there is felt in lower prices everywhere. However, those prices have come down so far for so long that there is the possibility that the recent selling was a "wash out" that can set the stage for a rally in commodities. Right in the middle of the worst of the recent selling, Goldman Sachs made a high-profile announcement of their projection for a price of $30 per barrel for oil. That created a bit of a panic as fear took hold that oil companies might default on their debt and create a domino effect through the banking system similar to what we saw in the financial crisis of 2008. As the contrarian gods would have it, oil prices almost immediately turned and rose from $40 to over $50 per barrel in the last few weeks. This bounce in commodity prices has certainly helped down-trodden energy and precious metals holdings. It remains to be seen whether they have established a durable low from which they might sustain an advance.

Energy investors have been surprised by how much oil the U.S. has been able to produce in recent years. That has contributed to increased supply which, when combined with Saudi production and possible Iranian oil coming to market, has kept prices depressed. However, much of the U.S. production is short-lived and those production levels may start to decline soon. The oil drilling business is being downsized drastically as there is no economic incentive to spend a lot to find marginal new reserves at these prices. At the same time, oil stock investors have been pummeled and were the subject of “margin selling” during the recent climaxes. These factors taken together may have established a near-term (and perhaps longer) bottom in that sector.

We have tried to maintain a conservative investment profile as we take positions in stocks of companies with better statistical value and good dividend yields. One of our problems so far this year is that so many of those shares representing that value became still cheaper in the slide through September. Even healthcare stocks, which had largely been immune to the market’s downdrafts, were hit pretty hard in the quarter. Biotechnology stocks which had done particularly well this year were taken down sharply, partly because of one healthcare CEO bragging about how he buys companies and jacks up the prices of their drugs to pay for the acquisitions. This did not sit well with many people and it even has become an issue in the campaigns of some presidential candidates. The last thing any industry wants is more federal scrutiny, and some fear that pharmaceutical companies may become more of a target for regulators.

Throughout all the turmoil, we have had the difficult task of trying to protect capital in a down market while wanting to take advantage of cheaper prices as the markets decline. In some cases positions hit our tolerance levels and we reduced holdings in case we are wrong about the underlying value. We no longer have the option of getting decent returns on short term cash investments because the Federal Reserve has pursued ZIRP (zero interest rate policy) for some time now. That has pushed investors farther out the “risk spectrum” than they would otherwise have to go to achieve any given expected return. It is a quandary we’ve discussed before, but the fact is we are investing in very strange times. Short term interest rates are being kept artificially low and central banks have inflated assets in an attempt to jump-start economic growth. Accordingly, all asset values may be reset based on true “market discovery” once the tide of economic stimulus has changed. It is those fears of a slowing world economy and/or the withdrawal of monetary stimulus that keeps investors on edge.

During downturns like this recent one, we sometimes have the opportunity to upgrade our investment mix by selling our under-performers and buying good quality assets that have declined as much or more in price. A market technician recently pointed out that the majority of stocks had declined by 20% from their highs. We are screening through those now to find the best values for the next phase of what soon might be a “post-Federal stimulus” market.

Your third quarter statements and reports are enclosed. As always, please give us a call if you would like to change the mix of assets in your portfolio or if you have any other questions or comments regarding your investments.

Sincerely,

Claude R. Carmichael CFA