2015 FALL INVESTMENT OUTLOOK

The stock market remained in positive territory through the late spring months for the seventh year in a row despite slower than anticipated GDP growth, modest corporate profit gains, weak foreign earnings when translated into strong US dollars, and no shortage of geopolitical concerns. This progress was in some measure due to the continued accommodative stance of the Federal Reserve Bank, which held short term interest rates near zero thereby preventing little if any competition for marginal investment dollars from cash or bonds.

Global stock markets also advanced through mid-year. The Chinese market, representing the world's second largest economy (roughly half the size of the $17 trillion US economy), soared to new records as retail investors rushed to join the action and opened new accounts at record levels. The music stopped shortly after mid-year, however, as prices for a wide basket of world commodities fell sharply reflecting the reality of slowing demand in China and other emerging economies. Oil, natural gas, copper, base metals, iron ore and many other basic materials fell to multi-year low prices by mid-summer. This has dramatically impacted the profits and cash flow of extractive industries on a global basis and seriously impeded the export earnings of many countries. A modest July correction was followed by near rout conditions in August as Chinese indices fell by more than 35% from recent highs with US indices retreating more than 12%. A modest recovery followed in post-Labor Day trading.

The Chinese market downturn has brought a renewed focus on the underlying strength of that country's economy and the credibility of official government data. A growing number of economists believe China will be unable to maintain its targeted 7% growth rate and several have suggested that actual growth is much less than the rate reported by the government. It is also apparent that many poor capital investment decisions have been made by the myriad of public and private entities that make up the Chinese economy as evidenced by recently constructed ghost cities, empty warehouses and idle production facilities. American and European companies with important operations in China are now reporting weak results there while basic material imports are off dramatically. The Chinese government and central bank have taken extraordinary measures to prop up the stock market and economy. These measures include limits on stock sales for certain investors, lower interest rates, more lenient bank reserve requirements, a currency devaluation, and outright central bank buying of Chinese common stocks. The underlying trend appears to remain down despite massive intervention.

The Chinese slowdown has exacerbated global growth concerns as have notable slowdowns in key South American and other Asian countries. China has been a voracious importer of basic materials for many years and has recently accounted for the largest share of world consumption of aluminum (54%), nickel (50%), copper (48%), zinc and tin (46%), steel (45%) and lead (40%). Other key emerging market economies including Russia, Brazil, and Indonesia have also come up short recently and are either in recession or showing little if any growth. In short, emerging market and developing economies which had been the leading force of world economic expansion for many years are no longer in play and today are collectively growing at a rate little faster than the below trend line of 2%+ in the United States. Equity markets have sold off year-to-date (NASDAQ Composite being the one exception) as shown below:

2015 YTD Equity Market Returns (excluding income)

	9/18/15 Price	% Change
Dow 30 Industrials	16,384	-8.1%
S&P 500	1,958	-4.9%
NASDAQ Composite	4,827	+1.9%
MSCI All Country World Index ex-USA	246	-6.6%

Outlook

There are many uncertainties in the economic and capital market outlook. One major determinant is the outlook for growth and profit expansion in the United States, which continues to progress at a subdued and disappointing trend line rate. The current expansion which began six plus years ago in June of 2009 has recorded real (inflation adjusted) GDP growth of 2.1%, the weakest in all post World War II recovery periods. By comparison, real GDP expanded by 4.6% annually in the first six years of the Reagan expansion and some 3.6% in the first six years of the George H.W. Bush–Bill Clinton expansion. The nearly six year recovery period between 2002-2008 also topped 3%. Full year 2015 growth may not exceed the 2.2% rate of the first six months notwithstanding signs of progress in housing and auto sales. The negative wealth effect of lower stock prices could also begin to weigh on business and consumer confidence should volatility continue and stocks move even lower. Modest growth in this recovery period is notably disappointing when one considers the very aggressive fiscal and monetary policies employed by the Federal government since late 2008. On the fiscal front, the country has run a cumulative deficit of some $6.7 trillion over seven years, an amount approximating 50% of the total national debt at the beginning of that period. Academic and Keynesian economists would have predicted a notably higher growth rate given deficit spending of this magnitude.

Monetary policy of the Federal Reserve Board has also been in a very accommodative mode. Federal Reserve tactics have included holding short term interest rates near zero and significant open market purchases of bonds in a dramatic expansion of its balance sheet via three separate programs of quantitative easing (QE). It is difficult to say that QE enhanced growth, although on the positive side it did prevent debt deflation and enabled consumers and businesses to de-lever balance sheets. To be fair, it should also be noted that the Fed's job is complicated by the dual Congressional mandates of bringing the economy close to full employment and achieving a stable inflation rate of roughly 2%. The first goal has been achieved but the slow economy and weak commodity prices have kept the inflation rate well below Fed targets. At its recent and highly anticipated mid-September meeting the Fed voted to hold short term interest rates near zero and declined to begin an anticipated policy of restoring rates to more normal levels. Comments following the meeting used cautionary words such as "too soon" and "remain patient", while mentioning the weakening global economic outlook and the poor showing of emerging economies. Critics including James Bullard, President of the St. Louis Fed and a non-voting member of the FOMC, opine that the Fed has become overly focused on recent market volatility and the influence of global markets. By keeping short term rates near zero the Fed has left itself very little maneuvering room should a situation arise where appropriate Federal Reserve intervention is needed. Unintended consequences of the easy Fed policy continue and include low cost borrowing to fund speculative ventures, easy financing terms for the US Treasury and the penalty on savers. The challenge remains of how to exit gracefully from years of excessive monetary stimulation without causing significant financial dislocations.

It can now be fairly stated that years of aggressive fiscal and monetary policy have failed to restore US economic growth to the normal post-recession range of 3-4%. These policies are creating future challenges including projected higher deficits on the fiscal front as expanded entitlement programs have not been matched with corresponding revenue increases. Hence, federal deficit spending, which may drop to a multiyear low of some $425 billion this fiscal year, is projected to begin rising again and could eventually complicate the Fed's timing of future rate hikes. The door is certainly open for new approaches and or refinements to current fiscal and monetary policy which might produce better results. However, the political reality of the present Washington, DC will likely prevent any thoughtful changes to be made until at least January 2017 and perhaps longer.

The slowdown in corporate profit growth (the key driver of common stock price appreciation) to a mid-single digit rate is likely to continue for the balance of the year given very weak results in key sectors such as energy (expected to be down 50% from last year's third quarter) and related industries. Consumer spending remains a plus due to the strong employment market and low inflation. However, growth in median family incomes is stagnant while capital spending and nonresidential investment continue to be weak. Exports are challenged as evidenced by the latest recession in Canada, a key trading partner which accounts for 19% of US exports. American exports in general remain under pressure given strength of the US dollar and slowing foreign economies. Inventory accumulation, which was a plus in the second quarter, could very well unwind in the months ahead. Hence corporate profits are not expected to provide a tailwind in the near and intermediate term future and in fact will be a headwind for many companies. While credit expansion across the economy remains accommodative and there are no signs of a recession on the horizon, the profit outlook is uninspiring.

Geopolitical events and uncertainty will also play a role in the outlook. Destabilization and multi-faceted warfare in the Middle East has created a humanitarian crisis of epic proportions with hundreds of thousands of refugees now fleeing Syria and Iraq through Turkey and into Europe. The European economies and countries are poorly prepared to deal with migration of this magnitude while there seems to be no end to the lawlessness and brutality which is causing the civilian population to flee. The war Saudi Arabia is fighting with extremists in Yemen bears careful monitoring and any internalization of that conflict in Saudi proper would add further to concerns regarding world order. The role Iran will play in the region is particularly unclear given the soon to be lifted Western sanctions and the nuclear protocols negotiated by the White House without a thorough vetting in the US Senate. An additional worry is the recent deployment of small numbers of Russian combat troops and heavy weapons to Syria, purportedly to aid the Assad regime in its fight against ISIS terrorists. This raises the possibility of growing influence arising from Moscow, Tehran, and Damascus in the region which would be more than unsettling to the oil producing and conservative Sunni kingdoms in the Gulf States as well as to Israel. The United States finds itself in the very difficult position of sorting out relations with its strong and traditional Middle East allies, seeking improved relations with Iran, and limiting Russian adventurism.

Other global sectors also present uncertainties. The ultimate ambitions of Russia in the Ukraine, the Baltic States, and other central European nations remain unclear. China continues to expand its military while developing a blue water navy and building military focused islands on shoals in international waters in the South China Sea. The Korean peninsula should not be overlooked given the nuclear weapons capability and absolute control of a young and unstable dictator in the North.

Exotic financial instruments, bearing some resemblance to those which caused the financial crisis in 2008-2009, continue to flourish on Wall Street and notably in the loosely regulated hedge fund industry. Computer-based algorithmic models and quant portfolios drive a growing share of daily trading volume and can prove very disruptive to orderly markets when historical correlations between assets break down, forcing these programs to rebalance securities. A financial accident along the lines of Long Term Capital Management in 1998, which saw $4 billion evaporate overnight, cannot be ruled out. Shortcomings in the popular Exchange Traded Fund (ETF) industry surfaced last month when a brief 1,000-point drop at the morning opening produced erratic and unstable pricing for ETF investors.

The digital age which runs the country's financial system creates the need for ever present cybersecurity. Digital information and communications is the highway for commerce and finance today and those who would steal identities and financial assets are to be taken very seriously. There are radical elements who would seek to shut down vital communication and information systems in the developed world. This makes it more important than ever for governments to cooperate and be proactive in managing this threat.

With government policies going full tilt to enhance the economy, little has recently been said or acknowledged regarding the resourcefulness of free market economies. This firm believes there is enormous latent potential for growth and opportunity in our economy and society if government would simply back off a bit, regulate what truly needs to be regulated, and let markets function successfully as they have over and over again since the country was founded.

Investment Conclusion

Investors should be duly appreciative of the exceptional bull market in common stocks over the past six and one-half years. The popular stock indices more than doubled from their recession lows of March 2009 with bonds also gaining. At the moment, the US economy is moving forward but at a below average pace while growth in the global economy is slowing. Hence, headwinds exist in both the economy and geo-political environment which suggest common stock progress could be more challenging than it has been since the bottom.

This firm recommends retention of stocks of leading distinctive competence companies which, through strong management and value-added products or services, can make ongoing gains amidst a more difficult environment. Companies with excessive valuations or weak long term fundamentals are to be avoided. New equity investments should be made with notable caution and only when unique company features and valuation make for a compelling case. There will no longer be a "rising tide which lifts all boats."

The bond market appears more than fully priced and the inevitable return to at least a somewhat higher interest rate environment could put downward pressure on many fixed income issues. Hence holding short maturities is appropriate even though current returns are uninspiring. Quality should remain a key consideration as many so-called high yield bonds may fall short of making timely interest and principal payments. Holding an above average cash positon in the current instance also has merit.

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