ECONOMIC & CAPITAL
MARKETS REVIEW
NEWMAN DIGNAN & SHEERAR, INC.
Newman Dignan & Sheerar INVESTMENT ADVISORS

The Future Ain't What it Used to Be

3rd Quarter 2015

ECONOMY & MARKETS

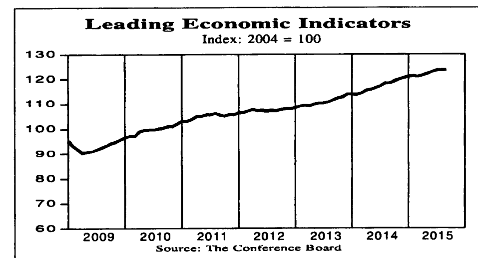
Lawrence Peter 'Yogi' Berra passed away in September at the age of 90, so we thought it was only appropriate to use one of his famous Berra-isms as our newsletter title. Berra was an amazing ball player having been an All-Star for 15 of his 19 playing years (playing in 18 All-Star games since two were held each year from 1959 to 1962) as well as a 10-time World Series winner. A highlight of his career was catching Don Larsen's perfect game in the 1956 World Series.

What does this have to do with investing and the world today? Glad you asked … '*The Future Ain't What it Used to Be*' sort of sums up the prospects for the markets over the next few years. During the third quarter the S&P 500 corrected 12.4% from its May record high to hand investors their first 'correction' in over three years. The proximate cause of the correction (as if one is really needed since they occur normally around once each year) was worse-than-expected news coming out of China (a slowdown in economic growth along with a surprise devaluation of the yuan). Investors also blamed the Fed for their wishy-washy press releases … will they or won't they raise rates soon? We believe that the markets corrected simply to reflect what will likely be lower global growth over the next few years.

The first correction in over three years brought increased volatility and investor nervousness during the third quarter. For the third quarter of 2015, the **DJIA** lost 7.6% while the **S&P** moved lower by 6.9%. The **NASDAQ** gave up 7.4%. International markets gave back earlier gains as the **EAFE** Index declined 10.8% for the quarter. Bond investors benefited from a flight-to-safety into U.S. treasuries. Bond returns were up decently as the Barclay's Aggregate **Bond Index** finished higher by 1.23% for the quarter … wiping out earlier losses in the bond index.

For the year-to-date period, the DJIA is down 8.6% while the S&P 500 is off by 6.7%. The NASDAQ is lower by 2.4%, and the EAFE index is down 7.4%. Bonds have held their own so far this year as the Barclay's Aggregate Bond Index is ahead by 1.1% through September.

Behind all the geopolitical noise around the world, the U.S. economy continues to plod along. Some of the positive signs pointing to economic progress include: improving **leading economic indicators** *(see chart below)*, healthy **durable goods**, early signs of improving **capital expenditures**, recovering **housing starts and prices**, improving **retail and auto sales**, low **interest rates,** low **commodity prices,** and mild **inflation**.

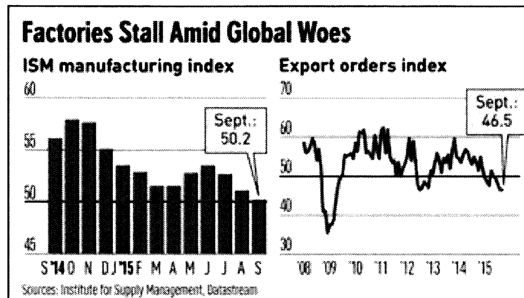


Commodity prices have mostly moved lower over the past few years. Lower commodity prices (particularly oil/gas) provide a tailwind to consumers and most businesses as input costs and expenses go lower. Retail sales and corporate profit margins should benefit.

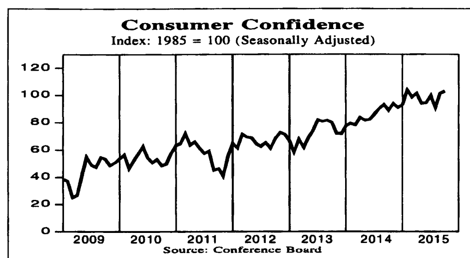
Missing from the above list of positive signs is **manufacturing** *(see chart on next page)*. Domestic manufacturing seems to have stalled lately as September's ISM Manufacturing Index fell to 50.2 … the slowest growth in more than two years. Global economic weakness and the strong dollar were mostly to blame for the anemic reading. Manufacturing in China and Europe remain weak as well (as evidenced by Germany's 1.2% drop in manufacturing orders for August). A bit of good news is that

Strong Dollar Impact

manufacturing represents only ten percent of the U.S. economy.



Consumer Confidence *(see chart below)* remains decent given low unemployment, low input/commodity costs, and rising real estate values. Contributing to the rise in confidence was U.S. household wealth climbing in the second quarter by $695 billion to $85.7 trillion (no doubt the third quarter's stock market drop lowered these numbers). Confidence remains high, and workers/consumers will soon be asking for higher wages. We'll see if businesses feel confident enough to increase wages in this low-growth environment.



Muddling along

In contrast to the Fed's data is the Census Bureau's recent report showing that median household annual income declined in 2014 and remains 6.5% lower than the median in 2007. The census bureau's report is yet another sign that the U.S. is simply muddling along in the weakest post-war recovery on record. As Yogi said – *"The Future Ain't What it Used to Be"*.

OUTLOOK

Bottom Line – Volatility is likely to stay high for the remainder of the year. We would not be surprised to see market averages move to positive territory by year-end. Uncertainty surrounding the Middle East (ISIS, Syria, Iraq, Iran, Afghanistan, etc...), China (slowing growth), the Fed (when will they hike?), political rhetoric from presidential candidates, and slumping commodity prices will likely provide enough drama to keep investors scratching their heads. Nonetheless, markets ought to move higher into year-end on reasonable economic data. Remember, market corrections/setbacks are always temporary, and the long-term advance of the markets is permanent (the past is prologue).

Market valuations have come down following the market's correction. The S&P 500 is trading at 15.4X 2016 estimated earnings of $125. Low inflation and low interest rates will allow valuations to creep higher before they become a concern again. Market multiples will probably move higher over the next few quarters as 2016 earnings estimates are revised lower (analysts are almost always overly optimistic with their initial estimates).

Bond prices should move a bit lower over the next quarter as bonds react to the ongoing rate-hike chatter (we expect the Fed to raise rates at their December meeting). Of course, geopolitical challenges could temporarily move bond prices higher and yields lower on a flight-to-safety. We anticipate keeping average durations in the short-to-intermediate range.

We remain constructive on equities even as the risk-reward calculus for equities is diminishing a bit. *Small and mid-cap equities* still add value to an overall asset allocation strategy, and the stronger US dollar will play to their strength. We continue to be sanguine on *international equities* – both *developed* and *developing,* as their valuations remain relatively attractive (as a result of recent underperformance). Large-cap domestic equities - *particularly those with higher quality attributes and increasing dividends* - remain overweight in portfolios. Our growth bias continues to play-out as global GDP growth remains fairly anemic. *Commodities* remain out-of-favor, but may see some dead-cat bounces over the months ahead. *Alternative assets* should continue to provide good risk-management for portfolios – particularly during times of volatility.

We suggest that investors maintain a fully diversified portfolio consistent with one's longer-term objectives and risk tolerance.

Happy Fall!

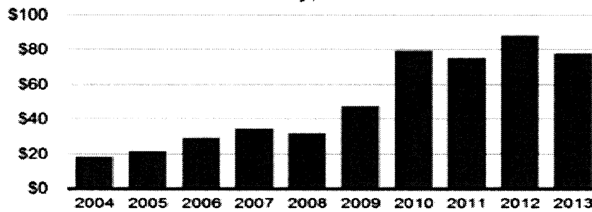
A Primer on the Federal Reserve System

The Federal Reserve System [the Fed] is the central banking system of the United States. It was created in 1913 in response to the severe 1907 bank panic. Its legislated goal is to maximize employment while maintaining stable prices via monetary policy [the infamous "dual mandate"]. The Fed's most recent comments seem to suggest that they now have a third mandate – "*international developments*".

Code Word for China

The Fed is neither fish nor fowl, since it is a combination of federal and regional government ownership combined with large commercial banks and various advisory councils. Its monetary policy does not require any outside approval [although in the real world outside lobbying is often intense].

The Fed has always been profitable, and its post-2008 expansion has only made it more so. Member banks receive a 6% dividend on their capital invested, and the rest is sent to the Federal Government. This was $20 to $30B prior to the financial crisis, but is now over $80B annually!



Source: Federal Reserve

The Fed is engaged in ongoing activities such as clearing checks and operating its discount window … it serves as the bank for the commercial banks. It is also the regulator of private banks and runs the new CFPB [Consumer Finance Protection Bureau … which is a new and growing regulatory body layered on top of the previous bureaucracy].

Un-precedented

Since the beginning of the financial market turmoil in August 2007, the Federal Reserve's balance sheet has grown in size and has changed in composition. Its **total assets** have ballooned from $869 billion on August 8, 2007 to well over $4 trillion.

Critics observe that it is much easier to create money than to mop it up, and perhaps that is one of the reasons that the Fed has been promising since 2010 to start the mop-up process [i.e., raise interest rates] "soon" but cannot find the gumption to do so.

The chart below highlights how stocks (the S&P 500) have responded to the past six Fed rate hikes. Conventional wisdom often points to stocks doing poorly after Fed rate hikes, but the data below tell another story.

Exhibit 1: Equities Survived Previous Fed Rate Hikes

S&P 500® Index Returns Before and After Rate Increases

Date of Initial Hike	Performance Before/After Initial Rate Hike: 250 Days Before	250 Days After	500 Days After
5/2/1983	36.6%	-1.1%	12.2%
12/16/1986	19.1%	-5.9%	11.2%
3/29/1988	-11.4%	11.7%	30.6%
2/4/1994	5.3%	0.6%	34.1%
6/30/1999	19.7%	6.0%	-10.7%
6/30/2004	14.8%	4.4%	9.1%
Average	**14.0%**	**2.6%**	**14.4%**

Source: Nuveen Asset Management, FactSet and Bloomberg. Past performance is no guarantee of future returns. Different indices and economic periods will produce different results. It is not possible to invest directly in an index.

Reasonable

~250 "trading" days are about 1 year.

3rd QUARTER 2015 SCOREBOARD

Index	Close	3rd Quarter % Change	Year-to-Date % Change
DJIA	16284.7	-7.6	-8.6
S&P 500	1920.0	-6.9	-6.7
NASDAQ	4620.2	-7.4	-2.4
Nikkei	17388.2	-14.1	-0.4
MSCI EAFE	1644.4	-10.8	-7.4

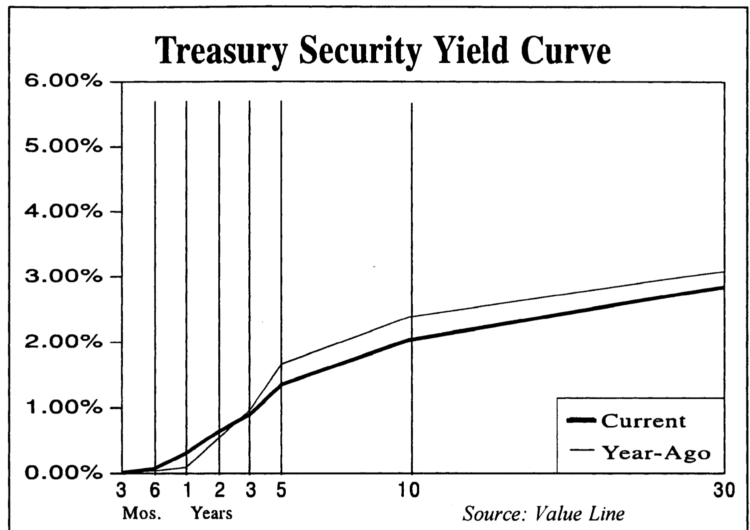
3 Month T-Bill	0.00%	Fed Funds Rate	0 - 0.25%
5 Year T-Note	1.36%	Prime Rate	3.25%
10 Year T-Note	2.03%	Gold	$1115.50
30 Year T-Note	2.85%	Oil	$45.09

Index returns are price only

Nothing Pretty

Oil is down 15.36% year-to-date.

Rates will likely move higher into year-end



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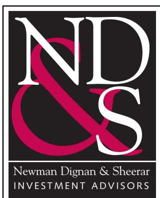

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