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Third Quarter 2015 Market Summary

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Third Quarter 2015 Market Summary

The third quarter was one of the most difficult periods for world stock markets since 2011. Most asset classes declined during the third quarter as volatility increased because of uncertainty related to the timing of the first Fed interest rate hike and worry that weakness in China could cause global growth to fall and further impact the earnings of global multinational companies. As a result, the S&P 500 was down 6.4% during the quarter and fell as much as 12% in mid-August from its recent all-time high in May before partially recovering during September.

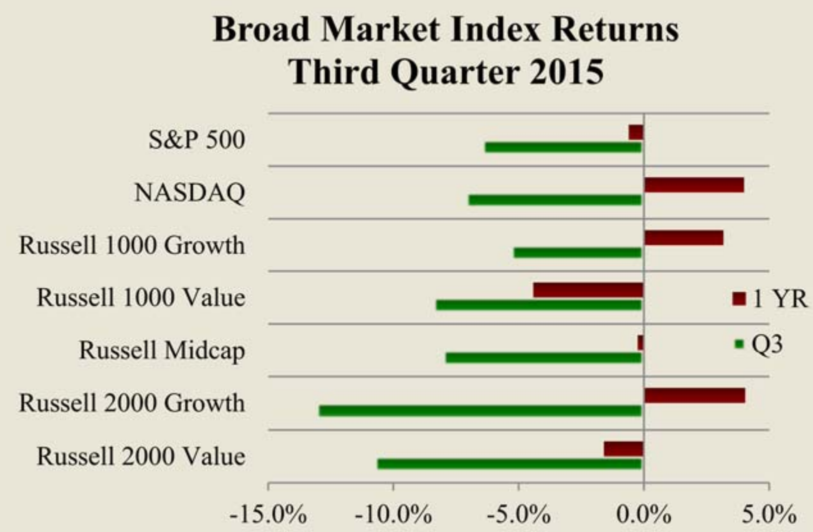
Despite its weakness, the S&P 500 held up relatively well compared to other assets as most were down more during the quarter. Small cap U.S. stocks fell almost 12%, while mid cap U.S. stocks declined 8%. International equity markets were hit harder than U.S. equity markets and the MSCI All Country World Index X – U.S., which represents broad-based International equity markets, was down a little more than 12%. Commodities faced more downward pressure and fell 14% during the quarter due to continued weakness in China.

Fixed income and yield-oriented assets achieved positive returns during the quarter as investors fled to lower risk assets. The ten-year U.S. Treasury bond was up 2.9% during the third quarter and U.S. Treasury bonds were up across the board as investors valued their safety. The Barclays Aggregate Bond index, which is comprised of a broader group of bonds, was up 1.2% during the quarter. Municipal bonds also did well as the Barclays Municipal 5-Year index was up 1.2% during the quarter and is now up 1.8% for the year. Investors also flocked to higher yielding equity categories as Utilities were up almost 5.5% and REITS were up almost 3%.

In the third quarter, bonds added value to diversified portfolios by muting the downside from the equity portion of the allocation. When interest rates eventually increase, it is likely that that it could put short-term pressure on bond prices, since bond prices move inversely to interest rates. We believe that the price pressure would be relatively minor and very short-term in nature and that the "cost" would be worth it because of the protection that bonds provide during periods of equity market volatility.

Investor concern is currently focused on China and the potential effect its economic slowdown could have on the U.S. and Europe. Manufacturing activity in the U.S. and Europe has clearly slowed during the past year and commodity prices have continued to weaken. The real concern is that Chinese economic growth will decline further and drag the world economy into recession. We believe that is not likely to happen as China continues to have a variety of fiscal and monetary policy options that could "engineer" a "soft" landing for their economy. Concern could dissipate as investors receive confirmation that conditions in China are not getting worse and that economic conditions in the U.S. and Europe remain stable. The much more significant consumer portion of the U.S. economy, which comprises 70% of GDP, continues to remain stable as auto sales and home sales have remained strong. Although the most recent jobs report was not as strong as expected, unemployment is on a downward trajectory and job growth continues at a similar pace as seen during the past five years.

While the relatively sudden drop in equity markets in August has been unsettling, we believe that we are only experiencing a "pullback" that is actually relatively common during bull markets. In fact, a 10% pullback in the S&P historically has occurred roughly every year. In fact, since 1980, the average intra-year decline has been 14.2% and yet annual returns have been positive in 27 of 35 years. Investors have not experienced this type of decline since 2011 when the S&P 500 plunged 19% before recovering during the fourth quarter to end the year relatively flat. Like then, it is entirely possible that the markets could recover by year-end as fear subsides and investors look ahead to likely stronger global economic growth in 2016.



HIGHLIGHTS

GDP

- The Bureau of Economic Analysis released the third estimate of second quarter 2015 real GDP, an annual rate increase of 3.9% from the preceding quarter. This is the second year in a row in which GDP rebounded after a slow start to the year.
- The University of Michigan Consumer Sentiment Index final reading for September was 87.2, which was a decrease from August and the previous quarter. Consumer sentiment remains high despite coming down the past few months.
- The ISM Manufacturing Index decreased during the quarter from 53.5 in June to 50.2 in September. The ISM Index has trended down since the end of 2014. Typically, when the ISM Index is above 55 it is bullish and when it is below 45 it is bearish.
- In September, the Conference Board Leading Economic Index decreased 0.2% month-over-month to 123.3. The Index has been increasing gradually over the past year showing steady slow growth in the economy.
- The price of WTI Crude Oil was $45.06 at the end of September, which is 24.2% lower than $59.48 at the end of June. The price of Brent Crude Oil decreased 21.6% in the quarter to $47.29. The price of oil has been volatile as the supply and demand dynamics are being affected by a weaker than expected global economy and the curtailment of U.S. shale production.
- In September, headline CPI increased 0.2% year-over-year, up from an increase of 0.1% in June. Core CPI, which does not include food and energy, had a 1.9% increase. Inflation levels have remained low over the past year and have been less than historical averages and the Fed's 2% inflation target.

HOUSING

- Preliminary existing home sales increased in September with an annualized rate of 5.55 million units from 5.48 million units in June. The September annualized rate is 8.8% above the 5.10 million units in September 2014. Home sales have picked up over the past few months after stalling in 2014.
- Median existing home sale prices increased during the quarter. The preliminary prices for September were 6.1% higher than the levels of one year ago and have been trending up since the beginning of 2012.
- New home sales increased during the quarter with a seasonally adjusted annual rate of 552k homes sold in August versus 513k in May. Home sales have rebounded from the lows of May 2010, when 280k new homes were sold. The past few months' new home sales growth have accelerated on a year-over-year basis.
- S&P Case-Shiller 20-City Home Price Index (seasonally adjusted) showed home prices rose 5.0% year-over-year in July.

EMPLOYMENT

- The labor market slowed during September as nonfarm payrolls added 142,000 jobs in the month which was lower than expectations. In the third quarter, nonfarm payrolls averaged 167,000 jobs added per month which was less than second quarter's average of 231,000 jobs per month and the lowest amount of quarterly jobs added in several years.
- The unemployment rate fell to 5.1% from 5.3% during the quarter.
- Initial Jobless Claims have been decreasing since 2009 and dipped to lows last seen in 1999.

DOMESTIC CORPORATIONS

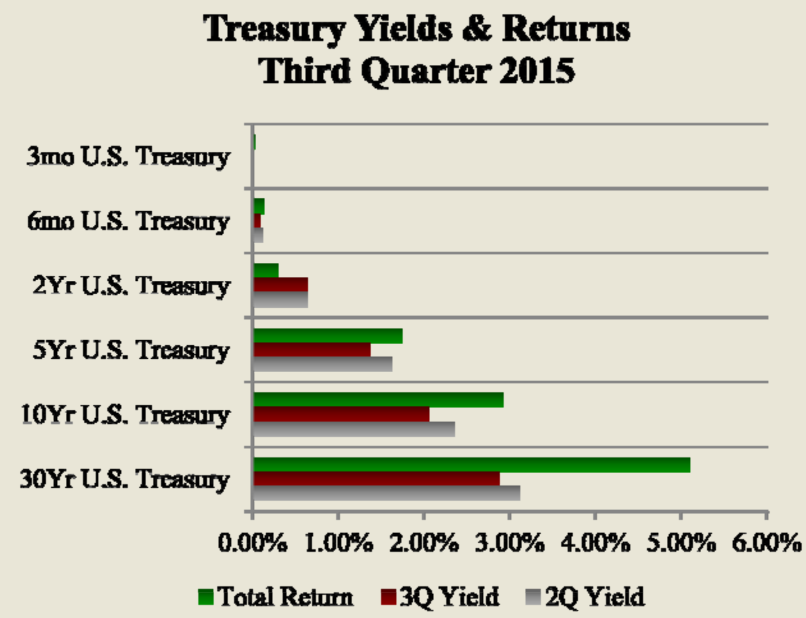
- Corporate operating earnings are expected to rebound in the second half of the year after a weak first half. Lower oil prices and weaker foreign currencies will continue to affect earnings over the next few quarters. Operating margins remain near all-time highs.
- With the third quarter pull back of the stock market, forward and trailing P/E multiples have dipped below historical averages.
- The U.S. dollar was relative flat versus the euro and yen in the quarter after appreciating considerably during the previous year. If the dollar remains strong, multinationals could see their earnings pressured due to their international exposures.
- The price of oil has declined by fifty percent over the past year. This has significantly hurt energy companies but lower prices should help other sectors that use oil as an input such as industrials, materials and consumer industries.

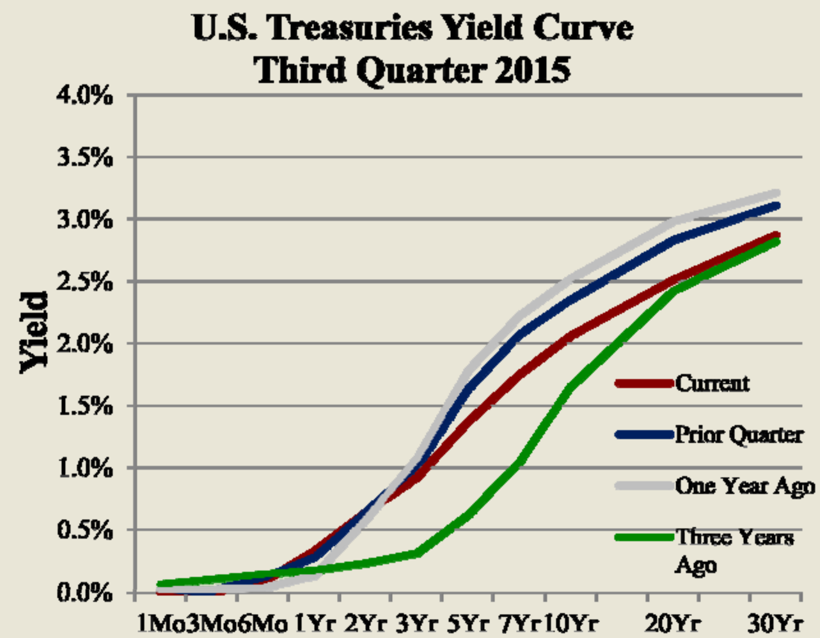
FED POLICY

- In September, the Federal Open Market Committee (FOMC) announced they would leave the federal funds rate at 0.0% to 0.25% percent. In their statement, the Fed noted the economy is expanding moderately and expressed that they have seen progress towards their goals of maximum employment and price stability.
- The consensus view was the Fed would raise rates slightly before year end as economic data points towards a relatively stable and growing economy. However, with lack of growth in Europe and China, in addition to softer than expected economic data in the U.S., many investors believe the rate hike may not occur until 2016.

FIXED INCOME

- The yields on longer-term Treasury securities decreased quarter-over-quarter, while yields on very shorter-term Treasury securities were about flat causing the yield curve to flatten.
- On a historical basis, the yield curve is relatively steep due to the Fed holding down short term rates. A steep curve indicates market participants are not concerned about a recession over the next year. Although the 30-year Treasury yield has decreased over the past year indicating lower economic growth expectations.



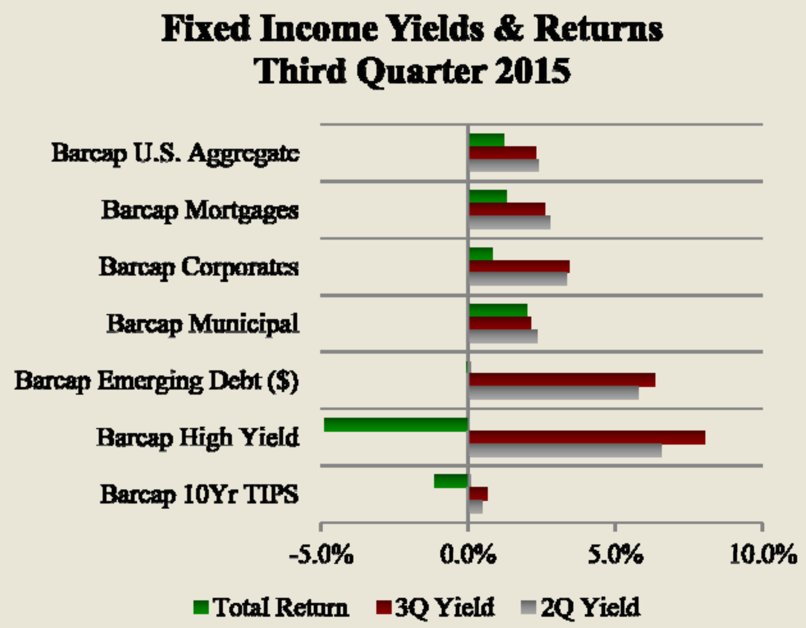


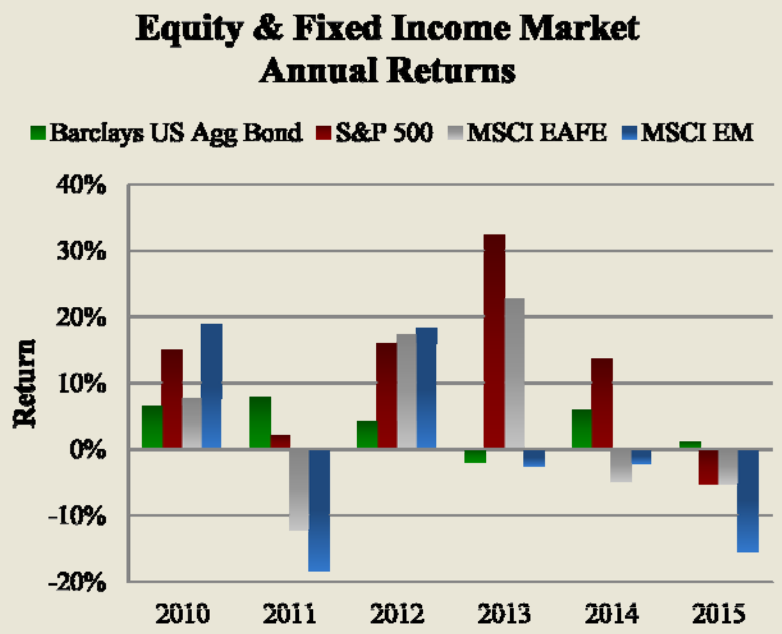
FIXED INCOME (continued)

- Yields in more credit sensitive fixed income sectors increased during the quarter as spreads widened. Returns were mixed across sectors with the Barclays U.S. Aggregate up almost one percent. High yield was the worst performing sector while municipals was the best performing sector. The high yield index was brought down by the energy and materials sectors, which have struggled.
- Fixed income returns, going forward, are expected to be lower than historical averages as interest rates are starting at a very low level. Historically, future ten year fixed income annualized returns have been about equal to the 10 year Treasury yield at the start of the period.

EQUITIES

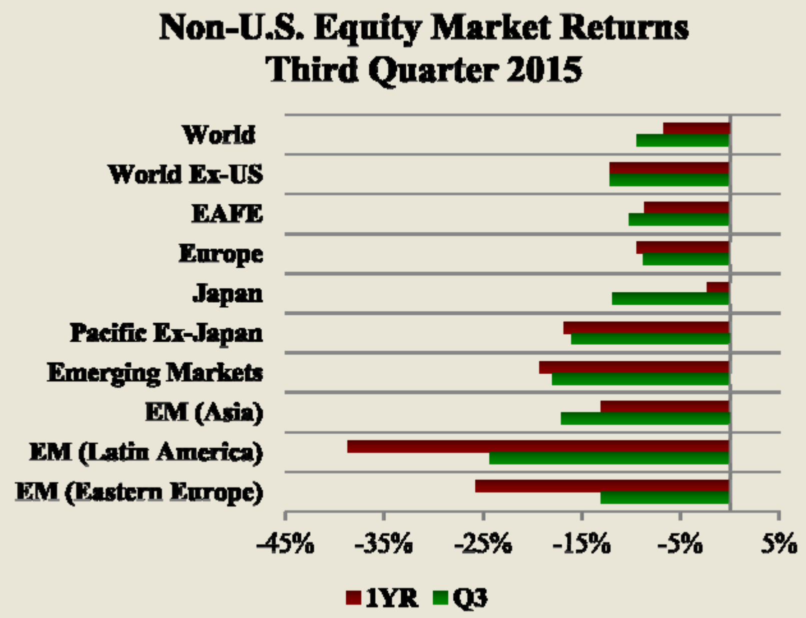
- International and emerging market equities started the year strong but third quarter was a different story as China and Europe are seeing lower growth than expected. The "risk-off" environment lead to better relative returns for U.S. large capitalization stocks than U.S. small capitalization stocks. Growth continued to strongly outperform value stocks across most market capitalizations during the quarter.
- After multiple very strong years for the equity markets, returns are expected to be lower as earnings growth remains sluggish and valuations are slightly higher than average. Third quarter was the first quarter since 2011 where we have seen a significant drawdown.





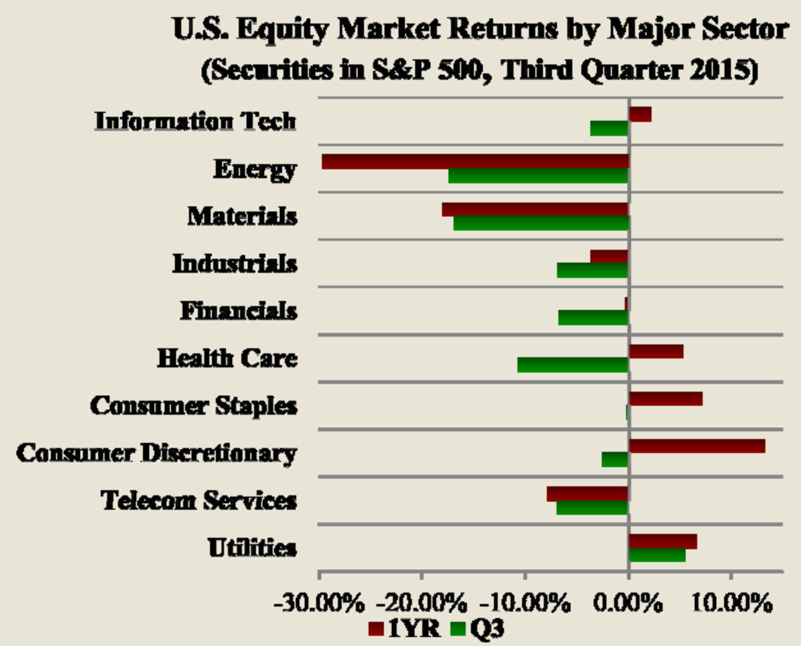
INTERNATIONAL EQUITIES (continued)

- Developed international stocks performed worse than U.S. domestic equities. The MSCI EAFE index of international markets stocks decreased 10.2% during the quarter. On a year-over-year basis, the EAFE is down 5.3%. Countries where their economies are more tied to commodities performed the worst during the quarter, such as Norway, Australia and Canada. Switzerland, France, and Italy were some of the better performing countries; however, they still had negative returns.
- During the quarter, emerging market stocks performed much worse than developed markets and are down significantly on a one year basis. The MSCI Emerging Markets Index decreased 17.9% in the quarter and has a negative 15.5% return over the past year. Returns were stronger in Eastern Europe than Latin America and Asia where currency devaluations have impacted returns.
- Valuations are lower in developed international and emerging market equities; however, many regions are trying to recover from economic slowdowns or are going through structural changes.



DOMESTIC EQUITIES (continued)

- Domestic equities had a volatile negative quarter which dragged down the major indices to negative returns on the year.
- The Russell 1000 Index of large capitalization stocks posted a total return of -6.8% during the quarter. On a year-over-year basis, the Russell 1000 Index has declined 0.6%.
- Small capitalization stocks, as represented by the Russell 2000 Index, posted a total return of -11.9% during the quarter. On a year-over-year basis, the index has declined 7.7%.
- Utilities was the only sector with positive returns in the quarter while energy and materials continued their negative slide. Health care which has been the best performing sector the past three years came under pressure during the quarter. The struggling global economy has caused increased volatility in the domestic equity markets and with that the first pullback since 2011.



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