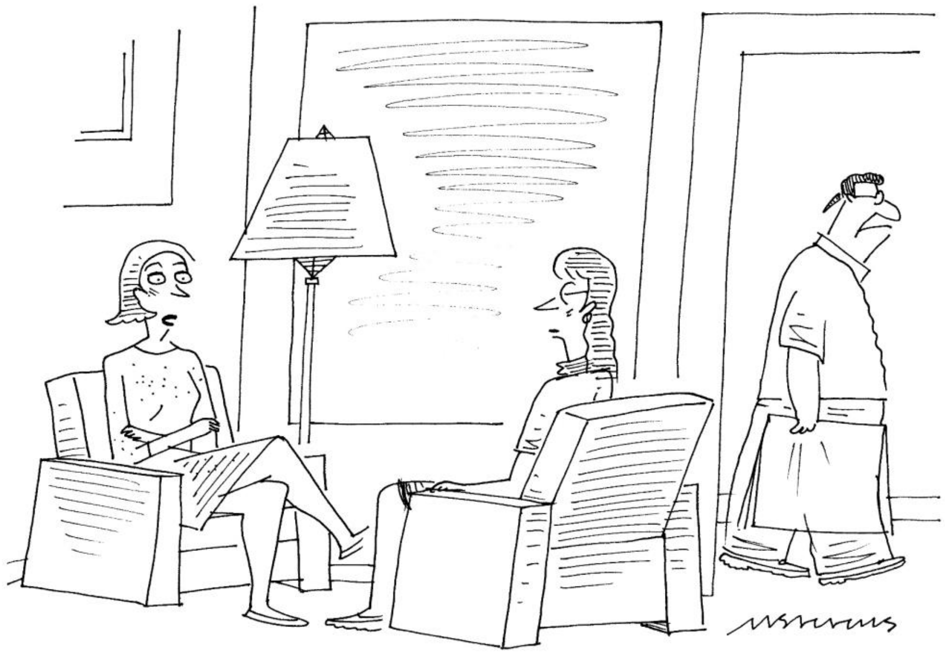
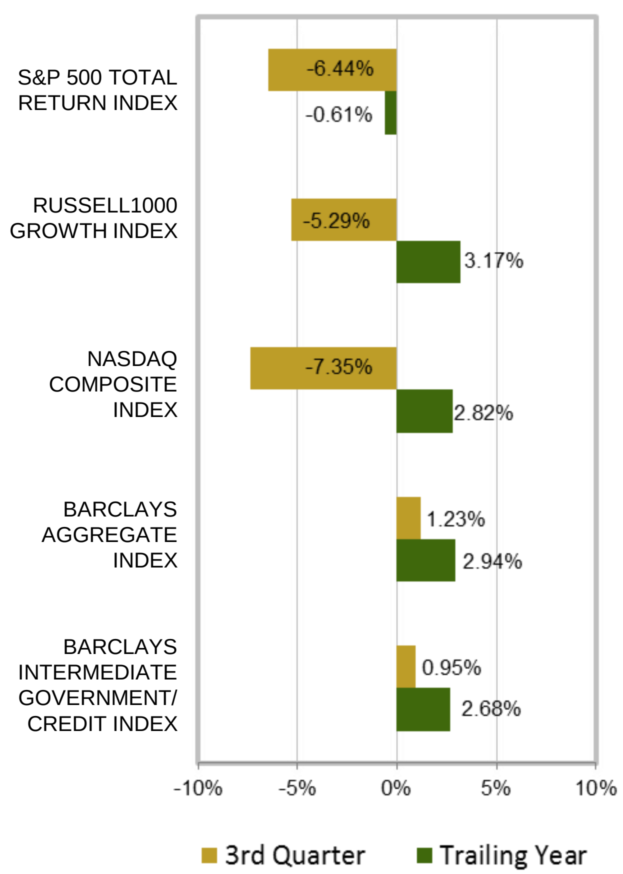


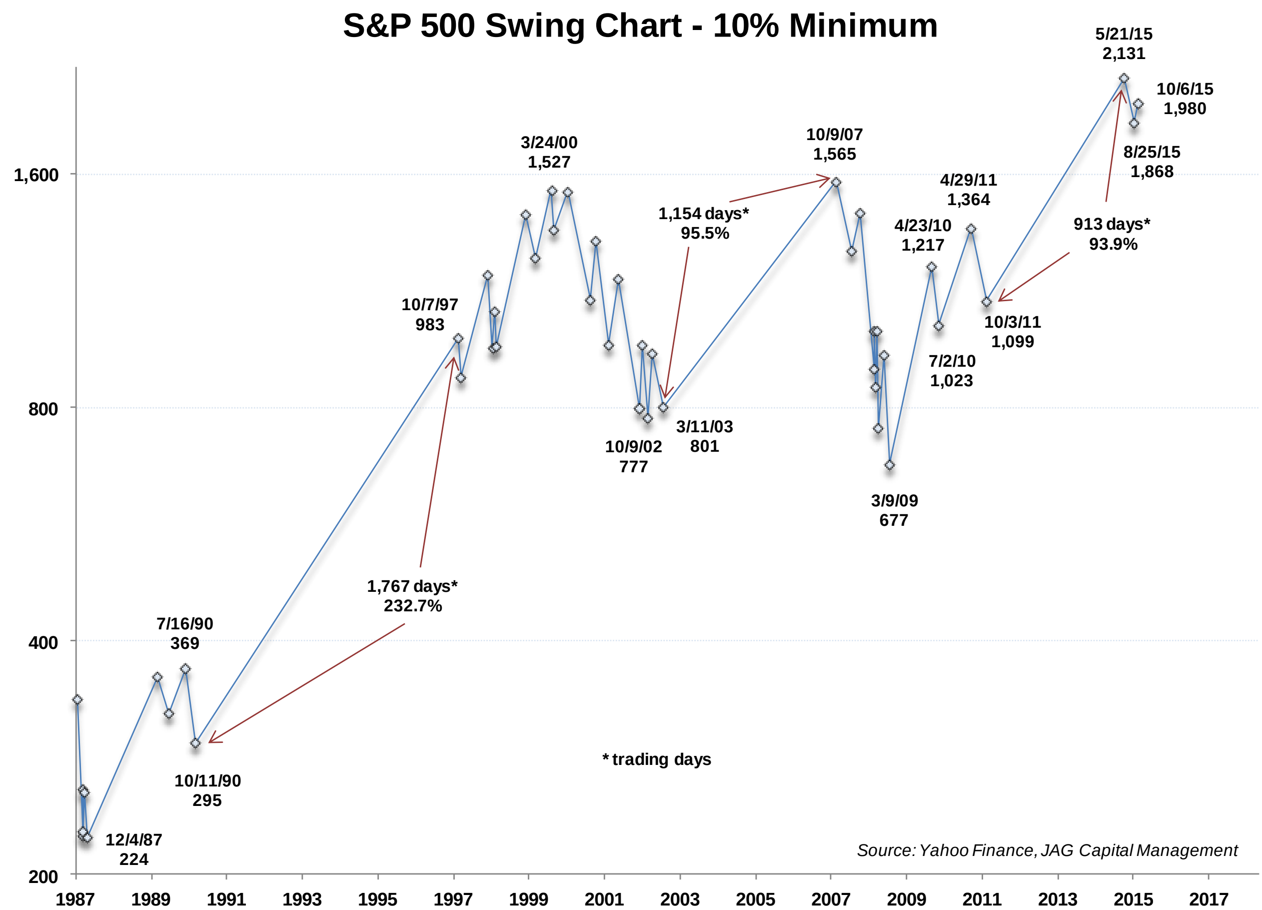
"His mood is pegged to the dollar."



3rd Quarter 2015: Moody Markets

After a flat first half of the year, the market's mood soured noticeably during the last several weeks of summer. Concerns over the slowing global economy, a potential tightening of Federal Reserve interest rate policy, and the ongoing plunge in commodity prices (driven in part by a very strong US dollar) culminated in a -6.4% loss for the S&P 500 during the third quarter. This left the index roughly 10% below its July peak, thus meeting the definition of a market correction.

Corrections are common occurrences, not rare mishaps. In just the last 29 years, the S&P has experienced 23 declines of at least 10% and 7 of 20% or more. On average, stock market corrections occur every 1.25 years. Therefore, while the fact that we have had a meaningful market pullback is nothing particularly special, the fact that we went roughly four years without experiencing one is fairly unusual.



For most of us, studying a long-term chart of historical stock prices is an antiseptic and unemotional exercise. We view all of those past dips and squiggles, bear and bull markets, spikes and the crashes, with the detached perspective we reserve for history class. With the benefit of hindsight, we know how each of those stories ended. In contrast, dealing with market volatility as it occurs is much more emotionally taxing than studying past market environments in the rear-view mirror.

In that context, we find investor psychology surrounding market corrections to be a truly fascinating subject. During a years-long bull market characterized by generally rising stock prices, one often hears investors saying that they are "waiting for a pullback" before investing. A quick Google search of variations of this phrase returns over 500,000 results, so we know how common this sentiment is. As a general statement, it seems like a sensible approach. But in practice, it is striking how difficult it is to successfully execute.

First of all, while corrections are relatively common in history, predicting when they will occur is virtually impossible. In investing, making a prediction that something will happen in the future is less than half the game. One must also be able to foresee when it will occur. Being early (or late) with an investment decision is substantially equivalent to being dead wrong. As an example, I can write with nearly 100% confidence that at some point in the future, stock prices will rise (or fall) by 10% or 20%. There is essentially no chance that I will be incorrect with either of these predictions. But this means nothing – or potentially worse than nothing - unless I can tell you with some specificity when these price moves will occur.

Secondly, not only are corrections unpredictable, so is both their depth and duration. Only rarely do corrections turn into big, bad, bear markets like 2000-2002 or 2008-2009. On the one hand, every single bear market (i.e. a prolonged market decline in excess of 20%) began with a correction. Therefore, once the market begins to dip, investors begin to fear that the worst is yet to come. Even those brave souls who claimed they were waiting for better prices tend to lose their nerve. Eventually, lower prices come and go, without many having ever had the fortitude to take advantage of them.

Back to where the markets stand today, in the midst of a sharp pullback for many stock prices. While we have no special insight into what will happen in the near future, we see signs that conditions could improve in the coming months. Corporate earnings have been disappointing, but the S&P 500 trades at roughly 15x next year's earnings estimate. If we divide these projected earnings by the S&P 500's current price of roughly 1980, we can calculate that the market's earnings yield is roughly 6%. This is higher than both 10-year Treasury yields of approximately 2% and BAA-rated bond yields of 5.35%. All of this implies that stocks are relatively attractively valued when compared to bonds.

More broadly, we think the effects of the crash in oil prices since the summer of 2014 has had wider-ranging ramifications than most observers realize. Hundreds of billions of dollars' worth of capital investment has plunged into U.S. oil production over the past decade. This figure includes not only the oil producing companies themselves, but also their suppliers, their suppliers' suppliers, and their hundreds of thousands of employees. The greater than 50% drop in the price of crude has placed a large number of smaller oil producers into an extremely difficult financial position, which in turn has made it more difficult for them to access the capital markets. We think all of these factors have combined to create doubt in the strength of the U.S. economic recovery, which has contributed to the environment that resulted in recent stock market weakness.

However, while we do not think oil prices will rocket back to $100 anytime soon, we think the forces of global supply and demand are getting closer to being in balance. If we are correct, oil prices could be bottoming and we could potentially see a decent recovery over the next 6-12 months. We think this could be a material positive factor for our economy and ultimately for stock prices.

Have a wonderful autumn!

Norm Conley
CEO & CIO