

## 3<sup>rd</sup> Quarter- Equity Market Commentary

The third quarter of 2015 saw the market experience its first true correction (defined as a 10% drop on closing values) since the summer of 2011 when the U.S. lost its AAA credit rating. By the end of the quarter virtually all sectors of the market had posted negative returns, with the exception of the Utility sector which managed to rise 5.4%. Carnage in the market was widespread with 50% of stocks in the S&P 500 down more than 20% from their 52 week highs. No segment of the market was spared as large, mid, and small capitalization companies all fell, as well as international markets. The S&P 500 posted a decline in the quarter of 6.4%, and is now off 5.3% for the year, and 9.9% from its high in May. Small capitalization stocks were hit extremely hard, with the small cap universe as measured by the Russell 2000 index falling 11.9%. Markets outside the US fared no better. The MSCI All Country World Index (ex US) was down 12% in the quarter. The trend of growth outperforming value continued even in the market pullback, with the S&P Growth segment down 5.2% for the quarter, versus the S&P 500 Value segment down 8.8%.

In looking at the equity market more closely for the quarter, energy and materials exhibited the worst performance declining 17.4% and 16.9% respectively. Emerging market weakness, dollar strength, and over capacity issues continue to plague these sectors. The Healthcare sector also declined 10.7% in Q3, after being the best performing segment in Q2, as well as the top performer year to date as of 6/30/2015. Fears over drug pricing drove the sector down following a tweet from Hillary Clinton that she would issue a plan to deal with outrageous drug price gouging. The biotech

segment was hit especially hard following her tweet. Market corrections are usually not over until the most recent batch of winners lose ground, and that has now occurred. The defensive sectors of the market did in fact perform better in Q3 with Utilities gaining 5.4% (ironically Utilities were the worst performing sector in Q2 and the worst sector YTD at mid- year), and Consumer Staples were down a minimal 0.2%. Consumer Discretionary only fell 2.6% in the quarter, as the US consumer is viewed as favorably positioned with the tailwinds of lower energy prices and a strong jobs market.

### **So what was the cause of the market turbulence?**

The market drop was precipitated by a major decline in the Chinese equity market, which was exacerbated by the poor policy decisions the Chinese leadership enacted to try and stem the decline. This naturally led to larger worries of slowing growth in China and doubts that their expected GDP growth rate of 7% was achievable; and then the subsequent devaluing of their currency that occurred on August 10th. The slowdown in China has peripheral impacts on emerging economies and the global commodities complex, both of which depend heavily on China. With the driver of global growth since 2000 in a slowing mode, the confidence of investors has been shaken as to whether the world economy can continue to move ahead with the world's second largest economy faltering. The Federal Reserve did not help matters on September 17<sup>th</sup> by not raising interest rates, which ultimately created more uncertainty for financial markets. Given that the unemployment rate has fallen to 5.1%, and Q2 GDP was revised upwards to 3.9%, the Fed has found itself in a difficult position. The US economy by all rights appears to be solid and should no longer be in need of a zero interest rate policy. However, the Fed has acquiesced to global growth concerns and the realization that higher U.S. rates (leading to even stronger US dollar) could further

hurt emerging economies, and commodity markets. In doing so, the Fed has now perhaps assumed the role of central banker for the world.

**Our opinion is that the US economy is solid, but recent international dislocations are having a ripple impact on US data.** We do not feel at this time that global weakness is sufficient to derail the US. China may already be stabilizing, with industrial production up 6.1% year over year and retail sales up 10.8%. Our expectation is for the U.S. economy to grow in a range of 2.4 – 2.7% in 2016. The U.S. economy added 142,000 jobs in September and was below estimates of 201,000, with August jobs also revised lower from 173,000 to 136,000. The Labor Force Participation Rate also remained low at 62.4%. These are two key statistics that we will be monitoring closely. Wage inflation has been running at 2% for the past three years. Recessions are usually preceded by average hourly earnings growth of 4% - yet today we are at just 1.9%. Inverted yield curves and rising energy prices are usually precursors to recession. We clearly have neither of those. The U.S. consumer (almost 70% of GDP) is still healthy with real disposable income growing .4% in August, and is up 3.2% year over year. Continuing low gasoline prices are a tailwind for the consumer, and show no signs of rising significantly in the near term. U.S. core retail sales (ex auto), grew by 0.4% in August, and were in line with expectations. It also provides evidence that the recent stock market sell-off has not resulted in consumers pulling back from purchases. The University of Michigan Consumer Confidence Index fell to 87.2% in September from a reading of 91.9 in August. The reading is still strong and comments from participants indicated they felt the market drop was due to international events. Housing remains strong with new home sales rising nearly 6% in August, and reached their highest level since February of 2008. Home prices also continued to rise, with the Case Shiller Home Price Index gaining 5.0% in July, and have increased 4-5% over the past two years. Existing homes sold at an annual rate of 5.6 million units in July, the best since 2007. The manufacturing side of the U.S. economy has slowed slightly with the Purchasing Managers Index for August dropping to 51.1 from 52.7 in July. This is not surprising given the

stronger dollar and weakness in the oil patch. Readings above 50 on the index indicate the economy is expanding, and this was the 32<sup>nd</sup> consecutive month of expansion. On the service side of the economy the non-manufacturing ISM came in at 59 in August, down 1.3 points from July. The service side of the U.S. economy is much larger than manufacturing and continues to be strong. Inflation is still tame with the August CPI headline number registering a decline of 0.1%. When looking at the inflation index less food and energy, the August number rose 0.1%, and the trailing 12 months inflation number is +1.8%. Inflation continues to be below the Fed's target of 2%, but the Fed does not necessarily have to wait for inflation to reach 2% prior to raising short term rates. We believe that the Fed could raise short term rates in December, but will remain data dependant in their decision and dovish in their commentary (i.e. initial raise to be followed by an extended period of data observation). Rates are not going anywhere quickly, and will not be at a level that would discourage or hinder capital investment.

### **What can we expect from the market for the remainder of 2015?**

The market still has to deal with the seasonal weakness that October usually brings. Market declines similar to what we have just experienced will normally retest the previous lows before establishing a bottom and moving higher. The correction in August of 2011 retested its lows in October, and then finished the year strongly. Volatility is likely to remain elevated in the near term. Third quarter earnings are projected to be negative at -4.5% (2<sup>nd</sup> consecutive quarter of negative eps), and revenues will also be down 3.3%. The foreign exchange impacts of a strong U.S. dollar are pressuring revenues and earnings of large U.S. multinationals. Full year 2015 is projected to see earnings growth of less than 1%. The market is not likely to move higher on those tepid numbers. However, the market as we all know is a forward discounting mechanism. The short term sluggishness in corporate earnings is not “new news”. The earnings picture for 2016 brightens considerably, with earnings projected to grow 10%, and revenues by over 5%. The most negative impacts of the stronger US dollar on comparisons will be behind us, as well as the large mark downs in earnings from the

energy sector. In short, the year over year comparisons become easier. In addition, while valuation was never excessive, the correction has made the market more attractively valued at 15.2X forward 12 month earnings, versus its long term average of 14.1X. We must not forget that investing is a relative exercise, and while cash is king in a correction, cash returns will remain paltry when the Fed does move, and bonds still trade at an equivalent price earnings multiple of near 50. Pensions, endowments, and foundations still require risk assets if they hope to achieve their long term required returns. Global monetary policy will remain broadly accommodative as the ECB, Bank of Japan, and PBOC pump liquidity into the global financial system. The old adage of “don’t fight the Fed,” or in this case, multiple global Feds, will remain true. Minimal inflation expectations will also continue to support valuations at or above current levels; and strong corporate balance sheets will continue to result in stock buybacks, merger and acquisition activity, and shareholder activism. Seasonality for the stock market is positive in November and December, and the market on average gains over 7% in the six months after the Fed’s first rate hike. If China can engineer a “soft landing” over the next few months as we anticipate, the market should respond accordingly. Reasonable valuations, a solid U.S. economy, and better forward

earnings make us constructive on the equity market as we move toward 2016.

**What would cause us to change our minds?** We will be vigilant to data points that might change our outlook, such as persistent declines in purchasing manager index readings, a sustained weakening in job creation, and a widening of corporate credit spreads (primarily within the financial sector). A widening of spreads within the financial sector would indicate concerns about a more systemic problem and would raise a caution flag. We would emphasize that we do not expect that to occur given the strong levels of capital within the U.S. banking system.

We understand that during periods of market upheaval you may have questions regarding your portfolio, and as always we encourage you to contact us, and we thank you for the confidence that you have placed in us to manage your assets.

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For more information about the commentary found in this newsletter, please contact a member of the investment committee.

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