The Fairlead Quarterly

Third Quarter of 2015

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Quarterly Overview

If the second quarter was flat to down, the third quarter was just downright ugly. Fear of a global slowdown led by China, and interest rate uncertainty resulting from mixed signals by the Fed, left markets with deteriorating optimism. The Russell 1000 (Large Cap Stocks) was down -6.83% for the quarter, and down -5.24% year-to-date. During the quarter growth fared somewhat better than the value side of the index down -5.29% versus -8.39%. Year-to-date the growth side has significantly outperformed value, with growth being down a mere -1.54% and value down -8.96%. The value side has many dividend stocks which are more sensitive to rising interest rates, includes many slower growth multinationals that are hurt by a weaker dollar, and finally includes many of the energy stocks decimated by the drop in oil prices. The NASDAQ Composite 100, which measures the 100 largest companies listed on the NASDAQ Exchange, and is a growth index, was down -4.91% for the quarter, and down -1.30% year-to-date. The Russell Midcap Index, was down -8.03% for the quarter, down -5.84% for the year. In the midcap space growth and value were down equal amounts for the quarter - but growth has significantly outperformed value year-to-date. The Russell 2000 (Small Cap), really got hammered - down -11.92 for the quarter and -7.73% for the year. Once again growth outperformed value -5.47% versus -10.06% year-to-date.

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Overseas, the EAFE (Developed Overseas Markets) was down -10.19% for the quarter, down -4.91% year-to-date, and down -8.27% for the past year. Foreign Emerging Markets (MSCI Emerging Markets Index), generally more exposed to China's woes, were down -17.78% for the quarter, down -15.22% year-to-date, and down -18.98% for the past year.

The Barclays US Aggregate Index was up 1.23% during the quarter, up 1.13% year-to-date. But, TIPS (Treasury Inflation Protected Securities) were down -1.14%, and High Yield (Junk- lower quality bonds) bonds were down -2.45%. Emerging Markets Bonds, as measured by the Barclays Global Emerging Markets Index, were down -2.33%. What is the bond market telling us? Safety on, risk off, no real expectation for inflation, strong dollar.

Real Estate Investment Trusts (REITs-FTSE NAREIT ALL Index), hurt in the second quarter (-8.93%), were flat this past quarter (up 0.76%), but still down -4.86% for this year. Utilities (DJ US Utility Index) staged a comeback of 5.78%, cutting its year-to-date loss from -9.39% to -4.15%. The Alerian MLP (Master Limited Partnership) Index was down -22.10% for the quarter, -30.67% year-to-date and down -39.19% in the past year.

Commodities (DJ UBS Commodity Index) which had a bounce in Q2 were down -14.47% for the quarter and are down -25.99% over the past year. The Metals and Mining Index, fell an incredible -30.65% for the quarter and is down -45.82% for the past year. Gold ended the quarter down -4.87%, down -7.63% year-to-date.

The Backdrop

Oil & Commodities: Crude which ended the last quarter at about $59 ended this quarter at about $45 - a year ago it was trading at $93 a barrel. Goldman Sachs predicted oil could fall to $20 per barrel - but, of course, they were the same guys that not too long ago predicted when oil was at $160 that it would go to $200 - turned out $160 was the peak.

The Fed and Global Central Bankers: The Fed continues to send mixed messages, contributing significantly to the volatility in the markets. After spending the first six months of the year all but assuring the markets that an interest rate increase was imminent, they softened their stance and ending up keeping rates at current levels. "In June, 15 of 17 officials said they expected to raise rates this year…Thursday (today) the number of people who expected to raise rates this year slipped to 13…"(WSJ 09/17/2015). While most announcements deferring an increase have led to market rallies - this one led to a steep decline. Why? Because after all the build-up leading investors to expect an increase in rates, the absence of one suggested that maybe the global slowdown was even more of a problem than investors had been thinking. "Most global stock markets fell after the U.S. Federal Reserve's decision not to raise short-term interest rates spurred fresh concerns over the state of the global economy." (WSJ 09/18/2017)

A week later, "Federal Chairwoman Janet Yellen laid out her most detailed case yet for the central bank to begin raising short-term interest rates later this year…" (WSJ 09/24/2015). The Fed's inability or unwillingness to be consistent in its messaging and action has made them part of the problem, not part of the solution.

U.S. and Overseas Economic Activity:

Europe: In spite of the accommodative monetary policy and a weaker Euro the European economy reported growth of 0.3% in the second quarter down from the first quarter of 0.4% and up 1.2% over the prior year. These persistently low growth rates, while better than negative, are worrisome as these beleaguered economies continue to struggle. The three largest economies, Germany, France and Italy all came in below analysts' expectations by 0.1% to 0.2%.

U.S.: GDP in the second quarter expanded at 3.9% - significantly faster than the 2.3% initially estimated. Home building and improvements up 7.8% and consumer spending up 3.1% were both bright spots in the report. The revised rate suggests the economy expanded at a rate of 2.3% in the first half of this year, slightly faster than the same period in 2014.

China: Last quarter Greece and China were weighing on the markets and we said "China is a situation to watch closely…" and that "Greece, and its ongoing 'debt crisis' ebbs and flows in the headlines…" and sure enough Greece has ebbed and China continues to loom large as a dark cloud on the horizon. Whether that cloud will darken or dissipate is a fulcrum point on which markets will hinge. China recently revised last year's GDP down to 7.3% from 7.4% previously reported, and has a growth target of 7% for 2015. Given that our greatest GDP growth rate since 1945 was a rate of 5.6% between 1945-1948, it seems likely that as China's economy matures its growth rate will slow.

Inflation: Inflation is a very important data point. Normally, in an economic recovery declining unemployment puts upward price pressure on wages, and increased demand puts upward pressure on goods. Bear in mind, mild inflation is desirable, deflation (even mild deflation) and runaway inflation are both undesirable. Most of the world is still battling deflation - keeping interest rates low and providing stimulus to try and prop up asset values. The Fed is in a corner because the low unemployment begs a rise in interest rates, but low inflation and slow global growth suggest they should stand pat. The result is the muddled signals the Fed has provided which have enhance market volatility.

Unemployment: In July 215,000 jobs were added and the unemployment rate remained unchanged at 5.5%. In August a fewer-than-expected 173,000 jobs were added but the unemployment rate fell to 5.1%. September was another weak month with 142,000 jobs - economists had expected 200,000 but the unemployment rate held at 5.1%. In summary, what we have seen in the jobs market is positive but disappointing job growth, job growth in low wage segments, and an historic low participation rate which contributes to a low unemployment rate - a rate which gives the impression of a jobs market that is healthier than it really is.

Housing: The most recent Case/Shiller data (published with a two month lag - July data) showed that the 10-City Composite Index gained 4.7% year-over-year and the 20-City Composite Index was up 5.0 %. According to David Blitzer "Prices of existing homes and housing overall are seeing strong growth and contributing to recent solid growth for the economy…Other positive indicators of current and expected housing activity include gains in sales of new and existing housing and the National Association of Home Builders sentiment index. An interest rate increase by the Federal Reserve, now expected in December by many analysts, is not likely to derail strong housing performance."

Going Forward

Super low interest rates have penalized savers and conservative investors. Put simply, there is no return without risk. The many higher yielding elements of the market (high-yield bonds, utilities, REIT's and MLP's) are all down almost as much as, and in some cases much more than, the general stock market. Over the past year the growth side of the stock market, typically considered the more aggressive side has significantly outperformed the value side where dividend paying stocks reside.

While we remain cautious there is no reason to run for cover. The fourth quarter is historically one of the best performing quarters and the economic news, while mixed is not terrible. The market may remain range bound as it is whipsawed by a mixed bag of data, but a year-end rally from these levels is quite possible.

As always I am available to discuss the markets, the economy, your portfolio and your concerns.

JOHN VREELAND

SUMMARY OF INDEX RETURNS

Global Markets Year to Date					
INDEX	3rd QTR 2015	YTD 2015	Calendar Year 2014	Calendar Year 2013	INDEX DESCRIPTION
Russell 1000	-6.83%	-5.24%	13.24%	33.11%	*US Large-cap Stocks*
Russell 1000 - Growth	-5.29%	-1.54%	13.05%	33.48%	
Russell 1000 - Value	-8.39%	-8.96%	13.45%	32.53%	
Dow Jones Industrials - Total Return	-6.98%	-6.95%	10.04%	29.65%	
S&P 500 - Total Return	-6.44%	-5.29%	13.69%	32.40%	
NASDAQ Composite	-7.35%	-2.45%	13.40%	38.32%	
NASDAQ - 100	-4.91%	-1.30%	17.94%	34.99%	
Russell Mid-Cap	-8.01%	-5.84%	13.22%	34.76%	*US Mid-cap Stocks*
Russell Mid-Cap - Growth	-7.99%	-4.15%	11.90%	35.74%	
Russell Mid-Cap - Value	-8.04%	-7.66%	14.75%	33.46%	
Russell 2000	-11.92%	-7.73%	4.89%	38.82%	*US Small-cap Stocks*
Russell 2000 - Growth	-13.06%	-5.47%	5.60%	43.30%	
Russell 2000 - Value	-10.73%	-10.06%	4.22%	34.52%	
MSCI EAFE	-10.91%	-4.91%	-4.48%	23.29%	
MSCI World ex USA	-10.51%	-6.32%	-3.88%	21.57%	*World ex USA (US$)*
MSCI Emerging Markets	-17.78%	-15.22%	-1.82%	-2.27%	*Emerging Mkts (US$)*
30 Day Money Market - All Taxable	0.01%	0.02%	0.01%	0.01%	*Cash*
Consumer Price Index - US	-0.13%	1.49%	0.76%	1.50%	*Measure of Inflation*
Barclays US Corp. High Yield Index	-4.86%	-2.45%	2.45%	7.44%	*High Yield (Junk) Bonds*
Barclays US Aggregate Bond Index	1.23%	1.13%	5.97%	-2.02%	*General US Bond Index*
FTSE NAREIT REIT: All	0.76%	-4.52%	27.15%	3.21%	*Real Estate Investment Trusts*
Dow Jones - Utility Average Tot Ret	5.78%	-4.15%	30.65%	12.69%	*Utility Index*
Alerian MLP Index	-22.10	-30.67	4.8%	27.58%	*Master Limited Partnerships*
Dow Jones - UBS Commodity Index Tot Ret	-14.47%	-15.80%	-17.01%	-9.52%	*Basket of Commodities*
Gold - London PM	-4.87%	-7.63%	0.12%	-27.33%	*London Spot Price*

Source – Thomson Financial Company