

After a largely uneventful first half of the year, markets fell sharply in 3rd Quarter in a manner somewhat reminiscent of 3rd Quarter, 2011. The selling was broad, this time hitting traditionally defensive large value stocks even harder than large growth.

3rd Quarter Market Declines from Peak to Trough:

S&P 500	-12.4%
Russell 1000 (Large Cap) Value	-14.0%
Russell 1000 (Large Cap) Growth	-11.9%
Russell 2000 (Small Cap)	-16.8%
MSCI World ex-US (Foreign)	-17.9%
MSCI Emerging Markets	-27.7%
Dow Jones Select US REIT	-10.9%
S&P GSCI (Commodities)	-23.8%

There were two distinct waves of selling, one in mid-August, and a second in mid-September:

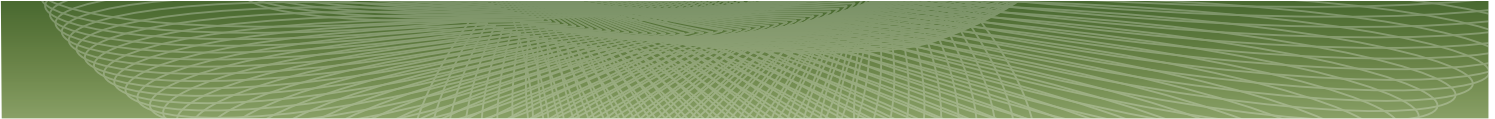
- The first seemed to be triggered in part by concerns emanating from China. Data showing a contraction in Chinese factory output, which followed a dramatic selloff in Chinese equity markets and a devaluation of the yuan by the Peoples' Bank of China, ignited compounding fears of a dramatic decline in the globally important Chinese economy.
- The second, coincidental or not, followed the Federal Reserve's decision to leave interest rates unchanged rather than raising them in September as widely anticipated. The market appeared to react very negatively, perhaps in uncertainty and confusion over exactly what message the Fed might be sending about the state of the global economic picture and what to expect from the Fed moving forward.

Perhaps more importantly, all of this played out in an already uneasy environment of generally rich equity valuations, dramatically lower energy prices, and concern over U.S. ability to sustain domestic growth in the face of a slowing world economy, among other factors.

Many have argued for a considerable time that a meaningful pullback would be healthy for the market. However, now that a meaningful pullback has arrived, the inevitable question on the minds of some is whether this is merely the long anticipated correction or the early stages of a more significant decline.

U.S. economic growth remains muted, with periods of mild acceleration followed by relapses into intervals of slower growth. After a 2nd Quarter surge, recent numbers have in most sectors faded to a slower pace. In concert with generally weakening global growth, the slowing in the U.S. data has sparked some recession fears. And recessions mean bear markets. So monitoring the direction of economic activity from current levels is particularly important.

Manufacturing and industrial production (including energy), the headline areas of weakness, have clearly slipped into contraction territory, negatively affected by low energy prices, a strong dollar, and weakness in international economies.



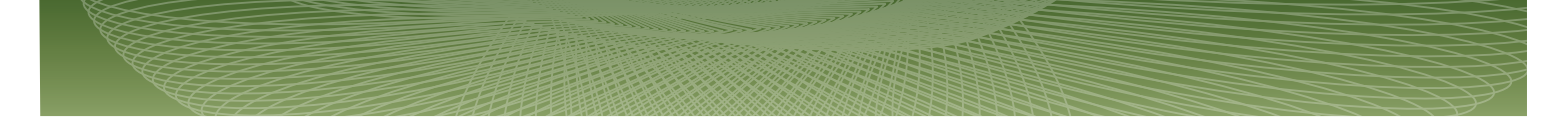
Consumer spending, on the other hand, is growing. As of the end of September, both personal income and expenditures were trending solidly higher. Similar data was much weaker late last year. Among other factors, there are now definitive indications we are seeing an incremental effect of lower gas prices filtering through to consumption in other sectors. Consumer credit is strong – with both credit card and mortgage defaults at very low levels and the household financial obligations ratio near multi-decade lows - and consumer confidence is near its highest levels since the financial crisis.

This could of course quickly change if the **employment** picture were to erode. There has been legitimate concern that the sharp decline of the energy sector and the slowdown in manufacturing could have a negative overall effect on jobs, but the job market has been resilient, replacing jobs lost in those sectors with growth in others. Jobless claims have continued to fall – now at the lowest level in over 40 years of data - and job openings are near all-time highs. The widely reported “poor” increase in jobs reflected in the September Non-Farm Payrolls Report may reflect a misinterpretation of an evolving economy. Baby boomers are retiring in record numbers; there are not enough new entrants into the labor force to offset this; and the now dwindling pool of unemployed workers does not appear to have the skillsets to match many of the available jobs. As recently noted by Pantheon Macroeconomics, “The data now signal unambiguously that the labor market is unable to supply the people companies need.” This has its own set of problems longer term, but the data indicates the economy is continuing to produce new job opportunities and reduce the rate of unemployment, factors which currently remain supportive of consumer spending.

Housing, another critical component of the economic outlook, though characteristically fluctuating from month to month, has continued its solid expansion. Home price appreciation slowed through the summer, a trend which bears watching but may portend a more sustainable pace moving forward.

The economy is far from robust, but it has over a relatively short period absorbed the withdrawal of the Fed’s quantitative easing programs, a significant loss of energy sector jobs and revenue, and a general weakening of international economic growth. These are providing challenges to domestic growth, but the overall data remains broadly positive, with little to suggest an impending recession.

- Leading economic indicators, which as the name suggests tend to turn negative in advance of a material economic downturn, remain broadly positive.
- The yield curve on U.S. Treasury debt is another closely-watched indicator. When it “inverts”, meaning long rates fall below short rates, it has been one of the most reliable early indicators of a coming recession. At present, not only has it *not* inverted, it has steepened – a pattern more suggestive of a possible return to higher trending growth a quarter or two ahead.
- Corporate profits are a concern, as they have declined for two quarters from the record levels sustained through 2014. This bears very close attention, but profits presently remain at historically high levels. Unless energy prices take another material leg down, their significant downward pressure on 3rd Quarter earnings should begin to stabilize moving forward.

- 
- As respected Gluskin Sheff Chief Economist David Rosenberg recently pointed out, “If there is a recession looming, it would be the first ever that did not see consumer spending or employment go down for the count.”

Still, at the current very slow pace there are multiple factors which could cause the economy to falter.

And it is also important to remind ourselves that the market and the economy, though inextricably linked longer term, are two very different things which are sometimes headed in completely different directions. The market seeks to uncover early indications of where the economy will be well up the road and, correctly or not, will often head in what seems the appropriate direction well in advance of actual events.

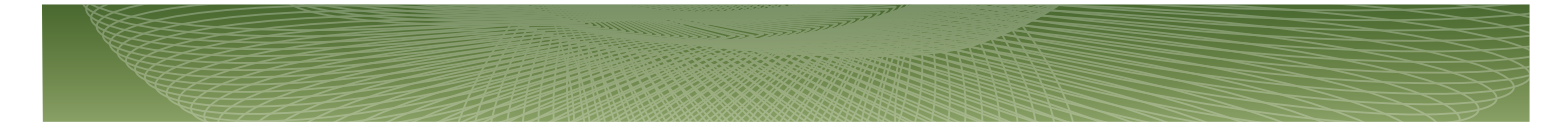
Prior to the recent turmoil, stocks were priced optimistically. Certain developments raised significant doubts about that optimism, and equity prices dropped. Now the market is trying to determine whether this is a healthy price reset, with opportunity for a resumption of growth in share prices – or an early indication that conditions are materially deteriorating.

Although general domestic economic conditions, as noted above, are not portending anything dire at present, we should further consider some of the factors that seemed to influence the market selloff:

Energy prices – The price declines in direct terms cut both ways, though not necessarily in equal measure – they are negative for energy-related jobs and profits, but they are positive for consumers, both individual and corporate. What is perhaps more concerning are potentially damaging credit defaults should a material segment of the industry find itself unable to meet debt obligations. For this reason, the pattern of energy prices moving forward is an important variable.

China – The Chinese government’s lack of transparency has likely contributed to an exaggeration of perceptions over time, both pro and con. The Chinese manufacturing sector is clearly contracting, and their overall economy is materially slowing relative to the very high rate of growth maintained for a number of years. Compounding the concerns are some very challenging structural issues. Independently compiled China Beige Book data and other sources trusted by many close observers indicate that growth is still likely above 4%, well below the “official” rate but far from the collapse many have feared. And a broad swath of forward looking data indicates that current conditions are stabilizing.

Federal Reserve – It seems that we are hearing constantly from one Fed governor or another in an apparent attempt to provide greater transparency, but their mixed messages have seemingly created only more confusion and uncertainty. And markets do not like uncertainty. Economically, the continued low interest rate environment is accommodative, the Fed balance sheet is not contracting, and the money supply is expanding along with bank lending. The Fed currently appears well away from rate tightening, but any perceived shift toward a regular cycle of rate increases, however unlikely that appears at this time, could quickly drive equity markets lower.



All of these bear close ongoing scrutiny, and they are far from the only significant factors, with potential for economic or political disruptions emanating from currently evolving conditions in Europe, Japan, the Middle East, emerging markets, or the U.S. Congress, among others, to send markets into turmoil.

Volatile markets are nearly always gut-wrenching, but they are particularly dangerous for those who abandon a disciplined investment process. In markets moving suddenly and sharply one way and then the other, often from day to day and sometimes from hour to hour, overly active attempts to move in and out of positions can do more harm than good. The trading conditions which have developed in recent years have only exacerbated this problem. In the short term, markets seem to be increasingly influenced – sometimes dominated – by large players engaged in short-term technical trading, often using algorithms which can react instantly to price targets and changing news, triggering huge waves of high speed electronic trading in both directions.

In this environment, managers who base their evaluation of companies and economic sectors primarily on fundamentals must exercise a degree of patience. Panic selling of fundamentally sound positions can leave investors far behind when markets rebound. As recent events have unfolded, we have selectively taken a handful of opportunities to add to positions at lower prices, but have otherwise made only limited allocation adjustments for fundamental reasons, in keeping with our normal process.

At the end of the day, while the market could correct further before stabilizing, economic conditions alone do not indicate that the market should make a sustained downward move at this time. With the correction, certain areas of the market have become more significantly attractive, and there is real potential for the market to move materially higher from these levels. However, markets are likely to remain volatile, and unanticipated events can always move them sharply in either direction, so investors should as always be positioned in a combination of strategies appropriately suited to their appetite for risk.

The S&P 500, Russell 1000 Value, and Russell 1000 Growth are unmanaged indices of large U.S. companies. The Russell 2000 is an unmanaged index of small U.S. companies. The MSCI World ex-US and MSCI Emerging Markets are free float-adjusted market capitalization weighted indexes designed to represent the equity performance of foreign and emerging markets, respectively. The Dow Jones U.S. Select REIT index is designed represent the performance of publicly traded U.S. real estate investment trusts. The S&P GSCI index is designed to represent the general price movement of commodities in the world economy.

This material contains forward looking statements; there is no guarantee these outcomes will be achieved. All investing involves risk of loss, and there is no guarantee that strategies which may have been successful in the past will be similarly successful in the future.