Investment Commentary

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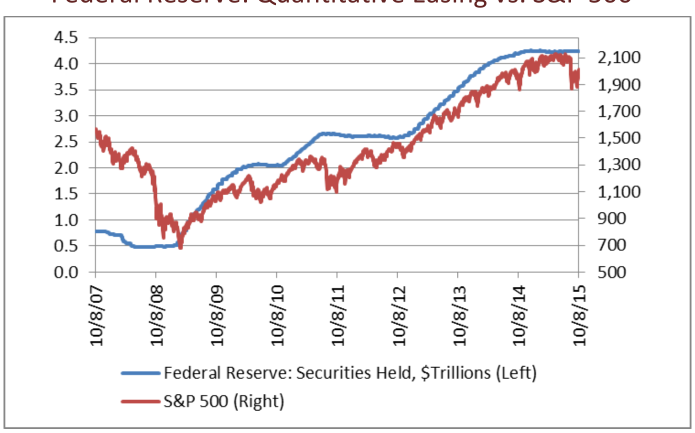
After six strong years of stock market returns, 2015 has proven to be frustrating. Not only have U.S. stocks failed to impress but so have a majority of assets classes. In fact, by the end of the third quarter, U.S. stocks, international stocks, and corporate bonds had not achieved a positive return for 2015 - including dividends and interest[1]. In this market review, we consider the factors that dominated 2015 and consider how the markets and economy are positioned for the next few quarters.

A Conglomerate of Headwinds

A number of headwinds weighed into market performance, namely:

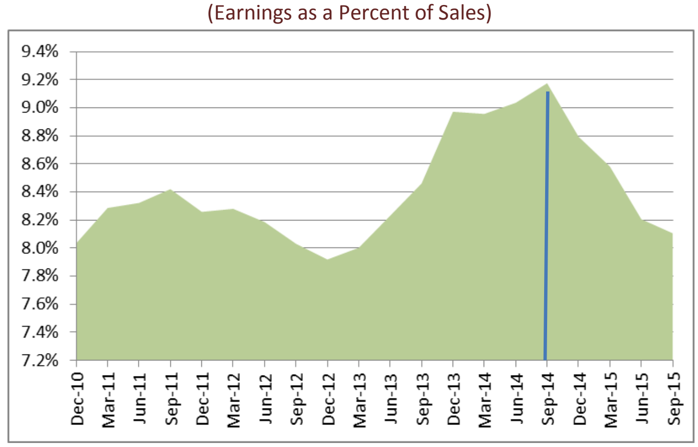
- A slowdown in China led to lower commodity prices hurting most businesses in the basic material and industrial machinery space;
- Weak oil prices had a major impact on energy companies;
- A stronger U.S. Dollar made it challenging for companies making money overseas;
- The end of the Federal Reserve's quantitative easing program meant less upward buying pressure on most investments directly and indirectly.

Federal Reserve: Quantitative Easing vs. S&P 500



These headwinds not only put selling pressure on investments but had a direct impact on corporate earnings. Coming out of the 2008/2009 recession, companies cut costs aggressively which led to record profit margins. The headwinds of the past several months have led to a considerable decline in margins but remain at respectable levels of over 8%.

S&P 500: Profit Margin
(Earnings as a Percent of Sales)



The good news regarding the 2015 headwinds is that the impact from each one listed above appears to be front-loaded. Whether we consider the adjustments in profit margins, Chinese economic growth, oil and commodity prices, or a stronger Dollar, we are, at worst, closer to new equilibriums and, at best, will see a rebound in a number of these factors. In either scenario, the worst is mostly behind us in our view.

Looking forward, additional concerns relate to slow-global economic growth and the increase in the Federal Reserve's target rate for overnight lending. However, our view remains that the U.S. economic growth prospects look solid and that some increase in the Fed Funds rate would be welcome; as demonstrated by the market's negative reaction to the delay of the first increase in September.

[1] 12/31/14 through 9/30/15: S&P 500 total return of -5.3%, Dow Jones Corporate Bond Index total return of 0.0%, MSCI EAFE total return of -4.2%.

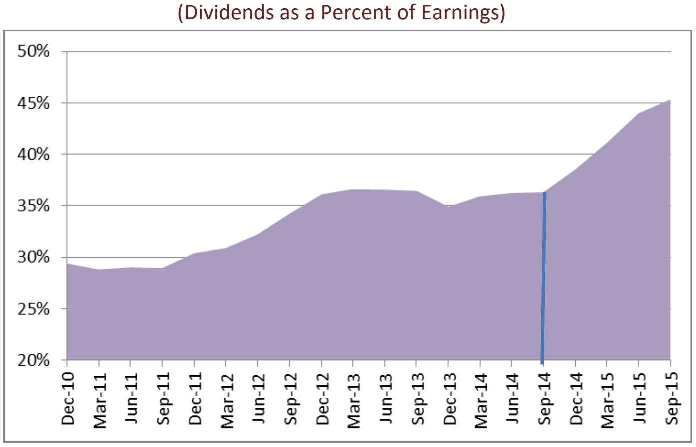
Finally, when we consider the underpinnings of market performance, each point to a reasonably bright future. Specifically:

Dividends Appear to be on Steady Footing

Despite falling profit margins, companies have been reluctant to cut dividends. This has led to a higher percentage of earnings that get paid out to investors – today at a higher but still reasonable 45%. As a result, we feel confident in the income compenent of the market's future prospects.

S&P 500: Payout Ratio

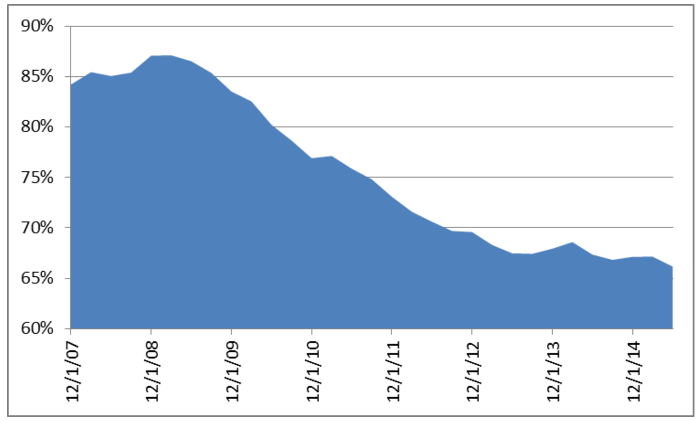
(Dividends as a Percent of Earnings)



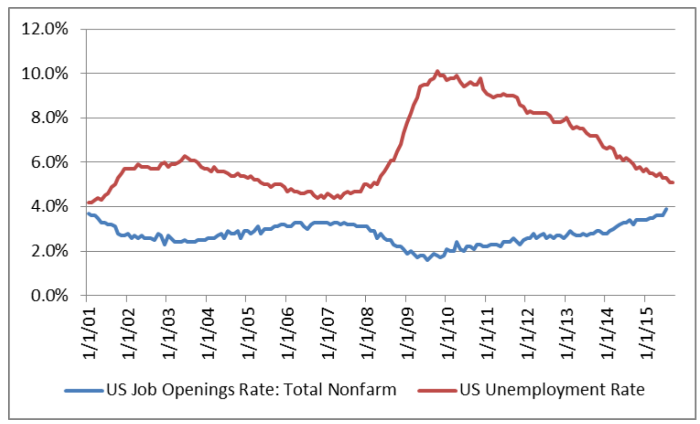
Business Growth Appears to be on Solid Footing

As the two charts indicate below, the US consumer is reducing debt and working more. Together these factors paint a picture of a consumer that has more money to spend on goods and services, which gives us confidence as over two-thirds of the US economy is based on consumer spending. Given our view of a healthier and more employed consumer, we are also confident in the prospects for business growth – and ultimately the growth component of future market results.

U.S. Total Household Debt / U.S. GDP

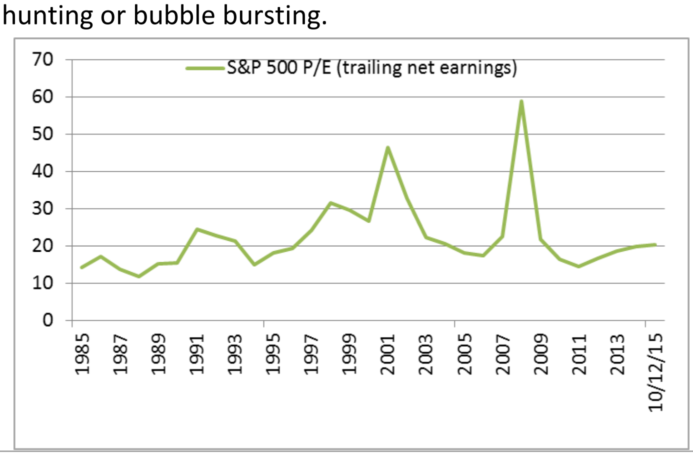


Job Openings and Unemployment at Healthy Levels



Stock Market Valuations Appear to be Normal

There are numerous measures of a stock market's valuation that shed light on whether stock prices are too high, too low, or something of a normal variety. In our view, today's market valuation falls within the normal variety price range. Changes in valuation over the next year or so will result from investor interpretations of risk and growth prospects and less the result of bargain hunting or bubble bursting.



Conclusion

2015 has thus far proven to be somewhat challenging for most investors. However, the profit and confidence eroding factors that dominated market returns for the first nine months appear to be receding. We believe stocks are positioned to perform in line with historically decent returns, and our economy will continue to grow – aided by a relatively dovish monetary stance (i.e. still low and accommodative interest rates).

As a result of slow global growth and a lack of normal levels of inflation, interest rates will generally remain low, and will, we believe, stay low for some time (outside of riskier bond markets). This view could change once the economy begins to grow at above normal rates and bank lending accelerates. While the fixed-income markets remain the superior place to preserve capital, especially over shorter periods of time, investors seeking higher levels of income will have to consider some additional risk in equity or higher-yielding bond markets.

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