# Market Commentary

Third Quarter 2015

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The third quarter of 2015 saw the long-awaited correction in US equity markets as each of the major indices (S&P 500, Dow Jones Industrial Average and NASDAQ Composite) saw intra-quarter declines of over 10%. The benchmark S&P 500 index finished the quarter 6.44% lower on a total return basis, bringing the year-to-date total return to -5.3%. While there are many reasons we can point to for the sharp and rapid decline in equity prices, we believe the primary catalyst was investor concern over global growth prospects. Statistically, the just completed quarter was the worst for the S&P 500 since the third quarter of 2011 when the index declined by 13.9%. We note that in the six months following that decline, the index rose by a whopping 25.9%. Interest rates declined during the quarter as the flight to quality during volatile times was partially offset by concerns of significant selling of US Treasury securities by China and other countries facing slower economic growth. The yield on the benchmark 10-year US Treasury Note declined to 2.06% on September 30, down from the 2.34% yield on June 30. The US dollar added to its gains versus most major currencies as the differential in growth rates between the US and other countries was expected to widen during the coming quarters.

## Economic and Market Outlook

The Federal Reserve chose not to raise the Federal Funds rate at its September meeting. After many months of expecting a rate hike in September, concerns over economic growth in China and other emerging markets caused the Fed to refrain from increasing short-term rates. While previous decisions to not raise rates had been cheered by equity investors, this time equities headed lower after the decision due to fears that perhaps the global economic outlook was worse than previously thought.

Returns in both equity and fixed income asset classes will be driven by macroeconomic events along with Federal Reserve decisions during the next few months. While market pundits have been trying to predict when the Fed will begin to raise interest rates, we believe the timing is less important than the trajectory. Our belief is the Fed should have moved rates up from zero several months ago. While the first move from zero will likely add to volatility in the markets, we do not see rates rising rapidly for several years. There is minimal difference to the US economy with a Federal Funds rate of zero versus 25 or even 50 basis points. There is however, a large difference to the psyche of investors who are impatiently waiting for a long-telegraphed rate hike. We believe the Fed is trying to walk a fine line between watching the unemployment and inflation rates while trying to calm investor volatility.

Along with the recent negative stock market returns, there is a prevailing pessimistic mood emanating from the media. Many bemoan our "broken" political system, while others believe the country is on the wrong path. This is not the first time we have heard news stories bemoaning the negative issues facing America. It has occurred many times in the past 50 years, from wars to stubbornly high inflation, oil embargoes, hostage crises and a severe recession. Through each instance, the American spirit has rallied and raised the country and the US economy to even greater heights. Human desire, potential and ability are the greatest assets we have. The US system – with few exceptions – is the greatest in the world for harnessing these capabilities. We admit the future does not look particularly promising currently, but we believe in the American dream today as much as we did 10, 20 and 30 years ago.

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In our view, the US economy continues to perform solidly with encouraging job growth evidenced by rising payroll across the country. Household wealth climbed to new high levels during the second quarter, reflecting strong American balance sheets. Continued low energy costs and the lack of inflation further strengthen consumers' purchasing power. Housing prices have rebounded and once again become a tailwind for the US economy. These are some of the fundamental reasons for our optimism.

## Portfolio Positioning

Tandem has been focusing on large-cap multi-national companies in investor portfolios for the past several quarters as we anticipated an increase in volatility during 2015. In equities we favor companies with proven track records, strong management teams and solid balance sheets. While these stocks will not always rise as fast as the broader market during rallies, they will provide significant downside protection when markets weaken. We note that during the recent decline, smaller companies with US-centric operations performed relatively better than larger ones due to investors shunning companies with large international exposure. We expect this to reverse in the coming months as the China growth scare subsides and investors once again focus on differentiating companies by their fundamental characteristics. In fixed income, we hold relatively short-term maturities that will better withstand a rising interest rate environment.

Investors with balanced portfolios were cushioned meaningfully from the recent sharp declines in equity markets. Market activity during the past few months may have moved asset allocations away from previous levels as fixed income portfolios grew as a portion of the total portfolio. Rebalancing back to desired asset allocation targets is prudent after sharp movements in the markets. You may see this being done in portfolios over the coming weeks.

## Conclusion

Although volatility is not welcomed by most investors, we remind you of the specific role that equities play in their portfolio. Equities are <u>not</u> purchased to ensure a good night's sleep each day. Rather, they provide investors with one of the best forms of protection from the ravages of long-term inflation. Although we have not faced significant inflation in the past two decades, inflation remains a more significant threat to long-term financial gains than volatility will ever pose. We do not believe in market timing and feel that a well-designed portfolio with proper asset allocation and periodic rebalancing will lead to better long-term returns with less emotional decision-making.

US economic growth continues to move at a consistent, albeit sub-par rate of 2.0-2.5%. With muted inflationary pressures helped by significantly lower commodity prices, and interest rates expected to stay low into 2017, equity valuations appear somewhat attractive after the recent decline. The political rhetoric will increase over the next few months as the major parties choose their candidates for next year's Presidential election and we advise investors tune out the "noise". While refraining from choosing sides in elections, we focus on each candidate's economic, tax and regulatory policies and how these may affect investors. Volatility will likely remain elevated for the next few months, but properly managed, volatility can provide long-term investment opportunities for those with the courage and conviction to ride out short-term market moves.

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