ROOF ADVISORY GROUP, INC.®
INVESTMENT ADVISORY & FINANCIAL PLANNING SERVICES

INVESTMENT INSIGHT

3rd Quarter Review

After a Long Reprieve, Volatility Returns

Market Update

After spending the first half of the year in one of the tightest trading ranges in history, global equity markets retreated in the third quarter with the S&P 500 Index declining 6.9% and developed international markets (as measured by the MSCI EAFE Index) falling 10.7%. The third quarter drop was even more severe in other asset classes – such as – emerging markets (-18%), commodities (-14%), and China (-29%). Contrary to most forecasts, longer-term interest rates declined during the quarter resulting in positive returns for widely followed fixed income indices. The U.S. Barclays Aggregate Bond Index advanced by 1.2%.

Global equity markets logged their worst quarter since 2011. The S&P 500 Index registered its first 10% correction since the fall of 2011 and included a "flash-crash" on August 24th that saw the Dow Jones Industrial Average drop by 1,100 points in a matter of minutes. The decline in equity markets can be attributed to a host of factors. Fears of a Greek default rattled markets in the early part of the summer. However, this issue has largely moved closer to the bottom of investors' list of near-term worries. The slowdown in China and other emerging market economies has recently become a serious concern. Markets were also unsettled by the Federal Reserve's commentary on September 17th when they decided to hold off on raising interest rates. Part of their commentary/rationale was concerns over global growth. These comments did little to inspire investor confidence about the state of the world economy. Investors are also grappling with the continuation of the decline in commodity prices (especially oil) and the signaling effects for overall economic strength. This list could be expanded but the result has been elevated levels of uncertainty and correspondingly a dramatic increase in volatility.

Economic Update

Despite tepid global growth, the U.S. economy remains a relative bright spot. Data released in August showed above-trend U.S. GDP growth of 3.9% in the second quarter. However, there seems to be a measurable divide between the consumer/services sectors and the manufacturing/export side of our economy. Many data points linked to the consumer are healthy. The housing market looks to be gaining momentum with new home starts and existing home sales at roughly eight year highs. Retail sales have shown some improvement this quarter, consumer debt levels have climbed slightly, and auto sales remain at ten year highs. These are all encouraging signs of confidence and positive inputs for our consumer driven economy.

Manufacturing and export activity, while still generally in expansion territory, has slowed. This slowdown can be explained by weakness in China, a drop in capital expenditures related to the energy sector, and a strong U.S. dollar which makes American produced goods more expensive abroad. The drop in manufacturing activity has translated into less robust additions to the employment payrolls in the third quarter. Employment gains averaged 167,000 per month in the third quarter compared to over 210,000 per month for the first half of the year. The fact that the unemployment rate (currently 5.1%) has dropped to levels close to the full employment mark also helps to explain the moderating pace of job growth. While we still feel the economy is continuing to improve, it looks as though the consumer is going to have to pick up some slack from other areas.

Fed Commentary

It is hard to recall another recent market event that attracted more attention and debate than whether the Federal Reserve was going to raise interest rates at their September meeting. Investors were absolutely obsessed with this topic. Some of this is understandable since we have not had an interest rate hike in nine years.

The Fed had a tough decision. Many data points, primarily the improvement in the employment picture, suggest that it is time to move away from their zero interest rate policy. However, other issues such as low inflation, slower growth outside of the U.S. and equity market volatility gave the Fed pause to move forward. Now investors will have to endure the uncertainty and play the guessing game for a while longer.

We are less focused on the timing of the initial rate hike and more on the trajectory and overall path of interest rate movements. The path to higher interest rates is likely to be very slow, gradual and data dependent. With the Fed's reluctance with just starting the process of normalizing interest rates, it is difficult to envision a scenario where the Fed embarks on a path of raising rates too quickly and aggressively and chokes off economic growth in the near-term.

China Commentary

Major concerns have developed in regard to China's stock market and the health of their economy. After advancing by roughly 125% from late 2014 to June of this year, the mainland Chinese equity index has since plummeted by over 40%. The incredible advance in the equity market was fueled by leverage, speculation and unsophisticated investors. At the height of the market, brokers in China were opening an average of 4 million brokerage accounts per week. The majority of mainland Chinese equity investors have less than a high school education, add in the massive amounts of borrowed money used for stock market speculation and the result was a steep correction.

Historically there has been little connection between the performance of China's stock market and their real economy. However, it is well recognized that their economy is continuing to slow down. Given China's position as the world's second largest economy, this is certainly a very real issue. China is taking steps to transform their economy from a manufacturing/export dependent economy to a consumption-driven economy powered by its internal growth. This is not a transformation that happens overnight and there will be bumps along the way. We are seeing those bumps now.

It is clear that China's manufacturing, industrial production and exports are slowing considerably. While this has greater implications for emerging market economies than the U.S., this weakness is having a spillover effect to commodity prices and to countries with significant economic linkages to Chinese demand. However, the services sector, which accounts for more than half of China's economy, is showing some improvement in sales, pricing, volumes and capital expenditures. We are monitoring developments in China and their global impacts closely and will make portfolio adjustments if warranted.

Portfolio Positioning

After reducing our equity allocation in the first quarter, we took another step to trim back our equity exposure in the third quarter. These sales resulted in a 5% reduction of stock exposure across Investment Policies and were implemented in early August, prior to the measurable downturn at the end of the month. While we have done some selective buying after the market moved considerably lower and valuations became more attractive, we ended the quarter with equity exposure at or just slightly above the mid-point of Investment Policies. This neutral or balanced stance between stocks and bonds is reflective of our still constructive view on the U.S. and developed international market economies, reasonable valuation levels, and expectations for an improvement in corporate earnings in 2016. However, we are also very aware of the issues outlined above (China slowdown, weakness in emerging markets, the potential for more volatility associated with interest rate hikes, etc). Given the positives as well as the uncertainties, we feel a balanced stance is prudent.

Our fixed income positioning has not changed dramatically. We continue to maintain a relatively short duration or sensitivity to interest rate movements. With the contraction in interest rates this quarter, longer maturity bonds look considerably less attractive from a risk to reward basis.

Third Quarter Performance Attribution

While our fixed income mutual funds had a strong first half of the year and are still generally performing better than the U.S. Barclays Aggregate Bond Index (which we use as a proxy for "core bonds") on a year-to-date basis, our fixed income performance lagged in the third quarter. Our tilt towards shorter-term bonds was not advantageous this quarter as interest rates contracted and as a result longer-term bonds outperformed. Also, several of our higher yielding and more credit sensitive fixed income strategies underperformed as investors shed risk exposure in favor of the safe haven of U.S. Treasuries. Given the ultra-low interest rate environment and the near-term prospects of higher rates, we are not compelled to increase our interest rate risk by buying long dated bonds nor do we believe U.S. Treasuries offer an attractive risk to reward opportunity.

In a quarter that experienced such a broad and sharp correction in equity markets, there were a number of areas within our equity allocation that held up better than the broad market as well as some that underperformed. On the positive side, our international managers performed better than domestic markets given their high-quality bias and conservative positioning. Our allocation to the consumer sector, several positions within the technology space, and our general tilt towards large-cap/high-quality stocks were all positive contributors on a relative basis. There were also a number of detractors. Our exposure to more economically sensitive sectors such as energy, industrials, and materials lagged the market given global growth concerns. Financial stocks were also a detractor as the sector sold off aggressively after the Federal Reserve's decision to not raise interest rates, which would have been a positive for banks' profitability. The healthcare sector also experienced a reversal of a long outperformance streak as politicians sounded off about recent drug pricing increases.

Closing Thoughts

This was a tough quarter for equities, as we mentioned above, it was the worst quarter in four years. However, we are reminded that the domestic equity market has not experienced a correction (defined by a 10% decline from the peak level) during that four year period. We are also reminded that corrections are a common occurrence in equity markets. In fact, over the past 35 years, the average intra-year decline in the S&P 500 Index has been over 14%. However, despite those setbacks and volatility, the S&P 500 Index has recorded positive returns in 27 of those 35 years.

The uncertainty and elevated volatility levels are likely to persist in the near-term as investors struggle to gain clarity on the pace of global growth, the timing of interest rate policy normalization, corporate earnings growth and the prospects for stability of commodity prices. However, we continue to believe that the overall environment is supportive enough to warrant maintaining a reasonable allocation to risk assets. We feel our balanced positioning is appropriate given the positives as well as the uncertainties. We are continuing to monitor fundamentals as well as new developments and will make portfolio adjustments as we deem necessary.