Making Sense of Finance

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Third Quarter Review

STOCK MARKET

After a somewhat innocuous second quarter for the stock market, all major stock indexes in the U.S. crumbled in the third quarter. The Dow Jones Industrial Average had the worst performance of the top three indexes, - 7.6%; while both the Nasdaq Composite and S & P 500 lost 6.9% and 7.4%,respectively, last quarter. All three now register year-to-date declines. The Russell 2000 Index, which is a measure of smaller company stocks, performed even worse with a drop of 12.5%! When there is a decline of over 10% from the market highs, this is considered a correction. One might have said we were overdue, since the average time between corrections is roughly twenty months and we had long surpassed that time period. With earnings growth stalling in the aggregate, investors made a case for abandoning the stock market.

However, not all companies are created equal. We tend to talk in terms of "the market" however each industry and each company within those industries can have very different characteristics. On the back of improving employment numbers in the U.S, consumer discretionary companies are expecting double digit earnings growth for the third quarter; the same for telecom companies. On the opposite side of the spectrum, energy companies are expecting declines of 65% in earnings from the previous year. In the aggregate, earnings for the S & P 500 companies were predicted to decline over 4% in the second quarter; however earnings actually were basically flat with a slight decline of 0.7% for that period. For the third quarter, earnings are forecasted to decline 4.9%. We will have to wait and see what the actual results are, but the market appears to anticipate something worse. Stocks can overshoot reality on either side, rising too far versus fundamentals and the same can happen on the downside.

Consumer discretionary stocks such as footwear and home improvement retailers were among the best performers last quarter, as consumers were feeling good and had more disposable income with oil and gasoline prices so low. Oil prices declined 24% last quarter. Oil was not the only commodity to experience large

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Everyone and their neighbors have an opinion. At Karagosian Financial Services, we have a combined 40 years of investment experience. We have seen the markets at their highest highs and lowest lows. Through this newsletter we attempt to convey our opinions on current events in the investment world and their likely outcomes. Forecasting is inherently difficult and our advice is geared toward making sensible and prudent choices based on logic and experience, and not based on emotion.

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drops the last few months. Prices for iron ore, copper and coal slid. The worst performing stocks in the third quarter were in the coal, metals and steel sectors. The utility sector had a positive return but that was primarily due to dividends paid. Healthcare stocks, after being one of the best performing sectors for a long time, did worse than the market as a whole in the period.

Most foreign markets performed worse than the U.S. market in the third quarter. Emerging markets, in particular, were hard hit especially when measured in U.S. dollar terms. Also, developed countries that have economies tied in large part to natural resources, such as Canada and Australia, saw their stock markets and currencies take a hit. Of note, Brazil's currency depreciated over 20% in the last few months. In China the Shenzhen A Index, which had been up 74% year to date as of the end of June, took a dramatic turn in the third quarter and declined 30%. The devaluation of the yuan by the Chinese government in August caused investors to become concerned about growth in the Chinese economy.

BOND MARKET

Bonds for the most part had a positive return in the third quarter. U.S. Treasuries in particular did well as the yield on the 10 Year Treasury decreased (bond price therefore increased) from 2.35% at the end of June to 2.06% by the end of the third quarter. Treasuries are still viewed upon as a safe haven in a tumultuous world. Again the threat of the Federal Reserve raising rates did not come to fruition, as previously had been expected to happen in September. Now the expectations are for the Fed to start increasing the Fed Fund target rate most likely in December this year. Weak inflation in the U.S. was cited as a reason for not raising rates last month. The prospect of continued low inflation has caused TIPS (Treasury Inflation Protected Securities), to be one of the few bond sectors with a negative return in the third quarter. Other bond segments which declined last quarter were those that are considered riskier; emerging market debt and high yield (below investment grade) corporate bonds. Also, with rates remaining at very low levels, corporate bond issuance in the first nine months of this year was running about 7% higher than the comparable period in 2014.

Municipal bonds performed relatively well in the third quarter. In municipals, the riskier categories performed even better. Even after a rally last quarter, long term municipal bonds still provide higher tax-equivalent yields versus a comparable term Treasury. However, it is important to remember that both types of bonds are close to their historically low yields so there is much risk in longer maturities.

OUTLOOK

The volatility over the past quarter wasn't entirely unexpected by us, given that we noted the six years of consecutive advancement in the stock market. We would argue that investors had been looking forward to this market correction for well over a year, possibly making it a self-fulfilling event. Ironically, much of the downward movement in prices occurred when domestic macro-economic factors seem to be improving. The revised GDP number increased to 3.9% from originally 2.3% for the second quarter. With the froth off of the general stock market, we are finding more opportunities for investment. Although equity markets are much more volatile in the short term, the longer-term prospects remain more advantageous than fixed income securities that pay virtually nothing and have little upside value over the same time period. As professional investors we understand that markets rise and fall almost irrationally in the short term, but that over years, equity investment returns average out to more acceptable rates. In the current environment, we have been more of a buyer than seller. Few are immune to the natural volatility of the stock market. For instance, Berkshire Hathaway (BRK-A), a conglomerate composed of some of the best and most diversified businesses in the world, lost nearly 9% in the months of August and September, yet Warren Buffet (CEO) did not sell a single share and hasn't done so since he took control of the company over 50 years ago, because his investment time frame is always measured in years, not weeks or months. As Buffet is often quoted as saying; "Be Fearful When Others Are Greedy and Greedy When Others Are Fearful."