viewpoint

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No Place to Hide

The third quarter started in much the same way the second quarter ended – directionless markets with one or two up days followed by one or two down days. This all changed in August when investors began to focus on their fear of the unknown. The primary fears were whether or not the Federal Reserve was going to raise interest rates and the future of the Chinese economy. Investors hate unknowns and have a tendency to think the worst.

These two issues affected most equity markets, with US equity markets, international equity markets, and commodities all dropping over 10% during the quarter. At one point, it seemed like the only place your money was safe was in high quality bonds and savings accounts.

On a side note…it is always interesting how buyers take advantage of sellers in markets like this. Often when markets are falling you hear it is because there are more buyers than sellers. This is not true. Every transaction has both a buyer and seller. But when emotions are running high on the down side, buyers keep offering lower and lower prices taking advantage of seller's emotions. Once all of the emotional sellers have washed out, markets start to head back up. The opposite happens in up markets. In our opinion, this has little affect on long term investors other than to make them nervous when listening to the news.

As emotions calmed down and markets started to recover, both the Federal Reserve and the Chinese government made comments that started the markets back down again.

China, in order to make exports more attractive, devalued its currency. This move surprised investors making them worry that growth in China is even slower than originally thought. China's government is not as forthcoming with economic information as the US, so rumor mongers took over and emotions turned negative again. On the news of the currency devaluation, Chinese companies pulled back along with any company that had anything to do with China. Commodities started to slide again because their growth is dependent on developing countries demand. Oil, at one point, traded below $40 a barrel. A price not seen since the bottom of the economic crisis in 2008.

As this news and market action was being digested, investors went on Fed watch. For the last 2 years, debate has raged over when the Federal Reserve would raise interest rates above zero, where they have been for over 6 years. This was widely expected to happen in September. For the week leading up to the meeting, equities started to rise again with the thought that a rise in interest rates would signal that the economy was doing well, even with China slowing.

When the Federal Reserve met in the middle of September, all but one member voted to maintain rates at zero. This disappointed many investors who felt a ¼% rise in rates would be a signal that the Federal Reserve felt the economy was doing well. When they did not raise rates, investors feared that the Federal Reserve saw the economy slowing in the future. This sent the market back down testing the lows for the year.

Since then, the markets have bounced around with a upward bias. We feel this will continue until the uncertainty in what is happening in China and the Federal Reserve's view of the economy becomes clearer.

We do not see this as an end to the bull market that began 5 years ago - just a pause. Unless something unexpected occurs, we feel the markets will resume their upward trend as the unknowns about China and interest rates become clear. The outlook for the economy and corporations is better than the way the market is acting. For instance, The US economy was projected to grow a 2.3% during the second quarter but actually grew at 3.7%. Europe is continuing its slow turn around. Stocks are fairly valued at 15 time earnings and earnings are projected to grow at over 9% next year. All positives for the markets.

With the average company in our portfolios projected to grow its earnings at over 11% next year, we feel our portfolios are well positioned for when the market resume their upward move.

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