

Fourth Quarter Commentary - October 2015

It has been a volatile third quarter. The stock market, as measured by the Dow Jones Industrial Average (DJIA) dropped from 18,350 on May 19th to 15,370 on August 24th; a drop of nearly 3,000 points, or 16%, the biggest decline over the past three years. As we write this report, the DJIA has recovered to a level of just over 17,000, up over 10% from the low in August. In this report we will comment on some of the major factors effecting the stock market. We will focus on why we had a correction, why the market has rallied, and our outlook for the future.

There were a number of factors contributing to weakness in the market, some of them fundamental, some technical. By some indications, we were overdue for a market correction because we have not had a correction of over 10% since 2012. After the Great Recession, market multiples contracted considerably and have slowly been rising over the last several years as markets began to recover. This summer market multiples became slightly over valued based on historical levels for the first time since the Financial Crises. Moreover, due to the strength of the American Economy, the U.S. dollar has risen steadily over the last year and is now almost 20% higher than a year ago. This has caused earnings of U.S. corporations to stagnate and even drop because U.S. corporations get half of their sales overseas on average. The same level of sales overseas now translate into less earnings once the revenue is returned back to America. In addition, the Federal Reserve Bank has been threatening to raise interest rates all year long due to the strengthening American economy. This has continued to fuel the strong dollar, which continued to put pressure on earnings. The final trigger for the

August sell off was the announcement out of China that they were going to devalue their currency to spur exports and strengthen the Chinese economy. This led investors to dump stocks as they no longer wanted to pay a slight premium for equities when earnings were flat, the dollar was high, interest rates were rising, and China was slowing quickly.

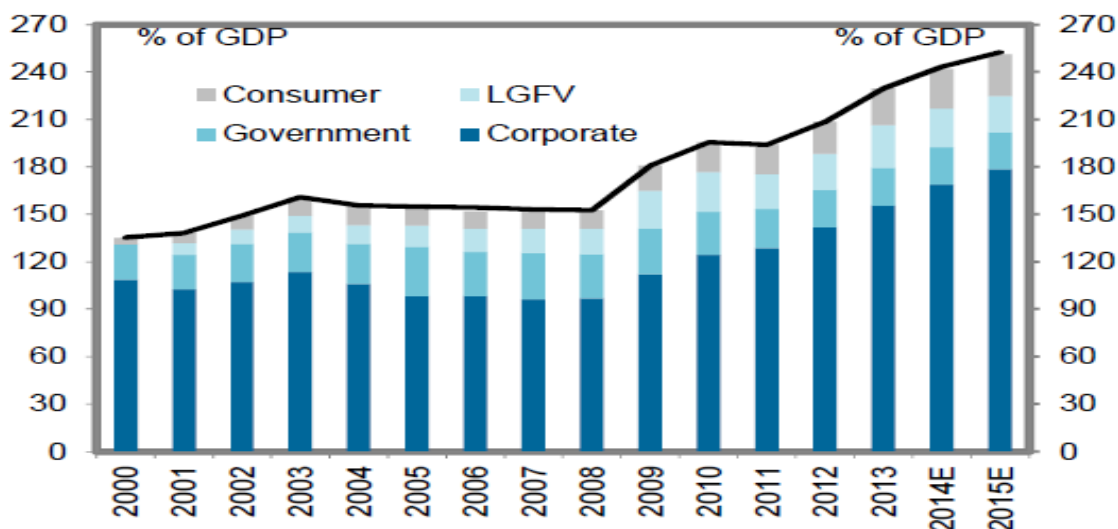
In addition to the above factors, we believe a technical factor also aided the selloff. The electronic nature of stock and bond transactions in today's world, whereby trades of hundreds of billions of dollars can change hands instantly, augmented by so called high frequency trading, exasperated the selling. When many sell orders come in at once, there is not enough buy orders to fill the trades in an orderly fashion. As a consequence of this, every once in a while the system momentarily seems to break down, and it takes a while for it to come back to normalcy. Recall the "flash crash" in May, 2010. We believe it possible that the July – August drop in prices was one example of such a malfunction. Time will tell.

Even though China only represents a small portion of our exports (we primarily buy things from them, not vice versa), they are the World's 2nd largest economy, and are very important for economic sentiment, and because they are the world's leading commodity importer. On the fundamental side, problems in China have been building for several years and reached a tipping point this summer. First, China can no longer grow its manufacturing base by simply adding new products to sell to others because they are already manufacturing most items. Second, the demographics of the country are changing. As China ages, older workers are not being replaced by younger workers. China's one child policy has created a work force imbalance which has led to rapid wage inflation, and reduced China's cost competitiveness. Moreover, even though the Chinese have changed their one child policy, the U.S. Census Bureau estimates that the

working age population of China peaked in 2012, and will decline for the next 15 years. We believe this will have an impact on Chinese growth and productivity. Along these lines, HSBC (Hong Kong Shanghai Bank Corporation) estimated that the Chinese PMI manufacturing index has been flat or contracting for two years.

In addition, China has a debt problem. To supercharge their economy, the Chinese were building a lot of infrastructure with little demand for its usage, and doing it with borrowed money. Unused or half empty buildings are all over China. Many of these buildings are not earning an economic return to pay for their construction cost. In fact, Chinese debt has doubled since 2009, while growth has been cut in half. At the same time, they continued to peg their currency down from the dollar in order to maintain their trade advantage with us. When the Chinese devalued their currency this summer, it showed the rest of the world its debt driven expansion was running out of steam.

Exhibit 1: China's rising debt load
Debt by major borrower segment, as a percentage of GDP

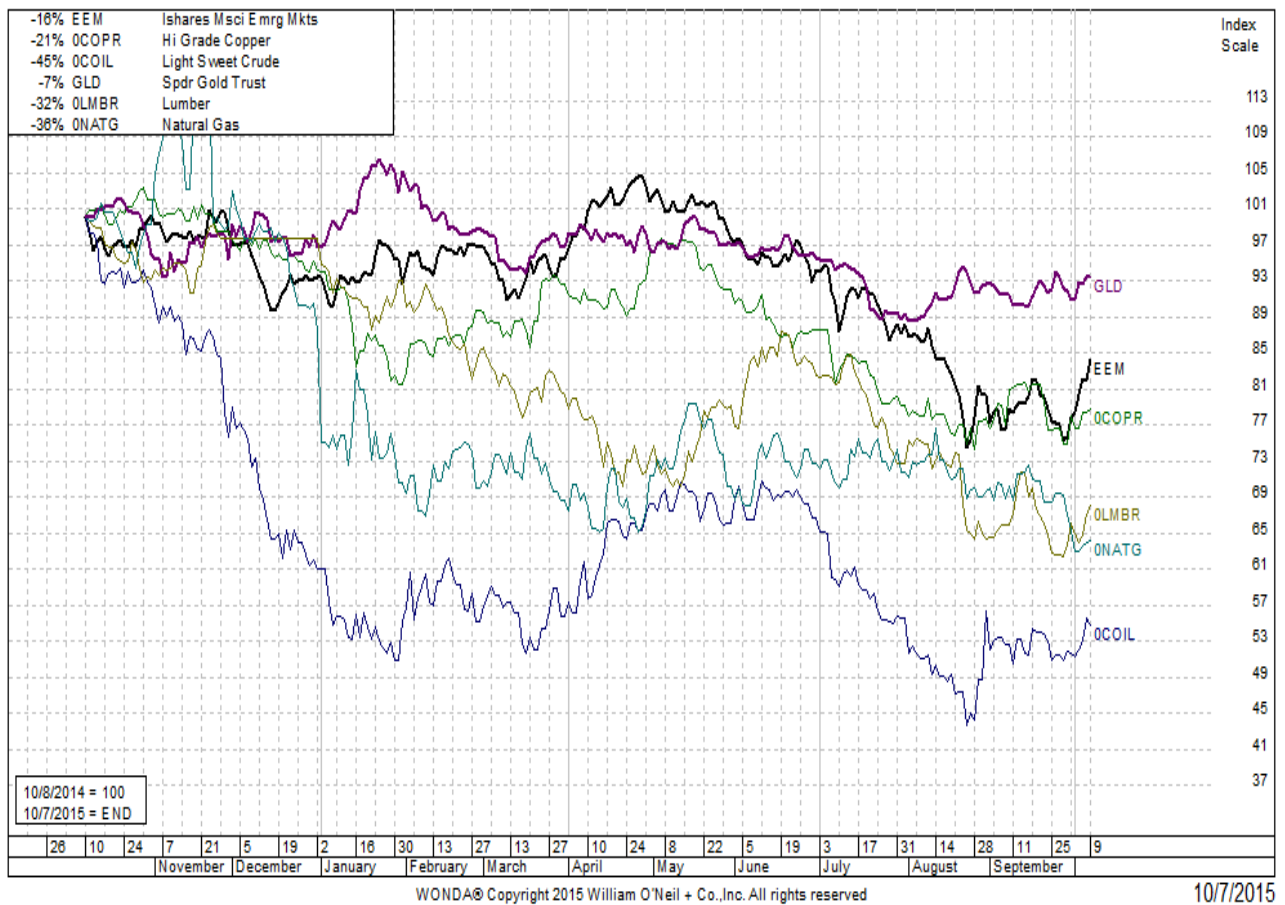


Note: financial institution credit is excluded and only half of entrusted loan amounts are included due to double counting
Sources: PBoC, China Bond Online, Gao Hua Securities Research

Note: LGFV= Local Government Finance Vehicle, Corporate Debt includes State Backed Companies

In addition, because of the slowing economy in China, real estate prices in China have begun to stagnate and even fall in some areas. This is causing problems. In China, many loans are backed by real estate, so if prices fall, many companies begin to face liquidity problems because their access to credit gets cut off. Worse, some loans get called because there is no longer enough collateral to back the loans. As liquidity gets cut off, less loans are made and less new investment in new construction takes place. This is already happening.

**Chart of Emerging Markets Stock Indexes and Commodity Prices for 2015 YTD
(Emerging Markets -16%, Copper -21%, Oil -45%, Gold -7%, Lumber -32%, Nat Gas -36%)**



The fallout from China's slowdown has manifested itself in many ways. First and most important, they have reduced buying natural resources from suppliers around the world, impacting natural resource producing countries; such as Brazil, Canada and especially Australia. So the commodity markets have been very weak, and the

aforementioned countries are all facing a slowdown. There is also the fact that China is expanding their military, and are moving to take over disputed areas in the South China Sea, which may be a diversion from economic problems at home. China is still a large and powerful country with plenty of foreign currency reserves. So they will undoubtedly try to increase their growth with various stimulus measures going forward, but the slowing Chinese economy will be a concern going forward.

Why did the Market Rally off of the Lows?

In the end, interest rates are the most important variable for equity investors. If investors could get a good return from merely buying a CD or bond, they surely would. So when a bad jobs report came out on October 2nd, and the previous two jobs reports were revised lower, market sentiment quickly recalculated that the Federal Reserve would probably take longer to raise interest rates. It would be hard to raise rates with a slowing American economy and weakening Chinese economy, along with weakness in Europe, the emerging markets, and growing geopolitical unrest.

Lower interest rates also mean that the dollar would most likely stop rising and maybe even fall (a windfall for corporate profits). Low interest rates also ensure that the equities markets have no completion for capital, and that the stock market is the only place to really make any returns with surplus capital. Not only this, low rates continue to aid the slow growing U.S. economy, and continue to pad corporate profits as they take advantage of cheap money. For these reasons the market rallied.

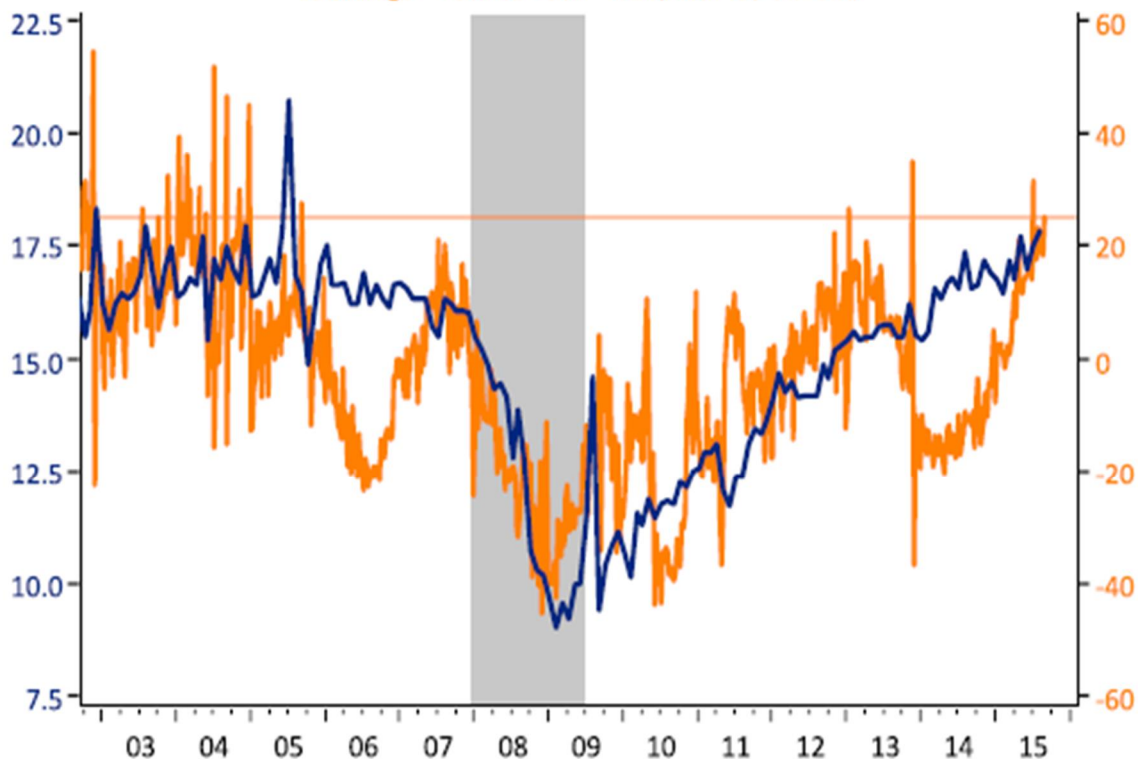
Outlook for the Future

The U.S. economy will continue to grow, but the growth will be uneven and slow. Manufacturing will continue to be hurt by the stronger dollar, and the once fast growing

energy industry will continue to downsize due to lower energy prices. However, after several steady years of an improving job market, auto sales are the best they have been in years. This is helping to offset weakness in almost every other manufacturing sector outside aerospace. The average age of cars on American roadways is near the highest point ever – almost 11 years! So the natural replacement cycle is underway and giving a much needed boost to the industrial side of the economy. Moreover, after the Great Recession, many young people delayed marriage, or moved back home because of economic uncertainties. Again, because of an improving labor market, we are now starting to see new household formation pick up which is fueling a rebound in home construction and mortgage loans.

Total Light Vehicle Retail Sales [Imported+Domestic]
SAAR, Mil. Units

MBA: Volume Index: Mortgage Loan Applications for Purchase
% Change - Year to Year NSA, Mar-16-90=100



Sources: AUTODATA, MBA/Haver

As the chart illustrates, big ticket purchases of autos and homes are at the highest levels in almost ten years. Big ticket purchases are a sign that consumers feel confident in their economic futures and bode well for the country. Other economic indicators are also positive, for example:

- U.S. corporate profits are still near record highs (despite dampening effect of the strong U.S. dollar on exports).
- U.S. economic growth has been revised higher (Q2 GDP raised to +3.7% from +2.3%).
- The unemployment rate continues to drop (at 5.3%, a 7-year low).
- Interest rates are near historic lows (3.95%, 30-year mortgage rate) which will remain massively accommodative even if the Fed modestly increases short-term rates.
- Stocks now have reasonable valuations (improved after the latest index price declines). The S&P 500 is now at 16.3 times earnings in line with historical averages.
- Massively accommodative central banks around the globe (e.g., European Central Bank and People's Bank of China) are pouring fresh liquidity into these countries, which will help buoy those market.

What this all means is that the sharp summer pull back was most likely a normal correction, and that the markets will rebound. However, due to the ongoing international weakness, and strong dollar, the growth will likely be sluggish and the markets volatile.

Conclusion

We see continuing growth, positive but slower, but with little margin for error. We see international markets remaining weak, especially those commodity countries supplying China's real estate building boom that is now slowing down.

Finally, we expect more volatility as we head into fall. However, we think a good part of the damage is behind us, and moreover, we plan to use the volatility to add to good companies at good prices. In terms of what we want to buy, we continue to favor

large capitalization companies, especially those that are not only providing services that we either eat, drink, use, need, or consume on a regular basis but also returning cash to investors through dividends and stock buybacks.

As always we thank you for your continued support. Please call with any questions you might have.

Sincerely,



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