SCHNIEDERS
CAPITAL MANAGEMENT, LLC

Third Quarter Market Commentary July 2015

As we move into the second half of 2015, we believe the economy, the stock market, and the bond market are all sending mixed signals. In this report, we will give an update on the market, and we will attempt to clarify some of these positive and negative signals, as well as address recent events in both Greece and China.

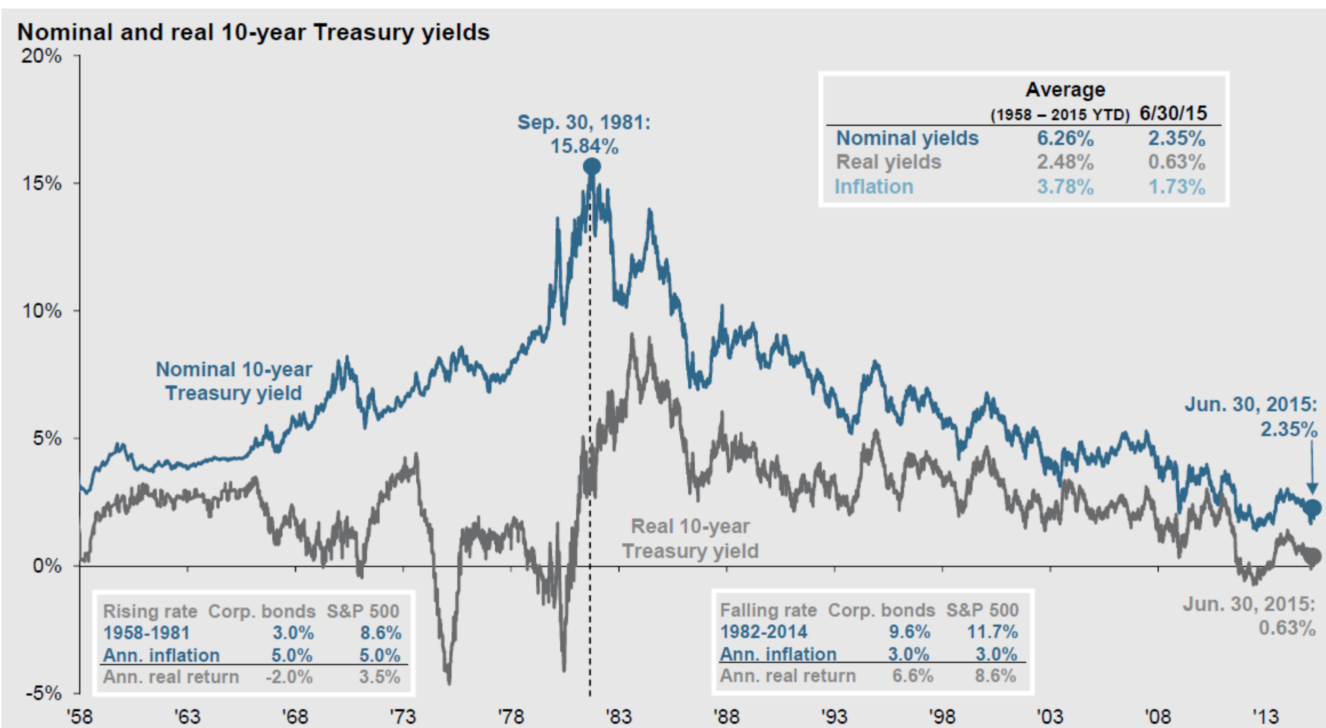
As we go to print this report, the stock market, as measured by the S&P 500, sits at 2100, which is 17.5 times expected 2015 S&P earnings of $120 per share. This level is slightly above historical valuations of the S&P. Over the past 15 years, S&P price earnings multiples have ranged from a low in 2009 of 10 times, and a high of 23 times in 1999.

Historically, these multiples will vary with economic activity and itʼs not unusual for prices to fluctuate. Most major indices are near flat to up slightly on the year. Moreover, there is usually one 10% decline and two 5% drops per year, and often one 20% decline during the course of an average three year period for the S&P 500.

Since the start of 2015, the Dow Jones Industrial Average has fluctuated between positive and negative ground nine times, and the S&P 500 crossed between positive and negative territory on six occasions.

Meanwhile, as stocks have still been holding at relatively high levels (both the S&P and Dow 30 indices are still close to their highs), the bond market (and income investments such as dividend paying stocks and REITS) have begun to fall. The reason the bond market has begun to fall is that interest rates have been slowly creeping up. For example, the yield on the 10 year Treasury, which was 1.8% two months ago, is now priced at 2.5%. That is not much in aggregate terms, but substantial in percentage terms.

Recall that there is an inverse correlation between bond prices and bond yields. As interest rates begin to rise, the valuation of existing bonds will tend to fall. Since this is beginning to happen, the fear of investors is that this might be the beginning of something bigger that could last longer. Fears that this might evolve into a longer trend of interest rate hikes, while probably overblown, are nonetheless bringing some degree of havoc in the bond and income markets, which has carried over to the stock market as well. (Chart Below Source: Federal Reserve, J.P. Morgan.)



One might look at the above chart and wonder why interest rates have been falling for so long, and if they may stay low. The answer to these questions are as follows:

1. The Quantitative Easing Programs that we have written about extensively from 2009 through the end of 2013 generated trillions of dollars of liquidity ï not just in the United States, but worldwide. That liquidity was designed to generate enough capital at the banking level for the banks to resume lending, and jump start the economy.
2. Remember that interest rates are the cost of money, so if you flood the system with money, interest rates go down. Interest rates going down usually stimulates the economy.
3. Quantitative Easing (money printing) was accomplished by the Fed buying everything from Treasuries to blocks of syndicated loans, thus refreshing banks with liquidity, backed by checks the Fed printed. While the jury is out and history books not yet written, most observers have labeled the Federal Reserveôs actions as a success ï at least partially. We say partially because many of the large banks ñblessedò by the Fed just turned around once they received the money, and redeposited the new funds at the Fed itself for a 1/4 of 1% risk free return, instead of using all the new found money for new loans.
4. What the banks did lend, however, has had a positive effect, as we are officially now in the sixth year of our economic recovery, but one that has created asset inflation, without spreading benefits through the whole economy.

Why Interest Rates May Stay Low

1. The extensive buildup of our national debt has acted as a brake on whatever plans the Federal Reserve might have to increase interest rates. The national debt now stands at $18.5 trillion, $8 trillion higher than just six years ago.

2. The average interest rate on our debt is currently in the high 2% range. Given the current debt level, each 1% change in interest rates would cost the Federal Government (i.e. ï taxpayer) $185 billion. An increase from 2% to 6% would essentially break the bank, insofar as funding any other discretionary federal program.

   Thus, we believe interest rates will rise, from todayςs ultra-low levels, but they wonαt rise enough to upset the apple cart and throw the economy into recession.

As a result of low rates and stimulus, we are seeing a rebound in the economy, but not a very powerful one. Part of the reason for a slow economic recovery is the high value of the dollar versus the currencies of our major trading partners.

The dollar rose 25% against the currencies of our major trading partners from January 2014 until March of this year. So on top of everything else, we have been subjected to what some believe is the beginning of a currency war. Corporate earnings would be much higher if it werenαt for the fact that overseas earnings have to be transferred back into dollars, so this has definitely been a major headwind. Since overseas operations account for a large percentage of overall earnings, a strong dollar hurts overall profitability.   Lower profitability affects valuations, which affects stock prices. In fact, Reuters News Service is now forecasting a 3% drop in corporate profits, and 4% decline in corporate revenue for the upcoming quarterly earnings season.

Greece and China

If Greece leaves the Eurozone, what will happen to world markets? This has been a question being tossed around for weeks. In our view, market volatility would increase; however, steps have already been put in place which would prevent a market contagion which analysts feared during the last Greek crises. The original fear was that if Greece defaulted, it could lead to a credit crunch in Europe (the worldÕs largest market) as European banks who hold the Greek debt would have to call in capital and curtail lending to make up for their losses. Since the last crises, the European Central Bank (ECB) has been authorized to engage in a new round of quantitative easing (money printing) which given their existing tools, would allow the ECB to purchase sovereign bank debt on the primary market through the European Stability Mechanism. This would Òring fenceÓ the Greek debt and prevent financial contagion.

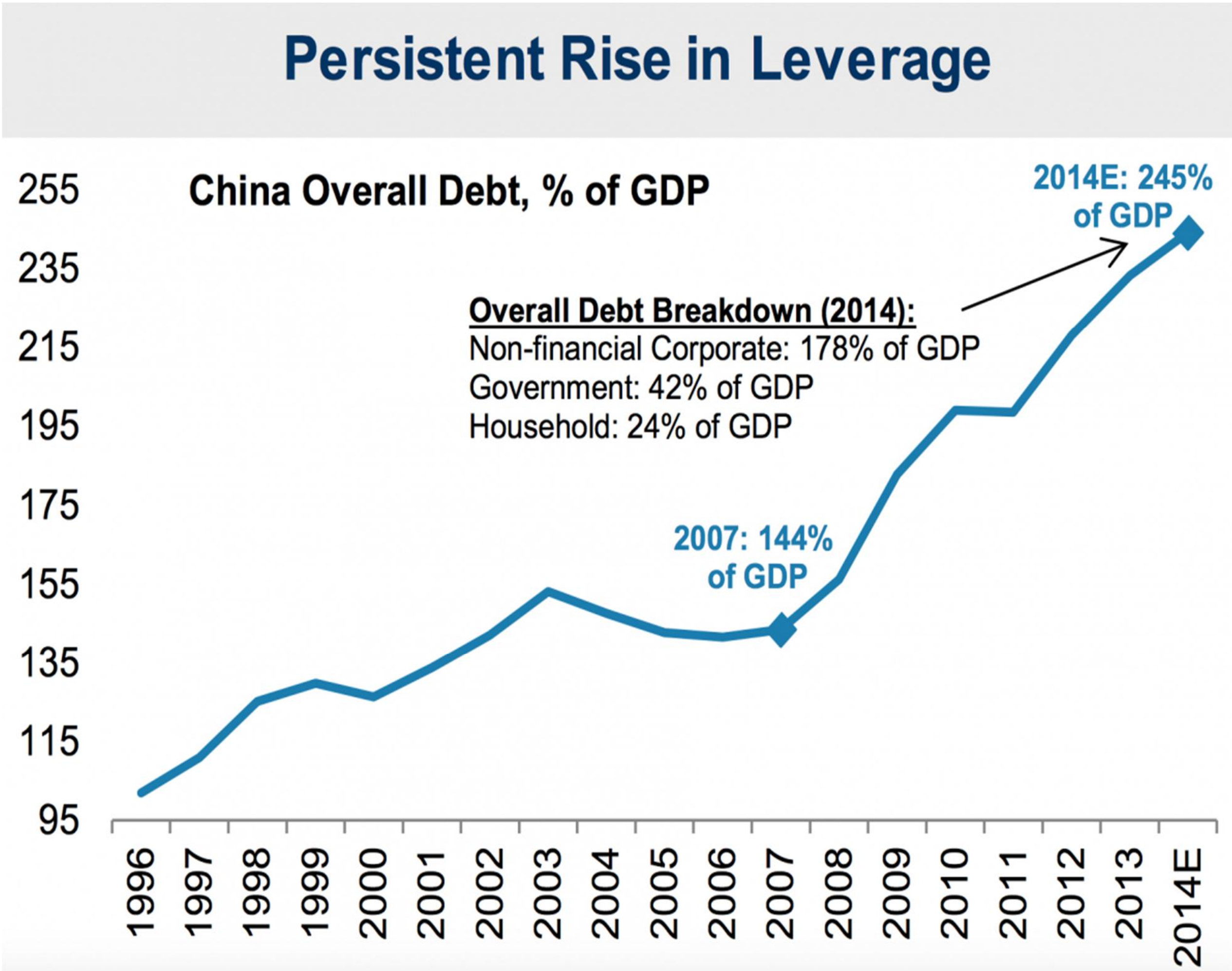
The immediate impact on the Greek people, given a default would be far more painful. If Greece were to leave the Eurozone, they would have to issue their own currency, which would immediately fall in value against other major currencies. This would cause the price of all imported goods to raise significantly (creating inflation), many Greek depositors could get wiped out, unemployment would get even worse, and GreeceÕs already weak economy would get weaker. Longer term, a Greek exit may be what Greece needs in order to compete. Once the dust settles, Greece, with a lower value of their currency would then be a cheaper area in which to produce and export goods and services, and it would become a much cheaper place to visit. This in turn would help to stabilize the Greek economy and get it growing again.

In reality, a Greek exit from the Eurozone will not be a one day event but rather a process that evolves over an extended period of time. The Greeks could default on some loans and not on others. Furthermore, a new government in Greece could change direction and be more open to structural reforms, thus bringing in more European aid. At the end of the day, the Greeks know that the ECB now has the tools to prevent a Greek default from spreading to the rest of Europe. On the other hand, the Greeks feel they can wrestle more aid from Europe because if Greece leaves the Euro, ñit would be the first time since 1951 that a treaty-based integration process would have been reversed[1].ò This in turn would cause a great deal of damage to the entire European integration process, something the diplomats in Brussels wish to avoid. Our view is that the Euro and European integration will survive, with or without the Greeks.

A much more serious issue, in our judgement, is China. The Chinese stock market is in the process of correcting. The Hang Seng Index is down 30% from its peak just a few weeks ago. This correction in China coincides with some economic weakness. Chinese debt has doubled since the financial crises, yet their growth rate has been cut in half. This has caused the cost of servicing the debt to rise and increased the probability that there will be defaults in the future.

---

[1]Citibank- June 24, 2015



Source: Businessinsider.com

As the threat of defaults rise, lenders have become more cautious, which has started to create a credit crunch for many small Chinese businesses. Traditionally, China has fueled their growth through exports and the building of new roads, highways, bridges, buildings, and factories- often with borrowed money. Many of these infrastructure investments now cannot cover the cost of the loans that built them. Moreover, the recent fall in the Chinese stock market has been compounded by the fact that Japan has dramatically reduced the value of their currency and they are now stealing export market share and growth from neighbors, including China.

China is trying to respond by cutting interest rates to spur growth, but it has only been marginally successful thus far. We are concerned about what is happening because China is the second largest economy in the world, and the largest consumer of commodities in the world. A recession in China could have a ripple effect worldwide. China's weakness has been a contributing factor to the weakness we are seeing in our own markets.

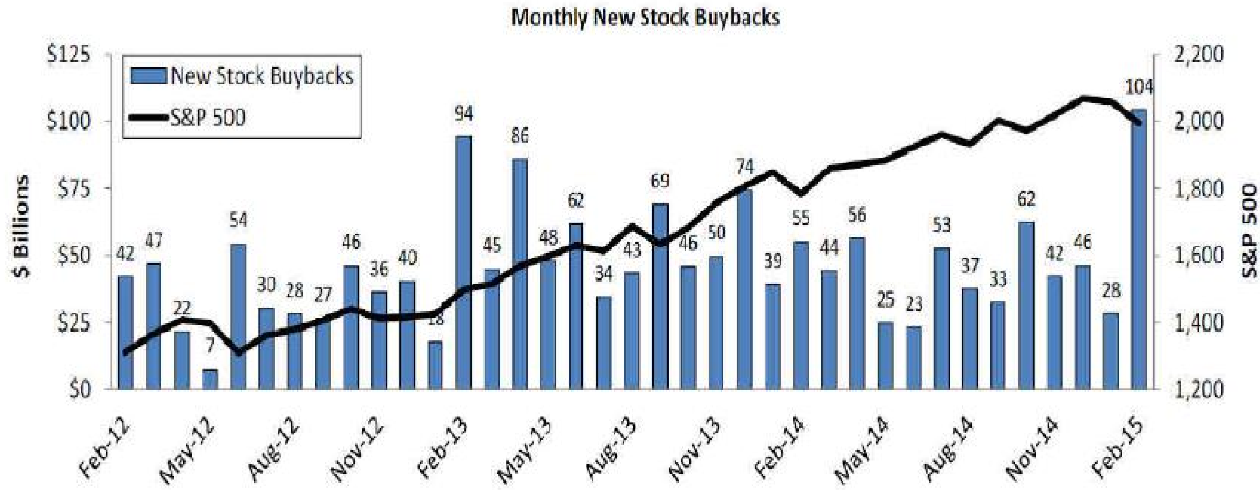
Where does this leave us looking forward?

The economy officially emerged out of recession six years ago, and while the economy has steadily improved since then, it has done so at a very slow pace. Even now, the economy is sputtering. This is borne out by flat rail traffic, and a decline in truck tonnage. There has also been a decline in factory shipments and an over 50% drop in oil rigs operating[2] .

So why has the market held up as much as it has? Corporate stock buy backs are one reason. When a corporation buys back its own stock in the open market, it reduces the amount of shares available for trading, thus reducing its share count. Essentially it is a tax free dividend, because investors receive a larger share of future earnings. In fact, major corporations purchased over $500 billion of stock in 2014. In addition, over $100 billion of corporate stock were bought back in the open market in the month of February, 2015 alone. This large corporate buying has helped to offset selling of stocks.

[2]Barron's Market Laboratory Indicators- June 30, 2015

Monthly New Stock Buybacks



Source: B of A Merrill Lynch Global Investment Strategy 3/3/15

In conclusion, the market this year has been weak for several reasons. First, market valuations which had been cheap after the market crash of 2009, are now actually slightly ahead of historical valuations. Indeed, the forward market multiple of 17.5 times earnings is now higher than the historical 15.7 times earnings. Thus, market gains going forward must come increasingly from earnings growth. However, the rising US dollar has crimped the earnings growth of large companies in the Dow Jones and S&P 500 because typical companies in those indexes receive almost 50% of their earnings from overseas operations. When the dollar rises, the earnings that are made in overseas operations translate back to fewer dollars on the same sales levels after repatriation. Worse, companies that export goods from the USA, now have to raise prices just to receive the same level of income, and are likely to lose overseas sales. Importers to the USA get the benefit of selling their products to Americans at cheaper prices when the dollar rises. On the positive side, the economy continues to slowly improve, corporations continue to return record amounts of cash back to investors through dividends and share buybacks, and interest rates will most likely remain low relative to historical levels. With interest rates at low levels, there are fewer alternatives to invest in. As a result, we continue to favor investments in companies that are dominant in their industry group, global in scope, and who are returning increasing cash flows to investors as the best risk adjusted investments for a volatile world.

We thank you for your support and wish everyone a happy summer.

Sincerely,

Bill

William H. Schnieders
Principal

Jim

James F. Schnieders, CFA
Principal

John

John C. Schnieders, CFA, CFP®
Principal