Investment Management

US Equity Market Environment

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The past six weeks has been anything but pleasant for most stock market investors. The S&P 500 is down over 12% from its previous high, marking the 22nd correction in the S&P 500 since WWII. We are carefully monitoring events and the level of volatility. We thought our readers would like to know our thinking in regards to what has caused the recent decline as well as our outlook for the market.

Longer Term History of Bull and Bear markets:

The Market began its current decline in August 2015. Through July, 2015, the recent Bull Market had lasted for 76 months. We believe the decline is totally within expectations given the Stock Returns we have witnessed since the market Bottom in April 2009.

	Duration in Months	Cumulative Return
Average Bull Market	67	178.09%
Median Bull Market	50	123.81%
5th Percentile	20	46.64%
95th Percentile	153	439.24%

Source: Shiller, Period is 1871-Present

While 76 months represents a relatively long bull market, it is not close to the longest. Since 1900, there have been 123 stock market corrections and 32 bear markets (correction defined as at least a decline of -10% and bear market defined as -20% or more). Hence, most market corrections ***do not*** turn into bear markets.

Typically, bear markets occur when the current economic/business cycle is ending. While growth is slow, SSI believes that the US Economy is healthy. We therefore believe that the current correction will not turn into a bear market.

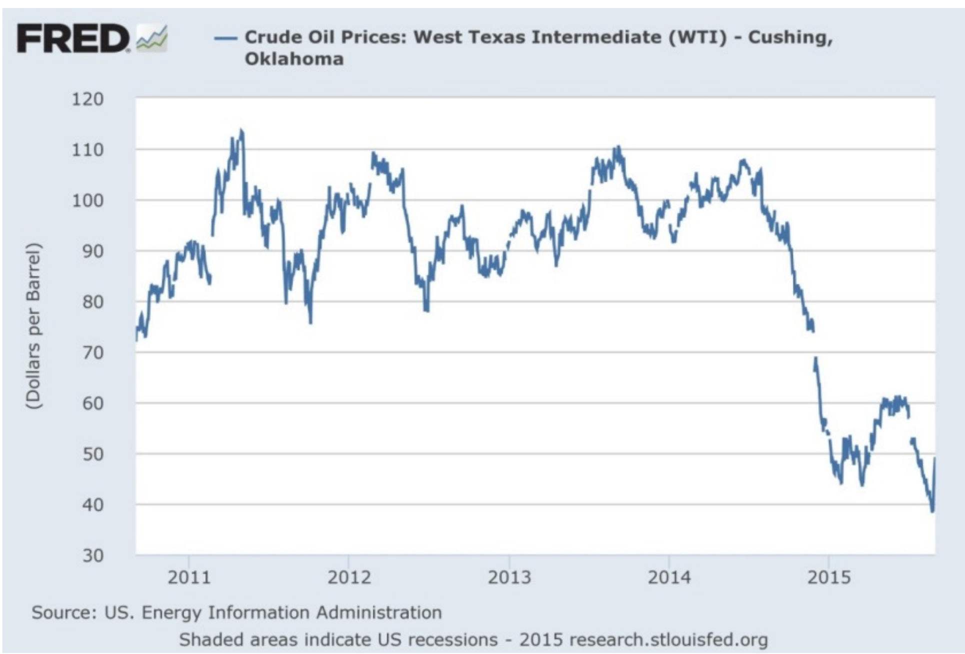
The Recent Downturn

The primary culprits for lower global stock prices in August and September are: 1) the massive decline in oil prices; 2) the economic slowdown in China, and 3) the anticipation of the Federal Reserve raising interest rates.

<u>Oil prices</u> started their descent in the summer of 2014, culminating in a bottom under $38/barrel on August 24. Normally, this is a tremendous positive for US companies, as the cost of goods and services which utilize petroleum-based products go down, increasing discretionary income and corporate profit margins.

The reason for oil's decline is a combination of increasing supply from the US and waning demand in China. OPEC production remains elevated after Saudi Arabia implemented a strategy to gain market share. The Saudi's cost to produce a barrel of oil is estimated to be as low as $20, while the average cost per barrel for US oil shale producers is over $80.

Production costs are significantly less for Texas crude, ranging from $45-60/barrel. With oil at these levels for an extended period of time, many US oil producers will have trouble meeting their debt obligations and may go out of business (keeping the US more dependent on Saudi oil). The end result has been fear, and rising credit spreads in the oil markets, which has now spread to other sectors of the market such as materials and industrials.



FRED: Federal Reserve Economic Data

Domestic oil production will likely decline as activity slows and some energy companies go out of business. As a result, oil prices are likely to trend higher. Investors are currently taking a "wait and see" posture, which may continue for some time, contributing to the delayed recovery in energy markets. As oil stabilizes and eventually moves higher, investor confidence will improve and most financial markets should react favorably.

<u>The economic slowdown in China</u> has major implications for the global economy. In addition to the oil markets, the entire commodity complex and other emerging markets have been under pressure. Since 2010, China's economy has been decelerating from double-digit growth to a reported level of 7% (see chart below). Given the lack of reliable data, investors remain concerned about the real level of economic activity in China. Investors fear the unknown, and their fear is heavily reflected in lower equity prices. As investors see indications of stabilization, financial markets should stabilize and global stock prices will likely move higher.

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We are encouraged by the strong steps the Chinese Government is taking to stimulate their economy. Since last November, China has cut its benchmark interest rate four times and reduced the required reserve ratio for banks by 1.5%. We believe stimulative actions by the Chinese government will eventually stabilize their economy and help the world avoid a global recession. Our confidence in the US economy is further bolstered by the limited impact Chinese demand has on US activity. Exports to China represent less than one percent of our GDP.

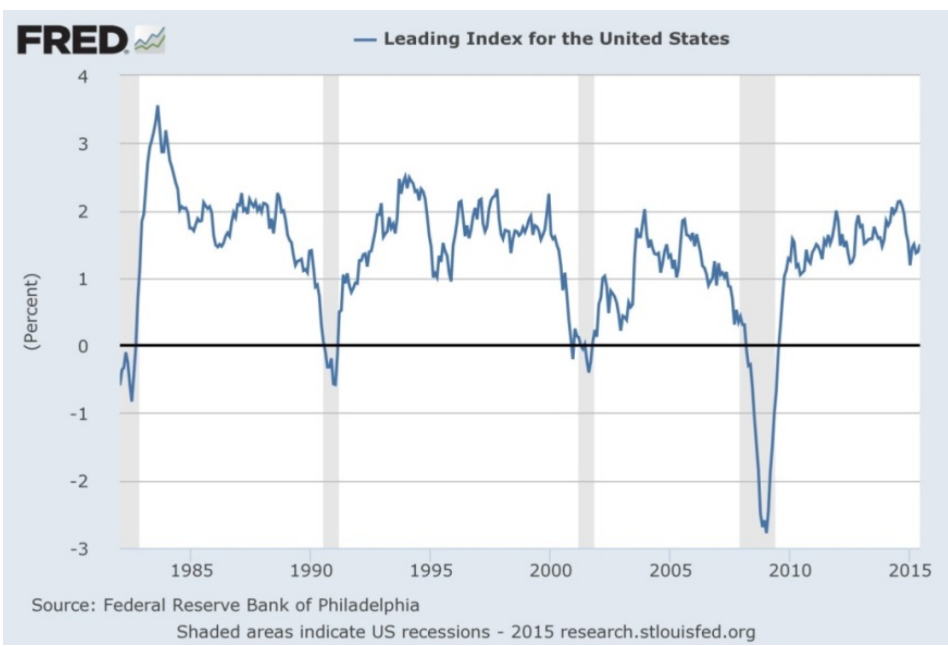
<u>The anticipation of a hike in the US Federal Funds rate</u> has also been weighing on the US Equity markets. The Fed has indicated that a rate hike before the end of the year is likely due to improving employment and prospects for higher inflation. Although inflation remains benign and there has been much turmoil in the financial markets, the Fed continues to indicate that a rate hike in September is a possibility. This has unsettled investors as the timing of the first rate hike remains uncertain. Again, investors dislike uncertainty.

Historically markets do experience inordinate volatility leading up to an increase in short-term rates. But after the event occurs, calm settles into the market and often times, equity prices resume their upward trajectory. SSI believes that in view of the prolonged oil price drop and the lower demand out of China, the likelihood of a September interest rate hike has diminished, which should act as a positive catalyst to the markets. Even if the Fed does proceed with a 25 basis point hike, they would likely signal that future increases will be very slow in coming.

US Economic Environment:

The US Economy remains healthy and risk of recession is relatively low. There are many positive forces underpinning the US economy.

Inflation is tame, which will help to keep interest rates low relative to historical levels. US corporations have been growing, as demonstrated by the declining unemployment rate. Consumers are in an improving financial position, as the consumer debt to GDP ratio has been declining since 2009. Finally, important economic industries within the US are expanding. For example, the housing market and associated industries have recovered nicely. Improvements in employment and income, along with easing credit, are driving household formations. However, there is still room for growth. In 2006, real estate construction contributed to 8.9% of GDP, and in 2014 it only contributed to 6.1% of GDP. The auto industry has also rebounded strongly in recent years, and sales (over 17 mm) are now well above the long-term average.



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Perhaps the best overall barometer of the condition and direction of the economy is the leading index of economic indicators (see above). The index remains positive. Given the healthy condition of the US economy, we do not foresee further decline in the index in the near future.

As we said before, in order for a bear market to form, an end to the business cycle is necessary. At this point, SSI does not see an imminent end to the current business cycle in the US. As a result, we do not expect the current correction in the equity markets to turn into an extended bear market.

Summary

- The malaise in the oil and commodity markets began in 2014 and affected both the credit and equity markets. Part of the downturn and end to the commodity super-cycle was driven by China's economic woes which were recently illuminated as the government took extensive actions to stimulate the economy. As a result, global equity prices have been in a decline. However, we do not believe China's economic problems will evolve into a global recession.

- Overall, the US economy is in good shape. Inflation remains low, important industries such as housing and autos are growing, consumer debt has declined, and interest rates – even if they rise modestly – are very low relative to historical standards. The health of the US economy will eventually lead to a recovery in the equity and credit markets.

- It will take time for the current events to settle down. In the interim, it is prudent to approach the current market conditions by maintaining a more defensive portfolio, by vigilantly monitoring the risks and by looking for opportunities to become less defensive as events unfold.