Managing through the Volatility: Keeping a focus on the long term outlook and fundamentals.

As concerns about Greece and Puerto Rico moved from the front pages, there were new events that combined to shake investor confidence leading to a dramatic global equity market sell-off. Volatility spiked globally and across nearly every area of the market including equity, commodity and fixed income markets. Increased volatility was driven by on-going concerns about Chinese economic growth, weakness in emerging market economies and rising geo-political risk, especially in the Middle East. Despite all the negative headlines, we remain constructive on outlook for the U.S. economy and financial markets.

China was certainly a major catalyst for the global equity sell-off. Following on last quarter, Chinese equity markets weakened further, despite multiple attempts at interventions by Chinese officials. China added to market fears by devaluing the Yuan, which raised concerns about the state of the Chinese economy. While the global market reacted poorly to the move, it is useful to note that the devaluation of the Yuan only partially offset the recent U.S. dollar-driven appreciation of the currency. The Chinese economy is clearly growing at a slower pace than in prior years, but this should not come as a surprise. The Chinese, much like the U.S. in the 70's and 80's, is shifting from an industrial based economy to a more service based economy. This transition can take a long time but should provide for a more stable domestic economy in the future. In addition, given the increased size of the Chinese economy, it is more difficult to grow at double digit levels indefinitely. While the level of Chinese growth may be hard to fully measure, it is clear that it is still growing and at a faster pace than most of the developed world.

The Federal Reserve has added to market volatility all year, but never more so than in the aftermath of its September meeting. It did not come as a surprise to most market participants that the Fed left interest rates unchanged at this meeting. The surprise came in its statement explaining the position. The Fed seemed to indicate that in addition to its two stated missions, full employment and price stability, that it would also consider global economic conditions in the decision making process. Prior to this the Fed had emphasized that its decisions would be "data-dependent". The inclusion of other global, qualitative factors makes it increasingly more difficult to discern when and if the Fed might begin to normalize rates. We still believe that the Fed should begin the process of normalizing rates sooner rather than later, given the progress that has been made in the labor market and the broader economy since the end of the last recession.

In addition to the concerns about China and Fed policy, we are seeing rising geo-political tension around the globe. The intervention by Russia in the Syrian conflict adds to an already difficult situation, as multiple factions fight for control of the country. The on-going conflict also raises concerns for Europe as they deal with a growing refugee problem. On the domestic front, politics in Washington have also added to investor anxiety, as Congress has to deal with a highly contentious budget deal, debt ceiling increase and highway funding bills all before the end of the year. While we are in the early stages, the ramping up of the Presidential campaign tends to add to market uncertainty as well.

All of these events combined to increase volatility across the global financial markets.

After reaching an all time-high in July, the equity market began to falter. The S&P 500 fell as much as 12% from its highs and ended the quarter down 6.4%. Global markets were also under pressure with China falling more than 28% and the larger European countries declining between 7% and 12% for the quarter. Longer-term interest rates fell during the quarter as investors sought the relative safety of U.S. Treasury bonds. The yield on the 10-year Treasury briefly fell below 2.0% before ending the quarter at 2.04% down from a high of 2.49% earlier in the quarter. Energy markets also exhibited increased volatility during the quarter, as oil prices fell 24.2% to $45.09 a barrel.

Despite all of the uncertainty during the quarter, the outlook for the U.S. economy remains largely unchanged. The labor market continues to show improvement. While the pace of job gains slowed a bit in August and September, the economy has added 1.7 million new jobs this year. The unemployment rate fell to 5.1% and the rate of under-employment, which includes people working part-time that would like to be full time, fell to 10%, the lowest level since May of 2008. The consumer continues to benefit from low energy prices, rising wages and rising household net worth. Wage gains have been somewhat more modest than in previous recoveries, but consumer real disposable incomes are up 3.2% over the last year. Consumers continue to pay down debt and while they have been saving some portion of their energy gains, there has also been a pick-up in consumer spending. Auto sales remain robust, as do purchases of appliances and other large ticket items. Despite the weakness in the equity markets, consumer confidence rose in the last two months of the quarter.

The housing market, which for much of the recovery made a very modest contribution to GDP growth, is finally showing signs of stable growth. Home prices are rising across most of the country at what should be considered a sustainable 4.5-5.0% year-over-year rate. In addition to increased purchase activity, homeowners are increasingly investing in updates and renovations to their existing homes.

The U.S. economy grew at a 3.9% annual pace during the 2nd quarter offsetting the weather-induced 0.6% growth in Q1. The economy is expected to continue to grow at a moderate pace for the remainder of the year, although the pace of growth in the 3rd quarter was likely lower than that of the 2nd quarter.

While investors faced increased uncertainty during the quarter, we still believe the underlying fundamentals remain intact. The U.S economy is expected to continue to expand. In addition, the combination of accommodative central banks and the benefit of weaker currencies should help drive moderate economic growth internationally. All of this should help support continued gains in corporate sales and earnings. Given the tailwinds facing the consumer, we continue to emphasize the consumer related sectors of the market. We continue to believe that interest rates are likely to move higher from the current levels and as such, prefer to position fixed income exposure to gain incremental yield without taking on too much interest rate risk.

It is likely that volatility will remain high for the remainder of the year and we will continue to monitor the events as they unfold. However, we still believe that over the longer-term, market returns are driven by economic fundamentals and as long as those remain solid we will expect to remain fully invested.