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A Registered Investment Adviser

Client Newsletter – Quarter Ending September 30, 2015

More Uncertainty

In March of this year the markets were hitting new highs. All indices shared in the festivities. The unemployment rate dropped to nearly 5%. Oil prices dropped too, giving hope to the consumer economy and diminishing inflation expectations, as inflation all but disappeared. In general, the outlook for the economy was positive. Then, slowly, the outlook began to change.

The International Monetary Fund spoke frequently of the declining outlook for the global economy. We had noted that previously, and we moved our money back to the U.S., saying the U.S. was the “best house on a bad block”. Commodity prices, other than oil, began to decline in response to China’s slowing growth rate.

Since the outlook in the U.S. was for rising interest rates, the dollar strengthened significantly and U.S. exports slowed. So, just as the world economy began to slow, the U.S. economy slowed too. Job creations numbers were revised down from 200,000 to 120,000 and U.S. job creation slowed. Now the outlook went from positive to negative. The U.S. equity markets took a tumble and went into a correction (a ten percent decline). Just as quickly the equity markets shot up recovering most of the correction, in a V shape recovery.

The Federal Reserve had been calling for increased interest rates. The Fed speakers had been talking in circles for month, but the hawks (those who wanted a rate increase) seemed to be the most numerous, certainly the most vocal. All of this hyperbole caused Barron’s to rename the Federal open market committee (the one that sets rates) the open mouth committee. They might have added, insert foot. In spite of all the chatter, when the decision date for the committee came, the Federal Reserve blinked. They did not raise rates. The IMF leaned on the U.S. to not raise rates, (something they deny). Past Treasury secretary, Larry Summers, urged them not to raise rates. Mohamed A. El Erian, the respected Chief Economist for Allianz, urged the Fed not to raise rates. In the meantime, in a surprise move, China devalued its currency, signaling a weakness in its economy. The Chinese equity markets tumbled, taking others, including the U.S., with it. Emerging markets were suffering from the strong dollar, which stood to get stronger if the U.S. raised rates. Massive capital outflows from emerging economies threatened those countries further. China has seen capital outflows in the order of $475 billion so far this year. In the Fed comments, Janet Yellen, Fed Chair, alluded to the problems in emerging markets, echoing comments by Christine Lagarde, head of the IMF; presto, the U.S. was the central bank to the World.

The market was shocked by the Fed decision not to raise rates, and in a reprise of the taper tantrum of several years ago when Ben Bernanke suggested he might taper quantitative easing, went on a rampage. Immediately the market plunged over 200 points, but the just as suddenly reversed itself and

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closed the day up 250 points, making a 450 point round trip in a day. Such volatility has become common place in recent years, causing us to warn frequently about volatility and cautioning our clients not to react to it, or react to it at their peril.

Now, the outlook for interest rates remains unsure. The Fed seems embarrassed by their on again off again rate comments. Now they say they want to raise rates before the end of this year. They say they are data driven. The data seems to point to a rate increase, but the outlook seems to be always turning against the Fed. As one wag commented, it is the right thing to do at the wrong time to do it.

Our position is that rates will increase, but we don't know when. We still think there is a less than 50% chance the Fed will raise rates this year. The market may have to be coddled a bit longer, but the Fed also knows it is their duty to take away the punch bowl before the party gets out of hand. We are about there.

Best,

William D. Rutherford

Rutherford Investment Management