Economic Update- Third Quarter 2015

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Economic activity during the third quarter of 2015 was a mixed bag, with good unemployment figures, growing housing, and strong auto sales. However, the equity markets reversed course in mid-August primarily due to weakening overseas economies (particularly China), continued softness of revenues for industrial and materials industries and the healthcare sector negatively affected by a reversal in biotech stocks.

The Economy

The US economy (gross domestic product-GDP) continued to grow in the second quarter rising 3.9%, which was up 0.02% from the previous estimate of 3.7%. Following a strong second quarter GDP number, third quarter growth decelerated to an increase (initial estimate) of only 1.5%. According to the US Commerce Department, a decrease in business inventories and an increase in imports was cited for the slowing of GDP growth. Personal consumption, government spending, nonresidential and residential fixed investment, and exports contributed to GDP growth. The Atlanta Federal Reserve had cut its Third Quarter GDP estimate to 0.9% from a previous estimate of 1.8 % primarily due to a “bigger-than-expected widening of the trade gap for goods in August”.

The third quarter of 2015 ended with a September unemployment rate of 5.1%. The unemployment rate remained flat from the prior month but saw a year over year decrease of 0.8%. Total nonfarm payroll employment increased by 142,000 in September but was below the year-to-date average of 198,000 per month. The participation rate declined to 62.4% in September; declining from 62.6% for the prior 3 months. The health care and information sectors experienced gains while employment in the mining industry fell.

US housing starts fell 3% to a seasonally adjusted annual rate of 1.12 million in August 2015, from a downwardly revised July number of 1.16 million but 16.6% above the August 2014 rate of 966,000. Sales of new single-family homes rose 5.7 % to a seasonally adjusted annual rate of 552,000 units in August 2015. According to the National Association of Home Builders (NAHB) Chief Economist David Crowe, “Today's report indicates the release of pent-up housing demand as the overall economy strengthens, consumer confidence grows and mortgage interest rates remain low" and "The housing market should continue to move forward at a modest but more persistent pace throughout the rest of 2015.”

Sales of existing homes reversed course in September 2015, rising 4.7% to a seasonally adjusted annual rate of 5.55 million units. This rate is 8.8% higher than last year’s rate of 5.1 million. Importantly, all four major regions experienced gains. According to the National Association Realtors (NAR), September sales rate is the “second highest pace since February 2007 (5.79 million)”.

According to the NAR, “The Pending Home Sales Index declined 2.3% to 106.8 in September from a slightly downwardly revised 109.3 in August but is still 3.0% above September 2014 (103.7). With last month's decline, the index is now at its second lowest level of the year (103.7 in January), but has still increased year–over–year for 13 straight months." The key factor affecting the decline appears to be a lack of "available listings in the lower end of the market for first–time buyers". All four major regions saw pullback in activity during the month. The September reading represents "the second lowest index reading in 2015". Also, according to Freddie Mac, the average 30-year mortgage rate for September was 3.89%. The rate experienced a 2bps decrease from the prior month and a 0.27% decrease from September a year ago.

The Consumer Confidence Index "improved moderately" to 103.0 from a reading of 101.3 in the prior month. The Conference Board noted "Consumers' more positive assessment of current conditions fueled this month's increase, and drove the Present Situation Index to an 8-year high (Sept. 2007, Index=121.2). Consumers' expectations for the short-term outlook, however, remained relatively flat, although there was a modest improvement in income expectations. Thus, while consumers view current economic conditions more favorably, they do not foresee growth accelerating in the months ahead."

In September 2015, the Federal Reserve (FED) stated that "economic activity is expanding at a moderate pace. Household spending and business fixed investment have been increasing moderately, and the housing sector has improved further; however, net exports have been soft. The labor market continued to improve, with solid job gains and declining unemployment. On balance, labor market indicators show that underutilization of labor resources has diminished since early this year. Inflation has continued to run below the Committee's longer-run objective, partly reflecting declines in energy prices and in prices of non-energy imports. Market-based measures of inflation compensation moved lower; survey-based measures of longer-term inflation expectations have remained stable." In order to support continued progress toward the FED's dual mandate of maximum employment and price stability, the FED reaffirmed its view that the current 0 to 0.25% target range for the federal funds rate remains "appropriate".

The Markets

At the end of the third quarter of 2015, the S&P 500 stood at 1920.03 down 6.44 % from the prior quarter. Both the DJIA and the NASDAQ composite under-performed the S&P with returns of (-6.98%) and (-7.04%), respectively. Of the 9 sectors represented in the S&P, the Utilities sector was the only positive performer for the quarter, up 5.39%, as measured by the SPDR sector ETFs." The three worst performing sectors were Energy (-17.86%), Materials (-16.96%) and Healthcare (-10.62%). Interestingly, the healthcare sectors reversal follows a strong 3-year performance of 20.10%, the strongest performance of any sector. The healthcare sectors negative performance was primarily related to a reversal in the biotech sector, which saw a -17.9% loss as measured by the NASDAQ Biotech Index (NBI). Less negative performance was experienced in the Consumer Staples (-0.21%), Consumer Discretionary (-2.57%) and Technology (-4.03%) sectors. The remaining sectors which showed negative performance were Financials (-6.68%) and Industrials (-7.23%).

In Fixed Income, the Barclays U.S. Aggregate Bond Index ended the third quarter up 1.23%. The yield curve steepened as U.S. Treasury yields continued to fall with the 10-year note and the 30-year bond falling by about 29 and 24 basis points respectively, ending the quarter at 2.06% and 2.87%, respectively. At the beginning of 2015, the 10-year note stood at 2.12% while the 30-year bond was 2.69%.

Inflation pressures continued to be weak in the most recent quarter, reflected in gold futures prices experiencing a loss of about 5% with a September 30 closing price of about $1,115 per ounce. Oil prices, as measured by the WTI, continued their declines through the quarter, falling more than $14.40/barrel to end the third quarter at about $45.06/barrel. The WSJ Dollar Index continued to strengthen in the third quarter rising by about 2.5% to 88.78.

The stock market has been increasingly turbulent over the past few months. All 3 major indices: Dow, S&P 500 and the NASDQ dropped between 6 and 7% for the month of August and continued declining in September but at a slower rate. In October, the markets showed continued volatility but regained some of the previous 2 months declines. We do not think that this downdraft is a sign of an imminent recession. As can be seen from the above information, the US economy remains healthy. However, the market volatility did appear to come into play as the Fed was making its decision on whether to raise interest rates.

When markets are moving lower, we need to remind ourselves that market downturns are part of investing. Making shifts to your portfolio in hopes of avoiding a loss or finding a gain rarely work long-term. The key to getting through unexpected turbulence is to understand that swings in the financial market are normal—and relatively insignificant over the long haul. In the meantime, the basics of successful investing remain the same. These include having a plan, watching expenses, staying diversified and making sure your portfolio is lined up with your risk tolerance and investment time horizon.

As a result, it is only natural that many investors are asking what to do in a falling/volatile market. The first thing is to not panic. Individual investors should rarely, if ever react in a purely emotional fashion to a dramatic short-term move in the market. According to modern portfolio theory, a well-diversified portfolio should be in a reasonable position to weather turbulent market periods. Rebalancing takes advantage of reversion to the mean. That is buying asset classes that have performed poorly relative to peers and selling out-performers. Also, by selling assets for a loss, you gain the opportunity to use that loss to offset other gains for the year on your annual taxes.

Another opportunity that should be explored as markets move lower is to revisit opportunities that were missed because the investment was overvalued. It may now be the time to rebalance the portfolio into new ideas. However, this should be done within the confines of each individual's risk tolerance and investment time horizon.

Conclusion

Economic activity during the third quarter of 2015 was a mixed bag with good unemployment figures, growing housing, and strong auto sales. However, the equity markets reversed course in mid-August primarily due to weakening overseas economies (particularly China) continued softness of revenues for Industrial and Materials industries and the Healthcare sector negatively affected by a reversal in Biotech. Although we remain bullish longer term for the markets, we expect continued volatility in the markets as investors try to determine how weak overseas economies will continue to be. Investors are also looking to see when the FED will finally begin to raise the Fed Funds rate.

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