THE PRIVATE CLIENT GROUP

WEALTH MANAGEMENT

## Economic & Market Review

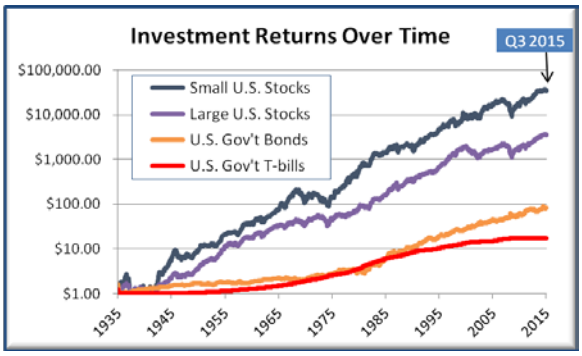
**~THIRD QUARTER 2015 NEWSLETTER~**

# Executive Summary

During the third quarter, investors experienced widespread declines across risk assets globally. Periods like these are challenging. When they happen following long stretches of relative calm, as we have had, they can be particularly unsettling. Save for a market correction in 2012, market volatility has been unusually low dating back to the aftermath of the financial crisis. Complacency can grow at these times as investors, in aggregate, lose sight of inherent market risks and the potential downside of owning risk assets (stocks, commodities, junk bonds, foreign currencies, and the like). Eventually, an exogenous catalyst of some sort upends the status quo and forces the repricing of assets. Such a phenomenon took place in the third quarter. A catastrophic decline in the Chinese stock market was the first of a steady stream of shocks that prompted a fresh look at risk and asset prices. Currency devaluations, a delay in Federal Reserve interest rate hikes, and a seemingly endless supply of negative economic reports from China and other emerging markets all added to uncertainty.

In short, the third quarter was a not-so-gentle reminder that risk is ever present, gains are not guaranteed or easy, and the potential for portfolio losses has not been eradicated — not by aggressive central banks and not through any particular form of investing: yield focused, smart beta, passive, active, low-volatility, tactical, or any other flavor of the month. When it comes to investing, there is no way to pursue gain without the potential for pain.

What should investors do now and what happens from here? We advise against reactionary portfolio management. Outside of changes in life circumstances or goals, deviation from a good plan is almost always emotionally driven and most often leads to horrible investment outcomes. Besides, a renewed appreciation for risk has led investors to demand greater returns for risks taken. That leads to either smaller losses or greater gains down the road — clearly a positive. Lastly, as shown below, over time investors have collectively priced assets sufficiently to generate appropriate returns for risks taken. That's basic human nature, and there is no reason to believe it will be any different in the future.




Data Source: Morningstar

Considering the international turmoil, it's interesting the U.S. economy has thus far hardly skipped a beat. The following pages portray a reasonably healthy domestic economy with continued growth similar to recent years. That said, it's not all positive and two particular issues should be considered and monitored going forward. First, manufacturing has weakened due to dollar strength, low energy prices, and weak global growth. Second, S&P 500 companies face their second quarter in a row of negative earnings growth. This "profit recession" is not supportive of stock market gains and likely accounts for some of the weakness in domestic equity returns in 2015.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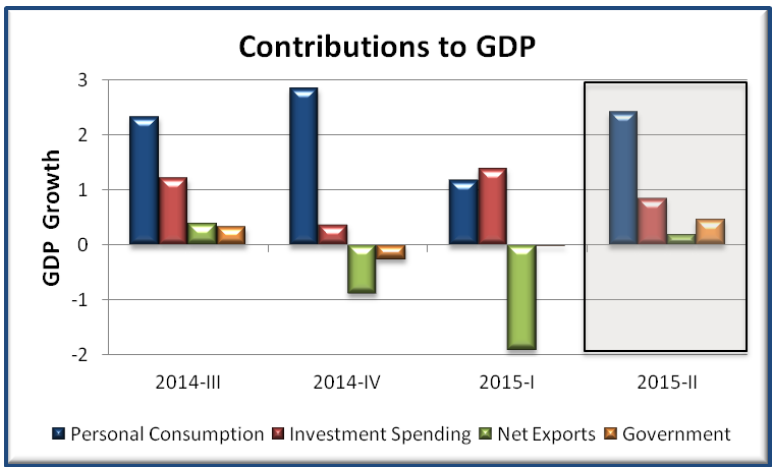
# ECONOMIC REVIEW AND OUTLOOK

## Key Economic Fundamentals

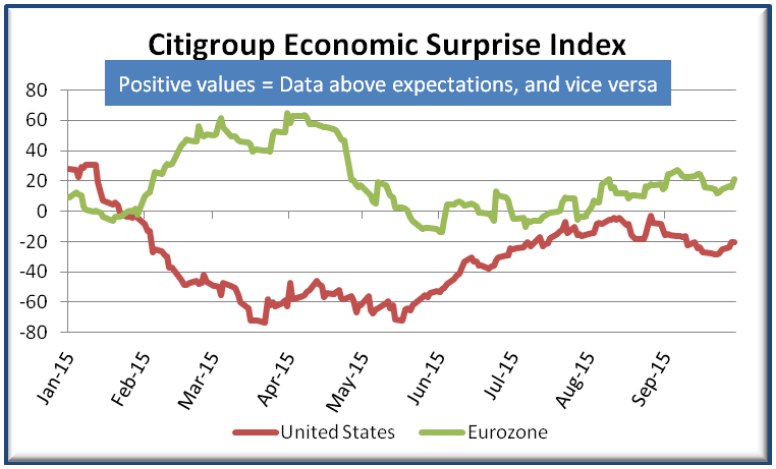

Data Source: U.S. Department of Commerce

Rebounding from tepid first quarter growth, the U.S. economy grew 3.9%, on an annualized basis, in the second quarter. Consumer spending accelerated, business investment remained healthy, and housing growth continued at a brisk pace following pockets of weakness last year.



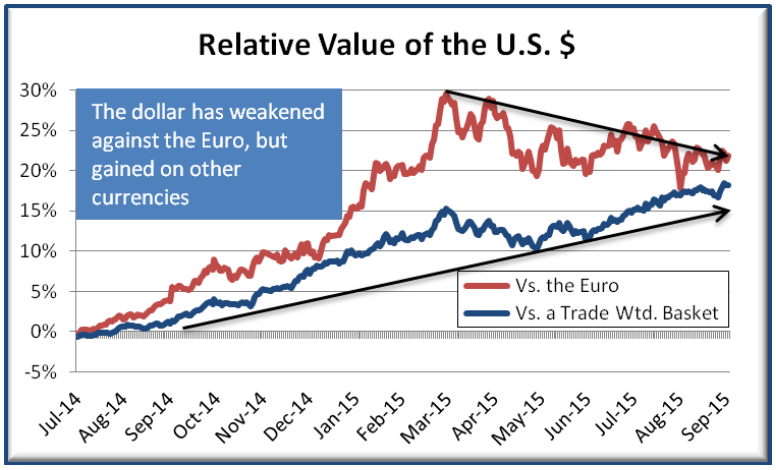

Data Source: U.S. Department of Commerce

Growth was well balanced in the second quarter, and each major category of GDP contributed positively. That said, inventory investment in the first half of 2015 was extraordinarily high. This tailwind to growth is unlikely supportable and certainly not sustainable. Growth in future periods will be negatively impacted as a result.



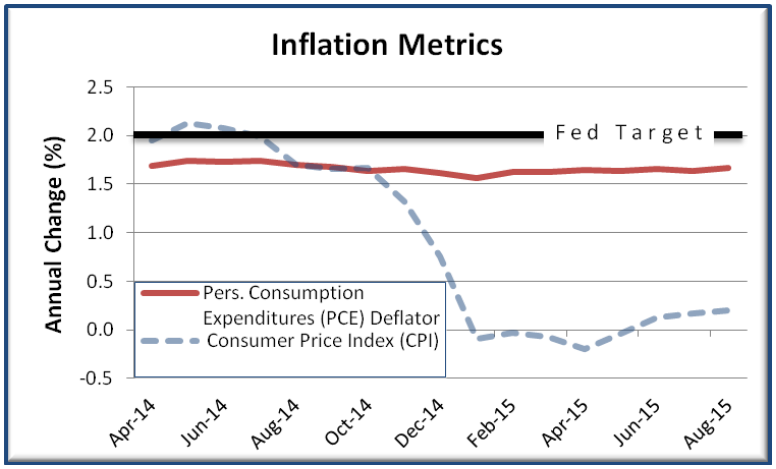

Data Source: Bloomberg

Earlier in the year, forecasters were excessively optimistic on the U.S. and inordinately negative on Europe. Expectations now appear better calibrated with outcomes. While this should stabilize investment markets, deteriorating conditions in China and other emerging economies have led to heightened volatility.




Data Source: U.S. Federal Reserve

The dollar has reversed some of its gains against the euro, but strength has continued against other currencies. Dollar strength slows the U.S. economy, suppresses domestic inflation, and hurts returns on international investments. Over half of emerging market equity declines in 2015 are due to currency.




Data Source: U.S. Department of Labor

Low inflation is a concern for the U.S. and many world economies. The Federal Reserve's preferred inflation metric, the PCE Deflator, has been below the Fed's 2% target for 41 consecutive months, and inflation expectations have dropped to levels last seen during the financial crisis. This is a key reason why the Fed has not raised rates.

## Global Growth Rates[1] (%)

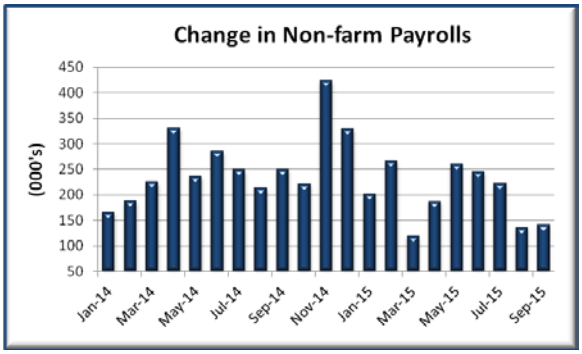
| | Q1 2015 | Q2 2015 | Q3 2015 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|
| **Advanced** | **2.0** | **2.1** | **1.9** | **1.9** | **2.0** | **2.2** |
| **Euro[2]** | 2.1 | 1.4 | 1.9 | 0.9 | 1.6 | 1.8 |
| **U.S.[2]** | 0.6 | 3.9 | 1.7 | 2.4 | 2.5 | 2.3 |
| **Japan[2]** | 4.5 | -1.2 | 0.5 | -0.1 | 0.6 | 0.8 |
| **U.K.[2]** | 3.3 | 3.0 | 3.1 | 3.0 | 2.7 | 3.0 |
| **Canada[2]** | 0.5 | 1.1 | 2.1 | 2.4 | 1.6 | 2.1 |
| **Emerging** | **4.7** | **4.4** | **4.4** | **5.1** | **4.2** | **5.1** |
| **China** | 7.0 | 7.0 | 6.8 | 7.3 | 6.8 | 6.4 |
| **India** | 7.5 | 7.0 | 7.6 | 7.1 | 7.5 | 7.9 |
| **Russia** | -2.2 | -4.2 | -5.0 | 0.6 | -3.3 | 1.0 |
| **Brazil** | -1.6 | -2.6 | -3.3 | 0.1 | -2.6 | -0.4 |
| **World** | **3.3** | **3.2** | **3.1** | **3.4** | **3.2** | **3.6** |

Data Source: Goldman Sachs, Central Intelligence Agency
[1]Q1 & Q2 2015 and 2014 are actual, all others are forecasts
[2]Quarterly numbers are sequential annualized, others are year-over-year

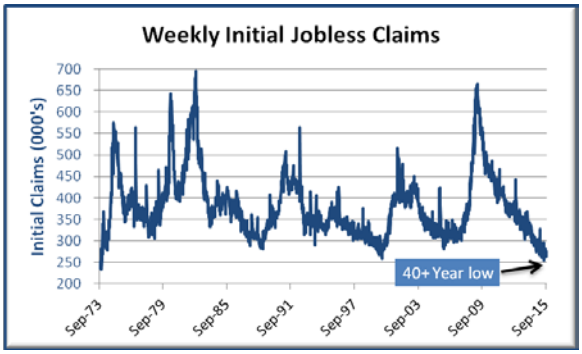
Worldwide growth, once expected to accelerate in 2015, is now forecast to be below that of 2014. Led by a steady decline in emerging market growth since 2010, global expansion has essentially flat-lined at 3.2% since 2012.

## Employment

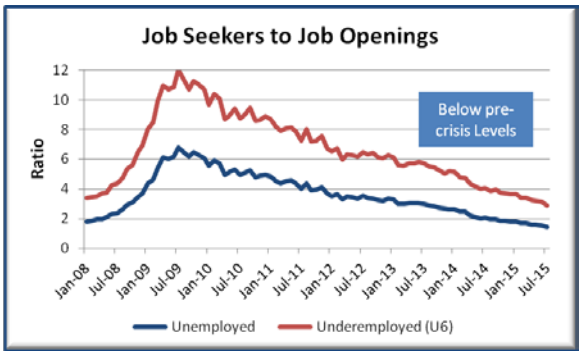
Despite slower payroll growth in recent months, the labor market continues to improve. Jobless claims hit a 40 year low, and the ratio of job seekers to positions available is below levels immediately preceding the financial crisis. Moreover, the unemployment rate, now at 5.1% and expected to decline further, has arrived at a level viewed by the Fed as full employment. Although vestiges of the financial crisis remain, labor market normalcy is being restored. Most particularly, underemployment has fallen to within historical bands, albeit at the top end of the range. A 38 year low in the labor force participation rate is still of concern, as is continued weak growth in wages. These points of consternation are both expected to improve as labor markets continue to firm.



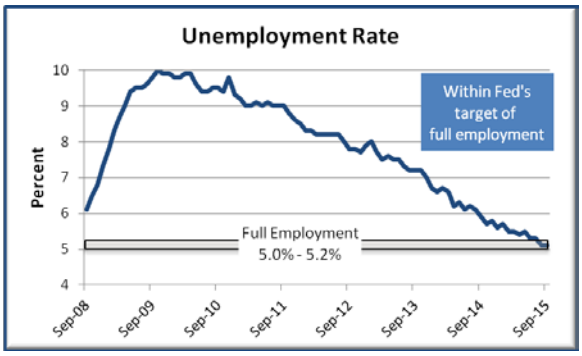

Data Source: U.S. Department of Labor



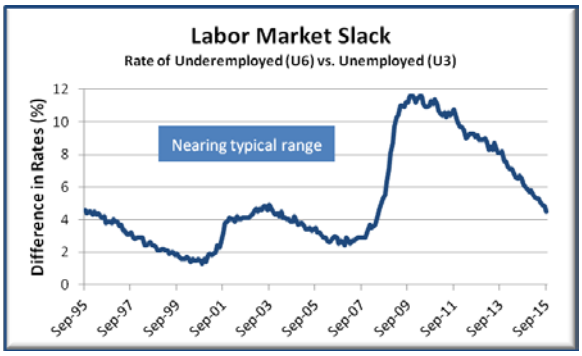

Data Source: U.S. Department of Labor



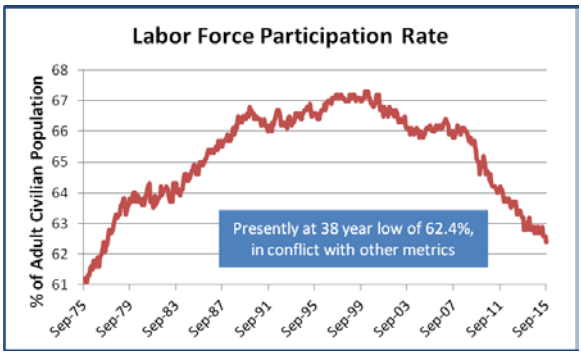

Data Source: U.S. Department of Labor




Data Source: U.S. Department of Labor



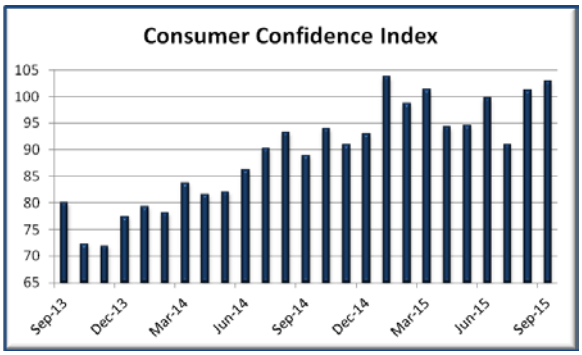

Data Source: U.S. Department of Labor



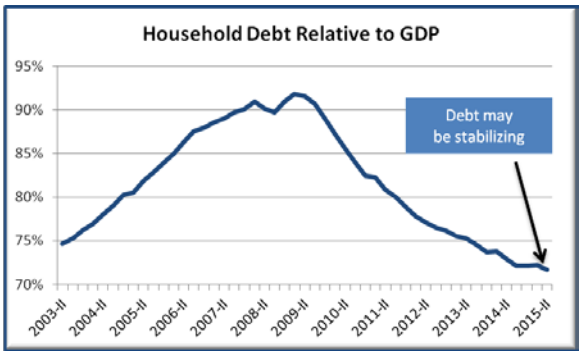

Data Source: U.S. Department of Labor

## Consumer

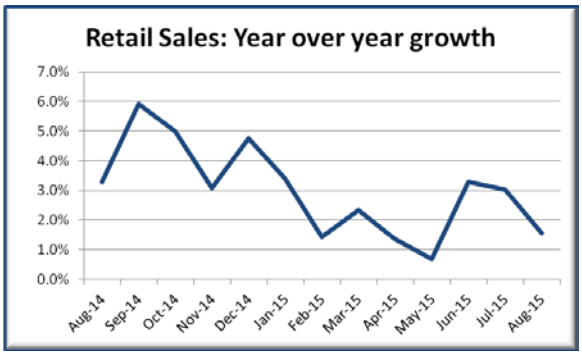
The U.S. consumer is in good shape, and the consumer confidence index suggests as much. Household balance sheets have improved, the economy is back to full employment, consumer spending accelerated in the second quarter over the first, and retail sales continue to grow, albeit at a diminished pace. Dollar strength improves the global purchasing power of U.S. consumers and puts a damper on inflation. Both help to compensate for tepid wage gains discussed earlier. A renewed decline in gasoline prices is beneficial as well. The decline in the national average gasoline price, presently down 36% to $2.32 per gallon, is estimated to save the average household $750 this year.



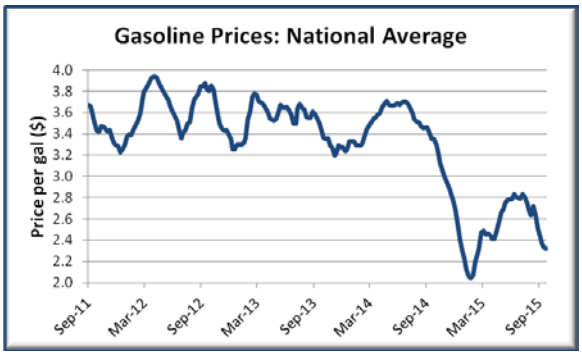

Data Source: The Conference Board




Data Sources: U.S. Bureau of Econ. Analysis/U.S. Federal Reserve



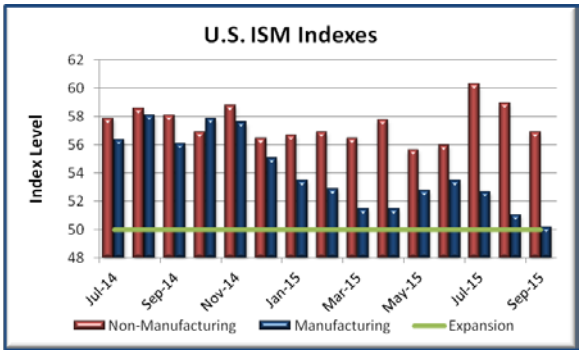

Data Source: U.S. Census Bureau



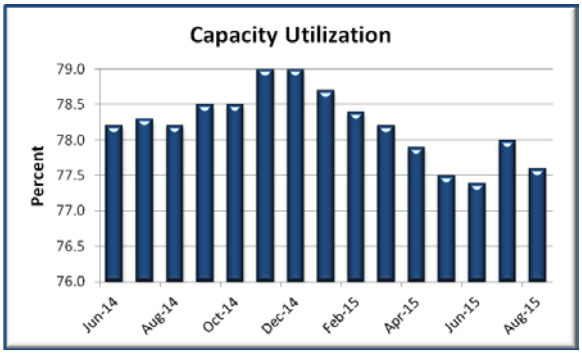

Data Source: U.S. Energy Information Administration

## Business Activity

As shown by graphs on the following page, the manufacturing sector continues to display weakness. The Institute for Supply Management's Manufacturing Index is only marginally above the line of expansion. New orders, production, and employment sub-indexes have deteriorated and export orders and backlogs each point to contraction. Key culprits are dollar strength, which weighs on exports, and oil price weakness, which has decimated capital investment in the energy industry. If anything, the Federal Reserve's gauge of capacity utilization tells an even more ominous story. The drop depicted, in both duration and magnitude, is nearly unprecedented in the absence of an outright recession. It is no doubt the weakness evidenced by these graphs was a contributing factor behind the Federal Reserve's decision to hold off on raising interest rates.



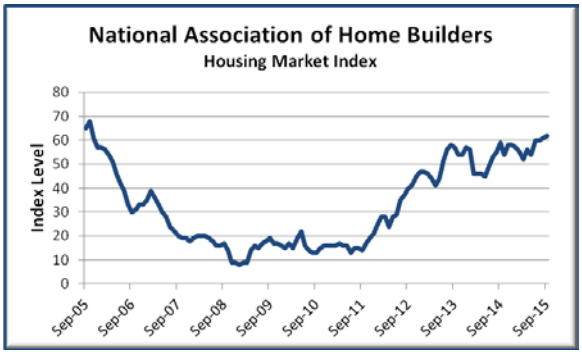

Data Source: Institute for Supply Management



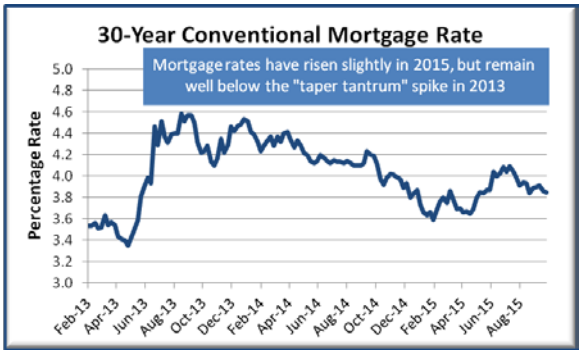

Data Source: U.S. Federal Reserve

## Real Estate

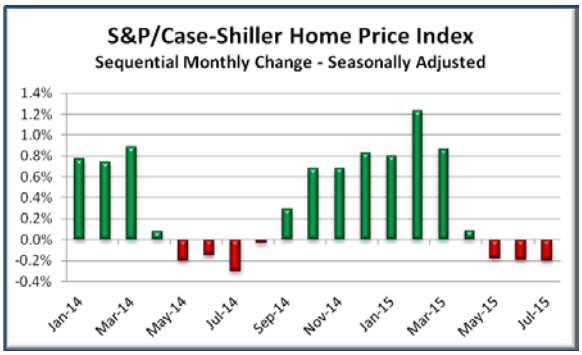
By many metrics, the housing market continues to improve and underlying economics are favorable. Residential real estate has been a positive contributor to GDP growth, activity levels are strong, and the National Association of Home Builder's Housing Market Index is at a new post-crisis high. Weak energy prices, an increase in employment, and a rise in household formation rates are equally favorable — as are continued attractive mortgage rates. Worth noting, however, are the following facts. Periods of pricing weakness, illustrated in the bottom two graphs, seem to be occurring with greater frequency. Likewise, price gains in many markets have outpaced wage gains, a self-defeating phenomenon whereby buyers get priced out of the market. It seems the steady 4 - 5% (or more) annual housing price gains in recent years are likely to diminish.



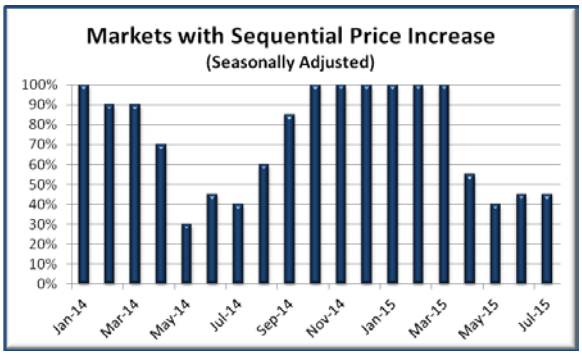

Data Source: National Association of Home Builders




Data Source: U.S. Federal Reserve




Data Source: S&P/Case-Shiller




Data Source: S&P/Case-Shiller

# CAPITAL MARKETS REVIEW

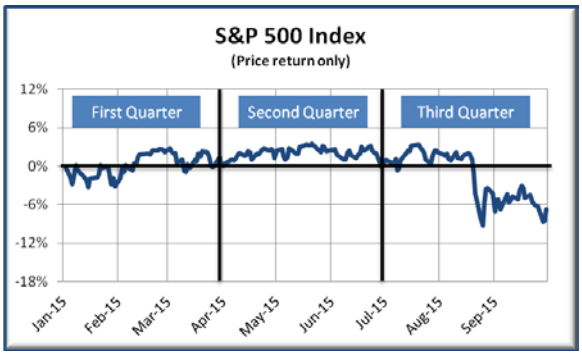
## Returns

| | 3rd Qtr 2015 | YTD 2015 |
|---|---|---|
| **Cash and Fixed Income** | | |
| U.S. Treasury Bills | 0.0% | 0.0% |
| Barclays Aggregate Bond | 1.2% | 1.1% |
| Barclays Municipal Bond | 1.7% | 1.8% |
| Barclays Gbl Agg. ex. U.S. | 0.6% | -4.8% |
| **Hedge Funds and Alts.** | | |
| Bloomberg Commodity | -14.5% | -15.8% |
| DJ US Real Estate | 0.5% | -4.8% |
| HFRI FOF Composite | -1.5% | -0.7% |

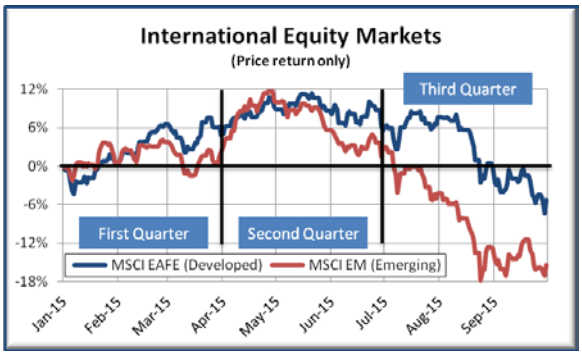
Data Sources: Morningstar & Hedge Fund Research, Inc.

| | 3rd Qtr 2015 | YTD 2015 |
|---|---|---|
| **Domestic Equities** | | |
| Wilshire 5000 | -6.9% | -5.4% |
| S&P 500 | -6.4% | -5.3% |
| Russell 2000 | -11.9% | -7.7% |
| **International Equities** | | |
| MSCI ACWI ex. U.S. | -11.9% | -7.8% |
| MSCI EAFE (Developed) | -10.2% | -5.3% |
| MSCI EM (Emerging) | -17.9% | -15.5% |

## Equity Markets

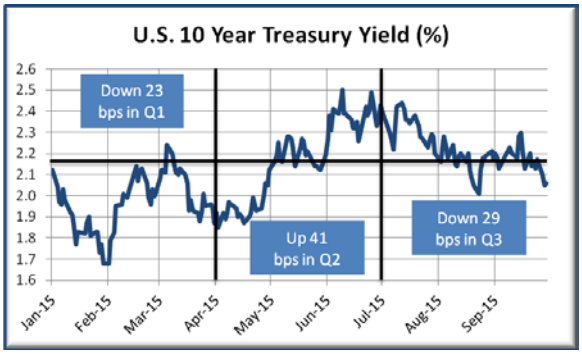



Data Source: S&P Dow Jones Indices LLC

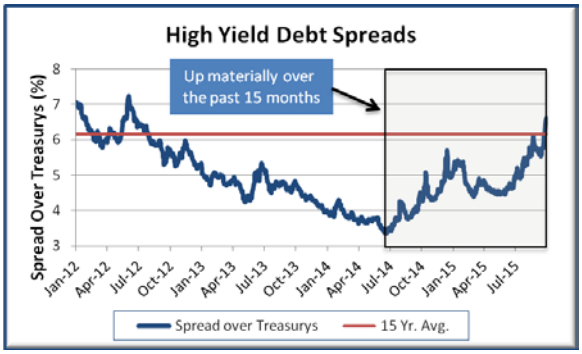



Data Source: Morningstar

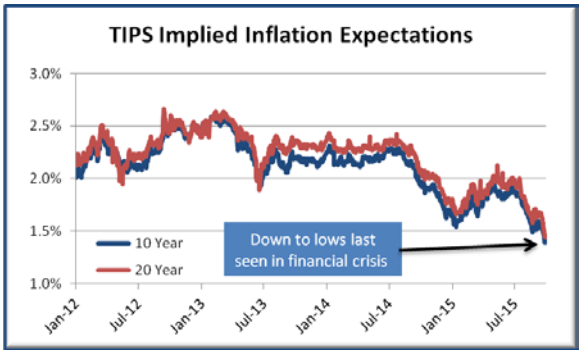
## Fixed Income Markets




Data Source: U.S. Department of the Treasury




Data Source: BofA Merrill Lynch

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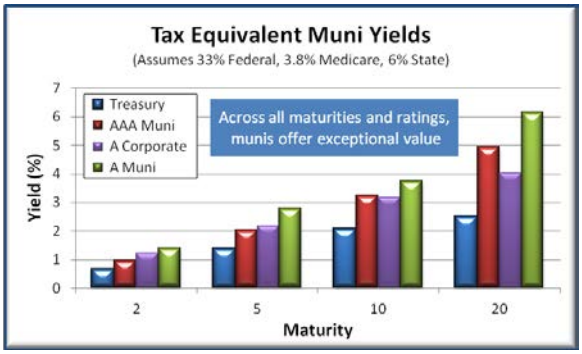
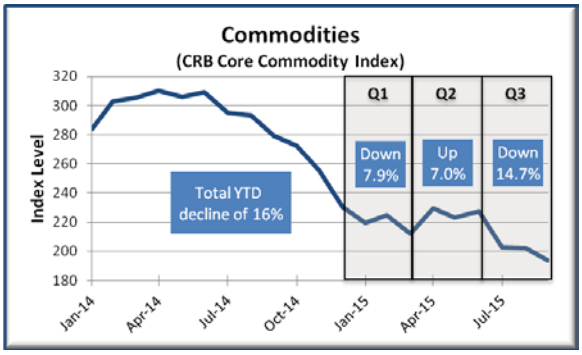
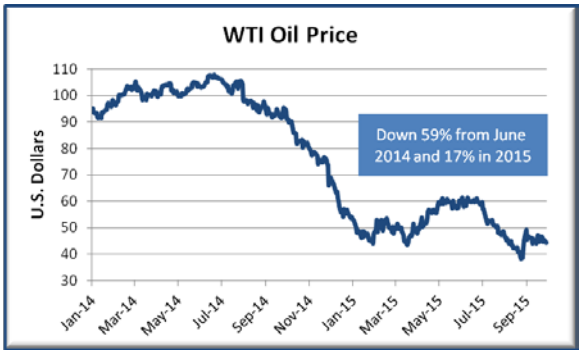



Data Sources: U.S. Department of the Treasury/BondsOnline.com

# Alternatives




Data Source: Thomson Reuters




Data Source: US. Energy Information Administration

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