If we are the product of our decisions, then uncertainty and fear of the unknown lay at the crossroads of each of our lives. How we choose to address them will define the quality of our decisions and the quality of our lives.

The financial markets are prognosticators of uncertain future economic events. They attempt to synthesize current events and expected future events to determine a reasonable price to pay for assets today. When our perception of what is known is challenged, uncertainty creates confusion and fear. This often elicits heightened emotions and volatile actions result.

The financial markets being a collection of human decisions and behavior are no different. The market’s natural reaction to uncertainty is to become more anxious. News creates a heightened sense of emotions and these emotions lead to more frequent actions. The increased actions; i.e. more buying and selling, creates wider price swings or volatility.

Because the markets are nothing more than our collective consciousness trying to determine future events, it comes as no surprise that there should be a fair amount of uncertainty and fear prevalent in the markets. With questions surrounding the Chinese devaluation of their currency, uncertainty of a Federal Reserve interest rate hike, the fallout of a declining commodity complex and the economic weakness in emerging market economies fear of a slowing global economy created a wave of selling we haven’t experienced for a while.

Equity indices across the board experienced sharp declines during the 2015 third quarter. It was a ‘risk-off’ market decline as the natural resources (-19.20%), emerging markets (-13.87%) and small cap stocks (-11.92%) declined most. The US major bell-weather indices the S&P 500 and the DJIA were down -6.44% and -6.98%, respectively. International stocks as represented by the MSCI EAFE index were down -10.23% for the quarter.

August 24th was the standout day for price swings in the quarter. The S&P 500 experienced a 5.27% intraday move in prices that day. To put it in perspective, it was only the seventh widest daily change in prices since the beginning of this current bull starting on March 9, 2009. (InvesTech Research September 18, 2015 p.5) Yet, watching the Dow ricochet back and forth 1,000 points in a day is enough to fray the nerve endings of most investors.

With the value of hindsight, we have learned that some of the volatility in this past quarter was exaggerated by programmed computerized trading and the presence of some esoteric securities. Computer program trading has increased the speed and volume of transactions in the markets. Some new products were created to provide additional liquidity over that of traditional mutual funds which can only be bought or sold based on the day’s closing price.

However, when the algorithms of many similarly designed systems give the same sell signal and there is a lack of liquidity (i.e. a lot more sellers than buyers) in certain securities prices will fall precipitously. There are examples of some packaged securities which fell 40% in a half hour of trading during the day when underlying securities in the products and the overall market were down only 5%.

We mention this for two reasons. One is that programmed trading is here to stay and there will be days when it will increase volatility in the markets. You must have an understanding of this characteristic of the markets to see through some of the short-term trading events. In the long run prices will find their rational levels. In the short run, irrationality and computerized trading can cause significant price irregularities.

Second, financial institutions have created a vast array of securities for investors to participate in the financial markets. Many are complex and require thorough study before investing. You must understand what assets you own, the tax implications, the liquidity issues, pricing issues, leverage involved, etc. This recent round of volatility put a spotlight on some. The rout in the commodity complex over the past 18 months has shed light on energy related securities and their inherent and unique risks. Understanding the investments you own (and your investment process) does facilitate better investor behavior and ultimately wiser choices.

A great deal of the focus in the quarter was on China, the emerging markets and the energy/natural resource complex. China’s demand for infrastructure build out is slowing. There appears to be a great deal of over-investment in the Chinese economy. For example, it has been estimated that China poured more concrete between 2010 and 2013 than the US did in the entire 20th century! Even if this statistic is as hard to validate as most information out of China, the scope of China’s economic might on the global economy is indisputable.

If the Chinese economy is approximately $10 trillion in GDP (the US is $17 trillion) and its growth rate is 7%, it will contribute an additional $700 billion to the global GDP in 2015. This additional contribution alone is approximately equal to the entire GDP of countries such as Saudi Arabia and Switzerland!
‘Build it and they will come’ is not an over-night process. This Chinese capital investment needs to be soaked up by an increasing future demand of its good and services; i.e. consumption. This is created by promoting capitalism and the growth of a middle class (urbanization).

As a frame of reference, the US in 1920 had a 50% urbanization rate and a real GDP per capita of $6,900. By 2010 the US had grown to 81% urbanization and per capita income of $49,000. Today China’s per capita income is estimated at $6,800 and their rate of urbanization is approximately 50%. They are by comparison equivalent to the US in 1920!

Considering how much faster the world moves today, it probably will not take China the 90 years it took the US to reach a mature middle class. The scope of this on the world’s economic landscape will be significant, at times both good and bad, for years to come. (The Real Story on China 3/2015 Oppenheimer Funds)

The most significant effect of China’s slowing growth prospects has been felt in the emerging markets. Many emerging market county economies are not as diverse as more developed economies and they are natural resource dependent. Consequently, the concentration of economic activity in one or few sectors can have a broader and deeper effect on these countries GDP and investment. China’s reduced demand for natural resources and weakness in the oil sector has created economic weakness in the emerging markets.

We have often said that one of the truly remarkable economic phenomena’s of our time is the addition of 2 billion people to the global middle class! Evidence of this has been the increase in capital investment from developed nations to the emerging economies. Capital flows from developed to developing nations increased approximately 400% from $240bn in 2002 to $1.1tr in 2014! (Financial Times, ‘The Big Read’ 10/10/2015)

And equally, if not more important, is the increase in foreign currency borrowing by the developing nations private sector from $1.7tr in 2008 to $4.3tr in 2015. This additional debt on the world’s stage should be monitored with a careful eye. History does reveal clues. And history has shown financial markets can ‘throw the baby out with the bathwater’ and present investment values with significant return prospects.

Emerging market and natural resource investment returns have suffered the most with this market correction. Though the returns are unfavorable the value of these securities are becoming more and more attractive. Please review ‘Looking into the Crystal Ball’ for more on our thoughts and strategies on these asset classes.
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The S&P 500 is an unmanaged index of 500 widely held stocks. The MSCI Emerging Markets Index is designed to measure equity market performance in global emerging markets. The Russell 2000 index is an unmanaged index of small cap securities which generally involve greater risks. Barclays Capital U.S. Aggregate Bond Index is made up of the Barclays Capital U.S. Government / Corporate Bond Index, Mortgage-Backed Securities Index, and Asset-Based Securities Index, including securities that are of investment grade quality or better, have at least one year to maturity, and have an outstanding par value of at least $100 million. The MSCI EAFE (Europe, Australia, and Far East) index is an unmanaged index that is generally considered representative of the international stock market. These international securities involve additional risks such as currency fluctuations, differing financial accounting standards, and possible political and economic instability. The Dow Jones-UBS Commodity Index aims to provide broadly diversified representation of commodity markets as an asset class. It is not possible to invest directly in an index. The Vanguard REIT Index is a real estate investment trust fund that offers investors wide exposure in the real estate sector at a low price. The fund holds each of its stocks in approximately the same proportion as the weighting in the MSCI US REIT Index. It is not possible to invest directly in an index.

The NASDAQ Composite Index is an unmanaged index of all stocks traded on the NASDAQ over-the-counter market. The Dow Jones Industrial Average is an unmanaged index of 30 widely held securities. The value of fixed income securities fluctuates and investors may receive more or less than their original investments if sold prior to maturity. Bonds are subject to price change and availability.

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