Polaris Greystone FINANCIAL GROUP, LLC

Polaris Greystone Educational Series

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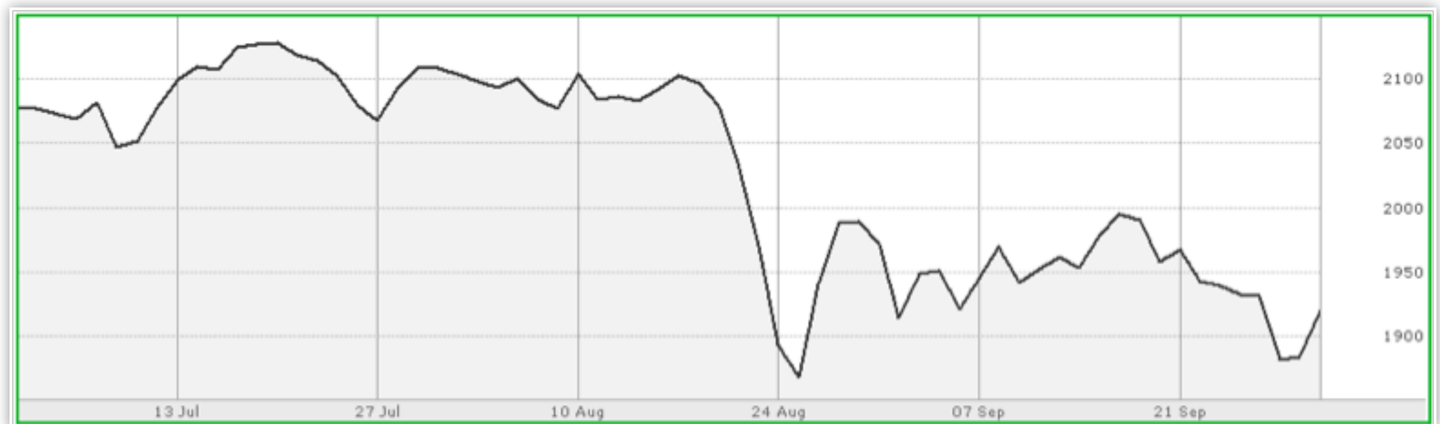
Third Quarter 2015 Review

After almost four years, the S&P 500 finally experienced a drop of over 10%, falling 12.4% from the high (5/21) to the low (8/25). For the quarter, the S&P 500 lost 6.94% of its value. As bad as this sounds, U.S. large-cap companies were some of the best performing areas to invest in during the third quarter carnage. In other words, the S&P 500 lost less than mid-cap and small-cap domestic stocks and lost less than its international peers.

S&P 500 Index



Here are some highlights and interesting facts for the third quarter in the markets:

- The S&P 500 loss dragged it into negative territory for the year, down 6.75% for the year.
- All nine Russell Index style box categories (a grid of large, mid, and small; and value, blend, and growth) lost value in the 3rd quarter and all are negative for the year.
- Growth stocks have outperformed value stocks in each of the size categories for the year. Large-cap has outperformed small-cap stocks in each style category. In other words, growth has lost less than value and large-cap has lost less than small-cap stocks for the year.
- Utilities were the only sector up in the S&P 500, gaining 4.40% for the quarter. The next best sectors were consumer staples and consumer discretionary, down 0.89% and 2.94% respectively.
- The worst performing sectors were health care, materials, and energy. They were down 11.05%, 17.34%, and 18.10% respectively.
- The dollar continued to show strength, increasing in value by 0.73% for the quarter, up 6.60% for the year.
- International markets faired far worse than U.S. markets. The EAFE (Europe, Australia, Far East) Index was down 8.98%. Emerging markets were down 12.10% for the quarter.
- All 46 countries in the MSCI All Country World Index lost ground in the third quarter; down 8.64% for the quarter.
- For the quarter (in local currency), Europe ex-UK was down 7.33%, United Kingdom was down 7.52%, Pacific Rim ex-Japan was down 11.92%, Japan was down 14.26%, Emerging Europe was down 11.92%, Emerging Asia was down 14.16%, and Latin America was down 11.30%.
- The Chinese equity benchmarks have been cut in half from their highs in May, down 23.21% for the quarter.
- The S&P GSCI commodity index has hit six-year lows, dropping 8.46% for the quarter.
- Bonds outperformed stocks. The Barclays Capital Long-Term Treasury Total Return index was up 5.08% and the Barclays Aggregate Bond Index was up 1.23% for the quarter.

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Why Did This Happen Now?

We were overdue – As we've discussed in several of our previous educational e-mails, the markets will drop 5% or more four times in any given year, or about once a quarter. On average, the markets fall 10% once a year. And every 2 ½ years, the markets fall 20%. This is just how the markets work. The S&P 500 dropping 12.4% is simply normal. The fact that the S&P 500 hadn't seen a 10% correction in almost four years is unusual.

The correction we had was driven by fear. The S&P 500 was slightly overvalued when looking at many 25 year statistical averages. The fundamentals remain intact, even with a weaker than expected earnings season. Our economy is on fundamentally solid ground.

Fear of Chinese economy –

The third quarter was riddled with headlines about the Chinese markets and economy. We highlighted the risks in our July educational e-mail, before the media shifted their spotlight from the Greek debt crisis to China. Please feel free to go to www.polariswealth.net and click on the Educational Series tab to review what we said at the time.

The Chinese economy is the second largest economy in the world. They are the largest exporter in the world and the second largest importer. A slow down there (as they've been experiencing) can certainly have a global ripple effect. According to the IMF, 43 countries consider China their number one export partner. According the U.S. Census Bureau, China is our third largest export partner but represents less than 8% of our total exports.

The Chinese government has been very aggressive in an attempt to stabilize their economy, pouring trillions of yuan into it. According to China's statistics bureau, their gross domestic product grew by 6.9% in the third quarter of 2015. This is down slightly from last quarter, when they reported 7.0% GDP growth, and down from the 7.3% GDP growth they reported during third quarter of 2014.

Fear of U.S. Reserve raising rates –

Any move by the Federal Reserve would put an end to our current zero interest rate policy, also known as ZIRP. This is a double edged sword. The Federal Reserve will only begin raising rates when they feel the economy is on strong enough ground that their moves will not have a negative impact on the economy's growth. That said, there is no guarantee that the Fed's actions won't have a negative impact on the economy, corporate earnings, or the stock market.

In days past, the Federal Reserve has been very secretive about what their plans were for rates. Do you remember when Alan Greenspan was the Fed Chairman? The media would guess at his actions based upon how thick his briefcase was or which hand he was holding his briefcase. But in recent times, Janet Yellen has given us the Federal Reserve playbook. The Federal Reserve estimates that the fed funds rate will be 1.26% by the end of next year, 2.8% by the end of 2018, and 3.34% at the end of 2020.

Historically, when the Federal Reserve has moved rates up slowly and predictably there has been little negative impact on the stock market (see April's educational e-mail). But a rising interest rate environment hasn't been as kind to bond investors. This is why we've encouraged all of our clients to rethink their definition of risk (please see February's educational e-mail).

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Where Do Things Go From Here?

I think there is little doubt that the Federal Reserve will begin raising rates soon. It will either begin in December (their next meeting) or in early 2016. The markets may have a "knee jerk reaction" but they should recover quickly. Many believe (myself included) that the markets have already priced in the first couple of moves. The markets should continue their upward movement as long as the Federal Reserve slowly raises rates, continues to clearly state their future plans, and backs their decisions with well-defined economic proof that their actions aren't harming corporate earnings or the economy.

All of Polaris Greystone's proprietary strategies are managed in a dynamic and tactical manner. Our investment ideology is based on understanding the risk we believe is found in the markets. **We assess this risk by applying our proprietary four pillars of investing: technical analysis, macro-economic analysis, fundamental analysis, and sentiment analysis.** If we assess high risk, we will lower our exposure to the stock market in all of our strategies and favor bonds or cash. If risk is low, we will take from our bond or cash holdings to overweight equities.

We are currently at a market weight for all of our strategies with extra cash (instead of bonds) poised to invest in the equity markets. Our current feeling is that we may soon overweigh our equity holdings. Please keep in mind that this may be a short lived investment, as our belief is that we are in a "traders" market, not an "investors" market. This will require us to be more active in your portfolio in an attempt to provide you the best return we can harvest based upon the current market environment.

I hope this helps you further understand the dedication and vigilance we take in the management of your portfolio. Your Polaris Greystone wealth manager will be happy to review all of our strategies with you to ensure you are invested appropriately. If you have further questions, please feel free to call or write me.

As always, I welcome your comments and questions.

Sincerely,

Jeffrey J. Powell
Managing Partner

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