3rd Quarter 2015 in Review

By Darren Nyce, CFA
Senior Research Analyst, Castle Investment Advisors, LLC

My son and I attend a couple of local minor league baseball games every year, but no future trip to the ballpark is likely to be as memorable as the time a few years ago when my 6 year old son walked away from the game with a bottle of ketchup, 3 baseballs, a baseball bat, and a knot on the head. While space constrains me from including all of the details, among the highlights are receiving a ball from an usher before the game, catching a foul ball hit in our section, me making a between-innings trip to the concession stand to get some nachos only to return to find my son had been hit on the head with an errant warm up toss by an outfielder who later in the game brought him a brand new bat as an apologetic gesture. I had just finished telling a friend of mine the full version of this story, which I thought was a glorious father-son adventure involving sports, danger, excitement, and a happy ending. My friend responded that yes indeed that was a great story, but he had already heard that story except with a different twist. You see, my wife had previously relayed her perceptions of the incident to his wife and so he continued, “The story I heard was that you went to a baseball game and your son got hit in the head because you left him alone to go get nachos.” Same event, different perspectives.

The investing environment has been a lot like that recently. Remarkably different stories can be told based on your perspective. When looking at the past quarter, a grim story of despair can be told as stocks are down significantly. When looking at the past 6 years, the story is much happier as stocks are up substantially (184%) over that time. If you expand the time horizon a little bit more and go back 8 years, the story is that the market is up a little (23%). Same event, different perspectives.
While it is human nature to become a bit anxious in the midst of negative returns, our job as financial advisors is to encourage our clients to maintain their focus on the larger narrative. Corrections like this are part of the long term nature of investing and are certainly not at all rare. The following chart shows that since 1960 a 5% correction happens in almost 95% of the calendar years, while more than half of the years see a 10% correction.

The next question becomes, is this run-of-the-mill correction just the beginning of a full-fledged bear market (typically defined as a market being down 20% from its high)? Making short term market predictions is rife with folly and generally to be avoided. So we won’t attempt to answer that question directly, but we are keeping watch over things that have been present in the economic landscape when these bears have shown up in the past. As you can notice in the following chart, bear markets typically occur in the context of certain conditions such as recessions, aggressive interest rate hikes, and spikes in oil prices – none of which is present currently.

While the present data doesn’t portend that the U.S. is on the brink of recession, there are a couple areas of concern that we are currently monitoring (see charts on next page).
The first is that the economic slowdown in China accelerates into what pundits term a “hard landing.” China has become a significant trading partner for many countries and a major decline there would send unwelcome ripples throughout the world. It appears that the Chinese leadership maintains several tools at their disposal to prevent disaster, but yet some risks remain.

The second is concern over the decline in earnings that we are seeing in many U.S. companies. As you can see in the following chart on the left, the aggregate earnings from S&P 500 companies have been falling for the past few quarters and is projected to do so again as the Q3 numbers start getting reported. The story that the charts on the right tell is that there are 2 major reasons for this decline – the rise in the value of the dollar and the decline in the energy sector.
With almost half of S&P 500 revenues coming from non-U.S. sources, the rise in the dollar has taken a bite out of these companies’ earnings. Simultaneously, the energy sector typically contributes significantly to the earnings picture, and with the drop in oil prices in the past year, this sector has been a detractor rather than a contributor. The good news is that the portion of the economy not related to these two areas is actually doing quite well and should be able to withstand these temporary issues.

The positive impact of lower gas prices should continue to help increase consumer demand. The overall labor market continues to improve despite the fact that the labor force growth has been slowing. These factors should continue to support GDP growth for the rest of the year, though lower growth than the strong numbers that came out for Q2 should be expected.

We will bring this quarter’s chart-heavy letter to a close with one final chart that describes typical investors’ emotional responses at various points of the market cycle.

Our advice is to be aware of these sentimental reactions in yourself and do not let them be the sole decision makers when it comes to your investments. Do not let the short term event dominate the long term narrative. Remember that markets have cycles and sticking to the designed plan is a better strategy than changing course with every storm.

Our clients will find included in this month’s letter the annual reminder of Castle’s privacy policy. We will only share your information with a third party, such as an accountant, if you expressly request us to do so. This would be a good time to make sure any such permission authorization and contact information is up to date.

Thanks for reading. Have a terrific fall.

Sincerely,

The Castle Investment Advisors, LLC Investment Team

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