The AUTUS Review

(Third Quarter, 2015)

The Economy

It's been a long time coming, but a cyclical market correction is finally here. China got the ball rolling in August with a harsh market decline in Shanghai, followed by a currency devaluation that called into question the health of their economy. News that the world's second largest economy could be slowing put further pressure on the already beaten up energy and commodity sectors.

While lower commodity prices are a net positive for most of the world, they have a disproportionately negative impact on some. Specifically, companies selling commodities and developed and emerging countries whose economies rely heavily on exporting natural resources are under pressure. Unfortunately, many of the players in this industry are heavily leveraged, which has heightened risks in the global high-yield debt markets.

Adding to the drama, investors face growing geopolitical tensions in the Middle-East and Eastern Europe. Indecision concerning domestic monetary policy, combined with fiscal budget wrangling and a growing scandal at one of the largest global auto manufacturers, only add to investors' angst. Mounting uncertainty at a time of stretched valuations is a timeless recipe for market corrections, but not necessarily for recessions.

If we take a step back and analyze the current situation, we realize that very little has changed significantly during the last few months. In fact, domestic GDP was revised up to 3.9% for the second quarter, unemployment remains near a 7-year low at 5.1% and both wage and core inflation have stayed below the Fed's targets.

True, China's economy does appear to be slowing, but for good reason. China is in the middle of a healthy and natural transition from an export-driven industrial focused economy to a more stable consumer-driven one that should create sustainable growth over the long-term. As for energy prices, they are actually trading higher than the lows set back in late August and the benefits of lower commodity prices will eventually overwhelm the limited negative economic impact.

While frustrating, cyclical corrections and market dislocations are natural consequences of extended periods of easy monetary policy and stretched valuations. However, they do not automatically lead to economic downturns. In fact, more often than not, opportunity is uncovered for investors who are disciplined and well positioned to take advantage of the increased volatility and overreactions that regularly seem to occur.

The Capital Markets

The third quarter turned out to be one of the most volatile periods we've seen in years. Global equity markets fell as investors struggled to comprehend what impact a slowing Chinese economy would have on the rest of the world. The S&P 500 index fell more than 12% during August, but finished the quarter down 6.5%.

Commodity prices remained under pressure as global supply continued to outpace demand. Investors are concerned that the longer this imbalance persists, the more likely we will experience some type of disruption in the high-yield or emerging international markets.

This cyclical correction has been broad based and affected nearly every economic sector. Companies with stretched valuations and highly leveraged balance sheets were hit hardest, but few areas have been spared. High-quality names with strong fundamentals and good cash flow have held up relatively well when compared to the broad market.

Global market volatility has stayed the Fed's hand for now, but a rate hike before year-end remains on the table. Interest rates declined during the quarter as investors realized a rate hike was not imminent and shifted assets to bonds for safety.

Portfolio Implications

Equity

Market corrections have a way of clarifying risk tolerance. Fortunately, our focus on high-quality holdings has helped portfolios hold up relatively well during this period of increased volatility. Going forward, we will be looking for great companies that have been excessively punished and present attractive valuation opportunities.

Fixed Income

The Fed remains committed to normalizing monetary policy by raising rates as soon as the data permits. We feel it's important to maintain relatively short average portfolio durations and focus on high-quality holdings to limit portfolio risk.

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