



RDM CAPITAL ASSOCIATES

WEALTH MANAGEMENT

2015 THIRD QUARTER MARKET COMMENTARY *October 2015*

EXECUTIVE SUMMARY

In the Third Quarter, equity markets took a major step backwards with the worst quarterly returns in four years. Despite a difficult Third Quarter, RDM Capital's composite of equity-oriented client portfolios has outperformed our most comparable benchmark, the Russell 1000 Value Index, for the year. This outperformance was due in part to an especially strong Second Quarter, for which Lipper ranked RDM's composite 20 out of 239 large-cap value-oriented composites surveyed. (See the performance chart at the end of this commentary for a full presentation of historical annual and quarterly performance.) In a year when investors are willing to overpay for speculative growth stocks, value-oriented stocks have been under-appreciated, with the Russell 1000 Value Index trailing the Dow, S&P 500 and Russell Growth Index. Nevertheless, value-oriented equity strategies like ours have typically outperformed over time and we have confidence that will continue as markets rebound from their current lows.

While most bull markets experience the occasional correction, equity markets grew mostly unabated over the past four years, with the exception of several smaller 5% pullbacks. Typical bull markets have approximately three 5% pullbacks each year, with larger 10% corrections occurring approximately every two years. The primary causes of the current 10% correction in the Third Quarter are three-fold: (1) weakening growth projections, especially in China and emerging markets, (2) significant commodity deflation, partially due to China economic deceleration, and (3) market uncertainty over the timing of the Federal Reserve's initial interest rate hike off of its current near-zero rate policy. However, none of these concerns are new.

With respect to China, our view is that the economic slowdown there will be a moderate drag on U.S. growth, due primarily to the impact of a stronger U.S. dollar on exports, but the market's fixation on the Chinese economy is overdone. As China is still primarily an export-driven economy, its direct influence on U.S. corporate earnings is limited. By one recent estimate, U.S. corporate earnings have only 1-2% direct exposure to China. Some fear that a "hard landing" of the Chinese economy could potentially cause a ripple effect across other emerging market economies that eventually reaches more developed markets, leading the U.S. into a recession. We view this scenario as possible but unlikely at this point. China is still expected to achieve near-7% economic growth in 2015 – more than double that of the U.S. economy. While it is unlikely we will see double digit growth in China any time soon, we view this deceleration as a natural result of China's change from an industrial-based, government-sponsored economy to a service-based economy more reliant on free markets. With the Chinese government's continued support, the Chinese economy is unlikely to implode in the near future.

Finally, we have written many times about the timing, pace and level of Federal Reserve interest rate policy over the years. We believe that equity markets would have responded most favorably to a small interest rate hike in September, with assurances from the Fed that future interest rate hikes would be small and gradual. However, the Fed opted not to raise interest rates in September, based primarily on



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low inflation and a strong U.S. dollar. While this outcome was not a huge surprise, the Fed provided a somewhat muddled outlook for the timing of rate hikes, leading to fears that the U.S. and world economies are weaker than expected and exacerbating market uncertainty. Markets likely will remain on edge in the fourth quarter until the Fed provides a clearer outlook. Ultimately, we view a 25 basis point increase in the fourth quarter as probable and, even if the Fed waits until 2016, we do not view the Fed's decision as somehow fundamentally hindering the continued slow growth of the U.S. economy.

Going forward, we do not foresee an immediate recovery from the lows of the third quarter, but we also do not believe the economy is headed for a recession or that another bear market (defined as a 20% decline from the market highs) is upon us. The U.S. economy is still growing slowly and unemployment remains near 5%. While the current declines in commodity and energy prices are obviously a negative for stocks in those sectors, they ultimately can benefit consumers and other sectors of the economy. In other words, it is unlikely a recession would occur because of low energy and commodity prices, especially against a backdrop of a strong, well-capitalized U.S. financial sector. We remain cautious in light of the often irrational price action in the Third Quarter, but we continue to look for value, especially in the financial, energy and health care sectors.

Equity Markets See Overdue Correction Amid Heightened Volatility

The Third Quarter was a rough quarter for equity markets as volatility increased. We will discuss the reasons for the correction below – namely China and the Fed – but it is worth understanding some of the underlying causes of market volatility in today's markets. The rise of ETF investing, algorithmic trading, and a liquidity vacuum that has been filled by large hedge funds are some of the root causes for the heightened market volatility today when compared to pre-Great Recession markets.

ETF investing plays a significant role in market volatility and sometimes irrational trading in certain sectors of the market. Many financial advisors and retail investors construct portfolios predominately with ETFs, which are passive investment vehicles that are structured to mirror a particular index, type of security, market sector or other subset of the market. Since they are not actively managed by anyone, they generally are low cost and easy ways to gain market exposure to a broad index without having to study and select individual securities. The downside to ETF investing for the markets as a whole is that individual securities will tend to trade in tandem during market extremes, due to the heavy buying or selling of ETFs that hold a basket of individual securities.

Additionally, algorithmic trading has over the years become a major source of market volatility and irrational behavior. High frequency trading involves capitalizing on market volatility over very brief periods of time and often very small fluctuations in particular stocks. In order to execute this business model, traders typically establish algorithms designed to read market behavior or news and execute trades automatically based on the goals of the trader. Unfortunately, this can sometimes lead to increased volatility and irrational market movements at times where a normal investor would react in a more measured way to market developments.



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Lastly, a little publicized side effect of the Great Recession, and the Dodd-Frank legislation passed in its wake, is the liquidity vacuum created by the Volcker rule. This provision is intended to limit the ability of the largest banks to trade for their own account (aka proprietary trading), which in the lead up to the financial crisis allowed some banks to become over-exposed to certain vulnerable areas of the market. This is seen as a problem for the financial system as the government wants to ensure that major banks remain solvent during market shocks. However, pre-Great Recession, proprietary trading did serve a legitimate market purpose in providing liquidity and a certain degree of rational trading during market dislocations. With the introduction of the Volcker rule and heightened regulatory scrutiny on major banks, this important source of liquidity has dried up and many trading desks at major banks are more heavily oriented towards simply placing orders for bank clients. In this vacuum created by Dodd-Frank, hedge funds have seemingly stepped in with their signature long/short trading philosophies and aversion to fundamentals-based investing, leading to increased volatility in the markets.

U.S. Economy Strong While China Deceleration Spooks Markets

Much of the markets' focus in the third quarter was on developments in the Chinese economy and the steps being taken by Chinese authorities to backstop economic growth. Many economists have been predicting a slowdown in the Chinese economy for years, as China's rapid industrialization and growing middle class supported years of 10-12% economic growth. In the third quarter, it became apparent that China would not meet its 2015 economic growth objective of 7% GDP growth. Further, a devaluation of the Chinese yuan signaled underlying economic weakness to the markets, as devaluation is often a policy measure taken to boost exports when economies are weak. As the second largest economy in the world and a significant producer and consumer of commodities, which have gone through a period of historic weakness over the past year, the markets took negative Chinese economic headlines poorly.

Despite all of the focus on China's deteriorating growth prospects, the U.S. economy continues to show moderate strength heading into the Fourth Quarter. Second Quarter GDP was recently revised up to 3.9%, which should reassure those concerned about the poor first quarter GDP growth of 0.6%. Unemployment dropped to 5.1% in August, which although aided by a low participation rate is a positive sign for the economy. Importantly, the U.S. consumer remains strong, as lower commodity prices has led to lower gasoline prices and consumer confidence is high. This has led to higher auto sales and strength in housing data, which have contributed to the economic rebound in the Second and Third Quarters this year. The consumer data bears watching, however, as continued market weakness and uncertainty may begin to dampen consumer confidence should the market correction continue for the quarters to come.

Overall, the current weakness in U.S. equity markets seems to reflect a fixation on the economic situations in Europe (i.e. Greece) and emerging markets (i.e. China), rather than the relative strength of the U.S. economy. Further, we believe that the direct impact of China's deceleration on U.S. corporate profits is limited. U.S. investors would only be significantly harmed by China in the event that its slowing economy caused a major global recession or a further deterioration in commodity prices. While neither of these consequences appears imminent, we intend to monitor the situation closely as Chinese economic developments are clearly having a significant impact on short-term market swings.



Federal Reserve Creates Uncertainty Over Rate Hike Timing

At their September meeting, the Federal Open Market Committee decided not to raise interest rates from 0 - 0.25% to 0.25 - 0.50%. Public opinion was split as to whether the Fed would raise rates. On the side of raising rates, many argued that the Fed had mostly accomplished its stated objectives to raise rates - namely, the unemployment rate declining to 5.1% and core inflation of approximately 1.5%. On the other hand, many dovish observers argued that inflation needs to be more comfortably within the range of the Fed's 2% long-term target and that recent global economic uncertainty - i.e. China and other emerging markets - had caused a strengthening of the dollar while also weakening the domestic economic outlook somewhat.

Ultimately, the Fed sided with the more dovish argument. Regrettably for equity investors, the Fed did not provide clear insight as to when the first rate hike might occur, although it seemed to indicate that a rate hike in 2015 was still on the table. Markets abhor uncertainty and the constant speculation over the first rate hike has roiled markets in recent years. For the equity markets, it would have been much more palatable if the Fed had raised rates by 0.25% and indicated that further rate hikes would be gradual. Instead, markets heard a message of continued uncertainty and global economic concerns. This messaging problem is exacerbated by the Fed's well-intentioned but backfiring policy of allowing FOMC members to grant media interviews and other public appearances where they can express their personal opinions on Fed interest rate policy – which may not be consistent with the official Fed consensus.

We believe the Fed may finally raise rates prior to the end of 2015, but if not, likely early in 2016. In some respects, uncertainty over Fed policy has dented investor confidence, which seems to have become a bigger issue economically than whether or not interest rates are pegged to 0% or 0.25%. The Fed is very in tune to what is occurring in domestic financial markets and is reticent to raise rates when markets are extremely volatile and confidence is low. However, traders are hanging on every word that Janet Yellen says these days, and a large portion of the volatility is due to the Fed's machinations. Thus, we believe that should the key economic indicators on employment and inflation improve in any meaningful way over the near term, the Fed should act to raise rates without haste, signal the great improvement in the U.S. economy over the past several years, and project that the Fed will remain highly accommodative in its interest rate policy over the medium term to support continued economic improvement. This would be the best outcome for investor confidence, financial markets and, ultimately, the economy.



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2015	<u>RDM</u> (after fees)	<u>Russell</u> Value	<u>S&P 500</u>	<u>DJIA</u>		
Year To Date	-9.53	-10.66	-6.74	-8.62		
3rd Quarter	-11.18	-8.98	-6.93	-7.57		
2nd Quarter	1.69	0.11	-0.23	-0.29		
1st Quarter	-0.04	-1.30	0.44	-0.26		
<u>Historical</u> <u>Annual</u>	<u>RDM</u> (after fees)	<u>Russell</u> Value	<u>S&P</u> 500	<u>DJIA</u>	<u>RDM 3-Yr</u> <u>Rolling</u> <u>Average</u>	<u>S&P 3-Yr</u> <u>Rolling Average</u>
2014	6.68	13.45	11.40	7.50	18.16	18.14
2013	34.31	29.45	29.60	26.50	16.57	14.34
2012	13.49	14.46	13.41	7.26	9.13	8.74
2011	1.90	0.39	0.00	5.50	12.27	12.10
2010	12.00	15.51	12.80	11.00	1.33	(0.23)
2009	22.90	19.69	23.50	18.80	(2.74)	(3.33)

Past performance is not indicative of future results.

Results for RDM include reinvested dividends, realized and unrealized capital gains and losses, net of transaction costs and net of investment management fees and other expenses.

Upon request, RDM will furnish to prospective clients a list of recommendations made by RDM within the immediately preceding period of not less than one year pursuant to appropriate federal and state securities law. It should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities in this list.