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FED UP

Investment analysts lost their bet last quarter that the Federal Reserve would raise the Fed Fund's rate target on September 17th. The markets didn't exactly yawn on the news (the S&P 500 index dropped 3.7% during the two weeks following the announcement), but everyone quickly re-focused on the December, January or March meetings (each have their supporters) as the likely trigger dates.

The third quarter's extremely weak "risk-off" environment (Figure 1, at right) doesn't appear to have been driven by concerns over whether the Fed woulda, shoulda, coulda. Instead, prices reacted most significantly to the early August announcement that China's July export levels had declined 8.3% year-over-year, followed shortly by a three-day period during which the Renminbi was devalued by 4% versus the Dollar. Chinese officials tried to de-link the two events, but many worry the policy shift in favor of a weaker currency (officially moving it closer to "market-determined" rates) may potentially set off a new round of competitive currency devaluations around the globe, as economies hunt for growth in an increasingly tough world.

From peak-to-trough, the S&P index drawdown totalled 12.3% in 35 days, dropping to 1867 on August 25th after a peak of 2128 on July 20th. A true correction, but once again leaving the bull market intact, albeit battered and bruised. Prices have recovered off that bottom two months ago, and the index today stands at 2075. Quite a turnaround.

During those 35 days, the FTSE 100 dropped 7.75%, the Dax dropped 12%, the Nikkei 225 was down 12.7%, and the Shanghai market plunged 21%. EM stocks entered a bear market for the first time since 2009 (>20% decline from peak-to-trough).

The debate on future Fed policy moved off center-stage during the quarter. Investors are well-schooled in the topic. Slowing global growth, and its impact on future corporate earnings growth, is now the main concern.

Figure 1: Index Benchmarks

Market Index	Trailing Returns *				
	3Q 15	**1 Yr**	**3 Yr**	**5 Yr**	**10 Yr**
S&P 500	(6.4)	(0.6)	12.4	13.3	6.8
U.S. Top-cap Stocks	(6.3)	(0.8)	12.2	13.4	6.6
U.S. Mid-cap Stocks	(8.0)	(0.3)	13.9	13.4	7.9
U.S. Small-cap Stocks	(11.9)	1.3	11.0	11.7	6.6
Non-US Stocks (**devel**)	(10.2)	(8.7)	5.6	4.0	3.0
Non-US Stocks (**emerg**)	(17.9)	(19.3)	(5.3)	(3.6)	4.3
3 mo. T-Bills	0.0	0.0	0.0	0.1	1.3
U.S. Aggregate Bonds	1.2	2.9	1.7	3.1	4.6
High Yield Bonds	(4.9)	(3.6)	3.5	5.9	7.1
Global Aggregate Bonds	0.9	(3.3)	(1.6)	0.8	3.7
CPI, annualized	***(1.2)***	*0.0*	*0.9*	*1.7*	*1.8*
Bloomberg Commodity	(14.5)	(26.0)	(16.0)	(8.9)	(5.7)
FTSE Nareit All REIT's	0.8	7.4	8.6	11.7	6.3
Chartwell Global 65/35	*(5.9)*	*(3.2)*	*5.4*	*6.5*	*6.0*

Figure 2: Average Mutual Fund Returns

Fund Category	Trailing Returns *				
	3Q 15	**1 Yr**	**3 Yr**	**5 Yr**	**10 Yr**
U.S. Large-cap	(7.3)	(1.4)	11.8	12.2	6.4
U.S. Mid-cap	(9.3)	(0.8)	12.3	11.8	7.2
U.S. Small-cap	(11.3)	(0.1)	10.9	11.5	6.7
International Lg. Cap	(10.4)	(8.0)	5.2	4.0	3.4
International Sm. Cap	(8.0)	(3.2)	8.5	7.1	5.9
Emerg. Mkt. Equity	(15.9)	(18.9)	(3.8)	(2.9)	4.1
Balanced/Hybrid	(5.1)	(2.1)	5.8	6.9	5.1
General Bond	0.5	1.7	1.6	3.3	4.8
High Yield Bond	(4.3)	(3.2)	3.0	5.4	6.2
Equity Hedge Index	(5.8)	(2.2)	5.0	3.6	3.6

*Annualized trailing returns for periods ending 9/30/15

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Economies, Economics, Prices, and Policy

	9/2015	**9/2014**
CPI - All, trailing 1-year	-0.0%	1.7%
Real GDP Growth, 1-year *	2.7%	2.6%
Employment / Population %	59.3%	59.0%

** through 2Q 2015 and 2Q 2014*

The final estimate of 2nd quarter **real domestic GDP growth** was an upwardly revised annual rate of 3.9%. Final Sales to domestic persons jumped almost 4% quarter/quarter in real terms. The biggest swing factors in that quarter were a jump in personal spending, a significantly improved import/export mix, and rising government expenditures. Fixed investment growth was restrained at both the business and residential levels.

Figure 3: Breaking Down Real U.S. GDP

% Change from Preceding Period
(seasonally adjusted at annualized rates)

Factor	**2Q '15**	**1Q '15**	**4Q '14**	**3Q '14**
Real GDP Growth	3.9	0.6	2.1	4.3
Nominal GDP Growth	6.1	0.8	2.2	6.0
Final Sales	3.9	(0.2)	2.1	4.3
Personal Spending	3.6	1.8	4.3	3.5
Private Investment	5.0	8.6	2.1	7.4
- Fixed, Businesses	*4.1*	*1.6*	*0.7*	*9.0*
- Fixed, Residential	*9.3*	*10.1*	*10.0*	*3.4*
*- Chg. In Inventories **($bn)***	*$128*	*$127*	*$89*	*$88*
Export growth	5.1	(6.0)	5.4	1.8
Import growth	3.0	7.1	10.3	(0.8)
Government Spending	2.6	(0.1)	(1.4)	1.8

US employment growth during the 3rd quarter was notably weaker than original expectations, with that weakness building as we moved through the quarter. Non-farm payrolls rose by only 501k, versus 664k during Q2. The larger household survey reported that employment increased by just 61k persons, compared to 408k in the second quarter! The labor participation rate fell to 62.4%, the lowest figure since 1977.

W**age growth** continues to be mediocre, but the pace has been rising of late. In nominal terms, median weekly earnings in Q3 rose by 0.75% over Q2, and were up by 1.6% compared to one year ago. With inflation flat to down, both figures represented real wage growth. But, after adjusting for CPI, real median wages in 3Q15 were still 1% *lower* than 3Q09!

Latest stats on **labor productivity** are reported only through the 2nd quarter. This important economic measure *increased* 3.3% in the nonfarm business sector. Output increased by 4.7%, and unit labor costs *decreased* by 1.4% (unit labor costs had risen by 6.7% in Q1). This reversed the two prior quarter's declines. Overall productivity increased just 0.7% during the past twelve months. Not very much, but not negative. And, with job and wage growth weak, 3rd quarter labor productivity is expected to be strong.

The **"headline" CPI** index declined at an annualized rate of (1.2)% during the quarter. This broad price index was flat during the past twelve months, continuing to reflect the downward pull of food and energy prices. But, it's not just been oil, and it's not just been recently. Over the past three years headline CPI has risen at just a 0.9% annualized rate, which is as low as any three-year period during the past 20 years.

Core CPI (ex-food & energy) rose 0.4% in the quarter (+1.6% per annum), and is up 1.9% over the past year. The last time this measure was at 2.2% (the Fed's stated target) on a trailing 1-year basis was June 2012.

The **Producer Price Index** for final demand goods declined 0.5% in September, was flat in August, and up 0.2% in July. The PPI/final demand declined a rather large 1.1% during the past year.

Nominal retail sales increased by only 0.9% during the 3rd quarter, compared to the second. Retail sales have risen by 2.4% during the past year. Almost all of the gains were due to an 8.5% rise in motor vehicle sales.

Industrial production rose at an annual rate of 1.8% in the quarter, after declining the first half of the year. The rise was telescoped into July, as August and September output once again declined. Total industrial production is just +0.4% above its year-earlier level. Capacity utilization for the industrial sector remains 2.6% below its 40-year average.

Total **housing starts** jumped a surprising 6.5% in September. After two months of declines, the gain in September brought starts back to just below June's level, which was an eight-year high. Rising homebuilding and nonresidential construction activity this year has offset declining domestic manufacturing, which has been hit very hard by the strong dollar. So far in the second half the factory slide has continued and the nonresidential building upturn has faded, but housing activity still looks to be solid.

The confluence of these three developments leaves underlying US growth somewhat wanting. **Third quarter GDP growth is expected to have slowed considerably.** The Atlanta Fed recently forecast real Q3 growth will be at an annualized rate of just 0.9%. The Blue Chip consensus figure is closer to 2.0%, but this has dropped from 3.2% in early July.

Most economists think slower domestic growth since June has pushed the Fed to the sidelines, and will certainly keep overnight rates "lower for longer." It's the global situation, *with 2016 growth forecasts marked down this quarter for every major country except the US*, that has investors up at night.

Credit Markets Weaken

Government bond prices throughout developed market countries rose during the third quarter, reversing nearly all of the mid-year price weakness, and reflecting subsiding concerns over the possible contagion effects of Fed's long pending rate rise (Figure 6). As global growth and inflation expectations moderated on the back of a slowing Chinese economy, and the ECB's own QE program took flight, bond yields fell in most of the world, especially the "rich world". This was quite the opposite of Q2. Observable exceptions to the government bond rally were to be found in Brazil, Russia, and select other Emerging Markets countries. Ironically, the quarter's best sovereign bond trade was to have gone long Greek bonds on July 1st.

Credit markets did not catch the wave, as Figure 5 reflects. While yields on 5-30 year US Treasuries were dropping about 25bps, yields on US$ investment grade bonds were rising as much as 20bps (depending on ratings). Non-investment grade credits, especially high yield corporate bonds, were hit even harder. Average yields in this sector closed the quarter at just over 8%, up more than 1% from the end of June, and over 1.3% since the beginning of 2015. The full HY $-bond index lost 4.9% in the quarter, with the lowest-rated paper off more than 7% despite huge yield advantages. The spread between the broad HY index yield and that of similar maturity Treasuries has widened to 630bps.

Prime securitized assets carry high credit ratings, thus were mostly insulated from the quarter's flight to quality. Agency MBS saw their yields drop nearly as much as Treasuries. Asset-backed bonds did not fare as well in terms of total return, but this was due to their shorter duration. The longer-duration profile of Commercial MBS indices helps explains their favorable total returns. CMBS is also a favored sector for those rotating out of investment grade corporates.

Another weak sector in the quarter (and the past year) was once again TIPS bonds. Declining inflation expectations have caused persistent price markdowns in these bonds during 2015. When inflation views shift around, one can expect this sector to outperform.

The weakest bond sector, by far, has been emerging market bonds, despite better overall credit ratings than high yield bonds. Those denominated in US$ were top performers in Q2, but that proved to be unsustainable. Q3 returns were -2.0%, which is also their 1-year return. Corporate EM bonds were hit harder in the quarter, falling 2.8%. This sector has declined 0.4% during the past year. Finally, local currency EM bonds have been disastrous for investors. The short-term Local Markets index, which is a proxy for EM currency positions, dropped 6.4% in the quarter and is off 12.5% over the past year. The longer-term GBI-EM local currency bond index dropped 10.5% in Q3, and has declined 19.8% since September 2014.

Figure 4: Primary Bond Sector Returns (%)

Index	3Q '15	1 Year	3 Years
US Aggregate Bond index	1.2	2.9	1.7
US Gov't: 1-3 Yrs.	0.3	1.2	0.7
US Treasury: Long	5.1	8.8	2.8
US Inflation-Linked	(1.3)	(0.9)	(1.9)
Mortgage-Backed (MBS)	1.3	3.5	2.0
CMBS	1.6	3.8	2.7
Asset-Backed (ABS)	0.7	2.4	1.2
Inv. Grade Credit, 1-10yr	0.4	2.1	2.2
Inv. Grade Credit, 10+yr	0.0	(0.5)	1.6
US High Yield Credit	(4.9)	(3.6)	3.5
Municipal Bonds	1.7	3.2	2.9
Global Aggregate, ($ hdgd)	1.3	3.1	3.0
Global Credit	0.3	1.4	2.8
Emerg. Mkts Bonds (US$)	(2.0)	(2.0)	0.5

Figure 5: Primary US$ Bond Yields

	Sep-15	Jun-15	Dec-14	Sep-14	1-Year Change
US Treasuries	(%)	(%)	(%)	(%)	(%)
3-month	0.01	0.01	0.04	0.02	(0.01)
2-year	0.63	0.64	0.68	0.59	0.04
5-year	1.38	1.63	1.66	1.78	(0.40)
10-year	2.06	2.33	2.17	2.51	(0.45)
30-year	2.88	3.10	2.75	3.21	(0.33)
BarCap Aggregate	2.31	2.39	2.25	2.36	(0.05)
BBB Credit	4.14	3.96	3.68	3.58	0.56
AA Credit	2.37	2.34	2.23	2.24	0.13
Agency MBS	2.61	2.78	2.60	2.90	(0.29)
Emerging Mkts ($)	6.46	5.81	5.64	5.40	1.06
US High Yield	8.04	6.94	6.71	6.26	1.78
UST30y-UST2yr	2.25	2.46	2.07	2.62	(0.37)

Figure 6: Sovereign Bond Yields, selected countries

10-year yields (%)	Sep-15	Jun-15	Dec-14	Sep-14	1-Year Change
United States	2.06	2.33	2.17	2.51	(0.45)
Germany	0.59	0.83	0.55	1.01	(0.42)
Switzerland	(0.10)	0.11	0.38	0.57	(0.67)
Britain	1.81	2.55	1.92	2.50	(0.69)
Poland	2.85	3.31	2.53	2.99	(0.14)
Italy	1.73	2.25	1.99	2.37	(0.64)
Spain	1.90	2.35	1.70	2.15	(0.25)
Greece (new bonds)	8.46	15.12	9.64	6.25	2.21
China (5 year)	3.09	3.24	3.55	3.93	(0.84)
Japan	0.34	0.45	0.33	0.53	(0.19)
Australia	2.61	3.01	2.92	3.61	(1.00)
Russia	10.98	10.85	13.44	9.39	1.59
Brazil	15.47	12.68	12.67	12.53	2.94
India	7.54	7.82	7.98	8.48	(0.94)

US Stocks "Correct"

Domestic equity markets were down in September, capping off the worst quarterly performance since the 3rd quarter of 2011. Back then, the S&P dropped 14%, and small-cap stocks plunged 22%. In this year's third quarter, the S&P declined 6.4%, and small-cap stocks were down 12%. Lots of red ink.

The correction has left the S&P's total 1-year return with a small loss of -0.6%. The Russell 2000 index of small-cap stocks have done a bit better over the past year, up +1.3%, despite falling nearly 17% peak-to-trough during the correction.

Stocks had been losing momentum since the last half of 2014, after a terrific run since 2011, but the immediate catalyst for the decline appears to have come out of Asia, in the form of intensifying concerns over the outlook for global growth as the Chinese economy continued to slow and the Renminbi was devalued. With so many US companies now heavily involved in international business, perhaps we shouldn't be surprised that troubles in the world's second largest economy had a significant impact on our stock market.

The obvious losers were commodity producers; energy stocks had been struggling for a while but lost another 18% as crude prices once again slumped below $50/barrel. The basic materials sector lost 17%. As market volatility soared and risk aversion spread more widely, investors aggressively took profits in nearly every other sector. Only utilities (+4%) ended the quarter higher (see Figure 8).

As we can see in Figure 7, the quarter's weakness once again fell disproportionately toward the value stock indices, across the entire size spectrum. However, most of this differential performance reflected differences in sector composition, and not necessarily style. Thus, we see that energy value stocks declined 16% in the quarter, while energy growth stocks dropped 23% (downstream versus upstream). Health care value stocks were off 9%, but health care growth stocks declined 12% (traditional pharma versus biotech).

Looking back a year, observable sector performance differences are severe; energy stocks have fallen 30%, materials stocks are off 18%, and telecom services are down nearly 8%. These sectors comprise 21% of the S&P Value index, and 5% of S&P Growth. Conversely, over the same period consumer discretionary stocks are up 11.7%, staples have advanced 6.8%, and health care 6.1%. These comprise 45% of the S&P Growth index, and just 29% of S&P Value.

Second quarter S&P operating earnings fell 11% year/year, compared to an expected 4.4% decline. First quarter earnings were off 5.5%, and last year's 4th quarter saw earnings drop 5.3% year/year. This year's 3rd quarter earnings are forecast to have dropped 4.5%.

That adds up to a 6.6% year/year decline in current earnings versus the prior year. If you peel back the onion, you see most of that drop is due to reduced contributions from energy and materials firms. At some point, that headwind is expected to blow itself out. Thus, fourth quarter earnings this year are optimistically forecast to be up 11% over last year's. And, 2016 earnings are optimistically forecast to improve nearly 16% over 2015's experience.

Figure 7: U.S. Equity Market - Size/Style Returns

		Trailing		
	3Q '15	1-yr	3-yrs	5-yrs
Growth				
Large Cap	(4.1)	3.9	13.5	14.9
Mid Cap	(8.0)	1.4	14.0	13.6
Small Cap	(13.1)	4.0	12.8	13.3
Value				
Large Cap	(8.6)	(5.4)	10.7	11.9
Mid Cap	(8.0)	(2.1)	13.7	13.2
Small Cap	(10.7)	(1.6)	9.2	10.2

Figure 8: US Sector Returns – 3rd Quarter 2015

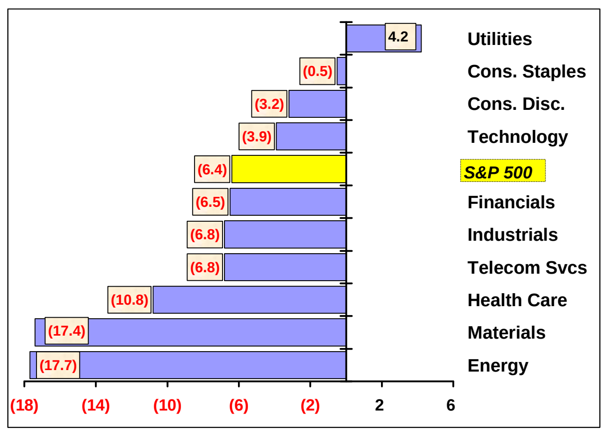


Figure 9: One-year Trailing P/E Ratios – Sept. 2015

	Value	Blend	Growth
US Large	16.2	18.3	20.6
US Mid	17.6	19.7	22.3
US Small	17.8	20.6	24.9
EAFE		14.5	
Emerg. Mkts		12.4	

International Stocks – A Bear Market

Global stock markets ended the third quarter sharply lower, also posting their weakest result since the third quarter of 2011. Developed markets (MSCI EAFE) fell (10)%, while emerging markets plummeted (18)%. This pulled year-to-date results into sharply negative territory, (5.3)% and (15.5)%, respectively. The rout extended beyond global equities, into oil, commodities and emerging market currencies. There appears to be two primary drivers of volatility and weakness: the sharper than expected slowing in the Chinese economy (and its spillover impact on global growth), and continued uncertainty on the Fed's interest rate policy.

Figure 10: International Equity Markets – Returns

	U.S. Dollar Returns (%)		Local Currency Returns (%)	
thru 9/30/15	3Q '15	1-Yr	3Q '15	1-Yr
World ex-USA	**(10.6)**	**(10.1)**	**(8.9)**	**(0.1)**
- MSCI Growth	*(9.1)*	*(5.9)*	*(7.4)*	*4.2*
- MSCI Value	*(12.1)*	*(14.3)*	*(10.4)*	*(4.5)*
- Europe ex-UK	(8.1)	(8.0)	(7.2)	2.4
- Pacific, ex-Japan	(16.0)	(16.8)	(10.7)	(3.7)
- Japan	(11.8)	(2.2)	(13.7)	6.8
- United Kingdom	(10.0)	(12.1)	(6.6)	(6.0)
Int'l Small Cap	**(8.0)**	**(3.7)**	**(6.5)**	**7.2**
Emerging Mkts	**(17.9)**	**(19.3)**	**(12.1)**	**(7.1)**
- EM Asia	*(17.0)*	*(13.1)*	*(13.5)*	*(6.6)*
- EM Europe	*(15.4)*	*(28.3)*	*(7.4)*	*(4.2)*
- EM Latin América	*(24.3)*	*(38.7)*	*(10.8)*	*(12.5)*
- EM BRIC	*(21.1)*	*(18.1)*	*(16.5)*	*(6.2)*

Within developed markets, European equities (8.7)% dropped less than the Asia Pacific region (13.2)%. The Japanese market declined (11.8)%, erasing much of its solid gains from the first two quarters. Japanese GDP for 2Q was reported to have contracted, sparking recession concerns. Data from the domestic economy was downbeat; weaker exports, falling industrial output, and sluggish consumption. Australia, Hong Kong and Singapore all posted weaker results than Japan, ranging from (15.3)% to (19.5)%.

After a July rebound, European equity markets suffered losses in August and September. In addition to global growth worries, equity markets were pressured by renewed concerns about potential deflation amidst disappointing 2Q GDP data, despite the ECB's QE program, low energy prices and a weak euro. Europe's two largest stock markets dropped double-digits:- Germany fell -10.9% and the United Kingdom -10%. Select peripheral markets dropped considerably less:- Denmark -2.4%, Ireland -3.2%, and Italy -4.3%.

A number of destabilizing forces that drove investors away from emerging market equities during the third quarter:

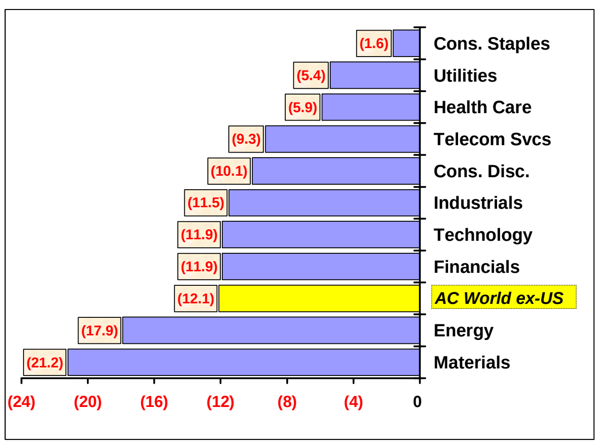
- China's surprise Renminbi devaluation;
- geopolitical developments in Turkey and Thailand;
- the expectation of a Fed Rate hike coupled with a sharp drop in commodity prices.

From April's peak to August's trough, the Emerging Markets index lost 21.6% in local currency terms and 27.7% in US Dollar terms. Latin America was the worst performing region, losing 24.3%, led down by Brazil (-33.6)%, as its resource-based export sector was battered by falling commodity prices. Emerging Asia fell 17%, with the Chinese and Indonesian markets dropping 22.7% and 24.2%, respectively, on slowing growth concerns. The Indian market fell the least, off just 6.7%, as investors were attracted back by their relatively stable currency, improving reserves and the current account benefits of being a net *importer* of lower priced oil and other commodities.

Emerging Europe was the best performing EM region, posting a 15.4% loss. Greece was the weak link, plummeting 36%, but the Czech Republic (-6.6)%, Hungary (-3.3)% and Poland (-10.8)% all benefit from being net importers of cheap oil and other commodities. Conversely, Russia bears the brunt of falling energy prices. Its stock markets dropped (15)%.

All sectors in the MSCI All Country World ex-US index posted negative returns. Falling commodity prices drove the energy and materials sectors to (-18)% and (-21)% declines, respectively. The largest sector is Financials, accounting for 27% of total market cap. It dropped 12%, and contributed 4% of the index's total loss. Less cyclical, more defensive sectors fared best; with consumer staples falling the least 1.6%, followed by utilities (-5.4)% and healthcare (-5.9)%.

Figure 11: Ex-USA Sector Returns (in US$ terms)



Back Page Perspectives: Déjà vu?

Last quarter, we wrote:- *US stock prices were little changed in the past quarter, leaving most domestic stock indices only slightly higher for the first half of 2015. So far this year, US stocks have neither climbed nor fell more than 3.5% at a time. Long-term volatility is also benign, as it's been more than 1,375 days since the S&P 500 index dropped 10%.*

Well, all those points are now moot. It's a good thing we didn't project these conditions to continue, because they certainly have not.

That got us to wondering about whether there were any parallels between 2015 and 2011 which might be instructive as we look forward past our recent experience. Turns out there are many similarities –

- Both years saw stock markets move essentially sideways from mid-February through mid-July. All-time highs were set during the 2nd quarter, and unsuccessfully retested in July. Markets broke down as investors indiscriminately sold to cash. The sell-offs only took 4-5 weeks;
- Non-US markets and small-caps absorbed the brunt of the losses, with Emerging Markets leading the way down. Equity market declines in 2011 were deeper and steeper (13-23%) than in 2015;
- In 2011, the focus of investor concern was weaker than expected growth in Europe and the US, with Europe's sovereign debt crisis at the top of the list of causes. Adding to the mix was the cut in the US debt rating, reports of a surprising weakening in domestic GDP growth, and China's attempt to engineer a soft landing for its overheated economy by imposing stricter monetary policies;
- The weakest stock sectors in the 3rd quarter of 2011 were materials, energy, industrials, and financials. Only utilities had a positive return;
- In both years, the reliably consistent flight to quality reflex saw US$ and Euro sovereign debt markets rally. Ten-year government bond yields in 3Q 2011 dropped more than in 3Q 2015;
- High yield bonds, which had been stronger earlier in the year, led bond markets down. Emerging Markets bond prices also fell;
- The Barclays Aggregate bond index ended each period with a yield-to-maturity around 2.35%. Although the yield curve in 2011 was quite a bit steeper, at +2.89% versus +2.25%, in both cases it had flattened since the year began;
- Core inflation (ex-food and energy) reflected a one-year trailing increase of 2.0%. Overall inflation in 2011 was much higher than in 2015;
- Forecasted 1-year GDP growth rates for the US and Europe were in the 2.5% and 1.6% range, respectively, even though each region was currently experiencing lower growth than those forecasts. In 2011, Europe's economy was seen as being hard to get a clear handle on, because of all the sovereign debt and political uncertainties. China's economy was growing at a very solid 9% annual rate, which was expected to continue. Today, China is seen as the hard country to read;
- Following the correction in 2011, domestic large-cap stocks were trading at a P/E of **12.4x**, based on trailing earnings. At the end of the most recent quarter, the S&P 500 was trading at a P/E of **18.3x**;
- At the end of September 2011, trailing 1-year S&P operating earnings were up 24% from the year earlier. In the following year they would grow 8.6%. In 2015, trailing 1-year operating earnings are down 6.6% from the year earlier. They are forecasted to grow almost 15% over the next year.

We think there are a surprising number of similarities between the 3rd quarters of 2011 and 2015. And, there are a number of fundamental differences (you never cross the same stream twice). For us, the differences between the market PE ratios and recent/forecast earnings growth stand out.

At current valuations, it's hard to see the next 1-3 years working out as well as they did back in 2011. By September 2012, US stocks were up 30% for the trailing one-year, and non-US stocks were up mid/high-teens. By September 2014, the S&P price index had climbed 74% from its September 2011 close. Annualized trailing earnings were 21% higher.

Our point is this – in October 2011, investors were severely chapped. The prior quarter's experience had just finished reminding them that another recession and bear market lurked just around the corner. Europe's problems seemed unsolvable, and they threatened to bring down the entire global economy. Today, simply insert China for Europe. Yet, the following three years worked out extremely well, especially for equity investors.

Today, company earnings may need some time to "grow into" current equity prices. Stocks indices could once again be flat next year, even if we see 15% forecasted earnings growth. That said, we think patient equity investors with a strategic perspective are well-positioned after the correction.

Sell high, buy low. See you next quarter!

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