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## Recent Market Volatility

Like you, we are unnerved to see the market decline in a significant way for the third day in a row as we write this note to you. But, we do not think it is time to sound the alarm.

For some perspective, the U.S. stock market has been going up to nearly triple its value with very little downside volatility since March 9, 2009. The stock market had not increased to the point it was in bubble territory. On the whole, stocks had been fully priced to slightly over-priced. If one were to have taken a closer look, an argument could be made that many growth stocks were in bubble valuation territory. By in large, value stock valuations, which we tend to prefer, were not out of hand.

At some point, we knew that the market would make a correction. It would appear that the time has come. Earnings are the fuel for improving stock prices. This correction aside, with stocks being fully valued, the economy would need to continue to improve for companies to increase their earnings. Easy gains in earnings ended in early 2014. So, what are the prospects for the economy? We believe that they are good.

The USA is a consumer driven economy with the consumer accounting for two thirds of Gross Domestic Product. So, what are the prospects for consumption? One of the strongest leading economic indicators is the four week moving average for unemployment insurance claims. The reading has been at a very good level for a little over a year. This level points to employment gains running above 200,000 per month. There are plenty of adults still looking for those jobs as well. Without boring you with statistical details, with an eye on unemployment, under-employment, and participation rates, we are about 6.5% away from full employment. That is plenty of fuel for additional economic gains. Additional hiring leads to more consumption and additional hiring.

Construction: New family creation has been running at a pace of 1.5 million since 2007. Construction of housing units has risen from 400,000 in 2008 to just over one million in 2014. Demand has been outpacing supply. The inventory of existing homes for sale is very low compared to historical levels. Home construction has risen to 1.2 million in recent months. This is a trend that should continue given the pent up demand. Construction usually accounts for nearly 5% of GDP. It is now rising from a low of 3.5%. The construction industry is ranked fourth highest as a jobs multiplier. That means new jobs in construction result in additional jobs in other industries.

The measure of industry by the Institute of Supply Management readings for Manufacturing industry and Service industry are signaling expansion at 52.7 and 60.4, respectively. Readings above 50 signal expansion.

Another strong leading economic indicator that we track is the St. Louis Federal Reserve Financial Stress Index. A reading of minus one (-1) indicates a lack of stress and good economic prospects. A reading of plus one (+1) indicates high stress and poor economic prospects. This measure has been hovering around minus one since 10/25/13.

So, what is making the stock market nervous? Mainly China and the strength of the dollar have put a damper on the stock market.

Specifically, China has been and is in need of adjusting their economy from one dependent on manufacturing and exportation to one more dependent upon personal consumption. Their challenges at navigating this "soft landing" and their policy interventions are well documented. In the last four years China's economy has grown from $4 Trillion to $10 Trillion. Their wages have grown to the point that manufacturing is cheaper in other parts of Asia and Africa. China has been doing a fairly good job of making that transition until recently. Government interventions to help slow down the economic growth rates and shift to consumption have led to very intense volatility in their stock market, a drop in raw material consumption (energy and commodities) due to overbuilding of housing and infrastructure in some cities, and world perception of a lack of ability to allow capitalism to work.

The dollar has risen over 35% relative to a basket of foreign currencies. This makes for a difficult environment for our multi-national companies to compete for sales in foreign countries. This adds to a difficulty in maintaining or improving earnings. The concept of an interest rate increase at the hand of the Federal Reserve in addition to the strength of the US economy relative to the rest of the world has led to the rising U.S. Dollar.

Lastly, the slow-down in raw materials usage in China has harmed many emerging country's economies that rely on natural resource exportation. These countries are in much better shape to survive this environment than they were 10 or 15 years ago.

Although the onset of interest rate increases are accompanied by initial market volatility, as a reminder, history shows that periods of interest rate increases are the result of economic strength and stock market gains. "Despite the rate hike, stocks have averaged double digit gains in the year before and after the first Fed move." (Source Fidelity) That said, DBFM questions the likelihood of a Federal Reserve led interest rate increase given the slack remaining in employment and low inflation exacerbated by the strong dollar.

It is our opinion that the stock market has over reacted to the combination of news coming out of China. "Overreacting to short term news and normal market movements often leads investors to inappropriately alter their asset allocations, potentially harming their ability to achieve long-term investment goals." (Dr. David Kelly, CFA, JP Morgan Asset Management) Given this correction we believe long term investors will be rewarded by being able to buy stocks at lower valuations.

The U.S. economy is strong and getting stronger. When the Federal Reserve does raise interest rates, we will have confirmation that they feel the US economy will get stronger yet without loose monetary policy.

Please feel free to reach out to us if you have any questions or concerns. As always we appreciate your continued trust.

Sincerely,

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