

## Market Update:

### Q3 2015 Review and Outlook

# Markets Gripped by Fears of China Slowdown and Effects on Global Economy

## Q3 Recap

Markets moved from one crisis to the next during the quarter. After the European Union was able to craft a Greece debt resolution in early July, markets shifted the focus toward a faltering Chinese economy and its impact on global growth. Weak economic data and crashing markets in China resulted in heightened volatility across the globe. Adding to the uncertainty was the Federal Reserve's decision in September to delay its first rate hike in more than nine years, citing increased volatility abroad and the prospect for weaker global growth.

No area of the globe was immune to the quarter's selling. In the U.S., the S&P 500 fell 6.4% despite a backdrop of strong economic data and improving consumer confidence. The decline meant it was the worst quarterly loss for U.S. stocks in four years. During the quarter volatility spiked to levels not seen since the European Debt Crisis after the People's Bank of China made a surprise move to devalue the country's currency, sending an already-strong U.S. dollar even higher.

International equities, as measured by the MSCI EAFE Index, fell significantly during the quarter, posting losses of 10.2%. Emerging markets bore the brunt of the quarter's losses, falling 17.9%. For emerging markets, the dual themes of slumping commodities and weak outlook for growth sent shares plummeting.

With volatility soaring, investors preferred the safety of high-quality bonds. The Barclays Aggregate Bond Index posted positive returns of 1.2% on the back of strong demand that sent the 10-Year Treasury yield down to 2.0%. After telegraphing intentions for months, the Federal Reserve's decision not to hike interest rates was a surprise to many investors as many felt the strength of the U.S. economy would outweigh any headwinds from slowing international growth.

## The Markets at a Glance

Asset Class	Representative Benchmark	Q3 Return	YTD Return
<b>U.S. Large Cap</b>	S&P 500	-6.4%	-5.3%
<b>U.S. Small Cap</b>	Russell 2000®	-11.9%	-7.7%
<b>International</b>	MSCI EAFE	-10.2%	-4.9%
<b>Commodities</b>	Bloomberg Commodity	-14.5%	-15.8%
<b>Municipal Bonds</b>	Barclays Municipal	1.7%	1.8%
<b>Taxable Bonds</b>	Barclays Aggregate	1.2%	1.1%
<b>Cash</b>	Citi 3-mo T-Bills	0.0%	0.0%

Performance returns are as of 9/30/15.

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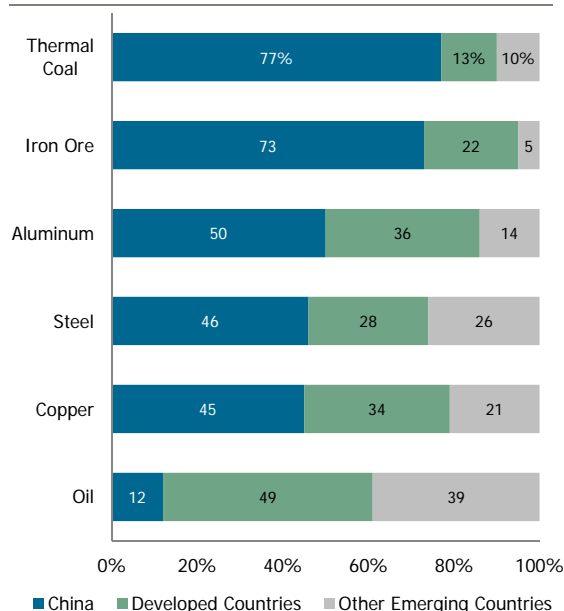
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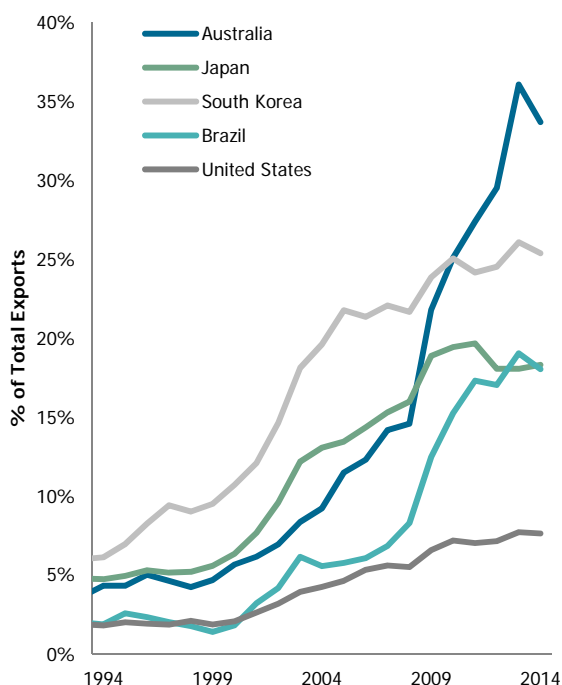
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Figure 1  
Country Demand for Commodity Usage



Source: 2015 Forecast, WSJ.com, Macquarie Research, IAE (oil)

Figure 2  
% of Total Exports to China



Source: Bloomberg, Baird Analysis

### Examining the Ripple Effects

For the past decade the Chinese economy has grown by more than 10% annually, and accounted for a third of the growth in the global economy, far outpacing 17% for the United States. But cracks are beginning to show and it appears the days of double-digit growth may be a thing of the past for the world's second largest economy.

Behind the slowdown is an evolutionary shift in China's economy, moving from an economy focused on debt-fueled investment and export-dependent growth toward a consumer-driven economy with a reliance on spending by the country's emerging middle class. As China moves to become more self-sufficient, the global economy is starting to feel the hangover. The first half of 2015 saw global economic output expand by a little over 2%, marking the weakest six-month period since the world emerged from the financial crisis. As the global economy moves into a lower gear, the ultimate question for investors remains what knock-on effects will come of a slowing China?

### Commodities in Crosshairs

The last decade has been marked by China's increased influence on global trade through its insatiable demand for industrial and other commodities. In response, many of the world's commodity-centric and developing economies have built their growth models on satisfying this demand. For decades these countries could count on Beijing's voracious appetite for natural resources. Today these same countries are facing commodities prices at their lowest levels in years as the economic outlook for China appears troubled.

Among basic materials providers, the weakening demand is particularly acute as China imports more than half of the metals exported by Australia, Peru, and Indonesia and more than a third exported by Brazil and Chile. As recessionary fears begin to grip many of these countries, it's clear these economies have not done enough to diversify away from their dependency on commodity exports.

For oil-producing nations like Russia, Venezuela, and Saudi Arabia who rely on triple-digit oil prices to fund their governments, the slowdown comes at a time when oil prices have been halved from levels a year ago as the world is plagued by oversupply. As the outlook for global growth faces headwinds, the chances of a near-term recovery in prices is unlikely.

### U.S. Economy Less Dependent

Fortunately for the U.S. economy, there is less reliance on strong foreign trade. Exports make up just 13% of the U.S. economy, while consumer spending accounts for more than two-thirds. This means a slowdown in China will have little effect on the overall U.S. economy as long as the growingly confident U.S. consumer continues to spend.

More of an issue, however, is the impact on U.S. financial markets. More than 40% of the revenue generated by S&P 500 companies comes from overseas. With slowing Chinese growth hitting other regions of the world, the U.S.'s large multi-national companies are particularly exposed. At the same time, the People's Bank of China made moves to boost the country's exports by devaluing the yuan during the quarter, pushing an already-strong dollar even higher. This results in making U.S. goods and services more expensive abroad, hurting the bottom line of America's corporations.

## Volatility Returns with a Vengeance

The S&P 500 experienced one of the worst quarterly declines in four years as investors grappled with the prospect of a China-led global slowdown and the timing and impact of U.S. monetary policy. With the decline, the S&P 500 went firmly negative for the year and officially entered correction territory—typically defined as a drop of at least 10% from the recent peak.

## Investors Take Shelter in Defensives

With fear gripping the market, investors preferred the relative safety of defensive sectors. Utilities was the lone bright spot among S&P 500 sectors with a positive gain of 5.4%. Consumer Staples (-0.2%) also held up well amid a volatile and risk-off environment for global equities. Energy and Materials were the worst performing sectors with losses of 17% as the outlook for global growth weakened and a strong dollar pushed commodity prices to their lowest levels since 1999. Despite leading the market higher during the first six months of the year, Healthcare - particularly Biotechnology - was also weak on the back of stretched valuations and the prospect of new drug price regulation.

From a market cap and style perspective, Large Cap and Growth-oriented segments of the market generally lost less than Small Cap and Value-leaning areas during the quarter.

## Earnings Showing Softness

Profits for S&P 500 companies moved lower during the quarter, falling 0.7% from levels a quarter ago. Combined with Q1, the first half of 2015 marks the weakest period of earnings growth since 2009. From an EPS perspective, the numbers are even less bullish as the S&P 500 posted a 3.4% decline, marking the third consecutive quarter of earnings declines, according to FactSet.

While at first glance the numbers look far from optimistic, a look under the hood shows things are not nearly as bad. The steepest decline in earnings have come from commodity-linked sectors such as energy and industrials. (Figure 3). By backing out the effects of Energy, the S&P grew earnings by 4.1%; below trend but expected given the headwinds of a strong dollar. While there are clear risks to the market at this point in the cycle, the market is not yet indicating an earnings recession is upon us.

## Growth Stocks Continue to Lead

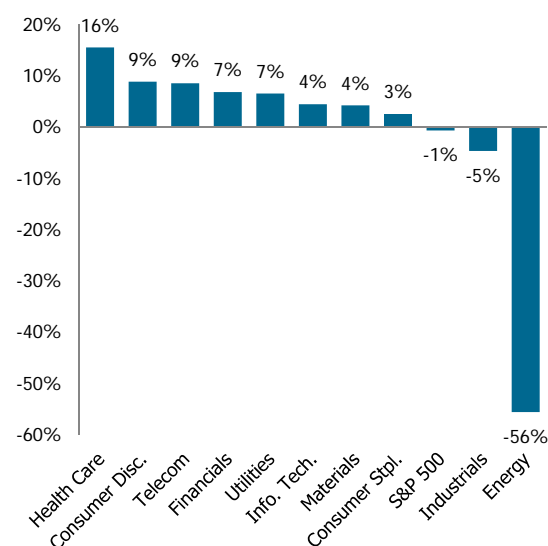
Growth stocks continued to lead the market higher in Q3. To date, Growth indices have lost 1.9% compared to -9.1% for Value. This preference for Growth is far from new as the current streak of Growth over Value since the financial crisis marks one of the longest on record. When looking at catalysts, this outperformance is not unexpected as today's low-growth world has forced investors to pay a premium for above-average growth opportunities.

While currently out of favor, Value stocks may be in a position to recover. When looking at previous cycles, Value tends to hold up better than Growth stocks during periods of heightened volatility as valuations of growth companies tend to revert in-line with the overall markets. As well, outperformance of Value has been associated with rising-rate environments. As the Federal Reserve inches closer to embarking on its first rate hike cycle in nine years and the backdrop of economic uncertainty persists, the stage may be set for Value stocks to outperform.

## U.S. Equity Market Benchmarks

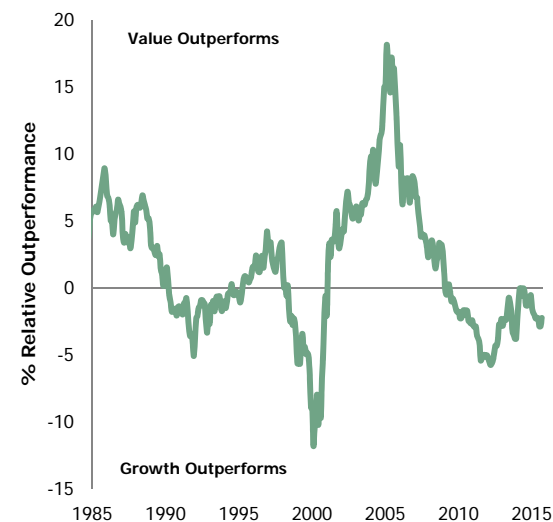
Asset Class	Representative Benchmark	Q3 Return	YTD Return
Large Cap	S&P 500	-6.4%	-5.3%
Mid Cap	Russell Midcap®	-8.0%	-5.8%
Small Cap	Russell 2000®	-11.9%	-7.7%
Value Stocks	Russell 3000 Value	-8.6%	-9.1%
Growth Stocks	Russell 3000 Growth	-5.9%	-1.9%

Figure 3  
Q2 2015 S&P 500 Earnings Growth



Source: FactSet

Figure 4  
Growth vs. Value Outperformance



Source: Morningstar Direct, Rolling 5-Year Periods

## International Market Benchmarks

Asset Class	Representative Benchmark	Q3 Return	YTD Return
Developed	MSCI EAFE	-10.2%	-4.9%
Europe	MSCI Europe	-8.7%	-4.8%
Japan	MSCI Japan	-11.8%	0.2%
Asia	MSCI Pacific ex Jap.	-15.9%	-15.4%
Emerging	MSCI Emerging Mkts	-17.8%	-15.2%

## All Eyes on China

The global markets were transfixed on the impact a slowdown in China would have on the world economy. China-related worries led to substantial financial market reverberations across developed and emerging markets. Triggering the rout was a series of weak economic data and heavy-handed attempts by the Chinese government to prop up the country's debt-fueled and crashing equity markets (Figure 5). After the People's Bank of China made moves to devalue the Chinese currency to spur economic activity and trade competitiveness, global markets responded with a surge of volatility that resulted in the worst single-day loss in eight years for the Shanghai Composite. As the rout continued, the government attempted to relieve fears by cutting interest rates for the fifth time in a year while reducing reserve requirements to encourage bank lending.

## No Place to Hide

The final scorecard for the quarter showed the MSCI EAFE index falling 10.2% with most of the losses concentrated in August. No country in the index was immune from losses, but in general, European markets held up best while Asia experienced the worst selling among developed nations.

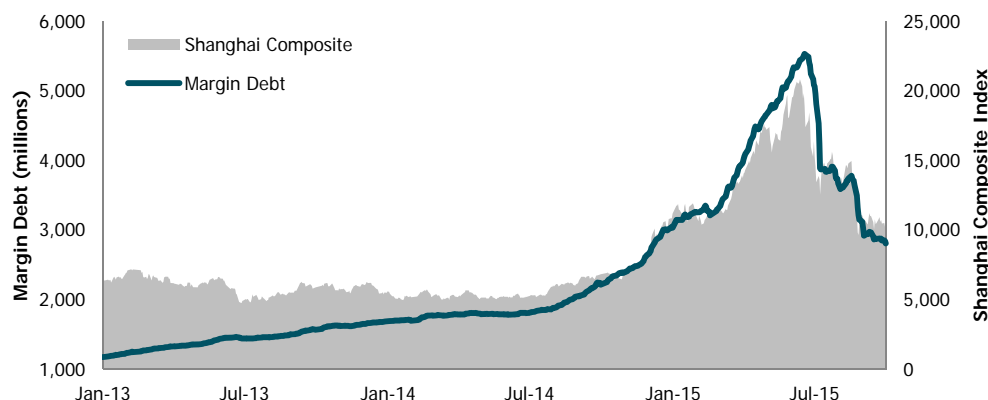
Similar to the trends that took place in the U.S., the demand for safe-haven assets increased during the quarter. Investors took refuge in defensive sectors while shunning sectors tied to global growth. While every sector in the EAFE was down, Utilities and Consumer Staples experienced modest losses. Materials and Energy had the most pronounced losses, followed by Financials, Telecommunications, and Industrials.

## Latin America Loses Among EM

With China holding a significant weight in the index, its not surprising Emerging Markets experienced the most significant selling. The MSCI Emerging Markets Index underperformed the developed world, posting steep losses of 17.8%. With the losses, Emerging Markets have officially entered into bear market territory – defined as a decline of 20% or more from recent highs.

Among constituents, it was Brazil, and not China, that was the weakest market in the index, losing 34% after officially falling into a recession in the second quarter. It has been a difficult period for the BRIC nations after emerging from the financial crisis as one of the world's premier growth markets along with China. Years of slumping commodities and a wave of political corruption has dampened the country's growth prospects. Inflation levels now hover near 10% while budget deficits have moved to the widest levels in two decades. At the same time, the Brazilian real has fallen more than 22% against the dollar to its lowest level ever. The instability resulted in S&P cutting the country's credit rating to junk during the quarter amid a deteriorating economic and fiscal outlook.

Figure 5  
Shanghai Composite Index (LH) and Chinese Margin Debt (RH)



Source: Bloomberg, Baird Analysis, Margin Debt: Millions of Chinese Renminbi

## Fed Passes on Rate Rise

September's much anticipated Federal Reserve meeting came and went with no action taken by members to raise rates off zero-bound levels. Despite strong economic data during the quarter, Fed communique cited increased uncertainty surrounding the durability of the world's economic outlook in explaining their decision to delay a rate hike. Further adding to the Fed's dilemma are cratering inflation expectations which fell to the lowest level in six years on the back of plummeting commodity prices and weak global growth (Figure 6). Given the backdrop of increased economic uncertainty and heightened volatility across global equity markets, interest rates consistently fell throughout the quarter with the 10-Year Treasury yield moving from 2.4% to end at 2.0%.

## Investors Seek Safe-Haven Assets

The violent swings of the global markets resulted in investors shunning risky assets in favor of safe-haven securities. Accordingly, Treasuries were among the best performing asset classes with a return of 1.8% while the broad U.S. bond market posted returns of 1.2%. Among corporate bonds, investment-grade corporate debt held up better than high yield, finishing with returns of 0.8% despite investment grade credit spreads moving to their highest levels since 2012 (Figure 7). Given the environment of falling interest rates in the quarter, bonds with longer maturities fared better than shorter-maturity peers.

## Weak Commodities Hurt High Yield

High yield bonds were the weakest fixed income sector with returns of -4.9% amid increased risk aversion and slumping commodity prices. At more than 18% of the market, energy and mining-related companies make up disproportionate share of the high yield market.

As the outlook for global growth appears more grim, the yields for many commodity-related companies moved into distressed territory, sending yields for much of the market higher as well. Distress was apparent in the market as credit spreads for energy-related companies moved to their highest levels since the financial crisis as investors priced in the prospect of significantly higher default rates (Figure 7).

## Municipals Follow Treasuries Higher

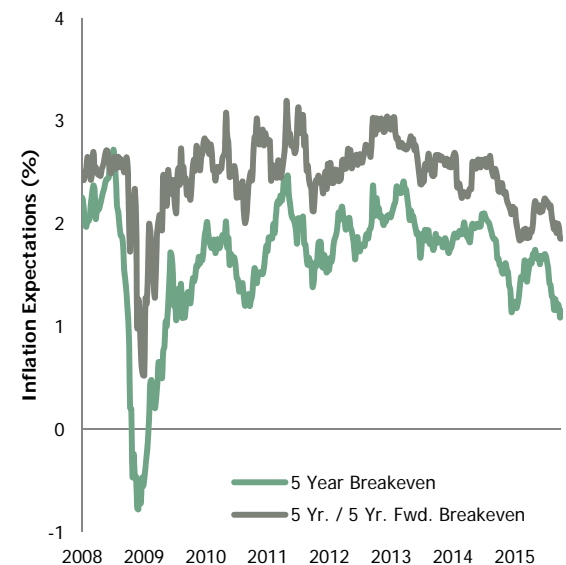
Insulated from the volatility of international markets and slumping commodity prices, municipals posted strong returns of 1.7% as measured by the Barclays Municipal Bond Market. Taking cues from the Treasury market, municipals rallied on lower interest rates and increased demand for safe assets. Unlike the taxable bond market, municipal performance was less influenced by credit quality as returns were largely similar across the investment grade credit quality spectrum.

In the high yield municipal market, positive developments in Puerto Rico helped drive returns. The Barclays Municipal High Yield Index posted returns of 1.4% after Puerto Rico took steps toward overcoming their \$72 billion mountain of debt by outlining plans for negotiated restructuring.

## Fixed Income Benchmarks

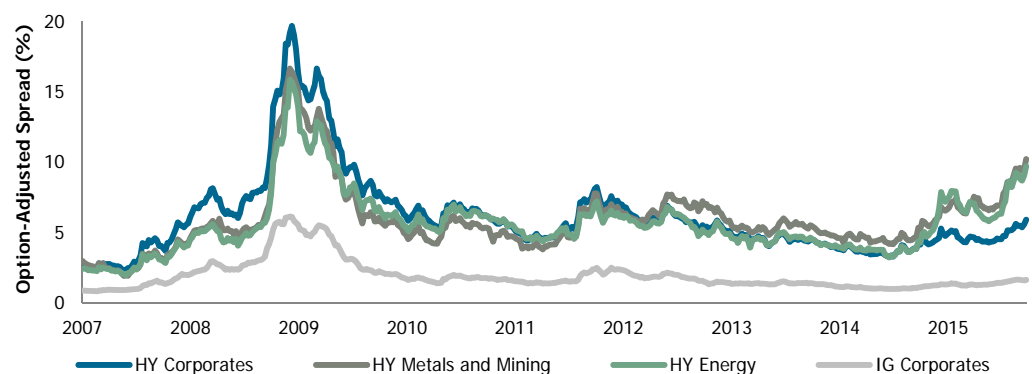
Asset Class	Representative Benchmark	Q3 Return	YTD Return
Taxable	Barclays Aggregate	1.2%	1.1%
Treasury	Barclays Treasury	1.8%	1.8%
Corporate	Barclays Corporate	0.8%	-0.1%
High Yield	BofA/ML HY Master II	-4.9%	-2.5%
Municipal	Barclays Municipal	1.7%	1.8%
International	Barclays Global Agg.	0.9%	-2.3%

Figure 6  
Inflation Expectations Near 2009 Levels



Source: Bloomberg

Figure 7  
Yields Spreads Among Select Sectors



Source: Barclays



### Benchmark and Asset Classes Definitions

**S&P 500 Index (Large Cap / U.S. Stocks):** A representative sample of 500 leading companies in leading industries of the U.S. economy. These are equity securities of large capitalization (generally \$7 billion plus market cap) companies having growth and value characteristics.

**Russell 3000® Growth Index (All Cap Growth / Growth Stocks):** Measures the performance of the 3,000 largest U.S. companies based on total market capitalization with higher price-to-book ratios and higher forecasted growth values.

**Russell 3000® Value Index (All Cap Value / Value Stocks):** Measures the performance of the 3,000 largest U.S. companies based on total market capitalization with lower price-to-book ratios and lower forecasted growth values.

**Russell 1000® Growth Index (Large Growth):** Measures the performance of those Russell 1000® Index companies with higher price-to-book ratios and higher forecasted growth values. These are equity securities of large capitalization (\$7 billion plus market cap) companies having growth stock characteristics (high price to earnings, high return on equity and low dividend yield).

**Russell 1000® Value Index (Large Value):** Measures the performance of those Russell 1000® Index companies with lower price-to-book ratios and lower forecasted growth values. These are equity securities of large capitalization (\$7 billion plus market cap) companies having value stock characteristics (low forecasted price-to-earnings ratio, low price-to-book ratio, high dividend yield).

**Russell Midcap® Index (Mid Cap / Mid Core):** Measures the performance of the 800 smallest companies of the Russell 1000® Index, which represent approximately 31% of the total market capitalization of the Russell 1000® Index. These are equity securities of middle capitalization (\$2-7 billion plus market cap) companies having growth and value characteristics.

**Russell 2000® Index (Small Cap / Small Core):** Measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represent approximately 10% of the total market capitalization of the Russell 3000® Index. These are equity securities of small capitalization (<\$2 billion plus market cap) companies having growth and value characteristics.

**Russell Micro Cap Index (Micro Cap):** Measures the performance of the 1,000 smallest companies in the Russell 2000® Index, which represent approximately 3% of the total market capitalization of the Russell 3000® Index.

**MSCI EAFE Index Net (International / Developed Markets):** A free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. As of May 27, 2010 the MSCI EAFE Index consisted of the following 22 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom.

**Citigroup 3-month T-bill Index (Cash):** This index measures monthly return equivalents of yield averages that are not marked to market. It consists of the last one-month and three-month Treasury bill issues, respectively.

**Dow Jones-UBS Commodity Index (Commodities):** Composed of commodities traded on U.S. exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME). Sub-indices include Petroleum, Grains, Industrial Metals, Livestock, Precious Metals, and Softs.

**MSCI Emerging Markets Index Net (Emerging Markets):** A free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. As of May 27, 2010 the MSCI Emerging Markets Index consisted of the following 21 emerging market country indices.

**MSCI Country Indices (Country-Specific Markets):** To construct an MSCI Country Index, every listed security in the market is identified. Securities are free float adjusted, classified in accordance with the Global Industry Classification Standard (GICS®), and screened by size and liquidity. MSCI then constructs its indices by targeting for index inclusion 85% of the free float adjusted market capitalization in each industry group, within each country. By targeting 85% of each industry group, the MSCI Country Index captures 85% of the total country market capitalization while it accurately reflects the economic diversity of the market. This includes the MSCI Japan Index. International indices.

**Barclays Aggregate Bond Index (Taxable Bonds / Bonds):** Comprised of approximately 6,000 publicly traded bonds, including U.S. Government, mortgage-backed, corporate, and Yankee bonds with an average maturity of approximately 10 years.

**Barclays Global Aggregate Bond Index (Global Bonds):** Provides a broad-based measure of the global investment-grade fixed income markets. The three major components of this index are the U.S. Aggregate, the Pan-European Aggregate, and the Asian-Pacific Aggregate Indices. The index also includes Eurodollar and Euro-Yen corporate bonds, Canadian government, agency and corporate securities, and USD investment grade 144A securities.

**Barclays Muni Bond Index (Municipal Bonds):** Bonds must have a minimum credit rating of at least Baa, an outstanding par value of at least \$3 million, part of a transaction of at least \$50 million, issued after December 31, 1990 and have a year or longer remaining maturity.

**Barclays U.S. High Yield Bond Index (High Yield):** Covers the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets (e.g., Argentina, Brazil, Venezuela, etc.) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. Original issue zeroes, step-up coupon structures, 144-As and pay-in-kind bonds (PIKs, as of October 1, 2009) are also included.

**Barclays U.S. Treasury Bond Index (Treasury Bonds):** Comprised of U.S. Treasury securities with at least one-year maturities.

**Barclays U.S. Corporate Bond Index (Corporate Bonds):** Includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements.

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