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Investment and Financial Consultants

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Third Quarter 2015 Economic and Financial Markets Review

After several years of calm stock market conditions, volatility suddenly returned in the third quarter this year, as concerns about whether the Federal Reserve Board would raise interest rates and weakening global economic growth spooked investors. Although a stock market correction had been anticipated for a while, the decline that began in August has been unnerving due to the velocity of the initial decline and several failed rally attempts. Much of this volatility has been attributed to high-frequency computerized trading and institutional trading, rather than individual investors selling their stocks or mutual funds. In fact, the initial plunge on August 24 is being referred to by many investment analysts as a "flash crash" due to the speed of the market decline caused mainly by computerized trading algorithms at the stock market opening that day. As a result of this decline, the S&P 500 Index ended the third quarter down 6.74% year-to-date while the Dow Jones Industrial Average finished down 8.63% year-to-date. Because the bond market was largely unaffected by the interest rate and economic concerns plaguing stocks, the Barclays Intermediate U.S. Government/Credit Bond Index actually gained 1.77% during the first three quarters of this year.*

The primary reason the stock market steadily appreciated over the past several years with little volatility was due to the Federal Reserve Board's extremely supportive monetary policy. In addition to keeping short-term interest rates near zero since the financial crisis, the Fed printed several trillion dollars and used those funds to purchase long-term bonds. This strategy, known as "Quantitative Easing," was intended to support bond prices thereby keeping long-term interest rates artificially low (there is an inverse relationship between bond prices and interest rates). Low interest rates help the economy to grow because they make the cost of financing for businesses and consumers attractive. However, this low interest-rate policy has forced investors to shift money into the stock market to try to earn better returns than the low yields that have been offered by fixed interest rate investments such as money market funds, CDs, savings accounts, treasury bonds, corporate bonds, etc. It has also encouraged speculation by hedge funds that have used low interest rates to borrow money to buy stocks, commodities, or other riskier investments. While the Fed signaled it would continue this extraordinary low interest-rate policy for a long period of time, investors and traders grew confident that the stock market was not likely to decline in a meaningful way. Therefore, over the past several years, each time the market declined, buyers were emboldened to "buy the dips."

However, last November the Fed stopped printing money, and this year they began discussing the possibility of raising interest rates. As a result, the stock market stopped appreciating while market breadth deteriorated. Then in August, the Chinese government decided to devalue their currency to help their economy while intervening heavily in their precipitous stock market decline. This led investors to believe that the world's second largest economy was weaker than the Chinese government had been previously indicating. Plunging oil and other commodity prices also signaled that there could be a more significant slowdown in the global economy than investors had been anticipating. Investors began to fear that the Fed would begin raising interest rates for the first time in over nine years just as the global economy was headed into a potential recession. In addition, raising interest rates while other countries are still lowering interest rates, printing money, and devaluing their currencies could further strengthen the U.S. dollar, which could harm U.S. corporate earnings.

After anticipating that the Fed would raise interest rates at their September meeting, investors became concerned and confused as to why they unexpectedly decided not to raise rates. Investors and stock traders worried that perhaps the Fed does not have enough confidence in future economic growth to raise interest rates by even 0.25%. This caused additional uncertainty and volatility in the financial markets. The dilemma for the Fed is that if they raise interest rates, investors fear that they will harm future economic and corporate earnings growth. However, if the Fed does not raise rates, investors fear that this means they are worried (and investors should therefore worry) about the negative impact of China's slowdown on the U.S. economy.

While we have been concerned that the stock market would decline as the Fed got closer to making a decision about raising interest rates, it is unlikely that a small-scale rate hike by the Fed or China's slowing growth will lead to a recession. Because the worst stock market declines in the United States typically happen during recessions, it is unlikely that the recent stock market correction is foreshadowing the beginning of a severe, long-term bear market. Rather, this correction occurred because stocks generally became overvalued and investors became overly optimistic. Therefore, despite the recent market volatility, unless the U.S. economy shows signs of weakening significantly in the near future, we do not recommend making drastic changes to portfolios at this time.

In the meantime, please call us if you have any questions or concerns regarding the financial markets.

** Index returns were obtained from the Wall St. Journal and Barclays on October 1, 2015.*

*** Information regarding the amount of money printed by the Fed was obtained from www.federalreserve.gov.*