

## Financial Market Commentary: 3rd Quarter 2015

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### Déjà vu, Market Disruptions Reminiscent of Summer 2011

The 3rd Quarter 2015 was the worst quarter for global financial markets since 2011 when a Greece default, a U.S. Government Shutdown, and a U.S. Debt downgrade were “breaking news” that summer. While the recent market selloff of this past summer was deep and broad-based, emerging markets were particularly punished. There is no shortage of concerns weighing on investors, including a global commodities rout, uncertainty about China’s slowing growth, an energy sector recession in the U.S. and a contraction in corporate earnings. On the other hand, consumers are back to spending on big-ticket items, as they benefit from low inflation, low energy prices, an improved housing market and nearly full employment in the U.S.

### Treasury Yields Drift Lower in the Face of Rate Hikes

Will they or won’t they is the question. Financial markets obsessed over the Federal Reserve (Fed) lift-off throughout the Quarter. In the end the Fed blinked, keeping rates on hold. Markets were understandably jittery, having faced an August of continued Emerging Markets turmoil, a devaluation of China’s currency and a 1,000 point plunge in the Dow in a matter of minutes on the morning of August 24. The Fed decision to not raise short-term interest rates sent a message to the markets that the economy is weak and may not withstand tighter monetary policy after almost seven years of zero percent rates. As contradictory as it sounds, global investors are pouring into U.S. Treasuries even though the Fed may eventually raise rates. The rate hike will affect the price of these securities. The global economy teetering back and forth has elevated the demand for Treasuries compressing yields from 2.35% to 2.04% during the Quarter.

The Fed cited there wasn’t a sufficient level of growth in domestic production or inflation to warrant a rate hike. The Fed forecasted only a 1.5% annualized growth rate during the quarter, which is still below the 2% target. Domestic inflation remained somewhat stagnant as the labor market provided little to no help in pushing prices up. Although it was the lowest level of jobless claims since the financial crisis, the real problem is incredibly sticky wages. The number of available jobs has increased post recession however in many industries wages have not increased over the last seven years. Despite wage stagnation consumer spending saw improvements, which shows signs of increased inflation and consumer confidence in the economy.

### The Greece Flare Up May Be Extinguished but the Fire in Oil Rages On

Market performance this Quarter was heavily impacted on problems in existence for a year or more. We entered the Quarter with investors nervous about the fate of Greece, and we exited the Quarter with a bailout resolution and a commitment that Greece will try harder. What does that mean? Only time will tell. Unfortunately, not all troublesome issues could turn out with fairy-tale endings.

Oil prices actually dipped to the lowest level since the financial crisis, bottoming at \$40/BBL on continuing data of oversupply and lagging demand. The oversupply continues to stem from U.S. and Saudi Arabian production in the face of lower prices. The dampened demand largely came from a slowing China.

## Bust of Commodities Felt Globally

Commodities often are as important as currencies to the producing economies that rely on them as a vital source of revenue; this is particularly true for emerging markets. While the decline of a few commodities is no cause for alarm, the fact that most global commodities have been falling in unison — and have yet to show signs of bottoming is a concern. If commodity prices do stabilize, the true carnage of the commodity bust likely has yet to be realized fully.

Commodity prices have plummeted 38% in the past year to approach lows last seen during the 2008 financial crisis. Oil, the most systemic commodity, collapsed by 50% within the past year. As a result, trillions of dollars' worth of global energy projects have been cancelled or suspended. Mining, drilling and exploration are capital and labor intensive activities that have added significantly to employment and corporate profits in recent years is undergoing retrenchment globally. China's growth continues to slow. The country has dominated the market's demand for commodities, accounting for nearly half of the demand for many metals, and is the largest importer of oil in the world.

## What's Happening with China

Founded in 1949 as a hard-line socialist country, the People's Republic of China has steadily embraced the tenets of capitalism, especially since economic reforms were enacted in 1978. Today, China's economy is the second-largest in the world and will likely overtake the U.S. sometime this century. For the first time in 25 years, Beijing is undergoing a massive transformation as blue skies can be seen. These skies were traditionally blotted out by yellow smog. This might please proponents of the green movement, but it's ultimately harmful to the health of China's manufacturing sector.

On the other hand, blue skies could be ahead for China's service industries. Misconception and exaggeration are circling China's economy like a flock of hungry buzzards. Listening only to the popular media, you might believe that the Asian giant is teetering on the brink of economic disaster, with the Shanghai Composite Index's recent correction and devaluation of the Renminbi held up as "proof." These events are indeed significant and have real consequences. They also make for great, sensational headlines.

What hardly gets coverage is China's economy is not weakening so much as it's changing, much like Beijing's skies. The world's second-largest economy has begun to shift away from manufacturing and more toward consumption and the service industries. While the country's purchasing managers' index (PMI) reading has been in contraction mode since March of this year, the service industries which include financial services, insurance, entertainment, tourism and more are ever-expanding. The problem is that the transformation has not been fast enough to offset the massive size of the manufacturing sector. In China, overseas travel, cinema box office revenue and ecommerce are all seeing "explosive growth". The country's once-struggling real estate market is also robust. The government just relaxed rules to permit more foreigners to purchase mainland property.

While uncertainties remain whether China's economic growth is indeed stabilizing, it is irrefutable that the country's services industry has overtaken manufacturing in recent years and surpassed 50 percent of total GDP for the first time in history in the first nine months of 2015. Retail sales have been the most resilient among all macroeconomic indicators amid China's ongoing slowdown. Consumer-oriented goods and services sectors should present more sustainable opportunities for investors going forward.

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## Financial Market Dislocation: Trend or Temporary Pause

Market volatility and even market corrections are normal. We've seen the current bull market in its seven years and counting suffer through several bouts of volatility, only to shake off the resistance and surge to new record highs. Key to the market's strength through these difficult episodes was fundamentals, which remained solidly supportive of higher valuations despite occasional market gyrations. "Fundamentals drive markets"; as long as fundamentals like corporate earnings are positive, the future direction of equity prices likely will be positive as well. A change of direction in the fundamentals historically has been the canary in the coal mine signaling trouble ahead.

September is historically a difficult month for financial markets, and that has been the case this year, particularly in international markets. Although the U.S. has suffered less damage so far, we have experienced market declines and are still exposed to growing geopolitical and economic turbulence. Markets can be expected to adjust to lower growth rates, and companies can be expected to adjust their expectations based on conditions in the rest of the world.

Although market price adjustments are never pleasant, they are an inevitable result of investors adjusting risk exposures and in the long run are usually not significant. Investors with properly diversified portfolios have enjoyed the market run-up in the past several years and should be prepared to take an inevitable downturn in stride. More short term turbulence looks quite possible; however, the U.S. remains well positioned for the future, and investors should continue to participate in the growth.



Disclosure: Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results. Diversification does not assure a profit or protect against loss in declining markets. All indices are unmanaged and investors cannot invest directly into an index. The Dow Jones Industrial Average is a price-weighted average of 30 actively traded blue-chip stocks. The S&P 500 Index is a broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks. The MSCI EAFE Index is a float-adjusted market capitalization index designed to measure developed market equity performance, excluding the U.S. and Canada. The MSCI Emerging Markets Free Index is a market capitalization-weighted index composed of companies representative of the market structure of 26 emerging market countries in Europe, Latin America, and the Pacific Basin. It excludes closed markets and those shares in otherwise free markets that are not purchasable by foreigners. The Barclays Capital Aggregate Bond Index is an unmanaged market value-weighted index representing securities that are SEC-registered, taxable, and dollar-denominated. It covers the U.S. investment-grade fixed-rate bond market, with index components for a combination of the Barclays Capital government and corporate securities, mortgage-backed pass-through securities, and asset-backed securities. The Barclays Capital U.S. Corporate High Yield Index covers the USD-denominated, non-investment-grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below.

## Equity Performance

Equity Index	Style	YTD Return As of 9/30/2015	1 Year Return As of 9/30/2015	3 Year Return As of 9/30/2015	5 Year Return As of 9/30/2015	10 Year Return As of 9/30/2015
Russell 1000 TR	U.S. Large Cap Stocks	-5.24%	-0.61%	12.66%	13.42%	6.95%
Russell MidCap TR	U.S. Mid Cap Stocks	-5.84%	-0.25%	13.91%	13.40%	7.87%
Russell 2000 TR	U.S. Small Cap Stocks	-7.73%	1.25%	11.02%	11.73%	6.55%
MSCI EAFE NR	Foreign Develop Stocks	-5.28%	-8.66%	5.63%	3.98%	2.97%
MSCI EM NR	Foreign Emerging Stocks	-15.47%	-19.28%	-5.27%	-3.58%	4.27%
DJ US Real Estate TR	Real Estate	-4.75%	6.95%	7.95%	10.72%	5.73%
Bloomberg Commodity TR	Commodities	-15.80%	-25.99%	-16.02%	-8.89%	-5.67%

## Fixed Income Performance

Fixed Income Index	Style	YTD Return As of 9/30/2015	1 Year Return As of 9/30/2015	3 Year Return As of 9/30/2015	5 Year Return As of 9/30/2015	10 Year Return As of 9/30/2015
BarClays US Aggregate Bond TR	U.S. Core Bonds	1.13%	2.94%	1.71%	3.10%	4.64%
BarClays US Corporate High Yield Bond TR	U.S. High Yield Bonds	-2.45%	-3.43%	3.51%	6.15%	7.25%
BarClays Global Aggregate Bond TR	Foreign Developed Bonds	-2.25%	-3.26%	-1.59%	0.81%	3.71%
Morningstar Emerging Market Bond	Foreign Emerging Bonds	-0.54%	-2.82%	0.90%	3.36%	6.16%
CitiGroup 3-Month T-Bill	Cash	0.02%	0.02%	0.04%	0.06%	1.26%

Source: Morningstar®