Quarterly Report- 3rd quarter 2015

On the Markets...

There is an ancient Chinese curse: “*May you live in interesting times...”*

If you are an investor or trader today in any market, things could not get much more interesting. For 6 months, from early February through mid-August, U.S. equity markets were constrained by massive uncertainty- trading in a range of little more than 3%, leading to the appearance of this prophetic headline in the digital edition of the Wall Street Journal at 8:46am ET on Jul 21, 2015- **It’s Official:**

This Is the Most Boring Stock Market in Decades

Uh oh......as the WSJ yawned, we became increasingly concerned. The weekly price action of the market was seemingly benign, but the daily movement appeared to us like an extended bipolar episode. The technical chart was filled with a continuous saw-toothed pattern of near-daily reversals, always threatening to break decisively up or down, but never actually doing so....until it did: The price action in the last 2 weeks of the quarter caused August to be the worst month for stocks in 3 years as all 10 S&P sectors fell and major indices posted declines of ~6 percent.

This was not totally unprecedented. As Morgan Stanley’s Adam Parker noted, the market has dropped more than 5% **sixteen** times since the recovery began in March 2009, and each time has moved on to new highs. So the anxious question hangs: What Now?- especially given the length of this recovery cycle...

As we’ve previously noted, the entire nature of this economic episode, the cause of its collapse, and the nature of its extended, frustrating and feeble

recovery, is an historical anomaly. But to try to put it in perspective, we observe that economic expansions in the modern era appear to be getting longer and longer. The longest recovery on record was the 1990's recovery, which lasted 119 months and the last 3 recoveries have lasted an average of 94 months. In late August, Goldman Sachs declared: “An economic contraction is decidedly NOT in our forecast. Our response is that, while the current US expansion is long in temporal terms (6 years), the magnitude of the recovery is weak and on that basis, the expansion phase is closer to early/mid cycle.”

We take a constructive, but more modest view- that the U.S. economy is in the middle-to-later stages of recovery. Of the numerous leading economic indicators we most trust, we continue to see less than a 5% probability of a recession within the next 6 months. Serious financial market declines- Bear Markets- are not caused by slow or slowing growth, but by an economic crisis which causes the economy to go negative and contract, inducing a Recession. With all due respect to Robert Frost, we must gently insist that our world will end with a bang, and not a whimper.

Which is to say, that absent some as-yet unrecognizable catalyst of major significance-- feel free to insert the geo-political, astronomical, global epidemic, or seismic catastrophe of choice-- this market should continue higher into 2016.

This does not rule out a deeper pullback in stock prices in the near-term. Indeed, 10% corrections tend to occur about every 26 months, although we may have forgotten this, as it has been 45 months since the last 10% correction. It is important to note that the 3 most recent and longest recovery periods each led to a 10% pullback.

We recognize that it can be difficult to maintain a rational & unemotional attitude to market volatility, especially with respect to the volatility of your own portfolio. This is why we are so focused on risk-management. But keep in mind that historically, markets have always displayed big swings. The “average annual market returns,” so frequently quoted, are the result of averaging together wildly different returns from several years, some much higher, some much lower; very, very few years actually return “the average.” Let us not make the fatal error of the statistician who managed to drown in a lake whose average depth was only 6 inches.

Here are 2 fundamental truths that experience has carved into our souls: Markets climb a wall of worry, for a simple reason. If everyone is convinced the market is only going higher, then everyone is buying, and partying like it's 1999 (-we remember how that ended-) until there is no one left to buy; then the crowd turns in a panic and sells.

Markets can tip, but they eventually right themselves as prices cause the supply of buyers and sellers to re-balance, and in that process, prices revert to a rational level of value.

Albert Einstein **and** Yogi Berra are each credited with saying that "In theory, there is no difference between theory and practice, but in practice, there is." ✱ So while we have articulated some theories for our current state of relative optimism, perhaps we should present some practical data points.

Yes, China's growth may be officially overstated, and it is most certainly slowing.....but even 6% GDP growth is heady stuff; U.S. exports to China are only 0.7% of our GDP; Gluskin Sheff's David Rosenberg notes that China's economy has only a 16% correlation to the U.S. economy and Goldman Sachs estimates that just two per cent of the S&P 500's revenues come from sales to China. Of greater importance is the service sectors of both the U.S. and the Eurozone which have been gradually improving over the past year or two.

Yes, the U.S. energy sector is already in a bear market, with even blue chip stalwarts, like Exxon and Chevron down 30% or more.....but that weakness began almost a year ago and hasn't precipitated a market-wide collapse, and, many industrial companies for which oil is a major feedstock, as well as ordinary consumers, are significantly benefiting from lower oil prices.

Yes, Corporate profits have probably peaked and earnings estimates for the S&P have been lowered for the last 6 quarters.....but they are still robust, and much of that erosion has been the result of a strong U.S. dollar which is a trend that appears to be topping out.

✱ Undoubtedly, this shared attribution can't be accurate, and we do have a theory, but we find this discontinuity so delightful we refuse to google for the truth.

Yes, Chicken Little, the U.S. Federal Reserve (and central banks around the globe) have dramatically increased financial reserves and "artificially" lowered interest rates to try to stimulate the economy.....but it has not created worldwide inflation; instead it has provided a boost to financial asset prices and as global growth has slowed, it has served to counter the widespread deflation we see in commodity prices today.

Yes, job growth in the U.S. has been anemic even 7 years into this recovery.....but much of the employment problem is structural- the destruction took a long time to develop and the repair will as well. Still, even slow healing is healing; consumer spending (roughly 70% of the economy) has not only held up, but continues to improve- particularly large purchases, such as homes and autos, further encouraged by lower interest rates.

And yes, the Fed will eventually raise interest rates..... but not in October and we believe there is an increasing possibility that "lift-off" in rates will be delayed into 2016. Not only did the Fed vote to keep interest rates stable at their mid-September meeting, it did so overwhelmingly. Fed Chair, Janet Yellen highlighted global economic uncertainty during her post-meeting press conference and specifically mentioned concerns that will only be resolved with time: "While we still expect that the downward pressure on inflation from these [domestic] factors will fade over time, recent global economic and financial developments are likely to put further downward pressure on inflation in the near term," she said in her opening statement. Current trends and prevailing risks aren't likely to clear up in the course of the next few months.

Increasing interest rates are of particular interest to diversified portfolios, like ours, with significant yield exposures - for example, to high dividend stocks, preferred, MLPs and REITs. Generally speaking, exposure to these asset classes makes sense in a world of near-zero interest rates. They have been, and continue to remain, an important part of our asset allocation strategy. The Fed has clearly signaled that they will be slow to move rates, and when they do so, they will move with caution. Real short-term rates, vs. inflation, are still negative, as they have been for the past seven years. Monetary policy won't be tight for a long time. Interest rates will simply become less low over the next year or so and shouldn't threaten the health of the equity markets. On the contrary, if the Fed is correct in assessing the appropriate time to raise rates, it will be a sign of increasing

strength in the economy to which the stock market should respond with confidence.

We will continue to be vigilant on your behalf. To paraphrase Cramer, there is always a bear market out there somewhere, but we shall follow the weight of the evidence, rather than the media's hyperbole or the uninformed, popular emotion of the crowd.

We welcome your feedback, we share your concerns and we are ever respectful for the resources you have placed in our care.

Sincerely,

Martin S. Lieber
Chief Investment Officer
585-662-4166
mlieber@strategicwp.net

William A Boselli
President
585-662-4165
wboselli@strategicwp.net

Opinions and examples herein are based on available historical trends and data which are limited in their nature and may not hold in the future. Past performance of any asset class, specific sector or security or management style is not necessarily indicative of future results. The observations made in this paper are general in nature and do not represent the certified results of actual trading activity. Opinions expressed herein are current opinions as of the date appearing in this material only. Reliable methods were used to obtain information for this presentation, but the author cannot guarantee it's absolute accuracy. In no event should anything contained herein be construed as an expressed or implied promise or guarantee.