**Market Update – Part 1: 8/21/2015**
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Stock markets around the world sold-off significantly yesterday, with the US broad-based index, the S&P 500, and its more concentrated counterpart, the Dow Jones Industrial Average, both falling more than 2%.

This was the largest single trading-day drop for either index since February of 2014, and after hitting new highs in May of this year, the S&P 500 and the Dow have declined 7.2% and 4.5%, respectively, as of last night's close.

Both aforementioned indices are lower by more than 1% this morning as well.

I want to address three items in this market update: 1) Discuss what is causing/catalyzing this recent spate of market weakness? 2) Provide some perspective on the magnitude of the recent drop. 3) Illustrate where we are able to find some opportunity amidst the negativity.

1) **Discuss what is causing/catalyzing this recent spate of market weakness?**

    Generally speaking, the market is very concerned that global economic growth is slowing.

    One catalyst for this concern has been largely emanating from China and several smaller foreign countries known as emerging markets.

    For the past 2 weeks, China's central bank has been intervening in the foreign exchange markets. In doing so, they are driving down the relative value of their home currency, intending to make their products cheaper to foreign buyers.

    This tactic has telegraphed a concern about the underlying organic growth of the Chinese economy at a time when their purchasing power is perceived to be critical to a stable global economy.

    China's monetary policy initiatives have been copy-catted recently by some other, smaller countries – most recently Kazakhstan.

    If you had no idea that the Kazakhstani currency is named the Tenge, then you are in good company. Until yesterday, its presence in currency markets was inconsequential, but the psychological impact of its intervention has exacerbated fears of a global economic slowdown and dented an already fragile framework of market psychology.

    That fragile framework is slathered in oil. The price of a barrel of crude has dropped precipitously since June of last year and now, at just over $40/barrel, is off more than 60% since then.

The prospects of a near-term price reversal seem dim should the following conditions arise/persist:

a) The Chinese and emerging market economies reduce their demand sufficiently and;
b) The foreign-exchange market manipulations result in a strengthening US Dollar, in which the price of oil is denominated (the higher the value of the dollar, the fewer the dollars a buyer needs to transact in a purchase).

Oil supply appears sufficiently in excess of demand at this point, challenging the outlook for companies in the energy industry, which comprise approximately 9% of the S&P 500 Index.

Additional catalysts for concern about global growth are:

- The prospects of the Federal Reserve Bank raising interest rates in the 2015;
- Reintroduction of Eurozone instability with the recent and surprising resignation of Greek Prime Minister, Alexis Tspiras;
- Geopolitical unrest as the rhetoric rises around the Iranian nuclear treaty.

Suffice it to say, the proverbial "wall of worry" that the market attempts to climb is steep and slippery right now.

**2) Provide some perspective on the magnitude of the recent drop.**

The 2 tables below provide some interesting comparative contexts for the current trading environment.

**Dow Jones Industrial Average:**

| Start | End | % |
|---|---|---|
| 10/7/2012 | 11/15/2012 | -7.8 |
| 1/1/2014 | 2/3/2014 | -7.3 |
| 5/19/2015 | 8/20/2015 | -7.2 |

**S&P 500 Index:**

| Start | End | % |
|---|---|---|
| 9/16/2012 | 11/15/2012 | -7.7 |
| 9/18/2014 | 10/15/2014 | -7.4 |
| 1/15/2014 | 2/3/2014 | -5.8 |
| 5/21/2013 | 6/24/2013 | -5.8 |
| 12/7/2014 | 12/16/2014 | -4.9 |
| 12/29/2014 | 1/15/2015 | -4.7 |
| 8/4/2013 | 8/27/2013 | -4.6 |
| 5/21/2015 | 8/20/2015 | -4.5 |

Certainly, the current pull-back is, at least for now, unremarkable in its magnitude.

**3) Illustrate where we are able to find some opportunity amidst the negativity.**

As referenced above, the preponderance of the market's problems and general listless trading – in spite of the recent drop, the S&P 500 has traded within a range of +/- 3.5% to this point of the calendar year: the first time such a tight range has been displayed in the HISTORY of the market – are wrapped up in the 3 areas of Currencies, Commodities and Interest Rates.

These 3 areas offer opportunity to the patient and somewhat contrarian investor that is as sensitive to valuation as they are to price. As the table below offers, there are upshots to the downsides on display in market.

And while the headline indices are displaying some new recent weakness, keep in mind that the internals of the market have been indicating some issues for a while.

Consider that over 50% of the companies in the Russell 3000 Index have experienced price declines of more than 20% from their peaks (this is the technical definition of a bear market in a stock); and that more than 50% of the companies in the S&P 500 have experienced price declines of more than 10% from their peaks (this is the technical definition of a correction in a stock). In many respects, the headlines are just now reflecting the secret that the individual components have been keeping.

We are deploying the table below to ascertain areas of opportunity as we attempt to capitalize on the market weakness – of course only as appropriate for each client's risk appetite and long-term objectives.

| | **Positive value drivers on stocks** | **Negative value drivers on stocks** |
|---|---|---|
| Fixed Income | Cheap access to capital elevates M&A activity;<br><br>Lower discount rates increase PV of stock prices;<br><br>"Slow & Low that is the Tempo"<br><br>"+"for healthcare, consumer staples, financials and bonds | Conventional loan demand is weak, impeding the transmission mechanism for growth;<br><br>Net interest margins are well below average;<br><br>Market bracing for Fed rate lift and any ensuing volatility<br><br>"-" for utilities, REITs |

| | | |
|---|---|---|
| Commodities | Lower input prices reduce costs and raise profit margins;<br><br>Consumers receive an energy “tax-cut” which could catalyze spending;<br><br>Particular beneficiaries could be European economies (who are also benefitting from ECB monetary policy) in that they are net oil importers.<br><br>“+” for consumer staples, consumer discretionary, Euro exporters | Energy sector is 9% of S&P and has been a drag on index performance;<br><br>Capital investment scales back hurting industrial equipment suppliers;<br><br>Weak housing markets and related sub-segments in parts of the country that are oil and energy dependent.<br><br>“-“ for energy, industrials |
| Currencies | Strong dollar favors smaller companies w/ less export reliance in their business models;<br><br>Weaker Euro intended to elevate export economies and companies in Eurozone.<br><br>“+” for US small and medium sized companies, Euro exporters | Strong dollar is a headwind in a weak economy (of which we are in) as aggregate demand will be reduced when exports fall relative to imports;<br><br>Stronger dollar lowers prices of commodities that are dominated therein, exacerbating the pull-back.<br><br>“-“ for materials, energy, large cap exporters |

Ideally, we would look to undertake a value orientation across the market cap (size) spectrum with active management and a strong international component.

The more pronounced the negative impact of any individual element, the more the emphasis otherwise.

We'll keep in very close touch as the market moves and please do not hesitate to call any of the team at Kavar Capital. It is in the midst of market mayhem that we will do all we can to be readily available to you.
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