

## Market Update – 8/31/2015

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After staging a stout comeback from the lows of early last week, the US stock market had difficulty sustaining any momentum with which to end the month.

In August, the Dow Jones Industrial Average fell 6.57% and the S&P 500 dropped 6.26%. On a year-to-date basis, the indices have declined 7.27% and 4.21% respectively<sup>1</sup>.

And if you hop online tonight or grab the business section of tomorrow's newspaper, you'll be inundated with contextual comparisons of August's gyrations, so here's one for you: the VIX Index (technically defined as an estimate of future volatility based on the underlying prices of protection available in the options market) just had its largest move higher in any single month, ever.<sup>2</sup>

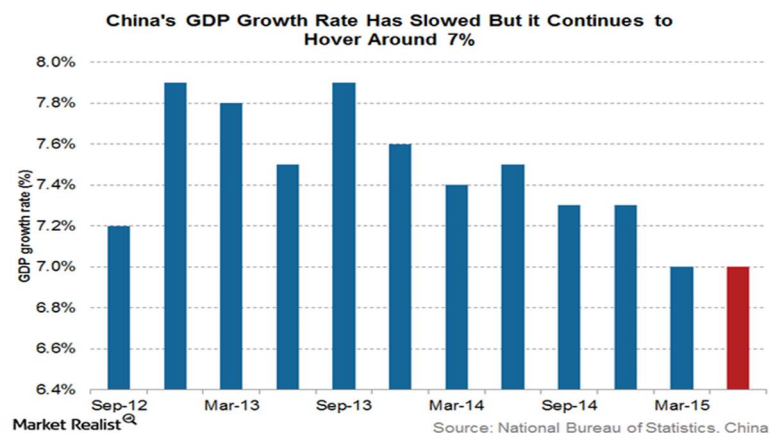
Suffice it to say, it was a month for the history books and a month to which we are glad to say goodbye.

So September begins tomorrow, but the main motivations of the market's malcontent remain:

1. Ambiguity as to the state of the Chinese economy and financial markets;
2. The timing of an interest rate increase by the Federal Reserve Bank in the US;

**China.** It is difficult to determine the long-term implications on US & developed foreign stock markets of an economic and/or stock market slow-down in the world's second largest economy. That difficulty is underscored by the fact that such an economy is under Communist leadership, known for cryptic and selective points of data distribution from which an investor can devise a strategy.

It is known that the Chinese economy has slowed markedly from its peak performance but it is unknown just how precarious is its current plateau<sup>3</sup>.



It is known that the Chinese stock markets have correctly sharply over the last few months but it is unknown how disconnected those stocks were from their underlying valuations when they were ascending.

It is known that the Chinese government has been intervening to defend their currency (designed to make their exports cheaper) and their stock markets (designed to bolster an esprit de corps ahead of a commemorative military parade<sup>4</sup> – this is not a joke) but it is unknown whether any of their policies will be stimulative enough to foster a tangible turnaround.

These unknowns, in our opinion, deemphasize any short-term interest in stepping into this area and we will look to align/invest in parts of the world with clearer inputs into our expected return calculations while the unknowns remain.

In an age of high interconnectivity amongst financial markets, it is naïve to think that we can immunize stock portfolios from Chinese shock waves, but it is practical to side-step their epicenters.

**Interest Rates.** The Federal Reserve Bank of Kansas City held their annual symposium of monetary policy this past weekend in Jackson Hole, Wyoming.

Wonky luminaries from around the world weighed in on the facts and facets of interest rate policy and its prospective implications. The keynote address was delivered on Saturday by Vice Chairman of the Fed, Stanley Fischer.

The financial markets have been captivated by the timing of the Fed's first interest rate increase (a.k.a. "tightening" of monetary policy) since June of 2006 and fearful that any reduction in the availability of liquidity (rate hikes make money more expensive and therefore scarce) could incite economic contraction at time when growth is arguably not robust.

I thought that the International Business Times did a great job itemizing the 3 key take-aways from Vice Chairman Fisher's remarks<sup>5</sup>:

1. **Central bankers are following developments in China's economy.**

*"At this moment, we are following developments in the Chinese economy and their actual and potential effects on other economies even more closely than usual."*

2. **The path of interest rates matters more than the particular timing of the first increase.**

*"For the purpose of meeting our goals, the entire path of interest rates matters more than the particular timing of the first increase."*

3. **The Fed shouldn't "wait until inflation is back to 2 percent to begin tightening."**

*"Given the apparent stability of inflation expectations, there is good reason to believe that inflation will move higher as the forces holding down inflation dissipate further."*

Whether the Fed raises interest rates in a couple weeks (their next meeting is on September 17<sup>th</sup>) or in a couple months (the Fed meets also in October and December of this year), it seems likely to us that they will raise rates this year.

We're utilizing the volatility that this proposition is providing as an opportunity to invest in areas of the stock market that are economically, not interest rate sensitive. And in areas of the bond market where maturities are short and qualities are high.

We think it is fair to assume that the longer that the Fed deliberates on the timing of the rate hike, the longer the market will be in high fluctuation mode. Like the crescendo of a crowd before the lift of a concert curtain, the sound and fury may signify much less once it commences.

Barron's recently (June, 2015) a report from Nuveen's Bob Doll who noted<sup>6</sup>:

*"While equities have generally performed well before and after Fed rate hikes, we have seen increased volatility. In particular, a period of consolidation often accompanied the start of rate increases. The table shows the average daily returns of the six time periods discussed above. In the 250 days before the rate increases and the 500 days after, stock prices trended higher but experienced a modest selloff. The numbers are different for each of the six time periods, but on average, equities have experienced a peak-to-trough decline of roughly 10%."*

## Equities Survived Previous Fed Rate Hikes

### S&P 500® Index Returns Before and After Rate Increases

Date of Initial Hike	Performance Before/After Initial Rate Hike		
	250 Days Before	250 Days After	500 Days After
5/2/1983	36.60%	-1.10%	12.20%
12/16/1986	19.10%	-5.90%	11.20%
3/29/1988	-11.40%	11.70%	30.60%
2/4/1994	5.30%	0.60%	34.10%
6/30/1999	19.70%	6.00%	-10.70%
6/30/2004	14.80%	4.40%	9.10%
<b>Average</b>	<b>14.00%</b>	<b>2.60%</b>	<b>14.40%</b>

While this is not a prediction by any means, we do firmly believe that only when the investment trees are shaken as they have been can delicious fruits fall freely. And we want to be in a position to pick them up, provided that it is consistent with, and appropriate for, each client's risk appetite and long-term objectives.

There is no way to determine when more calm will return to the markets. And it can feel defeatist to be relegated to reacting. That is, however, a large part of investing: accepting the current conditions, calculating an expected return with historically-rooted probabilities and biasing in the direction(s) of income, safety or growth dependent upon your individual circumstances.

We'll keep in close touch and we'll also hope for more tranquil trading in the coming weeks and months.

<sup>1</sup>Source: Bloomberg Market Data

<sup>2</sup>Source: Bloomberg Market Data

<sup>3</sup><http://marketrealist.com/2015/07/slowdown-in-chinese-growth-measured/>

<sup>4</sup><http://fortune.com/2015/08/31/china-stock-market-military-parade/>

<sup>5</sup><http://www.ibtimes.com/stanley-fischer-speech-3-takeaways-federal-reserve-vice-chairmans-comments-jackson-2074111>

<sup>6</sup><http://www.barrons.com/articles/what-stocks-really-do-when-the-fed-hikes-rates-1433434654>

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