3rd Quarter Market Update and Outlook

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The third quarter of 2015 was certainly an eventful one in markets and the economy. As we head into the final quarter of the year, let's take a look back at some notable occurrences and themes.

1. Market correction

For most investors, the third quarter will be remembered for the markets correction in August. It was the first time the markets went down more than 10 percent since 2011.

However, as we discussed in past commentaries, these corrections occur on average about once every year and a half – it's happened many times in the past and will happen again in the future. Corrections can be healthy if they rid the market of shorter-term investors that move prices farther away from their fundamental value.

Before the correction, market participants were bullish, but since the correction many have turned bearish. At this point, it's safe to say the market has more realistic expectations, and all other things being equal, we prefer that to very high expectations.

The technical definition of the bear market is a 20 percent decline from its peak, and for this to happen the economy would probably have to enter a recession, which seems unlikely based on figures we are seeing today. Overall, estimates are for the U.S. to grow at around 2 percent annually. Economic data and indicators, such as job numbers and wage numbers, while improving slowly are improving nonetheless.

2. Interest rates

Less than a month after the correction, attention turned to the Federal Reserve's decision regarding interest rates. Many believed the Fed would finally raise rates during the September 16-17 meeting. That didn't happen.

We must remember that the members of the Fed can't predict the future any more than we can. If they had a crystal ball, they probably would have raised rates a few years ago.

Because it didn't, the Fed is now in a difficult position. Chairwoman Janet Yellen and the other board members are seeing global slowdown, especially in China, and slow growth here in the U.S.

The board is concerned with growth domestically. If this slow growth continues, raising rates could further impede its progress.

Our base case is that interest rates will slowly move higher over the next several years. It's important to note that one the biggest movers of interest rates is inflation, which also currently is low. One telling sign is the difference between what an investor can earn on a nominal Treasury bond or a TIPS bond (interest + inflation). Both are yielding approximately the same amount on one year bonds, indicating low inflation expectations from the bond market.

The Fed is also looking at the employment rate, which is showing improvement, albeit gradually. Wages need to grow faster.

Regardless of the Fed's decision, the markets ultimately determine rates; assuming the market is as concerned with inflation as we are, it will be a slow ride higher.

3. Market valuations

Let's now look at how stocks performed this past quarter. Stock prices are lower than they were a few months ago.

We believe that U.S. stocks are fairly priced given the slow growth, low interest rates and low inflation. There are some areas in the U.S., particularly momentum stocks, that appear to be overpriced. Megacap growth stocks look expensive on average, and while we have some in our portfolios, we are generally not adding to our exposure.

Value stocks are attractive, but involve more risk because these companies don't have as strong balance sheets and income statements as compared to their growth counterparts. They're trading at about five to six times cheaper than the valuation of growth companies (source: Ken French's website), a higher spread than average. As such, over the next three to five years we would expect these companies to have relatively good performance.

We continue to like international stocks, which are producing higher earnings yields and dividend yields than US companies on average. International markets are trading at deep discounts because they are weaker, but the relatively low prices provide much more room for growth. Investors who provide capital to markets that need it are usually well rewarded.

Some countries – like Canada – are in recession, but the positive news is those markets are already priced for that.

Looking ahead

In the fourth quarter, we will keep an eye on a few things. First, we'll be closely tracking gross domestic product growth. Of all market risks, we're most concerned with growth. We will also be monitoring top line growth, another issue companies have been struggling with.

Additionally, we'll be paying attention to interest rates. The Fed's next meeting is at the end of October, but investors should understand that the Fed tends to be a lagging indicator. If the board members feel confident enough to raise rates, that means we've already seen growth.

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