NOTTINGHAM ADVISORS
ASSET MANAGEMENT

THIRD QUARTER RECAP
(OUCH! What Just Happened?)

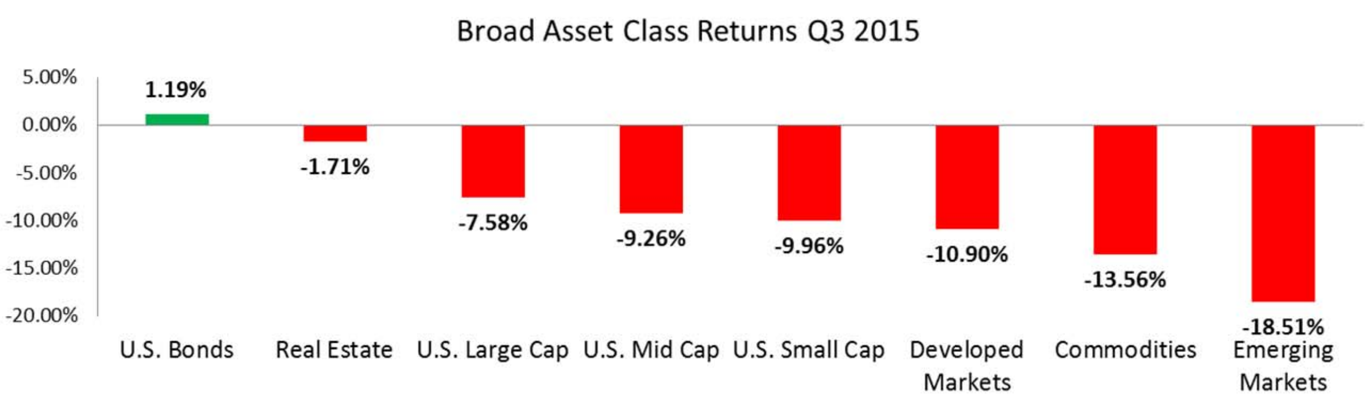
"Love is the most important thing in the world, but baseball is pretty good, too."

-Yogi Berra

The third quarter provided investors with the unwelcome reminder that risk still exists, markets can go down abruptly, and the mere threat of a quarter-point interest rate hike by the Fed is enough in this fragile environment to cause mayhem in all corners of this inter-connected world. For those of us "professionals" that do this for a living, it was an extremely confusing and oftentimes irrational quarter. For the laymen or amateur investor at home, I can only imagine the angst and emotional roller-coaster ride they must have felt they were on.

We'll spend a little time here at outset debunking some of the myths around this recent surge in volatility, try to explain what happened, as far as we are aware, and offer some thoughts and guidance as we look ahead to a "post-Fed" world. I may come across slightly less sanguine than I normally try to be in these missives, but just know that longer-term, I am exceedingly bullish on many fronts, certainly on equities and the U.S. economy. Near-term, though, I feel we may face some challenges.

Let's get some of the ugly stuff out of the way first by looking at broad asset class returns for the 3rd quarter of 2015.



What began as a promising year for stocks, rapidly fizzled over the summer; the old saw "sell in May and go away" once again proved prescient. If you recall from one of our earlier letters, we did point out that the S&P 500 had never posted 7 consecutive years of positive returns and 2015 would have been the first time that had happened. We still have one quarter left but it would take a fairly heroic rally in order to establish a new precedent here (we're cheering hard!).

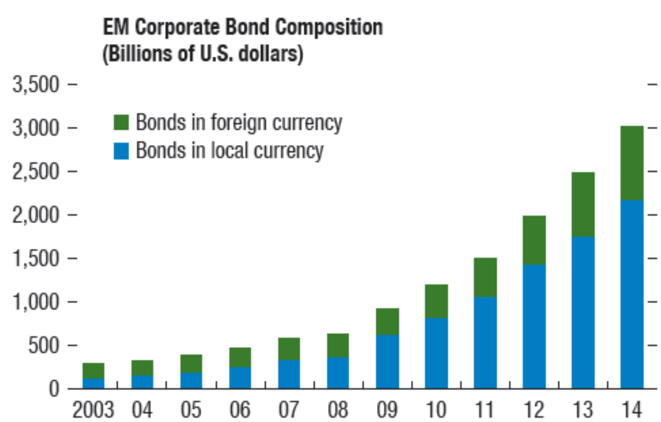
The proximal cause of the decline in the U.S. equity market was China's decision to devalue the Yuan versus the dollar on August 10th. Somewhat more remotely, the real tremors began echoing through the EM space on April 28th, when the U.S. Federal Reserve hinted at higher interest rates before year-end. This triggered the investor nervousness which resulted in capital outflows from EM countries throughout the summer, despite a steady U.S. equity market. China was clearly responding to a slowdown in its own economy, while trying unsuccessfully to manage the deflation of the equity bubble that still exists.

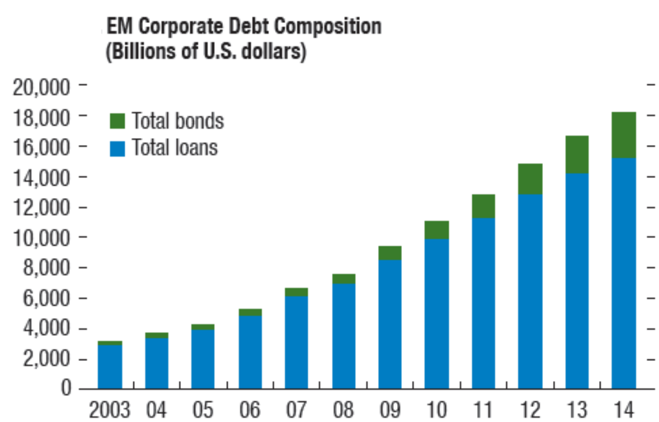
Source: Bloomberg

The chart of the Shanghai Composite index started to look very reminiscent of the NASDAQ back in 1999-2000. What struck us as odd was that many analysts were amazed at the speed of the descent while few were commenting on the completely irrational rise of the index over the past year. Much like in the U.S. during the tech bubble, speculative fever gripped many ordinary Chinese and stories of individuals dumping their life savings into the market and borrowing heavily to invest in ridiculous companies abounded. A lot of money was made in the preceding years and a lot more was lost during this recent rout. The more things change, the more they stay the same, unfortunately.

Contagion can be a nasty thing when it involves fear, and so it didn't take long for the selling to extend to other EM markets. The mere thought of China's economy slowing from 8%+ growth annually to a pithy 4-5% was enough to trigger wide scale selling of the broader EM space. True, lower growth rates do alter prospective investment returns and some amount of adjustment is necessary. Still, given the modest pace of global growth (estimates of which were recently lowered by the IMF to 3.1% for 2015), an economy expanding at a 5% pace is still quite strong.

The problems really extend to the other EM darlings, formerly affectionately known as the BRIC's. After booming throughout much of the past decade, Brazil is facing serious challenges to economic growth. Poor political leadership, combined with corruption and a decline in commodity exports to China has the Real collapsing versus the Dollar, which is particularly troubling given the amount of U.S. Dollar denominated debt they have. The chart below illustrates the broader problem in the EM space – too much debt! Because of this, the need for EM currency stabilization soon is paramount.



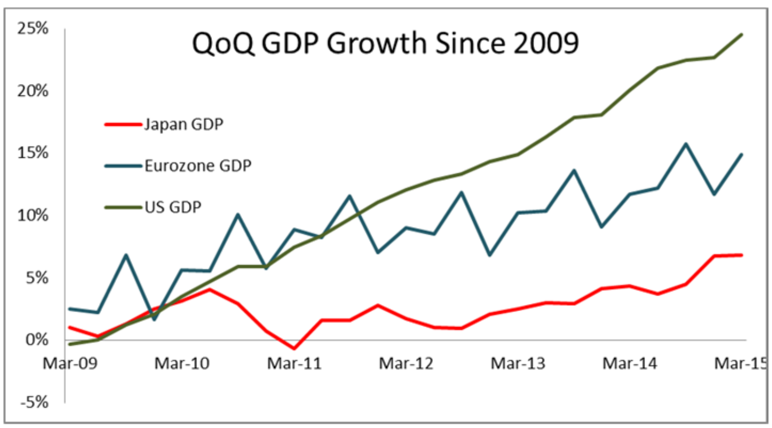


Source: International Monetary Fund

Russia continues to struggle from falling oil prices, the backbone of its economy, as well as international economic sanctions imposed on it by the U.S. and others as a result of their incursion into Ukraine. We now see Vladimir Putin taking advantage of the leadership void created in the Middle East by the U.S. withdrawal from the region, as he looks to war to help revive his moribund economy. It will be interesting to watch how this plays out and how an increasingly isolationist U.S. responds. Nonetheless, the current hostilities are bound to add to the overall volatility of both oil prices and equity markets around the globe.

India, our favorite EM country, is slowly - too slowly in our view - adopting many of the reforms its new Prime Minister Narendra Modi promised upon election. As the world's biggest democracy, India is poised to become a true economic giant this century, if it can overcome endemic political corruption and massive income and wealth inequality. We are studying this country and its economy closely in hopes of adding some greater exposure to some of our portfolios soon. The future looks bright to us, but much of this good news is already priced in and we're seeking a more attractive entry point.

Turning towards developed economies, our near-term focus remains on Japan and the Eurozone. Our currency-hedged exposures to both regions fared very well during the first half of 2015, only to see both the Yen and Euro rally in the face of global economic strife. We remain bullish on the U.S. Dollar, however, and will likely keep at least some of our international holdings currency hedged going forward.



The U.S. has witnessed steady economic growth since the 2008 crisis while Europe's experience has been maddeningly inconsistent. Japan, meanwhile, appears to finally be benefitting from Prime Minister Shinzo Abe's reform efforts, now commonly known as Abenomics. Global deflationary pressures remain extant, however, and near-term advances in growth may prove more difficult.

Unlike the U.S. Federal Reserve, both the Bank of Japan and the European Central Bank are still pursuing quantitative easing measures and this should help propel equities higher over the coming year. Taking what central banks give has been a huge driver of investment performance over the past half-decade and we expect this will continue to be a rewarding strategy until central banks finally agree to step back and return both equity and fixed-income markets over to their original participants, both retail and institutional investors.

Domestically, we have held on to our three sector overweights - healthcare, technology and financials - for quite some time. Healthcare has been a spectacular performer going back 5 years now and despite the pounding it took in Q3 (the S&P Healthcare sector was down -10.7% in Q3), we still believe it will be a solid performer going forward. The implementation of universal healthcare here in the U.S., combined with the aging of the baby-boom generation and the wave of consolidation that we've seen in this sector all bodes well for investors looking forward.

The technology space has been dominated by so-called "new tech" over the past few years. Although not necessarily new, Apple and Google are both part of the new-tech cadre and continue to rule the tech landscape, with companies like Facebook, Twitter, Alibaba and Baidu coming on strong. Valuations in this space can get a little screwy as high growth rates get baked into many equity prices (private company Uber recently raised funds at a $50 billion valuation while private equity investors are valuing many loss-making start-ups at $1 billion+!).

All that being said, technology continues to change the way we live (yes, Uber has become my transportation of choice when traveling) and I honestly wonder if children born today will ever need to actually learn to drive a car. All that said, Dell's recent takeover attempt of venerable EMC has us shaking our heads, as a private company

(Dell was taken private in a $25 billion leveraged buyout back in 2013) buys a public company for $67 billion, using over $50 billion dollars in debt to finance the deal. Does anyone else feel there's moral hazard to the Fed's zero-interest rate policies continuing?? So far this year, over $4.4 trillion in global M&A activity has been announced and this is likely to continue as long as both economic growth rates and interest rates remain low and banks remain willing to lend.

Financials have been hamstrung the past few years by a combination of low interest rates and intense regulatory scrutiny. Dodd-Frank legislation, designed to obviate the "too big to fail" mentality that existed pre-2008, has only served to saddle banks (i.e. depositors) with new costs and layers of complexity, doing little to stem the problems caused by the repeal of the Glass-Steagall Act in 1999. I'm willing to bet that if JP Morgan or Wells Fargo found themselves in financial trouble tomorrow, Uncle Sam would be right there to help. All that said, banks stand to benefit from rising interest rates and we expect better performance from financials in the years ahead.

INTEREST RATES

The third quarter was dominated by headlines over when the Fed will navigate off the zero-boundary for interest rates, initiating the return to a more normalized yield curve. Many thought September would mark "lift-off", but EM rioting quickly put that to rest. Our best guess at this point is that the Fed will hold off until Q1 of 2016 before raising the Fed Funds rate. Although we've long advocated a return to market-driven interest rates, the low-growth rate of the global economy, combined with the absence of inflation (and still strong disinflationary forces) has given the Fed cover to hold off a little further. In our view, the timing of the first hike is less important than the terminal rate for Fed Funds a couple years out.

Over the past 60 years, the Fed Funds rate has averaged roughly 5.25% while inflation has averaged 3.9%. The table below summarizes various interest rates over this period, but its use is in giving us some perspective on where we are today. Central Bank monetary policy is still hugely accommodative and will remain so for some time to come. This should buoy risk assets for a while and give investors ample time to de-risk portfolios, after years of being forced out the risk-curve by the Fed.

	Current	60 Year Average	High	Low
Federal Funds Rate	0.13%	5.27%	22.36%	0.04%
Inflation Rate	0.00%	3.87%	14.80%	-2.10%
2 Year Treasury	0.63%	5.66%	9.98%	5.31%
5 Year Treasury	1.38%	6.01%	15.93%	0.62%
10 Year Treasury	2.00%	6.33%	15.32%	1.53%

Source: Federal Reserve St. Louis

As one can glean from this historical framework, U.S. interest rates are a long, long way from their mean. Our bet is that the Fed will proceed ever so slowly in normalizing rates and we'll likely see below average rates for some years ahead.

POLITICS

The silly season is closing in upon us rapidly, with U.S. Presidential elections a year away. Already the jockeying is taking place among both Republicans (why can't they all just get along?) and the Democrats (remarkably unified for now). Hillary Clinton appears to be the frontrunner for now amongst the Dems while the Republican race still appears wide-open, despite the strong early showing of The Donald. Election Day is still a long way off and much is bound to change between now and then - it's very possible today's front-runners won't even appear on a ballot come next November.

Our bigger concern centers on the debt-ceiling and the potential for a government shutdown. Congress has thankfully contributed little to market volatility over the past couple years, but that is changing now with John Boehner resigning, the Speakers role up in the air, and crucial agreements concerning this nation's debt-limit and willingness to fund itself going forward hanging in the balance. Partisan politics is once again rearing its ugly head and both stock and bond markets will be impacted should negotiations go down to the 11th hour. One can only hope that some level-headed individual (Paul Ryan?) can unify the Republican Party and effectively negotiate a bipartisan agreement soon.

As I pen this note, we're set to kick off third quarter earnings season. The bar has been ratcheted down a bit and we're hopeful we'll see sufficient surprises to justify the somewhat elevated levels of large, mid and small cap equities. The U.S. economy continues to muddle along at a 2.5% pace and the Fed remains friendly. That said, the margin for error is shrinking. A U.S. recession at this point would leave the Fed with little room to maneuver, likely exacerbating and extending the downturn. We're hopeful the economic expansion we've seen since 2009 can continue, but we're mindful it's long in the tooth and running out of steam.

Most of this letter has been penned on a plane, as I've spent much of the past month attending meetings and seeing clients around the country. From Buffalo to St. Louis, San Francisco, Denver, Palm Beach, back to San Francisco, I was struck by the completely full airplanes (Southwest, you manage to make a miserable experience tolerable - thank you!), mobbed airports, booming cityscapes and scores of foreign travelers I encountered. This is 2% growth?? If so, I'm not sure we could handle much more!

It's clear to me, however, that our country is in dire need of infrastructure improvement. Chicago's Midway Airport should be twice the size given current passenger volume. Everywhere I went, roadways and bridges were in need of repair, mass transit could use modernizing and affordable housing was in short supply. A fiscal boost from government has been sorely lacking during this recovery - as Ben Bernanke has been brave enough to point out. The Fed has carried the ball long enough - and frankly I don't think it can do any more. The president and congress would be wise to address our outdated infrastructure ASAP. This would not only put more people to work, helping drive up wages, but create the types of jobs that have disappeared from the American landscape.

As we enter the 4th quarter, be prepared for volatility in equities and interest rates. Daily swings in the S&P are likely to be magnified by Congressional uncertainty. It's probably a good time to rethink your risk profile. If we enter a recession, can you stomach a 15-20% drop in your equity portfolio? If interest rates rise 1%, are you prepared for the value of your bonds to fall? Rethink your time horizon. 10 years? You've got time on your side. 20 years? Even better - own stocks! 3 years? Not much time to recover - own safe bonds and begrudgingly accept lower yields.

Before closing, I want to take a minute and congratulate Nottingham Portfolio Manager Matt Krajna on achieving the Chartered Financial Analyst (CFA) designation. After years of intense study, Matt's a newly minted CFA, so feel free to call him and ask him some really tough questions. Also, Tom and I want to welcome a new member to our team. Jim Ferguson, CFA, recently joined us as part of our business development group. Jim's a real veteran of the investment management business and we're thrilled to have him on the team.

Nottingham's strategies continue to perform as anticipated - no shocks. As I've often noted, we're as much risk managers as we are return seekers. Much of Q3 was spent in risk management mode and I anticipate we'll be wary going into year-end. As always, we're available to talk with you. Whether you're a direct client or an advisor partner, our entire team is accessible, so don’t be shy, give us a call and let us know what you’re thinking or how we could help you further.

Happy Autumn,

Larry Whistler, CFA
President/Chief Investment Officer
October 2015

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