BIRCHWOOD
FINANCIAL PARTNERS

Market Insight

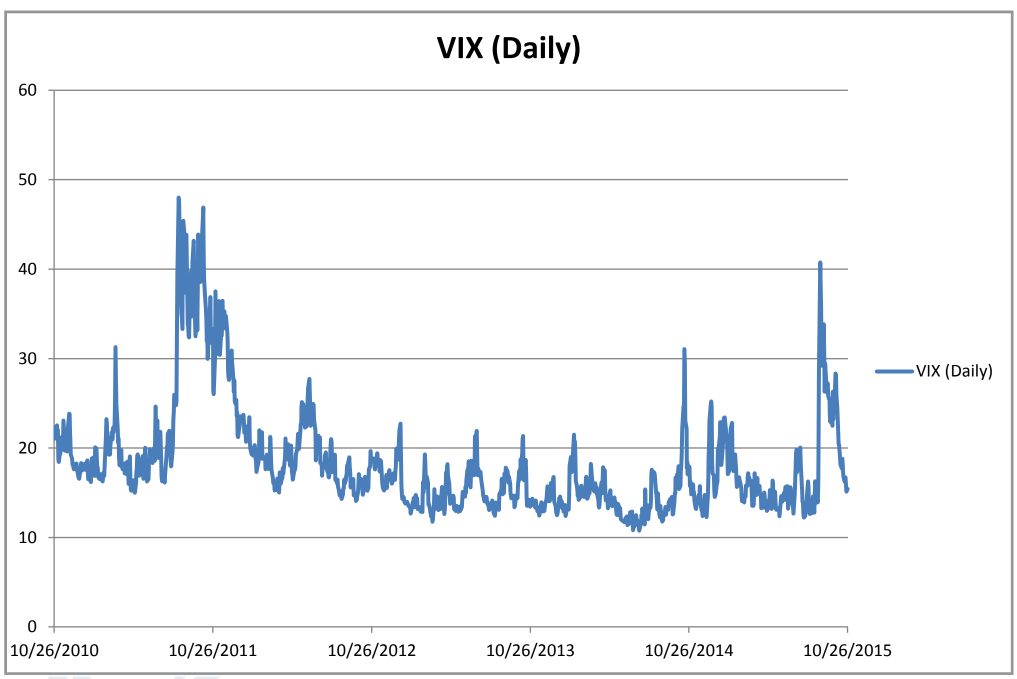
October 29, 2015

While the severity of the market correction during the prior quarter seems to have diminished in recent weeks, it does stand as a good reminder of the tenuous nature of the current global capital markets. Weakness in China took its share of the blame for sparking a 12-plus percent downturn in the S&P 500 Index from its all-time high point set in May. Relatively sluggish economic data from China may have been the match, but the uncertainty surrounding the Federal Reserve's looming decision to increase interest rates was the gasoline.

A brief note on China[1]. China is now the second largest economy in the world and is growing at nearly 7 percent per year. Relative to the double-digit growth it was experiencing a few years ago, this is concerning. The growth that's been slipping away in China is more of a problem now because growth in the developed world has been so anemic. China is in a transitional period, which will take time and will present challenges to attaining a higher rate of economic growth. However, it may not be as necessary now for China to continue to grow as quickly as it has in recent years in order to maintain stability in its economy. We aren't going to take a stand one way or the other on the near-term prospects for China, but it is worth noting that it remains the fastest growing large economy in the world. Point of fact for you sticklers to detail, India is growing at roughly the same rate as China, but its economy is only about one-third the size of China's.

Back to the drama during the prior quarter, Graph 1 displays the level of fear in the U.S. stock market over the past five years. The index shown is called the Volatility Index or VIX. In hopes of not turning you back to whatever else you were doing before picking up this letter, I won't labor on how this index is calculated. Suffice it to say that the value of this index is tied to anxiety in U.S. stock market. You can there are two big peaks on this graph. The first was in fall of 2011 when risks in Europe escalated and U.S. debt was downgraded for the first time in 70 years. Fear eventually subsided and remained fairly subdued until a couple of months ago when the reality of the Federal Reserve raising interest rates began to set in and an announcement from China that it would allow its currency to depreciate led one of the strangest market events I've witnessed.

Graph 1



On Monday, August 24th, the market opened in disarray. Many stocks were trading significantly below levels from the prior week, but some stocks were trading at levels that were quite remarkable. For example, General Electric traded off by nearly 20 percent at one point that morning. JP Morgan, Johnson & Johnson, Merck, Pfizer, Home Depot and Verizon and many more were down over 10 percent at one point that morning. That may not sound too strange given some of the daily moves in stock prices we saw back in 2008, but there really wasn't a justification for such a move on the 24th. Major financial institutions weren't on the brink of bankruptcy as they were seven years ago. Prices later recovered for the most part, but we are still surprised at how little coverage there was in the media following such significant price moves on these huge multi-national stocks.

We believe the dislocation we saw in the market on August 24th was exacerbated by the proliferation of computerized trading systems. Computer models that trade stocks and Exchange-Traded Funds ("ETFs") automatically based on algorithms designed by anyone from engineers to stay-at-home parents to hedge fund managers. The impact of these trading systems is the source of much debate among market participants and regulators. Some say the systems increase liquidity in the markets and others say they unfairly profit from access to market data before it's available to the public. They also are potentially prone to coding errors that may erroneously send trade orders to the market. Whether good or bad, their influence on the market on the morning of August 24th and during the "flash crash" on May 6, 2010 can't be denied. At Birchwood, we tend to rely on mutual funds as our investment vehicle of choice for a variety of reasons. Mutual funds aren't perfect by any means, but we have several concerns about ETFs as a reliable investment vehicle for long-term investors. More study and regulation needs to be done to ensure the stability of ETFs and protect the integrity of the capital markets. I'll step down from the soapbox to get on with the letter now.

In the midst of market instability, the Federal Reserve balked at raising interest rates in August. This was the most anticipated Federal Reserve monetary policy decision that I can recall. In my recollection, the last event that garnered such anticipation and media coverage of the like was when Congress voted on the $700 billion TARP legislation in 2008. The market is putting a great deal of weight on the action or inaction of the Federal Reserve. This puts a tremendous amount of pressure on the Federal Reserve to act in a transparent and predictable manner. Its lack of transparency and predictability caused the VIX in Graph 1 to spike in August to its highest point in four years. With the economy sending mixed signals and another Federal Reserve policy meeting in December, we wouldn't be surprised to see more anxiety in the next couple months.

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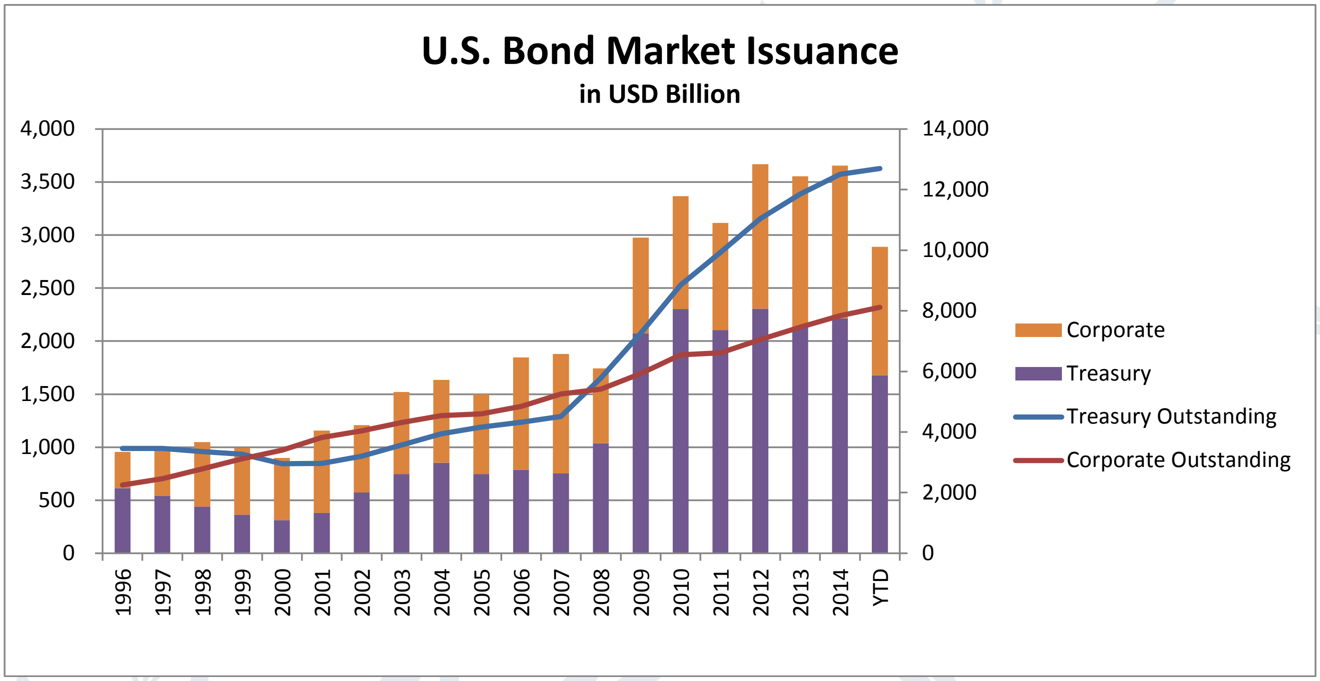
We continue to believe that interest rates are limited on how high they will be able to rise. Part of this belief is based on low inflation domestically and globally, as well as slow global economic growth. On top of that, we see continued actions taken in Japan, Europe and China to stimulate economic growth with lower interest rates and other government policy. Lower interest rates globally will likely cause investors to continue to see the U.S. dollar as an attractive reserve investment and keep a lid on how high domestic interest rates may rise.

An additional element to our expectation on interest rates is that the credit, or bond, markets have ballooned in recent years. Corporate bond issuance reached $450 billion during the second quarter of this year. Issuance is up over 8 percent this year from last year and the total outstanding market for corporate bonds has increased by $1.5 trillion since 2010 or 24 percent2.

In Graph 2, the bars represent the total value of bonds issued during the year and the lines represent the value of all outstanding debt. Both are broken out by U.S. Treasury debt and U.S. corporate debt. We excluded other types of marketable debt, such as municipals and mortgage-backed bonds for simplicity.

Graph 2



It shouldn't come as much of a surprise that companies have been borrowing more given how low interest rates have been. And of course we all know the government has been issuing more debt over the past several years in order to help repair consumer balance sheets and to spur economic growth.

Investors have absorbed the additional bonds in circulation for a variety of reasons, including an aging demographic reducing portfolio risk by adding more bond exposure and a desire for better yields than cash investments that pay next to nothing. We aren't seeing warning signs of risks in the debt markets just yet, but it is typical that the bond markets tend to flash worry ahead of the stock market. It's sometimes said that bond analysts are always looking for what will go wrong, while stock analysts are always looking for what will go right. An abundance of corporate bonds and an increase in investor allocations to these types of bonds can lead to overvaluations. As a result, we are evaluating bond allocations and may be making adjustments to reduce positions in the types of bonds that we believe could be at risk of a correction, more specifically high-yield bonds and certain types of corporate bonds.

We often remind clients that bonds are in the portfolio for income, diversification and liquidity. In recent years, it has been advantageous to sacrifice some of the diversification element for more income. We believe it is now prudent to refocus bond allocations on delivering strong diversification and perhaps giving up some income in order to do so. If we make any changes to your portfolio we will communicate that to you directly.

Table 1

Market Indices (as of 9/30/15)	3rd Quarter	One Year
Dow Jones Industrial Average	-7.0%	-2.1%
NASDAQ Composite	-7.1%	+4.0%
S&P 500 Index	-6.4%	-0.6%
Barclays Capital Aggregate Bond Index	+1.2%	+2.9%
Small Cap Stock (Russell 2000 Index)	-11.9%	+1.3%
Non-US Stock (MSCI EAFE Index)	-10.2%	-8.7%

As always, we welcome the opportunity to review your financial plan with you at any time. We continue to try to provide you with communication that spans from this quarterly letter to important financial-related topics or updates to what's happening at Birchwood. Kimberly has been improving our communication efforts and we'd be happy to receive any feedback from you regarding the frequency or content of those communications. If you haven't already, please follow us on **Facebook** and **LinkedIn** to keep in touch. It has been twenty-five years since Kay and John formed this company and we're driven to continue to provide outstanding service to our wonderful clients with the same passion and determination on which it was founded.

Sincerely,

Steve Dixon, CFA
Investment Manager
Let's Connect

Kay Kramer, CFP®, Dana Brewer, CFP®, Bridget Handke, CFP®, Damian Winther, CFP®
Financial Advisors

1. Source: The Economist (for all China and India economic data cited)

2. Source: Sifma.org
US Bond Market Issuance and Outstanding updated 10/5/2015

Graph 1
Source: Finance.yahoo.com

Graph 2
Source: Sifma.org, Birchwood Financial Partners

Table 1
Source: Morningstar. Market indexes are unmanaged and investors cannot invest directly in indexes. However, these indexes are accurate reflections of the performance of the individual asset classes shown. All returns reflect past performance and should not be considered indicative of future results.

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