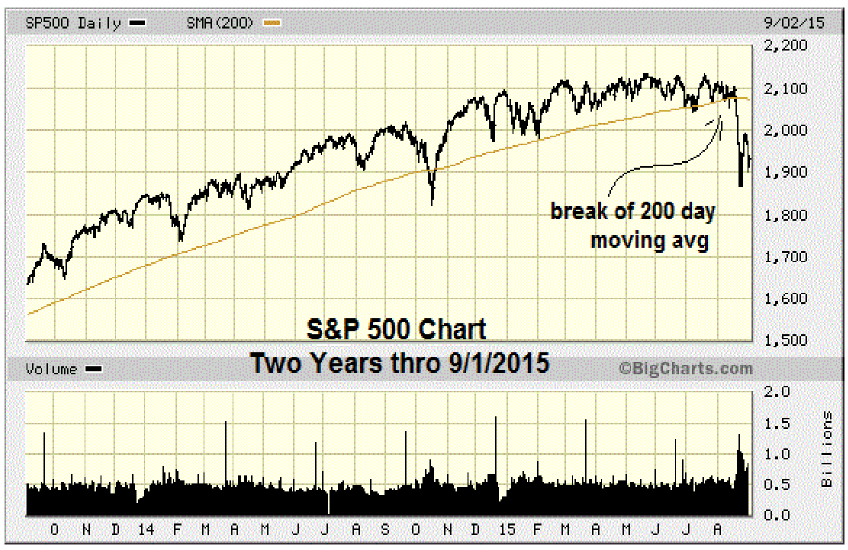
American Heritage Financial

September Update **September 2, 2015**

Awful August

Three of our last four market commentaries discussed the dull, sideways trading market and lack of volatility. **August took care of that!** Volatility skyrocketed in August—well, the last two weeks of August. The market was continuing its undisturbed ways through August 18, at which time the Dow was just 1.3% or 234 points lower than its July close. Prices began to unravel over the next three days with the Dow booking a 1,000 point slide into the weekend. The following Monday, August 24, we woke to news of a devaluation of China's currency and collapsing global stock and commodity prices. The U.S. market took its cue from the rest of the world and stocks gapped down over 1,100 points in the first few minutes. **Volatility was back** and any notion that the previous week's slide was simply market noise was out the window.



The market actually repaired much of that final week's damage with some up days that were as amazing as the down days but the major indices still finished down over 6% for the month. At their worst, the Dow and the S&P 500 were off 14.5% and 12.5%, respectively, from highs of May 2015; so the market officially entered *"correction territory"* (i.e. down >10%) for the first time since late 2011. While 10% is not necessarily a magic number, there is no question that the long uptrend has been broken. Further, growing fundamental questions suggest this correction may take some months to truly reverse.

Investors have been troubled by multiple issues over recent months but the driving factor for the rapid plunge was mounting concern of a global economic slowdown—primarily due to China. China continues its phenomenal 25 year growth record but there is no question that growth in the world's second largest economy is slowing. China is the world's manufacturer and manufacturing has been soft throughout the world, including the U.S., even as economies struggle to spur growth. Some analysts claim China is not really that important to the U.S. economy. They point out that out that China represents only 0.7% of U.S. GDP and our economy has shown little correlation to past strength or weakness in the Chinese economy. Yet, China's gradual slowdown has been one of the biggest factors creating a bear market in commodities and the consequences of Chinese weakness have pushed many emerging economies to depression-like conditions. With major new questions and uncertainty from the Middle Kingdom, it is not surprising that U.S. stocks have used China as a reason to fall into correction territory.

Rational investors are now asking, *"Is this just a correction or the beginning of a bear market?"* All indicators, increasingly, point to a difficult and possibly long correction. But, while no one can ever be certain about such things, **a bear market remains highly unlikely**. There is a long list of reasons for optimism with the most important being the strength of the U.S. economy. Significant economic news in the last week of August was drowned out by all the market noise; second quarter GDP was revised up to 3.7% (from a previous estimate of 2.3%), helped by stronger consumers spending. Extremely strong U.S. auto sales in August, gas dropping back toward $2.00 a gallon and steady job growth all point to continuing improvement in the U.S. economy. Bear markets just do not occur when the economy is improving.

INDEX	8/31/15 CLOSE	2015 YTD	52 WK CHG
Dow Ind	*16,528*	*-7.3%*	*-3.4%*
Dow Tran	*7,845*	*-14.2%*	*-6.7%*
Dow Util	*562*	*-9.1%*	*-0.4%*
S&P 500	*1,972*	*-4.2%*	*-1.6%*
NASDAQ	*4,777*	*0.9%*	*4.7%*

Of course, our economy is not immune to the global troubles. While there had been clear improvement in European economic conditions over the first half of the year, both Europe and the U.S. would feel the effect should China implode. Also, our strength works against us in the rebalancing of global economies because the dollar is a "safe haven." Global disruption results in greater dollar strength which makes our products more expensive and lowers the foreign profits our corporations bring home.

Finally, **the market has not forgotten about the interest rate question.** The Federal Reserve is under enormous pressure to raise interest rates. They have held their benchmark Fed Funds rate near zero (a range of 0%-0.25%) since late 2008. Many economists argue that the abnormally low rate is causing imbalances such as an over-valuation of risk assets (stocks in particular) and will result in inflation. In addition, the Fed has hinted at a rate hike this month and backing away could undermine its credibility. Considering the strength of the U.S. economy, it is hard for the Fed to justify a continuation such a stimulative interest rate. On the other hand, an increase in rates would further strengthen the U.S. dollar, put more pressure on global commodity prices, increase the burden on countries that own debt in U.S. dollars and generally add further instability to fragile global markets and economies. Our ***guess*** is that the Fed will announce a minimal rate hike in September or before yearend with clear guidance that further hikes will not occur until economic conditions are more stable.

To put some perspective on the recent market rout, we suggest investors consider these market traits:

- In the **short run**, markets are dependent on **psychology**. We just came out of a period of complacency. Fear, greed, panic and euphoria can create violent short-term swings. We are clearly in the throes of a fear/panic attack.
- In the **medium term**, markets are dependent on **economics**. Markets sometimes forecast recessions or expansions that never materialize. The market is now worried about a recession that is highly unlikely considering the economic conditions already discussed.
- In the **long run**, markets are dependent on **valuations**. This is because recessions always end and the economy always recovers. Investments purchased at a reasonable valuation will reward their owners when psychology and the economy turn positive.

The last maxim is most important for investors. Long-term, the economy grows and valuations improve, resulting in positive returns for long-term investors. Currently, the market is selling at a reasonable valuation of about 15.7 times 2016 earnings, the economy is healthy and—eventually—psychology will swing back to a more positive outlook.

Ted Ingraham

EGI Financial, Inc.
American Heritage Securities, Inc.

Questions or comments?

Email us at: ahs@egifinancial.com or call 330-535-0881. Visit us at www.EGIFinancial.com