KayneCast

A Podcast Series by Kayne Anderson Rudnick

Episode 26

A Market Review of the Third Quarter of 2015, and an Outlook for the Rest of the Year

Douglas S. Foreman
Chief Investment Officer

The stock market was very weak in the third quarter this year, erasing all the gains year to date in virtually all the major stock indexes. Large stocks, as measured by the S&P 500, declined about six and a half percent and small stocks, as measured by the Russell 2000, dropped almost 12 percent in the third quarter. International stocks were hit hard as well, dropping slightly more than 10 percent and emerging markets fell almost 18 percent in the third quarter. Overall, a very difficult quarter for equity investors in the third quarter with little to no places to hide. Energy and material sectors continue to be the weakest, but even health care, which had been strong year to date, started to show some signs of weakness late in the quarter.

In the fixed income market, traditional flight to safe havens performed well during this market turmoil, but credit-sensitive spreads continue to widen during the quarter. So high-yield and credit-sensitive strategies, such as emerging-market debt declined during the quarter despite the fact that the 10-year bond actually fell in yield from 2.35 to 2.06 percent during the quarter.

The most important question for investors now is whether this quarter has been just a painful correction which will soon end or is the beginning stages of an early global recession and subsequent bear market, which will result in further losses as we go forward. In order to answer this question, I think it's important to first understand what actually happened during the quarter and, therefore, what may happen in the future.

First of all, the quarter started off with concerns around Greece, which now seem like ancient history. The bailout package was highly debated, but when all was said and done, after much hand wringing, was resolved favorably and Greece did not leave the Euro as we believed would happen the entire time.

The second thing that happened was second-quarter earnings, which were reported primarily in the month of late July and early August, were not as strong as prior quarters, with many individual companies starting to struggle somewhat mainly due to energy weakness that we've seen throughout the year. Also, the rise in the U.S. dollar has really hampered reported earnings in many sectors, such as energy, materials, and increasingly in the industrial and transportation sector.

And then, in early August, the Chinese chose to devalue the Yuan a modest two percent, but this stoked a lot of fears of a global growth slowdown and that the Chinese government saw something that was worse than investors already saw and knew about a slowdown in their economy.

And then in the middle of September, the Federal Reserve decided not to raise short-term interest rates, which many market participants thought that they would, and this created some uncertainty about the path of future rate increases.

Our conclusion is that none of these events are highly likely to lead to a full-fledged bear market or global recession. We believe that this is more of a painful correction and should be very similar to that which we experienced in 2011 rather than the beginning of a global crisis which we experienced in 2007.

So what are the key events that need to unfold over the next 12-to-18 months in order for the stock market to recover and this turn out to just be a painful, albeit short correction?

The most important thing, number one, is the Chinese growth rates need to stabilize, albeit at lower levels (in the four-to-six percent range). This would stabilize their currency and go a long way towards alleviating global growth slowdown concerns. Commodity markets and emerging markets should start to stabilize if this happens. Unlike many other countries, China still has multiple monetary policies at their disposal to engineer this as we go forward.

The second thing which needs to happen, I believe, is that energy prices, which have essentially collapsed over the last year, need to stop declining materially. It's good when energy prices fall overall for the U.S. economy, but I think we've reached a point now where if we have further energy-price weakness, it would signify more meaningful global slowdown concerns from here. The collapse in energy prices has caused major problems for emerging-markets countries, such as Brazil and Russia, as well as a lot of financial players in commodity and commodity hedge funds which have been shut down recently. High-yield spreads have also been pressured by weak energy credits, and many overleveraged small-to-medium sized energy companies may default over the coming next 12-to-18 months if energy prices don't materially improve from here.

The third thing that needs to happen is that the U.S. dollar needs to stop appreciating materially versus a lot of these other emerging-markets currencies. The strength in the U.S. dollar has really hurt a lot of U.S. based manufacturing companies by drying up their export markets which has put pressure on their business here at home.

And then the last thing that needs to happen is S&P 500 profits need to continue to grow on a constant currency basis, at least in the five-to-ten percent range and sustain the high current margins that they have in growing cash flow from operations.

In our opinion, if these events occur over the next 12-to-18 months, it should lead to a meaningful restoration of investor confidence. It's always difficult to forecast the timing and outcome of these types of events, but it's difficult to imagine how investor concerns about these issues could become any worse than they currently are.

Equity markets are likely to stay volatile through year end, but many individual stocks do look attractive to us over a three-to-five year time horizon. And we believe long-term investors will be well rewarded from here over the next three-to-five years.

As always, we will continue to invest in high-quality companies whose businesses should do reasonably well in both good and bad times, and we thank you for your continue trust and patience in difficult periods such as these.