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"IT'S TOUGH TO MAKE PREDICTIONS, ESPECIALLY ABOUT THE FUTURE."

YOGI BERRA

The late, great Yogi Berra was not talking about financial markets when he allegedly made his statement about the difficulty of predictions yet the sentiment seems appropriate for the investment world. It is often said that the markets hate uncertainty but at the risk of sounding like the former Yankee catcher, in the investment realm, uncertainty is a certainty.

The third quarter of 2015 was the worst for stocks since the 3rd quarter of 2011 with the Dow Jones Industrial Average (DJIA) down 7.6% and the S&P 500 and NASDAQ down 6.9% and 7.4% respectively. Year to date the DJIA is down 8.6%, the S&P 500 down 6.7% and the NASDAQ down 2.4%. Concerns about the slowdown in China, the actions or inactions of the Federal Reserve, the impact of lower oil prices on energy company earnings and the impact of the strong dollar on the earnings of U.S multinational companies all provided more than enough uncertainty for the markets. Foreign markets fared even worse during the third quarter. The MSCI Developed Markets Index was down 10.2% for the quarter and is now down 4.9% for the year to date. The MSCI Emerging Markets index plunged 18.5% during the third quarter and is down 17.2% for the year to date.

In overseas markets the fears about Greece during the spring and summer were quickly overwhelmed by far more ominous developments in China. In August, China devalued its currency in response to slowing economic growth while at the same time the Chinese stock market collapsed. The impact of a slowdown in China on the worldwide economy is a significant concern for the markets. It appears that China may still be able to sustain growth in the 4-5% range but China's economy seems to be moving more to services rather than manufacturing and infrastructure. This will affect commodity producers both in developed and emerging countries and has negatively impacted U.S. heavy equipment companies such as Caterpillar.

In addition to the slowdown in China, the strong dollar has negatively impacted U.S. manufacturers worldwide. The decline in capital spending in the energy industry has also hurt many U.S. industrial companies. The most recent manufacturing data reflects this downturn and many investors are concerned this may indicate a worldwide recession. In the U.S. this manufacturing downturn is more than offset by the growth in services and the positive jobs data so a recession seems unlikely. The services portion of the economy represents 75-80%

of GDP in the U.S., Europe and Japan according to Ned Davis Research so that could be a powerful offset to problems in the industrial sector.

In the U.S. stock market the rolling correction apparent in early summer when over 100 stocks in the S&P 500 were down more than 20% from 52 week highs has become a full blown pullback. As of September 30th, over 200 stocks in the index were down more than 20% from their 52 week highs and close to 400 down at least 10%. The weak sectors of the market in the early summer, energy, materials and transports, have been joined by technology, healthcare and consumer staples as leading companies in each of these sectors such as Apple, Merck and Procter & Gamble (P&G) have all had declines of at least 20% from yearly highs.

A drop of over 20% in a stock's price is hardly comforting for current shareholders but it may indicate that the bulk of the damage has been done. The valuation of many stocks is much more appealing at current levels and these stocks may be positioned to recover lost ground and then move to higher prices over time. Given the current valuations of Apple, Merck and P&G for example, we are optimistic for the long term. Apple has a price/earnings ratio (P/E) based on trailing 12 month's earnings of 12.7X, with a dividend yield of 1.9% and expected earnings growth of roughly 15% per year for the next 5 years. Similarly, Merck sells at a P/E of 14.4X with a dividend yield of 3.6% and an expected earnings growth rate of 7% annually. P&G has a current P/E of 24X (16X expected earnings next year), with a yield of 3.7% and earnings growth expectations of 8% annually.

We also find the valuations of other companies with promising growth prospects attractive including Qualcomm, Cummins and Gilead Sciences. Qualcomm, a communications technology company, has a P/E of 14.8X, a yield of 3.6% and expected annual earnings growth of 6.5%. Cummins, a diesel engine manufacturer, has a P/E of 11.4X, a yield of 3.6% and expected earnings growth of over 10%. Gilead, a biotech company, has a P/E of 10.3X, a yield of 1.7% and an expected annual earnings growth rate of over 16%.

The case for energy stocks is less compelling in the short run but we believe that the price of oil and natural gas will rebound and top quality stocks such as ExxonMobil, Chevron, Kinder Morgan and Schlumberger will recover. The drop in energy stock prices may lead us to sell certain energy stock positions at a loss for taxable portfolios to offset current or future capital gains and replace the sold company with one of equal or perhaps better recovery potential.

We continue to believe that exposure to foreign developed and emerging markets makes sense in spite of the current turmoil. The slowdown in China and the strong dollar are causing problems for many foreign economies but the difficulties seem to be adequately reflected in stock prices. We believe broad based Exchange Traded Funds such as the Vanguard Emerging and Developed Markets funds are a good way to get exposure to this asset class.

In spite of the recent decline in stocks we obviously don't know where the markets are headed in the short run. We may be in a prolonged, volatile period with further meaningful declines or the fourth quarter may bring a year-end rally. Regardless of the current outlook, we have consistently recommended to clients that, if possible, they maintain a reserve in their portfolios in cash and short term investments to meet expected cash needs for a year or two depending on the clients' specific needs. For retirees spending dividends and interest and perhaps gradually drawing down their portfolios, this allows them to avoid having to sell stocks at inopportune times.

These are indeed nervous times filled with uncertainties but there appear to be opportunities as well. We believe a diversified portfolio of top quality companies purchased at reasonable valuations will continue to provide good long term returns. We would augment these holdings with exposure to foreign developed and emerging markets and we continue to favor stocks over bonds. We do not expect a dramatic rise in interest rates but we believe we will have the opportunity to purchase bonds at more favorable yields in the future. We thank you for your confidence in Knox & Downing Advisors and we wish you the best for the remainder of 2015 and beyond.

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