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## Third Quarter 2015



Fig. 1 – S&P 500



Fig. 2 – MSCI Emerging Markets

Stocks worldwide posted broad losses in the third quarter, the worst quarter since 2011. Fear over slowing growth in China and other emerging economies, in addition to plummeting commodity prices, led investors to cut risk. Most major indices fell more than 10% from their recent highs, entering what market watchers term a correction. The S&P 500 (**Figure 1**) fell 7.0%, and is now down 6.8% for 2015, -5.3% on a total return basis. Other indices were similarly weak, with the Dow Jones Industrials falling 8.6% and the Russell 2000 Small Cap index dropping 12.2%. Markets outside the U.S. were also down. The MSCI Emerging Markets Index (**Figure 2**) was particularly weak, falling 18.5%. The big bull market in Chinese stocks came to an end, as the high flying Shanghai Composite index fell 28.6% (**Figure 3**). The MSCI Europe, Australia and Far East Index of developed economies, which had done well in the first half of the year, lost 10.2% and is -5.3% year-to-date.

Looking back at the second quarter's earnings season, U.S. corporations continued to manage expectations effectively, reporting earnings that were generally better than projected. According to market research firm Factset, 74% of S&P 500 companies topped analyst estimates, and 51% beat revenue expectations. Health care companies posted the best track record, with 93% logging earnings above estimates. However, large company earnings in the second quarter declined 0.7% in aggregate, the first drop since the third quarter of 2012. The energy sector was by far the largest detractor from corporate earnings (-59%). If energy is excluded, S&P 500 earnings actually rose 5.9%. As companies begin to report third quarter earnings in October, traders will be particularly focused on guidance for the fourth quarter, as continued earnings growth will be needed to move stocks higher.

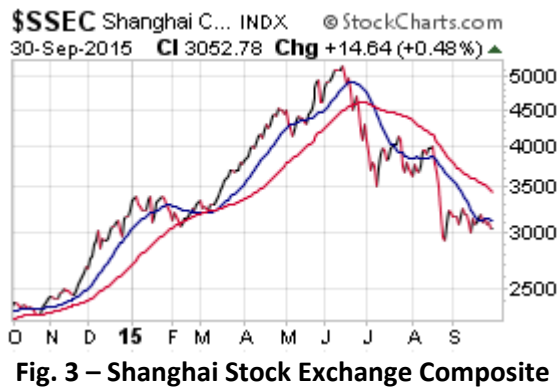
The U.S. economy grew more than expected in the second quarter, as evidenced by the +3.9% Gross Domestic Product (GDP) growth reported in September. Consumer spending and business inventory restocking were strong, rebounding from the winter doldrums of the first quarter. Employment trends were steady, as the U.S. economy added about 200,000 jobs each month, almost all in the private sector, and the unemployment rate dipped to 5.1%. Job strength appears to be boosting consumer confidence, which rose to the highest level since January, according to the most recent

survey by the Conference Board. In addition, consumers have been seeing modest increases in personal income, while inflation has remained almost non-existent. These factors appear to support growth in consumer expenditures.

Other data points in the quarter provided a more complex, muddled picture. The service sector remained robust, buoyed by steady hiring trends, and purchasing manager surveys point to further growth in the months ahead. Manufacturing, by contrast, has been slower, squeezed by weakness overseas, which has hurt exporters, and by the slowdown in commodity exploration and production, which has led to reduced capital purchases worldwide. Housing had been strong until August, when existing home sales were weaker than expected. New home sales and builder permits, however, showed solid growth over last year, and home sale prices have risen roughly 5% above last year's levels.

During the quarter, economic news outside the U.S. was also mixed. Chinese stocks pulled back sharply (**Figure 3**) amid uncertainty about the growth rate of the Chinese economy. China has enjoyed years of strong growth, exporting low-cost manufactured goods and consuming a rising share of the world's natural resources. Slowing activity there has been a key factor in the sharp fall in commodity prices worldwide, and has hurt exporters from the U.S. and Europe who sell to China.

Europe, on the other hand, appears to be stabilizing. The threat of Greece leaving the European Monetary Union has faded, and most countries are logging very modest growth. European stocks should benefit from the quantitative easing employed by the European Central Bank (ECB), which is keeping interest rates low and providing liquidity to investors and borrowers. Quantitative easing has weakened the euro, helping European exporters. Also, European consumers and companies will see lower input costs, assuming oil and natural gas prices remain low.



In September, the Federal Reserve once again put off raising interest rates, citing concerns about developments overseas. The Federal Reserve may finally raise rates before the year is out, but with low inflation and slack in the manufacturing sector, it is unlikely that rates will increase significantly in the next year. In the meantime, the U.S. consumer, 70% of our economy, will enjoy lower gas prices, higher wages, and a firm job market. Lower stock prices may present selective investment opportunities for alert investors, notably among retailers and other consumer focused companies (**Figure 4**).

As always, we encourage you to contact us at any time with questions, and to update us on changes in your lives.