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THE TEMPO VANTAGE

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What a Drag!

The equity markets around the world had a tough third quarter. Here in the U.S. the S&P 500 fell -6.4%. Other indices were down even more. The NASDAQ and small cap stocks were down -7% and -12%, respectively. Globally it wasn't any better. International stocks were down -10.2%.

The third quarter loss also put stocks in the red for 2015 year-to-date with most benchmarks (U.S. and international) down -5% or more.

The picture was slightly better on the fixed income (i.e. bonds) front. Long-term high quality bonds managed a modest gain of 1.5%, and intermediate term high quality bonds were essentially flat. But most other categories sustained losses (high yield bonds -4.5%, convertible bonds -6.9%, bank loan bonds -1.6%, inflation bonds -1.9%).

Year-to-date most bond categories were somewhere between flat and down -2.5%.

The question is: what caused the decline in equities and will it continue?

At face value little appears to have changed over the past few years. The U.S. economy continues to recover at a slow pace and unemployment is still trending lower.

Global and economic issues that were considered stock market threats have dissipated. Greece? No. Syria? Maybe. Ukraine? Doubtful. The housing market? No. End of the bond buying program? Done. Debt Limit? Soon, but not yet (as always).

And yet the markets are down. What gives?

Valuations are a bit high. The price/earning (P/E) ratio on the Dow Jones Industrial Average is 15, which is reasonable. But the P/E on the S&P 500 is 20, which is on the high side. I believe that a high P/E is sustainable when interest rates are low. Even if the Fed raises rates they will still be very low.

The yield curve is slightly flatter than last year but still positively sloping, which is a good sign.

Earnings for companies in the S&P 500 (the E in P/E) have come down, which is a concern. But that is mostly due to the energy sector. While low oil prices are bad for energy companies (and their employees) they are a net positive for the economy as a whole. The strong dollar has also negatively impacted earnings. A strong dollar hurts exports since our products are more expensive globally, and that affects earnings for large multinational companies.

The real problem is the slowdown in countries other than the U.S. The Chinese economy in particular has slowed considerably. This has put downward pressure on commodity prices. Lower commodity prices, combined with a strong dollar, have put pressure on developing economies.

It all seems like one big economic loop. And it is. The world is more interconnected today than ever. It is like the chicken and egg. The bottom line is the global slowdown is a drag on the U.S. economy, not the other way around.

Will it continue? Hard to say. Most forecasts are for modest growth in 2016 and beyond. But stock market performance doesn't always follow economic activity. In the short run market sentiment can trump other information, and that is a wild card.

Tempo Financial Advisors' 3rd Quarter Investment Performance

Returns for Tempo's three investment programs were what you would expect in this negative market. Lifestyle accounts fell the most, Dynamic Growth was in the middle, and Dynamic Income held up fairly well.

Returns for **Tempo Lifestyle** accounts were in the -6% to -7% range, regardless of whether the account was conservative, moderate, or aggressive. This is somewhat disappointing given that the S&P 500 fell -6.4%. Normally you would expect our accounts to hold up better.

What happened?

A few things. First, bonds, which often move counter to stocks when stocks are negative, fell instead of rising.

Second, as you know we generally maintain diversification in areas such as small cap and international stocks. These areas performed worse than the S&P 500 (see above).

And finally two of our overweight positions (energy and healthcare) were underperformers. While our overweight positions usually work out over the long run, over shorter periods that may or may not be the case. We've made a lot of money in healthcare over the past few years, but not in Q3. More on healthcare below.

Tempo Dynamic Growth accounts were down -3.8% for the quarter. This is about half the loss of the average stock fund. Certainly this is in the range of what we would expect in such an environment. But we had been holding up quite a bit better than that until Martin Shkreli and Hillary Clinton. Huh?

Martin Shkreli is the fellow who bought Turing Pharmaceuticals and promptly raised the price of Daraprim from $13.50 to $750 per pill. Of course this is outrageous and Hillary Clinton was right to say so. But rather than limit the inquiry to Turing, the microscope is now on all biotech companies. The entire sector declined quite a bit the last two weeks of September (biotech -20% and healthcare -10%). We own healthcare in both Lifestyle and Dynamic Growth and our portfolios were negatively affected.

It is wrong to penalize all companies in an industry because one player behaved poorly. Biotech companies spend billions of dollars developing new drugs, many of which go nowhere. When a drug does prove worthy these companies deserve to be compensated for their efforts. This one bad apple has caused a correction in the whole healthcare industry. I believe the decline is overblown and we are setting the stage for outperformance in the healthcare sector once the dust settles.

Let us not forget about the **Tempo Dynamic Income Program**, which was our best performer in Q3. Accounts were down -0.8%. Though we would have preferred a small gain to a small loss, we recognize that in this environment where almost nothing was up this may have been about as good as we could expect.

Reminder

Please contact us if there has been a change in your financial circumstances that would warrant a fresh perspective on your portfolio.

Daniel J. Traub