BRIDGES | INVESTMENT MANAGEMENT

Think Forward

Market Comments
August 24, 2015

S&P 500	1893
10 Year yield	2.03%

Stocks dropped sharply between August 19 and the morning of August 24, as fears of increasing economic weakness in China roiled global equity markets.

The sudden stock price volatility was a sharp contrast to U.S. equity trading over the prior six months, which saw the narrowest six month trading range for the S&P 500 in history, as the Index bounced between 2050 and 2130.

After a close at 2102 on August 17, the S&P fell 6% to 1979 on Friday, August 21, and dropped another 6% to an early morning low of 1867 on August 24 – a 12.5% correction from its all-time high of 2134 (set on May 20).

Stocks rallied off the opening lows on August 24 to close at 1893, down 4% on the day and 8% on the year, in a session marked by extreme intraday volatility.

We have several key takeaways:

1. Market internals have been deteriorating for several months, increasing the likelihood of a correction, which is now underway. It will likely take several months to repair the technical damage this decline has inflicted on the U.S. equity market.

2. We believe U.S. stocks are now undervalued relative to our estimate of "fair value." While earnings estimates are coming down due to concerns regarding China's effect on the global economy, ongoing weak commodity prices, and a persistently strong dollar, equity valuations are close to long-term historic norms, earnings are still growing, and interest rates remain low, which in our view, supports our fair value estimates for the S&P 500 of ~2200 for year-end 2015, and ~2300-2400 for year-end 2016.

3. The capital markets meltdown of 2007-2009 showed that global economies and capital markets are tightly interconnected and securities' price action is highly correlated, especially during times of extreme market stress. Low interest rates have likely increased the use of debt and leverage within the capital markets. Consequently, "diversification" is important, but it is not a panacea when many market participants are seeking liquidity (selling) at the same time.

4. We believe the best counter-measures for difficult equity markets include: having some cash available to deploy as buying opportunities from negative volatility arise; maintaining a long-term focus and time horizon; and focusing on companies that have excellent balance sheet quality and dominant business franchises. Every 10% decline from current levels increases the expected return by 2% annually over the next five years.

We expect that the next few months will see considerable stock price volatility, as investors grapple with the global effects of China's economic slowdown. As noted in our July market comments, we would not be surprised to see stocks decline or rise (or both) by 20% over the next 6-12 months.

We want to emphasize the importance of understanding business value relative to stock price, and stock price volatility. Equity markets usually experience price volatility that is much greater than the change over time in underlying business intrinsic value. As stock prices decline sharply and fall below business value, opportunities for long-term investors increase in number and improve in magnitude (it becomes easier to find more stocks that are attractive). Our focus remains on owning great companies that have a demonstrated ability to grow underlying business value for their shareholders over the long-run; stock price volatility increases our opportunities to buy great companies at a discount to their fair value.

We continue to believe that stocks offer significantly better long-term return potential relative to bonds, because 1) interest rates remain far below historic norms, and 2) equity valuations imply mid-to-high single-digit returns over the next five years from current levels, even if corporate earnings growth remains below trend.

We encourage you to visit our website at www.bridgesinv.com often, as we will be posting brief market commentary as events unfold.

We also encourage you to contact us at any time to discuss the current environment and our tactics and strategies going forward.

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