BRIDGES | INVESTMENT MANAGEMENT

Think Forward

Market Comments
October 19, 2015

S&P 500	2034
10 Year Yield	2.02%

Equities had their worst quarter since the third quarter of 2011, as investors focused on the effects on the capital markets of: slowing economic growth in China, weak commodity prices, a persistently strong dollar, and the timing of the Fed's eventual move from an accommodative to a more restrictive interest rate policy.

The following table summarizes total returns for major stock and bond indexes for the third quarter, 2015 year-to-date, and for the twelve month period ending September 30, 2015:

Index	Q3	YTD	LTM	Since 12/31/08	Annualized 12/31/08
	%	%	%	%	%
S&P 500	-6.43	-5.27	-0.62	145.50	14.23
S&P 400 Midcap Index	-8.49	-4.66	1.39	181.03	16.54
S&P 600 Small Cap Index	-9.27	-5.50	3.79	162.86	15.39
MSCI EAFE Index	-16.62	-4.80	-8.09	69.24	8.11
MSCI Emerging Markets Index	-24.17	-16.57	-21.13	47.71	5.95
Barclays U.S. Aggregate Bond Index	3.11	1.13	2.94	33.17	4.33

Investors focused on "risk factors" during the third quarter, and stock prices retreated as investors generally sought to reduce their exposure to "risk assets" in the face of a string of negative developments in the global economy.

The key risks that affected securities prices during the third quarter included: slowing economic growth in China (particularly in the commodity sector); declining commodity prices (primarily energy, but other commodities as well); continued strength of the dollar (which has become a significant drag on the earnings of U.S. companies that derive a substantial amount of their sales and earnings outside of the U.S.), and concerns regarding the impact of an eventual end to the Fed's quantitative easing operations.

The decline in stock prices from all-time high levels reached in late May has improved intermediate and longer-term expected returns for equities, even as earnings estimates for 2015 and 2016 have come down (stock prices have generally declined faster than earnings estimates have been cut). The earnings estimate cuts have been driven primarily by significant weakness in the commodity sector, most notably oil, and by continued strength in the U.S. dollar, which has negatively impacted reported earnings for U.S. companies with significant international revenues.

We currently estimate year-end 2015 fair value for the S&P 500 at 2100 (17.5x estimated 2015 earnings of ~$120 per share (down from an estimate of $130 per share at the outset of 2015), and 2300 for year-end 2016 (17.5x estimated 2016 earnings of ~$130).

The S&P 500 ended the third quarter at 1920 (down from its all-time high of 2134 in May); our fair value estimates imply modestly positive total returns through year-end 2015, and roughly 15% for the five quarters out to year-end 2016. U.S. equities have rebounded nicely – about 6% -- thus far in October.

Risks to our fair value assessment include both earnings (the risk that corporate earnings continue to slow in the aggregate due to a combination of a continued strong U.S. dollar and a continued sluggish global and domestic economic environment), and valuation (valuation multiples could contract as investors become less willing to pay for risk-based assets such as stocks during periods of slow and/or slowing economic growth, and/or as the Fed begins to raise interest rates).

Overall, while we expect a continuation of elevated levels of short-term stock price volatility (volatility spiked during the third quarter), we believe stocks are attractive for investors with time horizons that are measured in years as opposed to months. We believe that high volatility periods give us the opportunity to add to or initiate positions in great companies at attractive valuation levels that increase the probabilities of achieving good long-term returns.

Bond returns were positive during the third quarter, and year-to-date, as interest rates declined during the quarter and have been essentially flat on balance so far in 2015.

With that said, we continue to believe that the longer-term outlook for bonds is relatively unattractive (although bonds do dampen short-term portfolio volatility), because interest rates remain close to historically low levels, and are likely to increase over time as 1) the Fed begins to raise rates, and/or 2) as the economy eventually shows better growth, leading to increased demand for credit and increased inflation expectations. That may not happen soon, but we believe reversion to the mean is powerful, and it is likely that eventually, interest rates will revert toward long-term historic norms and be meaningfully higher than they are today. Higher interest rates will by definition hurt bond returns.

Should interest rates remain at or near current levels due to ongoing economic weakness for an extended period of time, we believe that valuations for stocks could expand as investors will be compelled to pay higher multiples for assets (such as dominant, high quality business franchises) that can actually show growth in value over the long run. We believe that a 10-year bond yield of 2% (the 10-year yield was 2.04% at the end of the third quarter) should lead to a P/E of roughly 20x earnings for companies that can show mid-to-high single-digit business value growth in a depressed global growth environment. To the extent such companies increase their dividends in line with their earnings growth, investors should find those companies to be attractive during a period of extended very low interest rates.

Stocks currently trade at lower valuations (~17.0x estimated 2015 earnings, ~15.6x estimated 2016 earnings) than we would expect (or believe justified) given low interest rates, because investors are concerned about both 1) the risk of corporate earnings deceleration and disappointments going forward and 2) the effect that higher interest rates may have on equity valuations. In essence, current equity valuations appear to have priced in an eventual meaningful increase in interest rates. If rates don't rise materially over the next several years, equity valuations would appear to have room to expand for those companies that can continue to deliver solid earnings growth.

Earnings growth remains a key component in the outlook for stocks. Aggregate reported earnings growth is clearly slowing due to the factors cited above: commodity price weakness, and U.S. dollar strength. We believe it will be important to look through aggregate earnings and reported earnings to understand which companies are generating organic business growth and building intrinsic business value for their shareholders. Companies that are able to show relatively strong revenue growth and solid growth in free cash flow should be able to achieve and maintain premium valuations – our focus will remain on identifying those companies and understanding how their financial performance and current valuation metrics combine to provide opportunities for investors.

2015 is shaping up to be the most difficult and challenging capital markets environment since 2008-09. Our approach will continue to be: 1) overweight stocks, because valuations for stocks remain reasonably attractive despite the risks we have enumerated; 2) underweight bonds, because bond valuations remain relatively unattractive; and 3) use periods of extreme market volatility to position capital in great companies at attractive valuation levels that should allow for good long-term total returns.

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