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~ OUR CHIEF INVESTMENT OFFICER'S COMMENTARY ~

We expect the economy to grow at a rate of two and a half percent this year, the same rate as 2014. We also think the economy will continue to grow at the same pace in 2016. In general, this is in line with GDP growth of slightly greater than two percent since the end of the recession. Our long term outlook for 2017 and beyond will be largely determined by Federal Reserve Bank policy; the longer the Fed waits to raise rates, the more aggressively they will raise rates when they begin. The effect on the economy of an aggressive rise in rates will be to further dampen economic growth in the future.

A key characteristic of the current economy is the striking divergence between domestic strength and the weakness of external demand. The dollar's 21% rise over the past year, combined with weak international growth, has become a huge drag on U.S. GDP growth. **While we think the trade weighted dollar will continue to appreciate, albeit at a slower pace, we think the disparity between a decline in real exports and the rise in real imports will become even more significant.** In part, this disparity has been disguised by the decline of oil imports over the past several years. With the collapse in domestic drilling activity, domestic oil production will decline, and we expect to see a renewed reliance on imported oil in the future. Also, the stronger dollar has made it more difficult for U.S. capital equipment producers to compete abroad and it is possible that U.S. firms have switched to purchasing imported equipment, a trend which is likely to continue.

The divergence between exports and the rest of the economy is notable. While ISM surveys show manufacturing at a two-year low, non-manufacturing activity is close to a decade high. At the same time, retail sales growth has rebounded while manufacturing output is stagnant. In the early years of this economic recovery, consumption was held in check by weakness of demand caused by credit constraints and fiscal tightening. **Recently, consumption has accelerated due to a number of factors; e.g. the stronger dollar reduces the cost of imported goods, lower fuel prices frees up more money for other purchases, and higher residential real estate prices contribute to greater household net worth.**

Perhaps the major factor boosting consumption is the labor market, which is very close to full employment. **Job openings are already at a record high and the rate of increase in job openings continues to accelerate.** While many point to the participation rate as an argument against full employment, we think the decline in the participation rate, which began well before the recent recession, is structural rather than cyclical, driven by the retirement of Baby Boomers and increased use of technology and automation. We do not believe these individuals plan to re-enter the labor pool. While there has been little improvement in wage growth this year, we think this is likely to change in the year ahead.

In the 1950s, Milton Friedman noted that economic forecasts were influenced by the forecasters' experiences of the recent past. Friedman saw this as an undesirable bias to accurate forecasts and described how to quantify this bias, and it was named "adaptive expectations". Why do we mention economic research from 60 years ago? Simply, it was and continues to be useful to understanding current behavior based on past experiences and past expectations for the same event. After five years of very low inflation, we think investors have adapted this recent experience to assume that inflation will continue to remain benign into the future and underestimate the potential near term trend in inflation. **We believe that domestic inflation is poised to eclipse external deflation.** In the early years of the recovery, low inflation was a consequence of slack available in the domestic economy which put downward pressure on both prices and wages. For the past year and a half, slow global demand has pushed inflation even lower through cheap commodity prices and a stronger dollar. This will continue, at least for the rest of the year, but begin to fade in the coming year. **Next year, with the economy approaching full employment, wage inflation could begin to put significant upward pressure on prices, pushing inflation rates well above the Federal Reserve's target of 2%.**

With the economy plodding along at about 2% for the past several years, producing fairly anemic growth in corporate profits, the stock market has turned in fairly predictable gains with relatively low volatility. It is claimed that, on average, the stock market experiences three corrections of 5% per year. Once a year we can expect a 10% correction, and every three years we should expect a 20% correction. Last fall, we experienced the first 10% correction in three years, followed this summer by a 12.5% correction. In order to understand this recent volatility, we have two observations. Markets become volatile when the future becomes uncertain or in reaction to surprise. For the past several years, the equity markets have been fairly predictable and surprises were either transitory or isolated to specific companies. Until about a year ago, sector rotation due to changing economic conditions mostly didn't happen. Market leadership remained with the same companies and industries. **In the past 16 months, with the 21% rise in the dollar and the 64% decline in the cost of oil, there began to be significant shifts in the prospects for companies, resulting in increased uncertainty.** We spoke of volatility as a product of uncertainty. Milton Friedman's observation of adaptive expectations, as it applies to inflation, is equally applicable to understanding the behavioral response to uncertainty and accompanying volatility. **Recent stock market volatility isn't more volatile than normal; it just seems so because we haven't experienced it for a while.**

Fixed Income Market

Both the stock and bond markets closely watched the Federal Reserve with bated breath during the third quarter. The markets and financial press had a field day trying to anticipate when the Fed's so called "liftoff" (a.k.a. "first rate hike") would occur. Widespread expectations for it to occur during September began to weaken after China devalued its currency. **Now that the Fed's September meeting has passed with no action having been taken, it appears that the first rate hike will probably occur early in 2016, though we can't rule out a 2015 increase.** Some investors interpreted the Fed's inaction as a reason to worry about future economic growth, which contributed to a modest reduction in long-term interest rates on Treasuries during the quarter. Yields on corporate bonds have moved in the opposite direction, rising about 1% so far during 2015 as many investors have demonstrated increased risk aversion. **Our clients' fixed income holdings are largely insulated from these fluctuations in rates since we invest in shorter-term investment grade bonds that will mature in 5 years or less, and because we typically hold bonds until maturity at which point the market price of non-defaulted bonds converges to $1,000 regardless of interest rates. Interestingly, the outlook for short-term interest rates has become increasingly controversial.** Fed officials and a survey of economists both estimate that the fed funds rate will be around 1.5% at the end of 2016 and 2.5% at the end of 2017. For these same years, investors in the market for fed funds futures contracts are betting that rates will be far lower; close to 0.8% in 2016 and 1.2% in 2017.

One party or the other will be massively wrong so we are happy to avoid the interest rate speculation game. As always, we treat fixed income as a way to protect portfolios from market volatility, not a way to 'reach for yield' or make risky bets on Fed policy.

International Market

China has been the center of attention throughout the quarter as it received a tremendous amount of attention from the mainstream media. This unflattering coverage of the Chinese economy is widely viewed as the primary driver behind increased volatility in global financial markets. **While the slowdown of the world's second largest economy undoubtedly adds psychological uncertainty to the market, it would be a stretch to conclude that the slowdown would introduce a global recession.**

There is no doubt that the Chinese economy has weakened from the last three decades' average annual growth rate of 10%. This year, according to the official estimate, the Gross Domestic Product (GDP) growth is expected to be 7%. This slowdown should not be a surprise to investors and the market should have already discounted it into valuation levels. **Why, then, did we recently see the Chinese equity market, Shanghai A-shares, undergo a near-50% plunge within a short period of time?** For market watchers who read beyond headlines, the reason is apparent: the bubble burst.

Chinese equities consist of three share classes: A-shares traded on Shanghai's exchange, H-shares traded on Hong Kong's exchange, and N-shares, which are all depository receipts traded on foreign exchanges. Unlike H-shares and N-shares where prices are determined by an open market, the characteristic of A-shares is unique. Shanghai A-shares are traded in a closed market that is only open to Chinese nationals, comprising of 90% individual investors and 10% institutional investors. Earlier this year, as Chinese equity prices kept attaining new highs, individual investors borrowed on margin to chase a sizzling market and the bubble began to form. In both theory and practice, share prices among different share classes should trade at relative parity. **But because A-shares trade within a closed market, the disequilibrium in price could not be arbitraged away, allowing the bubble to grow bigger. Shanghai A-shares at their peak traded at a 54% premium to counterpart H-shares in Hong Kong.** Sooner or later the markets will force the price to revert back to equilibrium; we believe we have just witnessed the first big step in that direction.

The rapid decline of its domestic equity market reinforces the belief that China is in the midst of a deepening economic crisis. Is China really in a crisis? **We believe a more appropriate description would be that China is experiencing "growing pains," while it transitions from an investment-driven economy to a market-dependent economy.** For many years, economists have warned that China's double digit growth led by huge capital expenditures could not be sustainable. If left uncorrected, China eventually would encounter a hard landing. The medicine prescribed was for China to emerge from a capital-intensive export-oriented economy to one that is more focused on consumption and services. That is exactly what China has been trying to do for the past few years.

In spite of the media focus on GDP growth, the sharp divergence between China's manufacturing and service Purchasing Managers Indexes (PMIs) might serve as an indication that we are actually seeing the early success of this transition. The manufacturing PMI has been constantly below the 50 threshold, indicating contraction in this sector of the economy, while the service PMI has remained in solid expansionary territory over the past several years. Additionally, China's weakened stock market has done minimal damage to domestic consumption. If China's economy is indeed in a crisis, it would be very difficult for discretionary consumption such as cinema box office revenue, overseas travel, and e-commerce sales to achieve the explosive growth that they have recently shown.

Amid the Chinese economic slowdown, the U.S. market has also experienced a larger correction than we have seen for a while. It is easy for people to ascribe a cause-and-effect relationship, but we believe that is just not the situation. Weakness in China's economy can transmit to equity markets elsewhere mainly through three key channels: direct trade links, downward pressure on commodities prices, and an increased aversion to risk. **Out of these three channels, besides the increased aversion to risk, which is a psychological factor, we do not see a compelling reason for Chinese economic slowdown to have material impact on the U.S. market.** According to the U.S. Census Bureau, exports to China accounted for less than 1% of U.S. GDP in 2014, so the impact through direct trade links is not likely. Since commodities production is a fairly small component of the U.S. economy, the decline in the price of commodities would not have a major impact on the U.S. economy either. In fact, the impact could even be positive, since the U.S. also imports commodities.

We still expect the Chinese market to be volatile in the foreseeable future. Transforming a huge economy like China will undoubtedly be a gradual and bumpy ride. But, China remains the only major global economy with both monetary and fiscal resources to accomplish such a transition. We continue to believe that Chinese policymakers have the tools and the will to manage this transition in a way that does not generate significant economic disruptions. Interest rates have been cut over the past few months, as have bank reserve requirements. Recently announced programs to boost infrastructure spending also signal an easing of fiscal policy. **We believe that the effects of China's fiscal and monetary stimulus should begin to flow through the economy and the continuing economic transition will benefit the country in the long-run; hence, having a carefully managed exposure to Chinese companies with an emphasis on consumer spending is a prudent strategy.**

Our vision is to provide sound financial management for each client, always placing the best interests of the clients first. We aim to preserve and enhance every client's wealth while providing peace of mind and financial security, now and for future generations.