October 9, 2015

Hit By China

Dear Investor:

It's probably safe to assume that the number one issue on most client's minds right now is the significant correction that has occurred in the last few months. This has been the worst quarter for stocks we've seen in a long time. The all-time high for the SP 500 was set on May 21st of this year at 2,130.82. In the month of June, things began to slide bringing us close to where we started the year, as I mentioned in my last letter. The averages were basically level in July and early August. The tumble began in late August and rolled on right through September, bringing prices down 8% - 9% from July, and around 5% - 6% for the year. While no one enjoys a correction, this has been overdue for many months. The last significant correction ended in October of 2011, almost four years ago.

Markets are always about price. The volatility we see on a daily and weekly basis is the market's way of adjusting to changes in opinion of the value of stocks based on the economic outlook and potential earnings per share. Prices had been high since last November as things in the US seemed pretty good. There was a lot of money going into stocks. Everyone knew this, but markets can stay high for a long time. What changed recently is the growth outlook. Growth in China has been slowing down. Their central bank devalued their currency in August. This was an unexpected move and set off a big reaction, as China is currently the second largest economy in the world at around $10 trillion dollars. The strong dollar has already slowed down manufacturing and exports in the US. Lowering the Chinese Yuan makes the dollar even stronger, which may have an effect on our growth rate. There was also substantial uncertainty if China might devalue further. No one could be sure this was a one-time event, and this is still the case. However, it was enough to bring the market down with a thud.

The correction was sharp, but it has brought the SP500 back into a price range that is much closer to its longer term averages based on price earnings ratios. So where does that leave us? What are reasonable expectations going forward? In my opinion, the bull market in the US has not ended. As the market adjusts to the new realities of the world growth outlook, it should reach a point where valuation is appropriate again and be able to advance. We may be there now, or this may take some time. If world growth slows more, we will likely drift lower before moving forward. The good news is the US economy is still doing reasonably well.

A correction of this nature does not specifically indicate that we are heading into a recession. Studies by S&P Capital IQ have shown that many corrections have occurred since WW2 that have not been followed by a recession. This is easy to understand when you see that markets often get ahead of what we can call "fair value". At some point, negative news comes up that trims back the excess exuberance and prices decline. I believe that's what we are experiencing now. There is not a strong case to be made that we are heading into a recession. Most of the data coming out in the US is pretty good. When we finally hit the point where the earnings in the energy industry turn around, they should provide a major boost to the SP500.

All that said, recessions are a fact of life. Sooner or later things will slow down in the US or elsewhere to the degree that we enter a recession. In the world of economics, a recession is generally defined as two consecutive quarters of negative growth. These slowdowns have always been a part of

Lyndon Office Park|7000 East Genesee St. Bldg D| Fayetteville, NY 13066-1139
315-701-5750|Fax 315-701-5751|dkeim@keimassetmanagement.com
www.keimassetmanagement.com

the business cycle, and I fully expect there will be more in the future. The important point to remember is that we can still experience success as investors in spite of recessions. Slowdowns do not put high quality companies out of business. For a period of time, their shares are worth less because the companies are making less money. In due time, things pick up again and the shares are worth more. In most cases, these firms pay dividends and will continue to do so in a recession. I think it's also important to point out that what happened in 2008 and 2009 was not a typical business slowdown or recession. It was named the Great Recession for that very reason. We have discussed this at length in our review meetings. Those types of moves are the extreme cases and have only happened a few times in the last century.

The other big story in September was the Federal Reserve. As most of you probably know, the Street had reached the point where most everyone was expecting them to raise interest rates for the first time in almost 10 years. At the last minute the Fed decided to hold steady with their current policy. This also sent out some shock waves and increased volatility for a while. The bottom line is the situation with China caused enough concern in the FOMC that they thought the more prudent path was to hold off on the increase for now. It seems true that downside risks have increased somewhat right now. Many companies around the world do business with China in different ways. There's uncertainty as to China's ability to manage the current slowdown. Hopefully, things will settle down, and the Fed will get back on track with their plans to slowly raise rates to more normal levels.

Please contact me anytime if you have questions or concerns on your portfolio.

Best Regards.

David Keim

Lyndon Office Park|7000 East Genesee St. Bldg D| Fayetteville, NY 13066-1139
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www.keimassetmanagement.com