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Third Quarter 2015 *Round Trips*

Global equity markets have just suffered their worst quarterly performance since the third quarter of 2011 when a downgrade of U.S. debt by Moody's unleashed a wave of selling that caused precipitous, highly correlated declines across world equity markets. That was a genuine panic. The past three months look more like a violent rotation driven by a surprise devaluation of the Chinese Yuan and subsequent lowering of growth expectations, with more clearly differentiated winners and losers among asset classes and individual stocks. It can also be argued that a correction of some magnitude was overdue as investors contemplate the end of zero interest rate policy in the U.S., however well telegraphed by the Federal Reserve.

The table below shows 2015 third quarter and year to date index and ETF returns for a variety of asset classes typically included in globally diversified portfolios. While the price drops alone are considerable, and sobering, we thought it would be interesting to add another column showing the calendar year in which these recent quarterly lows were last visited. The contrast between the performance of developed market equities (U.S., Europe, Japan), which lost a year or two of appreciation, and the commodity complex (Global Commodities, Crude Oil, MLPs, and certain Emerging Market Equities), which has given back five to sixteen years of gains, is stark. In addition, while U.S. High Yield Debt has traded down with U.S. Equities, U.S. High Yield Energy bonds have plunged to levels not seen since late 2010 (see graph on Page Two). Finally, though long dated U.S. Treasuries rallied 5.3% on the quarter, we expected better performance in a growth scare. Either foreign buyers of U.S. Treasury debt have been selling their dollar reserves to maintain liquidity and stability at home, or interest rate markets simply do not anticipate a recession.

Index or ETF	Third Quarter 2015	Year to Date 2015	Third Quarter Lowest Level Since:
Barclays Capital U.S. Treasury 20+ Year	5.32%	(0.21%)	2015
Euro vs U.S. Dollar	0.27%	(7.61%)	2003
Bloomberg High Yield Bond Index	(5.14%)	(2.01%)	2014
S&P 500	(6.44%)	(5.29%)	2014
MSCI Europe	(8.69%)	(5.20%)	2015
MSCI Japan	(11.80%)	0.21%	2015
Russell 2000 Index (Small Caps)	(11.92%)	(7.73%)	2014
MSCI All Countries (ACWI) Ex U.S.	(12.17%)	(8.63%)	2012
MSCI Emerging Markets	(17.90%)	(15.48%)	2009
S&P GSCI (Commodities)	(19.30%)	(19.46%)	1999
JP Morgan-Alerian MLP	(21.97%)	(30.99%)	2010
WTI Crude Oil	(25.04%)	(23.36%)	2008

Total Returns in U.S. Dollars. Source: Bloomberg, BlackRock. Returns are calculated with net dividends in U.S. Dollars.

When U.S. Treasury debt, the "risk free" asset against which all others are measured, was downgraded in 2011 by Moody's, the political infighting, regulatory backlash and global quantitative easing programs that have defined this post crisis era were just getting started. Commentators were writing about "Capitalism 2.0," extolling the virtues of a steady state hand and mapping common sense limits to free market activity as surely as one would take fireworks from the hands of children. It is worth remembering because last quarter's global growth scare emanated from the world's largest and least transparent planned economy. Though the Chinese government unleashed a variety of measures last summer to rebuild confidence in its plunging stock market, the steps taken

appeared reactionary, uncoordinated, and accomplished little. Trust in Chinese markets deteriorated further, prompting one of our favorite managers to write: “It is as if they [the Chinese] have read the operating manual of capitalism, but not the philosophy.”¹ Weakening global growth data and the sell off that followed were enough to spook the Federal Reserve, their inaction on U.S. interest rates in September only adding to confusion about the health and direction of the global economy. Is the decline in commodities a response to China’s pivot away from natural resources driven expansion efforts or a canary in the coal mine indicating global recession in 2016? We think it is likely the former, not the latter. We expect the Chinese will continue to manage their slowing economy clumsily but adequately, hopefully without another destabilizing currency move.

What is transpiring in the energy and commodity sectors is fascinating, if sometimes painful to watch. Apart from a collapse in stock prices, one way to mark the bottom of a cycle is to look for corporate events like

dividend cuts, write-downs, shareholder dilution, asset sales, bankruptcies, spin offs and merger activity. There are numerous actions in process involving companies like Glencore, DuPont, Alcoa, Halliburton, and various MLPs. On the exploration and production side, *The Wall Street Journal* reported on September 13 that “U.S. oil-and-gas producers have written down the value of their drilling fields by more in 2015 than any full year in history... according to a tally by energy consultancy IHS Herold Inc.”² IHS also reports that there are more than \$200 billion of oil and natural gas assets for sale globally, some of which are imperative just to service debt.³ We

have already seen the most liquid assets drop first – currencies, commodities, equities and junk bonds. The landscape of less liquid assets including energy reserves, mines, capital equipment, personnel and entire corporations, is now changing. Although these steps can take years to play out, once the decisions are taken such corporate actions allow capacity to shrink to levels that can eventually lead to new growth.

It seems apparent that even small, gradual increases in U.S. interest rates are not going to be easily digested, at least not until consensus forms about the pace and the ultimate level required to achieve equilibrium between the cost of money and U.S. inflation – and unstable commodity prices make inflation harder to gauge. In any case, severe underperformance of junk credits and deeply cyclical companies is actually a welcome sign for those of us who focus on quality balance sheets and try to avoid excessive cyclicality. Interest rates are one rising tide that will not float all boats.

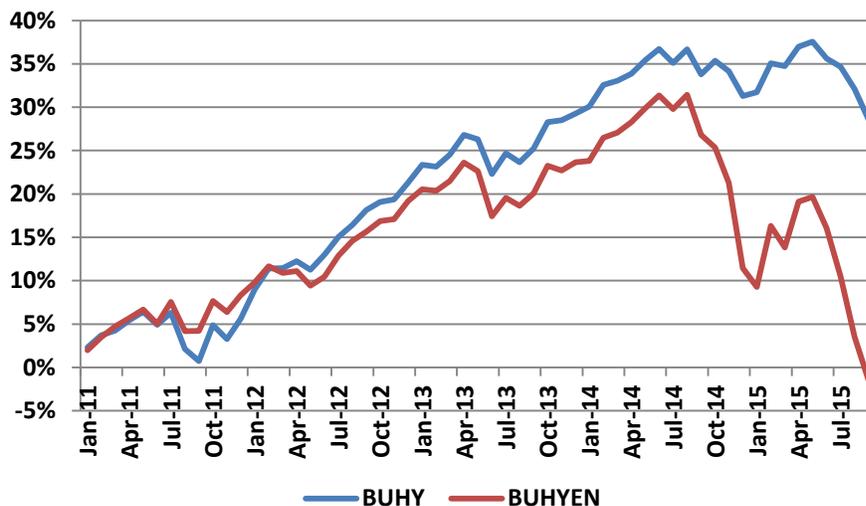
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Source of data not specifically cited: Bloomberg.

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Bloomberg USD High Yield Corporate Bond Index vs. Bloomberg USD High Yield Corporate Bond Index – Energy Only



¹ Chenevix-Trench, Richard. Sloane Robinson LLP. July 2015.

² Dezember, Ryan. (2015, Sept. 13). Write-downs abound for oil producers. *The Wall Street Journal*.

³ Clark, Aaron, & Stapczynski, Stephen. (2015, Oct. 14). Oil slide means ‘almost everything’ for sale as deals accelerate. *Bloomberg*.