TERRA NOVA ASSET MANAGEMENT

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The U.S. stock market underwent a severe correction in August of up to 11% from August 17 to 25 which was triggered by China's unexpected currency devaluation. The correction was amplified by technical factors such as an unorderly selling of exchange-traded funds (ETFs), speculators, (high frequency traders), and lastly by low trading volume as August is a prime vacation month. 42% of every dollar traded on U.S. exchanges on Aug. 24 was in ETFs, that have grown into a $2 trillion industry in the past 5 years. Unlike mutual funds, they trade throughout the day in lockstep at least with liquid securities they own. However, in the stressed market of August, the fragility of ETFs were highlighted when they traded up to 20% below the net asset value of their underlying stocks. Market controls need to be improved and the authorities are looking into this. The S&P 500 Index recovered since the correction, but is still down for the year. Most importantly, the damage to investor psychology has been deep. We are, therefore, not expecting the markets to rally significantly, but rather trade cautiously through year-end.

China Currency Devaluation

China is converting to a consumer driven economy. A slowdown in the economy was to be expected in the process. That the Yuan devaluation was staged to improve exports was misread by the markets in our opinion. As requested by the IMF, the yuan exchange rate had to become more market driven to be included in the reserve currency basket this fall. Interventions have to be limited only to times of excessive volatility. In order to assure an orderly market, China introduced new reserve requirements of 20% for FX forward contracts for clients, which have a minimum lock-up period of one year. This new control mechanism will take effect on Oct. 15 and is aimed to ease reduction in FX reserves and discourage speculation. It is noteworthy to mention that despite all the excitement the net change of the yuan/$ this year was just 2.62%.

Fixed Income Markets

China started to liquidate some of its $ 1.27 trillion holdings in U.S. Treasuries to buffer the yuan's depreciation. In the short term this is likely not to lead to upward pressure on U.S. rates which have remained at historical lows. In the absence of alternative investments as sound and liquid as U.S. Treasuries, we do not expect the pace of selling to accelerate. However, central banks' liquidity in financial markets is diminished as foreign exchange reserves (11.4 trillion is the dollar share) are shrinking, driven by a slower global economy, the Fed's pending interest rate increase, the collapse of oil and decisions in Switzerland and Japan to cease intervening in currencies. Reserves are being used to offset capital outflows or to manage currencies. Declining reserves could result in higher bond yields and a rising dollar against the euro and yen. The 10-year Treasury yield has increased from 1.9% in August to 2.15%, still well below the 3% which would be a fair value of the underlying economic fundamentals. Investment grade spreads in the materials and energy sectors have widened to 2.5% plus and start to look attractive.

U.S. Economy warrants a Change in Federal Reserve Policy

China is likely to have modest impact on the U.S. economy as exports to China are only 1% of U.S. GDP (4% to emerging markets). It will affect manufacturing to some extent, however, manufacturing is only 12% of GDP. The domestic U.S. economy is consumer orientated and will not likely be affected. Housing is robust, consumer spending is picking up (it was $11.9 trillion in 2014, greater than the GDP of any other country, including China (Int'l Monetary Fund), the labor market is supporting income growth in nominal terms and even better in real terms given the decline in energy prices. Domestically, the economy is improving and Q 2 GDP was revised upward to 3.7%. This was a notable achievement given the lower demand from overseas and the reduced spending by energy companies. Although the impact on other economies, in particular, emerging markets, may affect U.S. exports, total U.S. exports comprise only 15% of GDP. We continue to expect the economy to grow 2.5-3% during the remainder of 2015.

Federal Reserve Bank –Prudent Decision

The Federal Reserve Bank postponed rising interest rates in September due to renewed uncertainty about the outlook abroad and the financial market turbulence in August. However, the Fed can be expected to rate interest rates likely in December as their fundamental outlook on the U.S. economy has not changed. This would send a strong signal to the markets that the U.S. economy is robust enough to weather head-

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winds from a slower global economy. Overall the Fed's decision will be mainly driven by the fundamental data on the domestic economy.

Outlook

Since late January the expectation of a change in interest rate policy led to rising interest rates and thus put pressure on stocks including almost all dividend paying stocks, even those which are robustly growing dividend distributions. We recommend focusing on more cyclical sectors, such as consumer discretionary, and to maintain ample exposure in interest rate neutral sectors like healthcare and build positions in undervalued sectors like financials which will particularly benefit from rising interest rates. We expect the market to stabilize and trend modestly upwards in the next quarters.

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