CHINESE STOCK BUBBLE, INCOMPETENCE, AND ECONOMIC SLOWDOWN HITS STOCKS

The Chinese stock market, which raced up into bubble territory early this year, crashed in June and has not recovered since. Chinese authorities, fearful of the hit retail investors would take, tried several clumsy measures to prop up the market, but found no success. Faced with declining exports and an economic slowdown, China surprised the markets by devaluing the yuan relative to the dollar on August 11. Equity markets around the world sold off and the U.S. stock market suffered its first 10 percent correction in three years.

The Standard & Poor’s 500-stock index of large-cap U.S. companies was down 6.4 percent for the third quarter of 2015 and the Russell 2000-stock index of small companies fell 11.9 percent. Energy and material stocks, most affected by the shale revolution in the U.S. and the slowdown in demand for commodities from China, fared the worst—down 17.4 percent and 16.9 percent respectively. Utility stocks, which are defensive in nature and tend to do well in a market correction, rose 5.4 percent during the third quarter. International stocks, and particularly emerging market stocks, fared far worse than U.S. equities. The MSCI EAFE index fell 10.2 percent during the third quarter while the MSCI Emerging Markets stock index was down 17.9 percent. Markets in China and Brazil were down 22.7 percent and 33.6 percent respectively.

BONDS: ANXIOUS INVESTORS DEMAND HIGHER YIELDS FROM CORPORATE BONDS

As stocks fell during the third quarter, the “spread” or additional yield that investors require on corporate bonds, widened significantly. The stress was more severe in high-yield or “junk” bonds of energy and other commodity companies. High-yield bonds fell 4.8 percent during the quarter. Local currency bonds of emerging market countries were down 8.7 percent as the strengthening dollar caused capital to flow out of these countries. The broader bond market offered investors a positive return. The Barclays U.S. Aggregate bond index was up 1.2 percent in the third quarter. Investors sought safety in Treasury bonds. The yield on the 10-year Treasury note fell from 2.335 percent to 2.061 percent. The Barclays Long-Term U.S. Treasury index delivered a solid 5.1 percent return for the quarter. On the other hand, Treasury Inflation Protected Securities, also known as TIPS, lost 1.2 percent during the quarter as inflation expectations plunged due to worries over slowing global growth and disinflationary pressures from a stronger dollar and prolonged sell-off in commodities.
**COMMODITIES: DOWNWARD TREND CONTINUES**

Following a brief bounce-back rally in the second quarter, commodity prices continued their fall in the third quarter. The Bloomberg UBS commodity index, which tracks 22 commodities, fell 14.5 percent in the third quarter of 2015. The slowdown in China also hurt commodity prices, which were down across all the major sectors. Energy was the worst performing commodity sector – down 22.3 percent for the quarter. Low oil prices have curbed U.S. shale output by about 500,000 barrels per day and further cuts are expected into next year. However, a surge in OPEC production and the potential that Iranian oil could hit the market next year should keep the markets well supplied and inventories at peak levels well into 2016.

**OUTLOOK 2015**

We have become somewhat cautious in our outlook for risk assets in the near term. Slowdown in China and emerging markets, the strong dollar, and tightening financial conditions in the corporate bond market are giving us pause. We expect both third and fourth quarter earnings in 2015 to decline compared to last year. Valuations are not cheap and declining earnings are not a recipe for a rising stock market.

We believe the Federal Reserve was right in not raising rates in September and expect them to be on hold until next year. With inflation as measured by the personal consumption expenditure index down around 1.3 percent, we believe the Fed will “be patient” in moving to higher rates. A stronger dollar and U.S. interest rates that are higher than those of other large economies such as Germany and Japan will continue to attract foreign investors to the U.S. bond market. As such, we expect rates to stay low for longer and favor fixed-income portfolio durations that are neutral relative to an investor’s benchmark.

Emerging market stocks, currencies, and local bonds are likely to continue to be under pressure from slowing demand from China and the stronger dollar as the Fed begins to raise rates. Low oil prices may be with us for a while. High levels of inventories along with the potential of new supply from Iran should keep a lid on prices. We believe being overweight commodities is prudent right now. A stronger dollar, the slowdown in China’s economy, and excess supply are not great for commodities. China is dealing with its own credit real estate bubble and an economy that is slowly transforming from investment spending to consumer spending.

**KEY RISKS**

**China** — a hard landing for the Chinese economy is the most significant risk to the global economy, global trade, and to countries that do significant business with China.

**Emerging Markets** – slower growth, weaker commodity prices, capital outflows, and weaker currencies suggest more pain ahead for many emerging market countries.

**Earnings** – low oil and commodity prices and a stronger dollar continue to hurt corporate earnings as peak margins come under pressure. It is likely that fourth-quarter earnings will decline compared to last year and we will get three quarters of declining earnings in a row.

**Geopolitical** – emanating from potential action by Russia. The Russian economy faces severe stress due to sanctions imposed by the West and the fall in energy prices. Putin’s popularity in Russia remains very high and as with Ukraine he is now firmly engaged in Syria.

Sources: Wall Street Journal, Bank of America Merrill Lynch, Goldman Sachs, Northern Trust, Bloomberg, Factset

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Sources: Wall Street Journal, Bank of America Merrill Lynch, Goldman Sachs, Northern Trust, Bloomberg, Factset, Morningstar

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