GROWTH EQUITY REVIEW

Third Quarter 2015

THE CHINA SYNDROME

PERFORMANCE COMMENTARY

In 1979, in Ventura California, the discovery and publication by the press of unusual mechanical behavior in a nuclear power plant brought the government to action and the country to a state of heightened anxiety. The possibility of a reactor meltdown and resulting air and water contamination gripped the nation. Although physically impossible, fear escalated from reports by “experts” that the nuclear core could melt down from Southern California through the center of the earth “all the way to China.” The movie, *The China Syndrome*, received five Academy Award nominations.

Conversely, today among financial reporters, economists, and investors the risks are in the opposite direction; from the East to the West, from China to the US. There are numerous (almost consensus) predictions that a pending “melt down” of the Chinese economy will mushroom and contaminate the US economy. The audience for this doomsday script has been vast and impressionable. One of its most notable proponents is William Buiter, Chief Economist of Citigroup, whose recent pronouncements sent seismic tremors through the US securities markets. Time will tell whether his screen play will receive the nomination for best fact or best fiction.

During the third quarter, there were additional negative influences that resulted in a -6.2% decline in the total return of the S&P 500 average; 1) the threat of a currency war sparked by China’s modest devaluation of the renminbi, 2) uncertainty over Fed pronouncements and policy, 3) the Volkswagen scandal, 4) Hillary Clinton’s protestation on excessive prescription prices, 5) the refuge crisis in Europe, 6) spotty US economic data, and 7) extreme volatility in the US equity market which resulted, in good part, from the “portfolio insurance” aspect of high frequency trading.

Setbacks in the US markets were widespread during the quarter. The declines for the leading averages for 3Q and YTD were: Dow Jones at -7.6% and -8.6%, S&P 500 at -6.2% and -5.3%, Nasdaq at -7.4% and -2.5%.

The strongest (least weak) styles for the quarter were large capitalization growth at -5.3% and the weakest was small capitalization growth at -13.3%. Large cap growth YTD was also best at -1.5% with small cap value stocks the worst at -10.1%.

At the sector level, there was a very wide dispersion of returns. The best groups were defensive in nature: Utilities at +5.4%, Consumer Staples at -0.2% and Consumer Discretionary at -2.6%. Areas of greatest weakness were the economically sensitive: Energy at -17.4%, Materials at -16.9%, with Heath Care down -10.7% due to politically motivated product pricing proposals. YTD the winners were defensive areas: Consumer Discretionary at +4.1%,

Consumer Staples at -1.0%, and Health Care at -2.1%. Losers were economically sensitive groups: Energy at -21.3%, Materials at -16.5% and Industrials at -9.8%.

PORTFOLIO COMMENTARY

During the third quarter, the portfolios two best contributors were **Google (GOOGL)** at +18.2% and **Amazon (AMZN)** at +17.9%. Both companies personify the rapid changing of the guard in the US economy. They are among the new leadership which is R&D driven, new product centric, and address mass markets. **Martin Marietta Materials (MLM)** at +7.4% continued to benefit from firm demand and strong product prices in the construction materials (cement, etc.) markets. Sales and earnings advanced in the quarter and the outlook into 2016 and beyond is positive. While there was weakness in the Health Care sector during the quarter, it was most pronounced in biotechnology. **Merck (MRK)** at +16.0% ran counter to the industry pressures over optimism on its lung cancer drug. After operational problems in 4Q 2014, **United Parcel Service (UPS)** at +1.8% has benefited from improved execution and optimism over the coming holiday season.

On the negative side, **Universal Display (OLED),** a supplier to the flat panel TV industry, fell -34.5% as the result of a weak earnings report due to softening demand and needed inventory adjustments. Going forward the outlook is far more constructive. **Unisys (UIS),** an information services company, was down -40.5% as it struggled through a management change, product realignment, competitive markets, currency headwinds, and poor earnings. Longer term the company has groundbreaking cyber security technology that could revolutionize the industry. **Faro Technologies (FARO),** a provider of 3D measurement products, dropped -25.0% due to lack-luster US demand for capital goods, Chinese concerns, and pricing pressures from a European competitor. **America Movil (AMX)** is a leading telecommunications company in Mexico and is expanding operations into South America. It was off -22.3% in response to increased competition in Mexico from deregulation, a weak Brazilian economy, and currency headwinds from a strong US dollar. **BioLase Technology (BIOL)** was off -48.3%. The combination of being a small cap health care stock in a very weak NASDAQ market and the uncertainty over management changes took their toll.

PORTFOLIO ACTIVITY

United Parcel Service (UPS) was purchased during the quarter. With the correction in the market, the shares became attractive in light of their expected recovery in profit growth in 2015 and 2016. **Qorvo (QRVO)**, a leader in radio frequency products for mobile devices, was purchased as the stock declined sharply over concerns of accelerating weakness in the Chinese economy.

To facilitate the purchases, we sold **Merck (MRK),** due to concerns over its new product pipeline, **AT&T (T),** due to concerns over the rate of future earnings expansion, **Caterpillar (CAT),** given the outlook for continued weakness in the agricultural cycle, and **CACI International (CACI),** given the non-transparency of their business model (high security government work). **Boeing (BA),** which had grown to an oversized position, was trimmed.

MARKET COMMENTARY

Since the commencement of the bull market in March of 2009, there have been numerous corrections, with 2011's being the most memorable. The reasons for these pullbacks, in retrospect, were the economic or geopolitical crises de jours. In reality, they were caused by a psychological disconnect between investors' sense of perception and reality. The anxieties were from fear of pending calamities, while the forces of common sense prevailed and Greece did not bring down the EU and Ebola did not ravage the earth's population. We have recently experienced such a stock market event with the culprit this time being the Chinese economy.

The perceptions and realities are many:

Perception: As the result of economic weakness China devalued the renminbi risking a currency war. *Reality*: The modest 1.9% devaluation was in response to China's desire to gain special drawing rights status from the IMF. A more flexible foreign exchange policy, decoupled from the US dollar, is required.

Perception: China's economic statistics are manipulated and misleading. *Reality*: While there is no way to disprove this assumption, one should note that due to the US's methodology in collecting GDP data, its accuracy is equally unreliable.

Perception: China's growth is slowing dramatically and the government has lost control of the economy. *Reality:* Deceleration is inevitable just due to the size of its GDP. Demographics and tepid export markets pose additional headwinds. The government's economic plan calls for a transition from a manufacturing/export based model to a more balanced system with greater domestic consumption. The current disappointing GDP statistics are based on China's old industrial economy and do not yet give sufficient weight to retail/service sectors which include rapid growth in movie box office receipts, credit card activity, mobile phone usage, airline traffic, etc.

Perception: Volatility in the Chinese stock market will have a negative impact on consumer confidence. *Reality:* The Chinese public, unlike the US, has very limited participation in its equity market.

Perception: China's internal credit markets are in a "bubble" and at risk of bursting. *Reality*: With almost $4 trillion of foreign reserves and incoming monies from a positive trade account, China has significant financial flexibility.

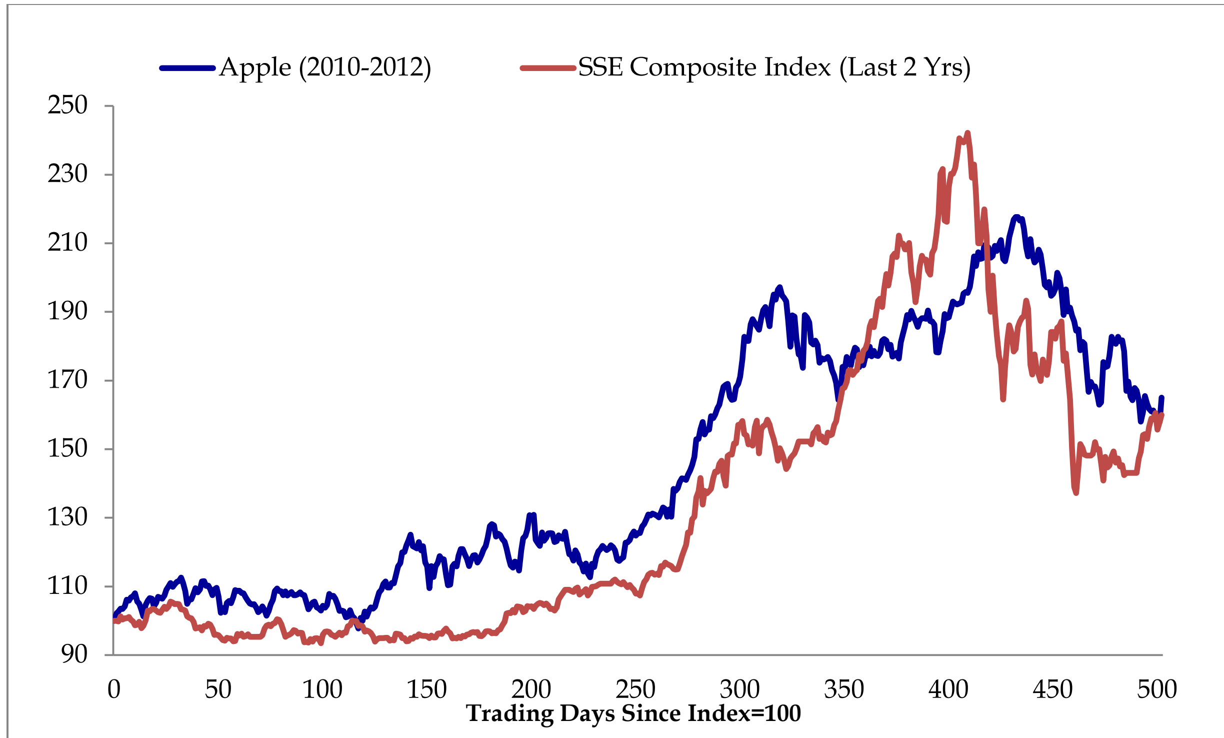
Perception: The combination of political oppression and slowing economic growth has brought the populace to near civil unrest. *Realty*: China has one of the fastest growing middle classes and wage growth has been meaningful. These historically have not been the precursors of political upheaval.

Perception: China's form of "centralized" government is ill suited for sustained economic growth. Reality: The Chinese economic model, while in transition, has proven to be meaningfully more decisive and effective than its counterparts in the US, EU and Japan.

The recent correction in the Chinese stock market sent a signal to investors that the end is near in the economy. However, is current psychology overriding a more likely positive outcome? Two "securities" are shown below that have similar characteristics: they have much growth

faster than their competitors, fortress balance sheets with vast cash reserves, abundant free cash flow, reasonable valuations and decisive managements.

Which line below depicts the current Chinese stock market? Which is Apple's performance ending in 2012? Can we be so sure that stock market corrections tell us anything about the future?



Strategas

While the perceptions and realities are not as black and white as expressed, on balance China has greater financial flexibility and political decisiveness than most of its global competitors. The likelihood of an economic "meltdown" is minimal and Citigroup economist Buiter's nomination will win a prize for best fiction.

China's challenges, while real, are surmountable and should not pose a meaningful threat to US investors. We maintain our belief that the US economy continues to improve (albeit not at a rate we wish for) and that there are still opportunities for investors in the US equity markets.

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