

MARKET COMMENTARY

It has been a rough third quarter for the financial markets. The S&P 500 dropped more than 6%. The Stoxx Europe 600 dropped more than 8% and the Shanghai Composite lost nearly 30% of its value. As we move into the holiday season, it is hard to have a sense of Thanksgiving for these third quarter numbers. At first blush, these numbers seem frightening because we fear that they reflect a weak world economy. However, they are more indicative of economic transitions than of real economic weakness. China is transitioning from a manufacturing and export driven economy to a service based one, in much the same way the United States transitioned in the twentieth century. That has spooked investors who fear that Chinese growth will more resemble our own in the future than the blistering 10% annual growth of the past. The US is also in its own transition. The Federal Reserve has indicated it intends to raise rates this year from the near zero rate set in 2008. Fearful of that change, US investors have pulled back. European investors, still dovish after the uncertainties of the Greek debt crisis, also tightened their belts.

As we discussed in our Second Quarter Market Commentary, Chinese economic growth has been slowing. In the second quarter, Chinese GDP

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growth fell from 10% to 7%. The International Monetary Fund forecasted Chinese GDP growth to slow even further to 6.3% by 2016. Investors began to look behind the curtain. What they saw was an evolving economy. China had been propelled to economic prominence by cheap labor and manufacturing costs and a weak yuan making China an export powerhouse. However, the influx of capital this brought began to slowly grow the Chinese middle class and improve the standard of living and with that came increased labor costs. With a burgeoning middle class, China began to transition, like western countries have, from a manufacturing to a service based economy. Investors, fearful that flagging Chinese economic growth would substantially reduce their gains, began to sell.

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On July 27, the Shanghai Composite Index (SHCOMP) fell 8.5%. Since June, the composite has fallen more than 27%. On August 11th, the Chinese government introduced a new currency trading system ceding some control back to the market in an effort to devalue the yuan and stabilize the market. However, this caused a steep drop in the value of the yuan as investors worried that the move was indicative of troubles to come. The US dollar appreciated by almost 3% against the yuan between August 11th and August 13th. Another sharp fall in the Shanghai composite

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followed on August 18th with the composite dropping some 6.2%. The SHCOMP ended the quarter down 28.63%. However, the SHCOMP does not necessarily reflect the overall health of the Chinese economy. Yearly GDP growth of 6%+ is still double what we have seen in the US in the past decade. Moreover, with more than a billion people, there is sure to be ample opportunity for business in China in the future.

As the world's second largest economy slowed down, so did its ability to drag the rest of the world's economies with it. This effect was felt particularly hard in other emerging markets and in commodities export driven economies.

Investors in the US, the world's largest economy, had been hopeful that dropping oil prices, continued employment growth, corporate mergers and acquisitions, share buyback programs, and low interest rates would turn the tide of falling corporate revenues and marginal earnings growth. This hope kept the S&P 500 tracking upward, though this upward trend was driven by only a few companies. The severe downturn in China was enough to undermine these hopes and send US markets into a correction. Though US stocks began to rebound, uncertainty over the future of the federal funds rate hampered growth.

Fed officials in June estimated they would raise the short-term federal-funds rate from near zero to 1.625% by the end of 2016 and to 2.875% by the end of 2017. However, due in large part to the market turmoil overseas, the Federal Reserve declined to move interest rates in July. In August and September, the Fed again declined to raise rates, citing weak inflation and slowing jobs growth. Jobs growth in September was a paltry 142,000, down from 173,000 in August. The average for the year is 198,000 per month. Personal consumption expenditures increased only 0.4% in July and August. August marked the 40th consecutive month the measure has run below the Fed's target. In an interview with CNBC, former Fed Chairman Ben Bernanke, who presided over the Fed during the great recession, said of the Fed's reluctance to raise rates, "easy money is justified by the need to get inflation up to target...the goal post was 2 percent inflation. We're not there yet." Moreover, central banks in the Eurozone, Sweden, Israel, Canada, South

Korea, Australia, Chile and elsewhere have all attempted rate increases since the financial crisis. All have had to retreat. That said, Janet Yellen, Federal Reserve Chair, and William Dudley, president of the Federal Reserve Bank of New York, have both indicated that the Federal Reserve is likely to raise short-term interest rates this year. They recognize the need to raise rates, not only to show investors that incremental increases will not sink the economy, but also to give the Fed some room to act should there be another recession.

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Despite indications from the Fed that it intends to slowly back away from its accommodative economic policy, the European Central Bank (EBC) remains committed to its quantitative easing program introduced in the second half of 2014 whereby the bank began buying roughly \$60 billion in government bonds per month. Though quantitative easing did weaken the Euro, pushing the euro-dollar exchange rate down to roughly 1.12 from a high of almost 1.40 in early 2014, European growth remains modest. The inflation rate for August was at 0.1%, GDP growth in the second quarter was at 1.5%, and the unemployment rate has remained at above 10% since 2008.

Unlike Europe, low interest rates and accommodative financial policies have seemed to exacerbate issues in emerging markets by encouraging firms to take on more debt, which they may not be able to afford. The International Monetary Fund (IMF) estimates the emerging market corporate debt-to-GDP ratio has grown 26% between 2004 and 2014. The IMF has warned that this combination of poor growth and increasing corporate debt has left emerging markets vulnerable. According to the Institute of International Finance, during the third quarter, investors pulled roughly \$40 billion from emerging markets, almost evenly divided between equities and bonds. This \$40 billion

outflow marks the third quarter as the worst single quarter for emerging markets since the fourth quarter of 2008, which saw investors pull roughly \$105 billion. Despite this, equities in emerging markets continue to be highly attractive on a relative value basis.

While all eyes are on worldwide equity markets, let's not forget that bonds can be volatile too. We have written before about the bond fund miseries of the 1970's to early 1980's when interest rates on intermediate bonds shot up from normal ranges of 4-5% to abnormally high rates in the low double digits. In response to the high interest rates, most bond funds significantly dropped in value as bond prices have an inverse relationship with interest rates. No one wanted to liquidate bond fund positions at 65 cents on the dollar or worse. Even short-term funds were impacted, and one money market fund lacked the liquidity to make cash payouts for a short period of time. Eventually the bond markets righted themselves, as markets do, but it was a rough few years for the fixed income side of portfolios.

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We think it is unlikely that we are poised to repeat that period of stagflation: unemployment is stable; inflation is low; the US economy is chugging along, and the Fed has committed to lead the march toward interest rate normalcy by increasing short-term rates slowly and deliberately. Nevertheless, old lessons die hard, as they should. As one client said recently, "I am not worrying about this because that is what I hired you to do." We agree. We are "on deck," and are carefully watching portfolios. However, you can help us to help you by keeping us apprised of your cash needs, especially anticipated large withdrawals. Please call or drop us an email if you expect significant cash needs. In the meantime, enjoy this beautiful Fall season.

The Deighan Team

THE VW LESSON: WHY DIVERSIFICATION IS A MUST

Volkswagen has been the jewel in Germany's economic crown; a symbol of postwar success. VW's factory at Wolfsburg was a smoldering heap at the end of the war but was resolutely built into the world's third largest automotive manufacturer. Not only was VW a postwar success story, but it was also billed as innovative and green with diesel engines that promised excellent fuel economy, low emissions, and respectable performance. As a result, VW stock grew and grew. How could a substantial position in VW be bad? Because a substantial holding in any single company magnifies portfolio risk.

Shares of VW plummeted more than 31% between September 22nd and 28th after the Environmental Protection Agency disclosed that VW could face fines in excess of \$18 billion dollars. Faced with irrefutable evidence, VW acknowledged that it had been cheating emissions tests in the US. The company installed software in cars with the EA 189 diesel engine that could detect the start of an emissions test, change the operation of the vehicle, and defeat the test. VW issued a sweeping policy and the company's CEO, Martin Winterkorn, stepped down. As the scandal unfolded, the company announced that it would recall some 11 million affected vehicles in January at a cost of \$7.33 billion to the company. The lesson for VW here is simple. Don't cheat. But there is a lesson in here for investors as well. Diversify your holdings.

We all have companies that we admire, and when we hold positions in those companies, it is easy to become emotionally attached to them, and it is sometimes tempting to just let them run. Try as we might, we do not know everything that is going on behind the curtains at any company. It is best to temper our admiration and manage risk by diversifying investments.

INVESTMENT CHANGES

SWAPPED

FedEx (FDX) replaces Emerson Electric (EMR)

We think that industrial companies involved in logistics will likely benefit from factors such as increased online ordering, low oil prices, and international expansion. FedEx capitalizes on these trends and has a strong established market share. EMR has seen substantial negative impact on revenues from exposure to the oil and gas market, and from US dollar appreciation. We see these issues continuing to plague the company for some time.

Exxon Mobil (XOM) replaces Noble Corporation (NE)

Exxon is a strong international integrated oil company with a large ever-increasing dividend and the ability to weather low oil prices. Offshore oil and gas driller NE, has been hit hard by weakness in crude prices and a resulting slowdown in offshore drilling demand. We think that there is a strong possibility of a dividend cut at NE. In light of these issues and continued uncertainty for the energy industry, a stable, high-dividend paying company like XOM is our preferred choice in this sector.

REMOVED

Mosaic(MOS)

While MOS shows relatively solid financials including reasonable debt and strong earnings growth, the company shows weakness in operating cash flow and profit margins. As flagging Chinese demand for commodities puts a damper on this sector, and uncertainty abounds as to when a reversal might begin, we chose to reduce exposure to the Materials sector by exiting the position.

ADDED

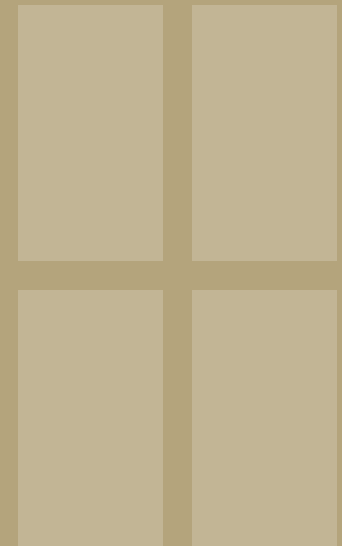
Wells Fargo(WFC)

Wells Fargo is one of the largest banks in the US, with a focus on commercial banking and mortgages. The addition of WFC helps diversify our Financial sector holdings and complements our holding of JPMorgan Chase, which focuses more on the capital markets side of banking. WFC

SOUNDBYTES

Tax season approacheth! Please let us know if you'll be donating shares or cash before year end so we can adequately prepare your portfolio.

Jean Deighan attended the Veres Insiders Forum conference, a gathering of industry leaders to discuss trends in portfolio management, technology, financial planning, best practices, and compliance. She returned with insight and actionable ideas.



Live

has a strong history of long-term growth and profitability. They have been able to maintain solid margins despite low interest rates, and have continuously increased dividends without sacrificing growth.

Give wisely; give appreciated securities. Donors who gift appreciated securities “in kind” to qualified charities may deduct the full amount of the gift without recognizing the gain. If you want to give more, are over age 70½, and own a Traditional IRA, then you might be able to gift from your IRA directly to a charity of your choice in lieu of taking your annual Required Minimum Distribution (RMD). Remember deadlines. Requests for year-end giving to charitable organizations should be submitted to Schwab by early December.

Talk to your tax preparer. See if it makes sense to shift certain deductions to this tax year, such as the second half of your real estate taxes. Also, portfolio management fees, like tax preparation fees, may be deductible. The foregoing tips are just some of the many ways that enterprising taxpayers can save a little money. We encourage you to meet with your tax preparer in the months ahead to be sure you’re doing everything you can to be tax savvy. For our part, we will continue to be tax sensitive when managing your portfolio, offsetting gains with losses whenever it makes investment sense. Should you have any questions, please call us or your tax professional for more information.

YEAR END TAX TIPS

Fall is here and pretty soon we’ll be closing the books on 2015. Now is the time to get your tax planning in order as the busy holiday season quickly approaches. Here are some things to think about:

Take full advantage of any tax-deferred retirement accounts, such as a 401(k), 403(b), SEP IRA, SIMPLE IRA, or Traditional IRAs. Your contribution will result in a dollar for dollar reduction in your taxable income and help ensure a comfortable retirement. To that end, consider contributing to your Roth IRA’s too, though they provide less immediate tax benefits. Remember, any contributions you do not make this year cannot be made back up!

OUR JOB IS TO
Listen
TO YOU

SUCCESSFUL ART SHOW SEASONS OF MAINE

We are pleased to report that our annual Seasons of Maine Art show and open house was a great success with more than 100 in attendance to appreciate the work of twelve artists who have been featured over the years in our annual holiday card. We also enjoyed the opportunity to feature guest artist Tim Shay, a member of the Penobscot Nation, whose line totem sculptures were amazing. Kevin Morse provided delightful classical guitar through the afternoon and evening, and the libations and hors d’oeuvres were delicious. Once again, we will be making a contribution to the University Of Maine Museum Of Art in celebration of Maine art and artists. Many thanks to those who attended! We look forward to seeing you all next year!

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