Palouse Capital Management, Inc.

Investment Commentary

3Q15

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MARKET OVERVIEW

“Still, a man hears what he wants to hear, and disregards the rest.”---Song “The Boxer”

The Third Quarter of 2015 was bombarded with international economic uncertainties over China and emerging markets, confusion over FED policy, unrest in the Middle East and other “hot spots”, and a US economy that continues to exhibit “stop and go” behavior. Investors tended to hear what reinforced their opinions and disregarded other data that appeared to conflict with their views of the world.

The hysteria reached a crescendo leading up to the FED meeting on September 17th, as those that thought the FED *should* raise rates thought it could **help** the stock market (get the uncertainty out of the way, get policy back on a normal rate path) or it could **hurt** the market (potentially cause a currency collapse in emerging markets, push China towards further devaluation).

Those of the opinion that the FED *should not* raise rates thought it could **help** the stock market (keeps the easy money policies in place that have helped propel the market upwards since 2009) or it could **hurt** the market (things must be worse in China or emerging markets than we think, since the International Monetary Fund and the World Bank had asked the FED to delay a rate rise).

The result, as you can imagine, was a confused and conflicted investment climate, and equity markets generally do poorly in these situations. So when the FED did not raise rates on September 17th investors assumed things were much worse than expected, and the stock market fell quickly back to the lows of August. Despite a rally on the last day of the quarter the S&P 500® Index still had its worst quarter in four years. The unknowns and uncertainties pulled about every sector of the market lower during the quarter.

Can any good come out of this? For starters, P/E ratios on US stocks declined to levels that appear to be average over the past several years. Also, the sharp decline in equities that began in August priced in a lot of bad news, so the market could respond in a positive fashion if some of the negativity is averted. This has happened to some extent, as the international economic news flow has been benign, and a weaker than expected jobs report for September has ignited the best rally of 2015 thus far in the quarter.

With P/E ratios at reasonable levels, the stock market direction may continue to be influenced primarily by earnings. The effects of lower commodity prices, especially for oil, have caused energy earnings to plummet so far this year, and energy company earnings could be under pressure throughout the year. Also, the strong US dollar has had a negative effect on the translation of profits earned overseas into higher valued US dollars. The effects of these headwinds are likely to cause S&P 500 earnings to be flat to down in 2015. It has been estimated that in the absence of the strong dollar and lower energy earnings, S&P earnings could be up in the 8 percent range this year.

In 2016, we will anniversary these headwinds, so earnings could resume their upward trend next year. As a result, the stock market could do better next year, and in the absence of unpleasant new developments, the market could begin to anticipate this upside potential as 2015 draws to a close.

STRATEGY FOCUS [1]

Equity & Fixed Income Strategies

Even with all the negativity mentioned above, the S&P 500 was posting a positive gain for the year - at least, up until the middle of August. The downward spiral from this point dragged the major equity indices into negative territory for the quarter, and the year. For a broad view, of the 2,255 mutual funds that focus on U.S. stocks, only three posted a positive return.

For the quarter, the S&P 500 Total Return posted a return of -6.44 percent. In a reversal from last quarter, utilities was the top performing sector, and the only sector to post a positive return for the quarter, closing with a total return of 5.4 percent. However, this still left it in negative territory YTD. At the bottom, we had energy, materials and healthcare posting double-digit negative returns.

Our portfolios were not immune to the sharp market decline, riding the wave down to close in negative territory for 3Q15. Our Large-Cap Value Strategy benefited from our under-weight in energy. However, individual stock selection, primarily in health care and industrials, caused this strategy to underperform the index. Our Large-Cap Value Total Return Strategy, which has a focus on dividend-paying equities, performed in-line with the index.

Our Small/Mid Value Strategy slightly under-performed for the latest quarter, but is still out-pacing its primary index year to date. With our focus on individual stock selection, it is not surprising that stock selection continues to be the main performance contributor. Interestingly, positions in energy provided the primary contribution, along with positions in the financial sector.

Recent events have been fueling uncertainty in the markets as to whether or not the Fed will raise interest rates shortly, or even by the end of 2015. As a result, the focus of our Diversified Income Strategy continues to be on dividend paying equities.

[1] PCM obtains all financial/performance data cited herein from Bloomberg, S&P Dow Jones Indices, and Russell Investments, as applicable.

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