PINNACLE
Capital Management, LLC

October, 2015

COMMENTARY

ECONOMIC STATISTICS					
	3rd Qtr (9/30/15)	2nd Qtr (6/301/15)	*% Change*	1 Yr Ago (9/30/14)	*% Change*
S&P 500 Index	1,920.03	2,063.11	*-6.9%*	1,972.29	*-2.6%*
10 Year Treasury Yield	2.04%	2.35%		2.49%	
Gold Spot ($ / oz)	$1,107.07	$1,172.42	*-4.9 %*	$1,208.16	*-7.7%*
WTI Crude Oil (next future)	$45.09	$59.47	*-24.2%*	$91.16	*-50.5%*
GDP Qtr / Qtr	N/A	3.9%		4.3%	
CPI Y / Y	0.2%	0.1%		1.7%	
Unemployment Rate	5.1%	5.3%		5.9%	

It's not just the Federal Reserve, though it seems that everyone is talking about the Fed and its failure to raise interest rates in September. We, in fact, had predicted in our last Commentary that they would raise rates. However, as equity markets began to melt down in China and U.S. markets began to soften, the Fed board members lost their collective nerve.

While it has been largely argued - though disputed by us - that the Fed's low interest rate policy was propping up markets, the Fed's announcement that it ***wasn't*** raising rates was followed by an ***acceleration of the declines*** in the U.S. equity markets. We have long felt and have iterated in these pages that by keeping rates at artificially low levels, the Fed was distorting market forces to the point that overall economic activity was slower than it would otherwise be. The record of the Fed during economic crises is actually quite good in our opinion. What it fails to do well is recognize that a crisis is over. By maintaining its low interest rate and easy money policies, market participants have adjusted to this reality. Wealth concentrates into the hands of those who can borrow at low rates - primarily governments and blue chip corporations. Meanwhile small businesses are denied access to capital, and savers aren't adequately compensated.

Were it just the Fed impacting the economies and markets, we think the market declines may have not been so substantial. Instead, we think other factors also have been at work. First, the regulatory environment has become much more aggressive. We've seen this in areas such as employment, finance, health care, and the environment. Irrespective of one's opinion as to whether this is necessary or proper, such an environment increases costs to businesses and dampens risk taking. A few companies have added fuel to the fire by taking, in our opinion, bone headed actions that have only served to bolster the arguments of those clamoring for even greater regulatory control. Exhibits A and B are Turing Pharmaceuticals, and Volkswagen (VW).

Turing, which was formed in February of this year, bought the U.S. rights to an anti-parasite medication. Turing made no changes to the drug that had been in existence for decades. The company promptly raised the price from $13.50 a pill to $750.00 a pill. Increasing drug costs were already on regulators' radars. Newspapers picked up the story about Turing, and Hillary Clinton tweeted that she'd unveil a plan to combat high drug prices. The stock prices of most drug companies then went into a tailspin. Though the decision by Turing to raise prices by that extent may have been legal, it probably wasn't wise. VW's actions were neither.

In September, VW admitted that it had programmed computers on its diesel vehicles with the ability to recognize when they were undergoing emissions tests. The computer would then cause the vehicle to temporarily reduce nitrous oxide emissions solely for the purpose of passing the test. During actual driving, the emission levels would be higher. Too often we have seen companies cheat. We have certainly seen companies cover up misdeeds and mistakes, sometimes with disastrous consequences. Though the environmental consequences of VW's cheating may not have been extremely severe, we nevertheless cannot recall a case in recent years where a company to such an extent and so overtly set out to defy government rules and mislead regulators. Deception was part of the vehicle design! Now VW faces billions of dollars in fines, regulatory costs and law suits. Governments worldwide have announced investigations not just of VW but of broader compliance with emission regulations. Stock prices of auto companies and suppliers promptly sank.

Businesses are often portrayed as evil and villainous. For the most part we believe this has been unfair and damaging to the economy as a whole. It is sad to say that these portrayals and accompanying tight regulatory environment, along with the negative economic impacts, will not abate while individual companies so egregiously fulfill the worst fears of their toughest critics.

Up to this point, we haven't discussed what prompted the initial negative market sentiment. It appears that economic growth in China is undergoing a meaningful slowdown. Now we're still expecting growth north of six percent. Theoretically, this shouldn't be a negative. However, while the country maintains large currency reserves, internally there has been an excessive amount of debt utilized - especially in the real estate sector. Unlike the situation in 2009 with our real estate bubble, we believe the government has sufficient financial strength to alleviate the difficulties. But having the strength is not proof that it will be successfully utilized. As a result, after a substantial run up, Chinese equity markets have fallen significantly. This, combined with fears associated with falling commodity prices, had spread to our markets before the issues discussed above came into play.

But speaking of falling commodity prices, we're glad you asked! There are two reasons why commodity prices fall – too much supply or too little demand. But only in the latter case should the situation be viewed as a broad negative. Too much supply caused by productivity gains – which appears to be the current issue – is only a problem for the industry in question. So, falling energy prices ***are*** a problem for the oil industry. For the rest of us they are the equivalent of a ***generous tax cut***. We think one of the greatest surprises that may occur in upcoming quarters is the benefit to consumers' wallets and corporate profits from the impact of lower energy costs.

It frustrates us that the markets and popular press do not focus on the benefits. Bernie, Hillary, Donald, Jeb, Carly, and the rest are much more interesting. Double digit declines in the Dow averages are much more interesting. Our view is, take heart. Despite all the noise and some real problems, economic growth marches onward. That's good for everyone!