FINANCIAL ADVISORS, INC.
3685 Mt. Diablo Blvd., Suite 200
Lafayette, California 94549-3736

THIRD QUARTER 2015 REPORT FOR BROKERAGE ACCOUNTS

After an extended absence, volatility reappeared in the third quarter as stocks suffered their first official correction since 2011. This 1,394 day stretch marks the third longest period without at least a 10% correction in history, following only a 2,553 day stretch from October 1990 through October 1997, and a 1,673 day stretch from March 2003 through October 2007. Markets initially became unsettled by a stream of weak economic data out of China, followed by devaluation of the Chinese currency. Indications also appeared that global weakness is beginning to create a drag on the upward trajectory of the U.S. economy. However, much of the reason for the magnitude of the market sell-off may have been investor anticipation of a correction given the historically long period since the last correction. Since the initial sell-off, stocks have taken incrementally weaker economic data points in relative stride. With a number of upcoming events, including FOMC meetings, the Federal debt ceiling, and a variety of economic data points, volatility is likely to be with us for the foreseeable future.

Bonds held up relatively well and helped stabilize overall portfolio returns for the quarter. Although speculation of an interest hike in September put some pressure on prices, the Barclays Aggregate bond index was still up 1% for the quarter and 2.2% year-to-date. Areas outside of what we consider "core" investment grade corporate, municipal and treasury bonds, were a little more mixed. High yield bonds, which are more exposed to credit risk, experienced a sell-off due to economic concerns and where we are in the business cycle. However, with a larger spread, or premium to treasury bonds, they have a greater margin of safety in a rising rate environment. International bonds were also a little mixed, with some geographies performing better than others and a currency drag in cases of locally denominated bonds.

Major Stock & Bond Indexes (Total Return)			*Lipper Mutual Fund Indexes (Total Return)*		
	3Q15	YTD		3Q15	YTD
S&P 500 Index	-6.4%	-5.3%	Large-Cap Core Funds	-7.2%	-6.3%
Dow Jones Industrial	-7.0%	-7.0%	Large-Cap Growth Funds	-6.3%	-2.4%
Russell Midcap Index	-8.0%	-5.8%	Large-Cap Value Funds	-9.0%	-8.6%
Russell 2000	-11.9%	-7.7%	Mid-Cap Core Funds	-9.2%	-6.4%
MSCI EAFE (USD Gross)	-10.2%	-4.9%	Small-Cap Core Funds	-10.8%	-7.6%
MSCI EM (USD Gross)	-17.9%	-15.5%	International Large-Cap Core	-10.9%	-5.6%
NAREIT U.S. Real Estate Ind.	1.0%	-4.5%	Emerging Markets	-16.0%	-14.5%
Barclays US Agg. Bond (3-5yr)	1.0%	2.2%	Core Bond	0.5%	0.5%
Bloomberg Commodity	-14.5%	-15.8%	High Yield	-4.5%	-2.3%

CHINA:

Concerns over China's economy and currency led to increased market volatility during the third quarter. Stocks fell sharply on China's surprise devaluation of the renminbi on August 18th. Concerns that this devaluation would lead to competitive currency devaluations in order to spur exports were the primary driver of the market sell-off. However, most indications are that the move was based on China's desire to internationalize its currency and remove its peg from the dollar. This move would increase the likelihood of inclusion into the International Monetary Fund's (IMF) Special Drawing Rights (SDR) basket in order to help trade.

Since this initial surprise devaluation, concerns over China's economy and its potential impact on global and U.S. growth have taken center stage. Officially, China has been growing its economy in the 7% range for the past four years. This is down from a double digit GDP growth rate achieved in 2010. Most economists believe that based on economic indicators in China, its actual growth rate is well below the official 7% and the true rate of growth is somewhere between 2% and 4%. It is clear that China's economy is slowing, and we do not yet know if the country will officially reach recessionary levels over the next several quarters. Currently manufacturing is in contraction, while services continue to expand, indicating that the consumer is spending as the country heads towards more sustainable economic growth.

Although slowing in China does have an impact on the global economy, the direct impact on the U.S. is fairly limited. Exports to China from the U.S. are less than 1% of GDP, and companies included in the S&P 500 index generate less than 3% of revenue from China. On a positive note for most developed market economies, slowing growth in China, particularly in infrastructure investment, has put downward pressure on commodity prices. As the U.S. and most other developed economies are importers of commodities, we benefit as net imports fall.

THE FED:

Although there had been much speculation about a September interest rate hike and its impact on markets, the decision to keep rates unchanged created a week long selloff in stocks as it raised concerns over economic conditions. The Federal Reserve had been quite vocal about its intentions to raise short-term interest rates at either the June or September FOMC meetings. A soft spring ruled out a rate increase at the June meeting, moving all eyes to the September meeting. With market volatility increasing in August and weaker than expected data points, the Fed chose not to raise rates. Although this would normally be a positive for markets, the decision raised concerns about the condition of the U.S. economy and stocks fell over the course of the following week. The Fed now says they expect to raise rates by December, which they may do, although they have lost significant credibility and recently released meeting minutes calls this into question.

THE U.S. ECONOMY:

The U.S. economy has shown some weakness over the past few months, also contributing to volatility in stocks and falling longer-term interest rates. Time will tell if these weak data points are an indication of a coming recession, or simply a soft patch as we work through manufacturing and trade inventories that have elevated through the year. A recent study by the

Federal Reserve looked at 26 indicators in regard to their ability to predict a recession. The only single indicator that was accurate in all cases was an inverted yield curve, meaning short-term interest rates were higher than long-term interest rates. With short-term rates close to 0%, the curve is not inverted, and is actually quite steep.

Over the past several quarters, inventory levels have increased, meaning factories were producing too many goods. To reduce inventories back to healthier levels, we need to manufacture less for a period of time, which results in slower economic activity. Although inventories increased, they remain well below the inventory spikes that occur in a recession, and should be corrected fairly quickly. Recent jobs reports also raised concerns, most recently with the September jobs report showing new job creation of only 143,000 compared to expectations closer to 200,000. Over the past six months, economists had overestimated new job creation four of the six months. Despite the weaker than expected jobs numbers, employment continues to improve, with the unemployment rate reaching 5.1% in the most recent report. Many indications are that we are running short of skilled workers for open positions and job turnover remains high, also an indication of a healthy job market.

Despite headwinds from slowing growth in China and high levels of inventory, there are still positive forces in the U.S. economy that should contribute to long-term "secular" economic growth. Most importantly, we feel a recovery in new home construction will help on many fronts as new jobs are created in home construction and related industries, such as banking, retail, and services. A combination of favorable demographics and recovery from a period of under-investment in new home construction should help push new housing starts to an annual rate of 1.6 million through 2024, up from well under one million per year since the financial crisis, according to Morningstar research. From a demographic standpoint, the millennials are starting to enter their 30's, an age when household formation and homeownership rates are the greatest. With the largest group of the population starting to buy homes, aging Baby Boomers should not subtract from housing demand until after the age of 75, which will not be significant until 2030. Cyclical tailwinds should also help contribute to home ownership as a tighter labor market improves job prospects, and a stronger banking system will help credit availability. Foreclosures that occurred during and after the crisis are also starting to roll off consumer credit reports, meaning up to another 5 million prior homeowners could be returning to the market. Homeownership rates are well below normal historical levels, leaving plenty of room for upside, even if they don't return to pre-crisis levels. In addition to new home buyers, rising home prices benefit large parts of the economy as people in existing homes feel more confident to invest in home improvements. Other positive indications for the U.S. economy are increased consumer spending and rising vehicle sales.

OUTLOOK:

With weakness in developing economies, we don't expect natural resource prices to recover anytime soon. Although oil supply should correct in relatively short order, the lack of demand growth from countries such as China should keep prices from overheating. Supply in other commodities, such as coal and iron ore, adjusts much more slowly and are likely to be very weak for an extended period. Low commodity prices benefit the U.S. economy as a net importer, keeping raw materials costs low and inflation in check. Although unemployment is very low according to the headline number, there still appears to be capacity to expand the workforce given the low participation rate and a high number of underemployed. This gives our economy room to run in the current expansion. Although the current recovery over the past 72 months is already ahead of the average expansionary period of 63 months at the end of the Great Depression, the depth of the downturn and the slow pace of recovery leave ample capacity for growth.

All eyes will again be on the Fed when they meet in December and decide on interest rates. At this point, we think an increase to short-term rates would send a positive signal about the Fed's view on the economy and be positive for stocks. However, we would most likely need to see strengthening data in order for a rate hike, and we don't view one as likely under the current scenario. The recent spate of weak data has brought longer term interest rates down, with the 10 year treasury back below 2.0%. Both stock and bond prices will closely track the economy over the next few months as we await more clarity on the health of the economy.

With the pullback in stock prices during the third quarter, stock valuations look more attractive than they have in a few years based on 2016 earnings expectations. As long as the U.S. economy can pull through this latest round of weak data, corporations should be on pace to grow earnings in 2016 after a disappointing 2015, which was mostly the result of falling earnings in the energy sector and currency headwinds from the strong U.S. dollar. With fairly modest expectations priced into stocks, domestic equities could do quite well over the coming months. In the current scenario, stocks could post gains on only modestly positive economic and earnings data. Low expectations generally lead to positive surprises while high expectations usually lead to disappointment. That said, the risk of recession is higher than it has been in a long time and it does make sense to take a more defensive stance in the event that economic activity does not rebound in the fourth quarter. To this end, we would favor a somewhat more defensive stance, such as reducing credit risk exposure in bond portfolios and overweighting counter-cyclical industries in stock portfolios.

COMMUNICATIONS FROM HC FINANCIAL ADVISORS, INC.

We want to meet with you at least once a year to review and update any changes in your goals and objectives. We want you to understand the decisions we are making on your behalf and be comfortable with your asset allocation. Please call us with any questions or concerns.

Stephen C. Biggs, CFP®, CFA

October 16, 2015