WOODSTOCK

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As the investment conversation turns to the alternatives to US stocks and bonds, we feel like we've been here before. Theoretically, many other asset classes should have their time in the sun. Until the 2008 financial crisis they did, at alternating times. Practically, however, there have been problems. If natural resources are finite and can be used up in some foreseeable future, why does their value fluctuate so much over relatively short periods bringing investors and managers who borrow money to promote their dreams to their knees? If very smart investment professionals use a great variety of leverage and creative high tech tools in a very lightly regulated niche, how have hedge funds performed so poorly over what is now a rather long period? If everyone knows that interest rates must eventually rise causing the market value of bonds with current low interest rates to fall, when will the stampede out of those bonds occur? And who bought a 10-year bond yielding less than zero or a 100-year bond yielding whatever?[1] The definition of "leadership" that we like is: not losing your head when everybody else is losing theirs. A significant number of high quality companies that are "leaders in their industries and have strong capital resources for continued growth"[2] are headquartered in the US, choosing a national business environment that mostly supports property rights and the rule of law. At Woodstock, we will continue the hard work of putting those companies into our clients' portfolios.

In today's investment industry advertising and marketing world most firms use the same words and images, but there are real practical differences among firms. Everyone wants to be a "trusted advisor". The hateful phrase "share of wallet" is used behind closed doors and a living tree, grand kids, a glass office, a green "yellow brick road" and even an orange squirrel are useful symbols. Practically, putting high quality companies into client portfolios in the S&P 500 sectors where Woodstock shops: health care, information technology, consumer durables, consumer discretionary and energy, requires a breadth of expertise and confidence in that expertise among managers to follow their co-workers' advice. All investment management firms with discretion over at least $100 million of assets under management (AUM) must file Form 13F quarterly. Most publicly traded securities qualify as 13F securities so a review of a firm's 13F shows you what they own. The proof of Woodstock's pudding is in our 13F. Other firms our size, follow our commitment to these sectors less well. You can see it in what they own. The results of that commitment by us are captured by our main composite, our Growth Composite.[3]

An upcoming event may well have a big impact on the investment world. You may not be familiar with the American Physical Society (APS). As their website describes, they are the premier scientific body dedicated to physics in the United States. Their members helped draft every United Nations Intergovernmental Panel on Climate Change (U.N. IPCC) proclamation on global warming over the last 40 years. On November 15, 2015 they will issue a new statement on man-made global warming. It is believed that they will revise their previous assessment and deny the existence of man-made global warming based on existing modeling. They will be the first major scientific body to refute the "settled science" of man-made global warming. Of course, the confusion should be real. Our children and grandchildren have been taught this settled science. The world is poised to spend massive amounts of resources on combating global warming rather than offering basic sanitation, transportation, and clean water infrastructure to the world's poor. Their website already carries the very complex discussion among six members of the APS. All we need now is the vote and the reaction.[4]

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We know that you are the most valuable business development tool that we have. Your referral of a friend, colleague or family member to us is the most important way that we grow.

We thank you for your support and want you to know that we are dedicated to serving your best interest.

William H. Darling
Chairman & President

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[1] WSJ April 8, 2015
[2] Letter to Boston Capital clients October 2015
[3] Please ask your portfolio manager for the details.
[4] See point/counter-point Letters, Harvard Magazine, January/February 2015

What's Going on With China?

Adrian G. Davies

An economic slowdown in China was certainly one factor which drove down the US stock market in the third quarter. The S&P 500 Index was down 6.4% over the three months through September including dividends, and it's down 5.2% year-to-date on that basis. The world's second largest economy gave investors ample reason to worry, with the bursting of a stock market bubble in June, officials' overbearing response to the burst bubble in July, and a currency devaluation in August. In addition, the general economic news out of China has been weak, evidenced not only in economic statistics, but also reflected in weak commodity prices as the country has imported less. Many investors fear China's economy will have a hard landing. Weakness in China was one factor the US Federal Reserve considered when deciding not to raise rates in September. We would argue that while China's economy has been slowing for some time, fears of a hard landing are backward-looking: the damage has mostly run its course and China's economy is due for a cyclical rebound.

China's Shanghai A-share Index was up 150% over the twelve months prior to peaking in June. Through September 30th, the A-share Index had fallen 41% off its peak. Capital controls limit the savings options available to Chinese. Most Chinese nationals cannot invest overseas, and, with some limited exceptions, A-shares cannot be bought by foreigners. The stock market bubble may have inflated because falling property prices scared many Chinese investors out of real estate and into stocks. These investors further reasoned that a slowing economy would prompt the government to implement further fiscal or monetary stimulus, with benefits accruing to stock owners. Chinese stocks ran up to very high valuation levels while economic growth was slowing, with the ensuing downdraft reflecting stocks falling more in-line with economic fundamentals. Some market watchers fear that the bursting of the bubble will take purchasing power away from well-to-do Chinese leading to further economic weakness. We believe the economic impact will be modest, bearing in mind that the market is still up roughly 50% since June 2014, and some stimulus measures have been implemented.

In response to the stock market collapse, one could imagine high level government officials demanding that the market go back up, particularly prior to President Xi Jinping's military parade honoring World War II and before he proceeded on a global tour visiting world leaders. In July, the Chinese Government bought shares worth billions of US Dollars in order to boost prices; officials required state-owned enterprises to buy back their own stock; and regulators simply barred trading in other securities. Major share owners were banned from selling. However, Chinese investors saw through the government's explicit attempts to manipulate stock prices. Regulators, then realizing the ineffectiveness of the measures and the futility of trying to support stocks at very high price-earnings multiples, stopped buying shares. The market fell further. The episode was particularly damaging to the credibility of an administration which has made economic reform a cornerstone of its agenda, but was perhaps a necessary growing pain as capitalist principles crowd out China's traditional central-planning mindset.

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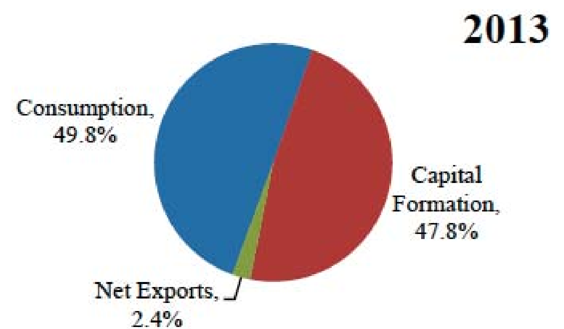
Further undermining foreigners' confidence in China, authorities allowed the Renminbi to devalue 2% on August 11th. While only a small amount, markets around the world were surprised. Investors interpreted the move to mean that China's economy was weaker than economic statistics suggested, and they feared that the 2% move was the first step in a much bigger devaluation. Previously, the level of the Renminbi had not been a worrisome factor.

However, the devaluation could have merely reflected the official rate adjusting to market forces in line with the country's overall agenda of liberalizing markets. Specifically, China wants the Renminbi to be considered a reserve currency on par with the US Dollar. To get there, China has to eliminate capital controls and allow the currency to float at market rates. The devaluation was in-line with capital flows that almost certainly would have driven the currency down had it been freely traded. From mid-2010 through December 2013, the Chinese Renminbi appreciated by about 13%, with a gradual 2.5% devaluation in 2014. Although the Renminbi has depreciated slightly against the US Dollar, the Dollar has been stronger against many other currencies, resulting in net appreciation of the Renminbi against many other currencies as well.

Authorities responsible for managing the currency were probably caught offguard by markets' reaction to the move. Even if currency officials were planning further devaluation, they appear to have changed their minds. On October 9th, finance minister Lou Jiwei told reporters, "the basis is not there for continued devaluation."[1] Since August 11th, the currency has actually appreciated slightly. The People's Bank of China spent $94 billion in August and another $43 billion in September of its $3.65 trillion foreign exchange reserves to support the currency. Fortunately, the amount needed to defend the currency is diminishing. To the extent that China is slowing on a more secular basis, global investors may have to come to terms with further devaluation of the Renminbi.

China's economy has been slowing for some time. Some of the slowdown has been a deliberate consequence of government policy. When Chinese President Xi assumed his current role in November 2012, he supported three government initiatives: (1) to fight corruption; (2) to allow capital to flow more freely within the private sector and financial markets; and (3) to rebalance the economy away from investment and exports, towards consumption and services. While President Xi's anti-corruption campaign may be about legitimately fighting corruption, skeptics have argued that the campaign has further served to consolidate Xi's power. He has strengthened his position, but the campaign has also had an adverse effect on the economy: government officials and businessmen are trying to keep a low profile so they are spending less.

Components of GDP - China



Source: 2014 China Statistical Yearbook

The administration has made some progress in terms of structural reforms and liberalizing markets, although much remains to be done. These reforms should lead to greater economic growth over time, but they could have a dampening effect in the near term as protected businesses are exposed to greater competition. Officials would like to see consumption and services increase as components of the broader economy for the sake of diversification and to reduce the economy's exposure to the business cycle. China has a way to go in recalibrating its economy – consumption and services are much larger components of GDP in developed economies. Bank lending was reigned in to scale back capital investment and property development. Much of the country's capital investment has been made possible by liberal debt expansion when the government was struggling to hit 10% GDP growth targets.

Official government statistics have pegged China's real annual growth rate at around 10%

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for many years. Although central planners were officially targeting real GDP growth of only 7% as far back as 2000,[2] global investors seem to have acknowledged China's slower growth rate only recently. It's not realistic to expect China to grow 10% indefinitely because of the law of large numbers: China's economy has doubled since 2009. The official real GDP growth target for this year is 7%, and it came in at 6.9% for the third quarter. The Bloomberg consensus forecast among economists is that China will still grow 6.8% in 2015 and 6.5% in 2016, although one skeptical of Chinese statistical methods might argue a rate of 5%-6% is more accurate.

Industrial production has also been declining for some time. The accompanying chart shows that Industrial production hit a recent peak of +19.2% y/y growth in November 2009 and has drifted lower ever since. Lower commodity prices have been another sign of weakening growth, particularly as China has imported fewer commodities from Brazil, Australia, and Canada, among others. Imports have slowed because the government has been de-emphasizing capital investments. In so far as China is able to emphasize consumption and services over investment and exports, the composition of import demand will change structurally. The services sector has been growing at a faster rate than manufacturing, offsetting weaker industrial production numbers. The economic shift will occur gradually over a long period of time, but we submit that there are cyclical forces at work as well, in that the government has allowed investment to rebound more recently. Delivering healthy economic growth is necessary in order for the existing leadership to retain credibility within the Communist Party, and by extension, the reins of power.

Chinese policy makers are certainly planning for long term growth, even if that growth rate is somewhat less than it was. GDP growth in the 5%-6% range is still better than most advanced economies, and that rate could accelerate from here. With the power to execute initiatives inherent in a command and control economy, and with $3.5 trillion in foreign exchange reserves, the government has a lot of flexibility. Historically, it has been responsive to economic conditions. The Bank of China has cut rates six times over the past year and reduced bank reserve requirements four times.

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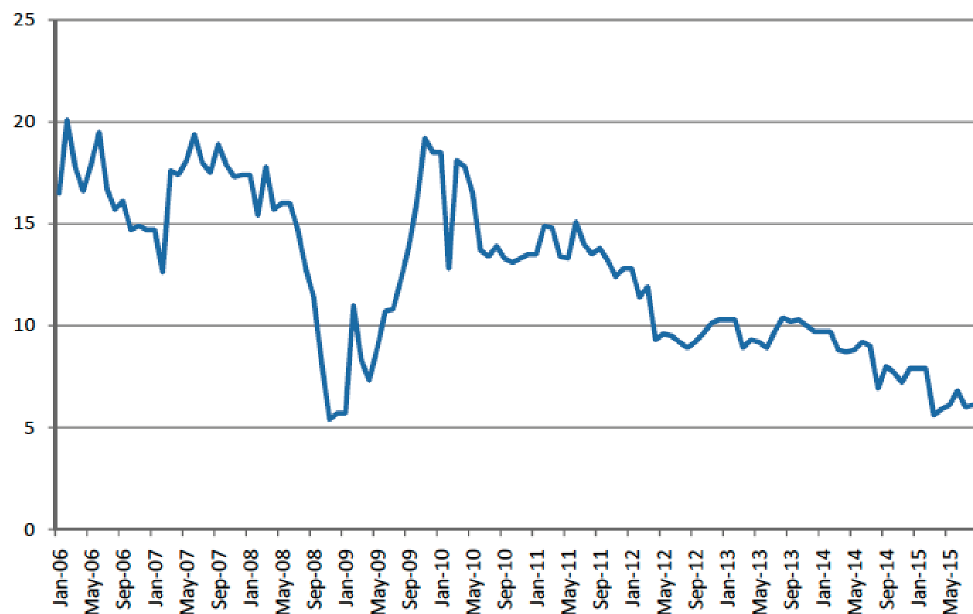

Source: Bloomberg
Where monthly data is not available, statistics were carried forward from the previous month.

Bank lending already appears to be rebounding, suggesting slightly more emphasis is now being placed on economic growth over economic reform. The central government has approved at least $284 billion of infrastructure projects so far this year.[3] According to a Reuters-National Bureau of Statistics Home Price Index, home prices in China declined through 2014 before bottoming earlier this year. The government also waived taxes on autos to stimulate car buying. Since parts of the economy had been slowing for a year or more already, followed by more recent improvement, it seems more likely that these components will rebound from a cyclical downturn. We believe the country has much potential to realize in the years to come.

We do not think investors should be afraid of China's impact on the US stock market. Although there are many other economic and financial factors at work in the markets, the sell-off of US stocks has produced some attractive prices. While we can look forward to economic growth improving both in China and Europe, the US seems to be on course to generate 2.0%-2.5% growth for the foreseeable future. Economic growth could always be higher, but a moderate rate of economic growth can provide a favorable environment for stocks. Interest rates are unlikely to rise quickly in an environment of moderate growth. We believe a portfolio of high quality stocks is the best way to navigate the whims of the marketplace and grow our clients' savings over time. As we've said before, and because this is what Woodstock does, we think our clients are in the right place. ◆

Adrian Davies is Executive Vice-President & CIO at Woodstock Corporation. You may contact him at adavies@woodstockcorp.com.

[1] *Harrison, David and Ian Talley, Chinese Officials Pledge Flexibility on Exchange Rate, Continued Economic Overhauls," 10/9/15, The Wall Street Journal.*

[2] *Wikipedia, "Five-year plans of China," 10/19/15.*

[3] *Magnier, Mark, "China Economic Growth Falls Below 7% for First Time Since 2009," 10/18/15, The Wall Street Journal.*

Tax Update

Jeanne M. FitzGerald

One of the most effective traditional year-end planning techniques involves deferring income into 2016 and accelerating deductible expenses. Delaying taxable income, if economically feasible, defers taxes. However, tax law may require the recognition of income when the individual has the right to receive it even if payment is delayed. Timing expenditures properly often can increase deductions. When you do not expect to be subject to the alternative minimum tax, accelerating deductible expenses such as estimated state tax payments and property tax payments may reduce your tax liability. Donations to qualified charities are generally fully deductible for both regular taxes and AMT purposes.

The annual gift tax exclusion allows individuals to give up to $14,000 (for 2015) to any person without being subject to the federal gift tax. There is no limit on the number of individual donees to whom gifts can be made under this exclusion. Spouses can consent to "split" their gifts to each donee, effectively raising the per donee maximum exclusion to $28,000. Spouses may give an unlimited amount of gifts to one another. The annual gift tax exclusion is an easy and effective planning tax strategy.

Now is a good time to review investments in order to minimize the amount of income tax on any capital gains. Capital losses can be used to fully offset capital gains. Losses taken in excess of gains can also be used to offset up to $3,000 in ordinary income. Generally, a gain from the sale of long-term capital assets is subject to a maximum federal capital gain rate of 15%. However, the maximum tax rate on qualified capital gains and dividends increases from 15% to 20% for taxpayers whose incomes exceed the thresholds for the 39.6% rate ($457,601 for married couples filing joint returns and $406,751 for single filers). A 0% rate is still available for individuals in the 10% or 15% tax bracket.

Year-end planning for 2015 also involves maximizing annual contributions to retirement plan accounts before December 31, 2015. A contribution to an employer-sponsored retirement plan reduces an individual's adjusted gross income (within specified limits), which reduces current income tax. Lower adjusted gross income also allows individuals the benefit of increasing the deductibility of itemized deductions and personal exemptions subject to the adjusted gross income floors.

Jeanne M. FitzGerald is the Tax Manager at Woodstock Services Company. You may contact her at jfitzgerald@woodstockservices.com.

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