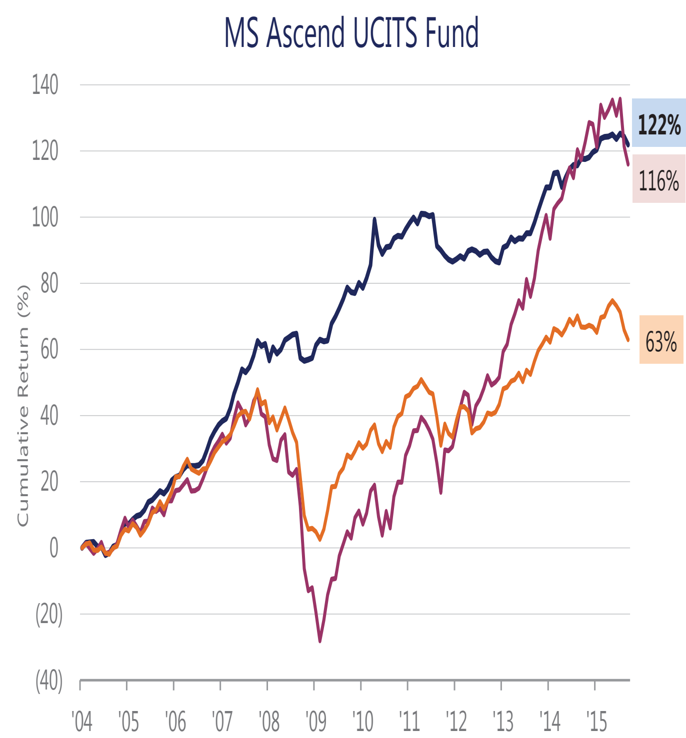
3rd QUARTER OVERVIEW

Equities, which apparently had been waiting for word on which way to break out of their lengthy period of sideways trading, got their cue on August 11 when the People's Bank of China devalued the yuan. Though small, the surprise markdown followed other moves by Beijing, some of them ham-handed, that investors interpreted as indicating the Chinese economy was in increasing trouble and precipitated a rapid correction in global markets that included a one-day, 1000-point waterfall decline in the DJIA. When the quarter closed, the S&P 500 had turned in its worst performance since the same period in 2011, when investors fled as a default on U.S. government debt seemed possible.

Things were worse overseas, with the MSCI EAFE Index of developed market stocks dropping 10.2% and the MSCI Emerging Markets Index sliding 17.9% (both in USD). Commodity prices continued to fall – the Bloomberg Commodity Index, which encompasses 22 futures contracts – was down 14.8% for the quarter. The broad and ongoing decline in commodities hurt sectors such as energy and materials, which were the worst performers (utilities were the only sector in positive territory). Investment-grade bonds gained, but investors shied away from emerging market debt, concerned about the ability of issuers, both corporate and sovereign, to service dollar-denominated debt. Standard & Poor's characterized the outlook for emerging markets as "much darker."

Maybe the rating agencies were in a bad mood, or trying to compensate for prior sins. Moody's Investors Service issued 108 credit-rating downgrades (40 upgrades) for U.S. nonfinancial companies in August and September, the most downgrades in a two-month period since 2009. Standard & Poor's Ratings Services issued 297 downgrades (172 upgrades) in the first nine months of the year, also its most downgrades since 2009. Meanwhile, the trailing 12-month default rate on lower-rated U.S. corporate bonds was 2.5% in September, up from 1.4% in July of last year, according to S&P.

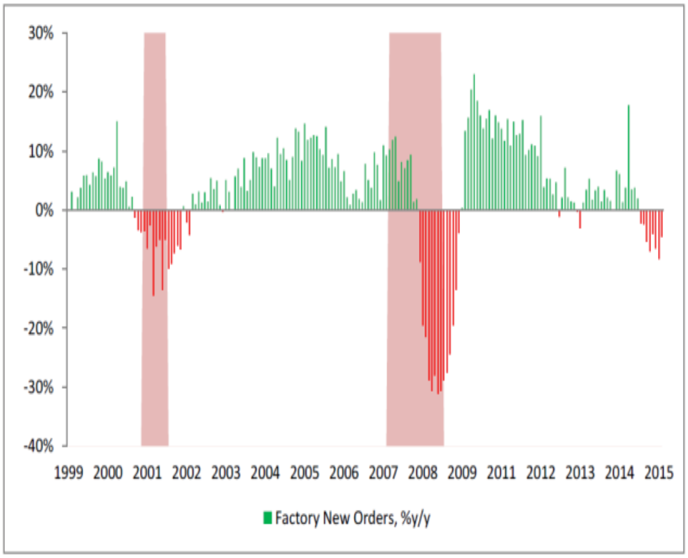


Net Returns (%)	MS Ascend UCITS	S&P 500	HFRI
Since Inception	**121.86**	115.92	62.91
2014	**5.11**	13.69	2.05
Q1 2015	**2.12**	0.95	2.11
Q2 2015	**(0.31)**	0.28	2.04
Q3 2015	**(0.75)**	(6.44)	(5.90)

S&P 500 Source: Factset. MS Ascend UCITS Fund Inception: May 20, 2011.
Note: 2015 returns are estimates, subject to year-end audit. From Feb 2004 to May 2011 returns are based o simulated monthly performance and net of fees (1.5% management fee and 20% performance fee).
Past performance is not a reliable indicator of future results.

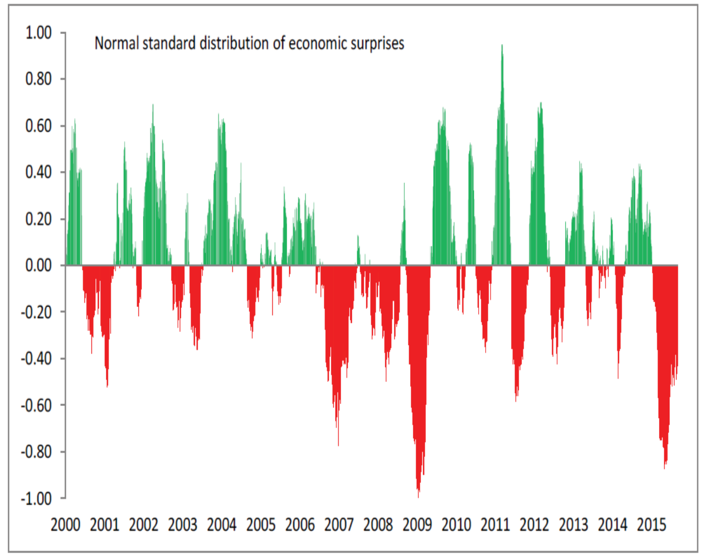
Nervous investors weren't comforted by third-quarter data points on the U.S. economy, which has entered an industrial recession that seems to be gaining momentum and has the potential to get truly ugly next year. Weakness is evident in a wide range of data, from factory orders to wholesale sales to job cuts

U.S. New Factory Orders, %y/y



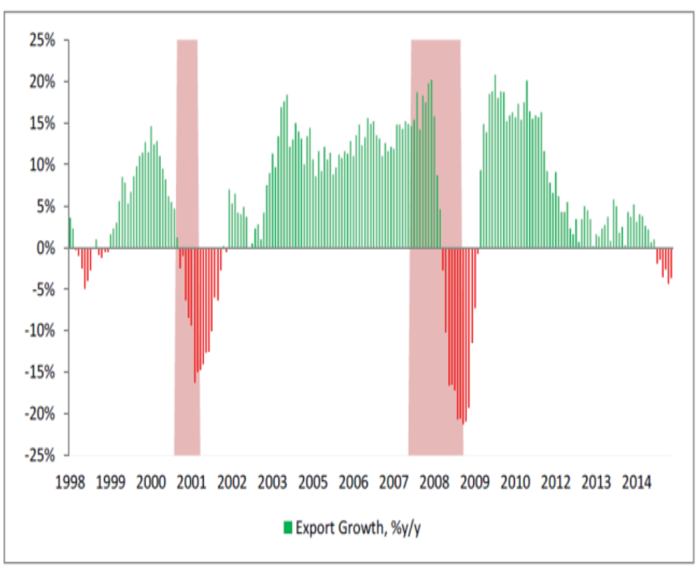
Note: Shaded areas represent recessions, as defined by the U.S. National Bureau of Economic Research.
Source: U.S. Census Bureau.

US Macro Economic Surprise Index[1]



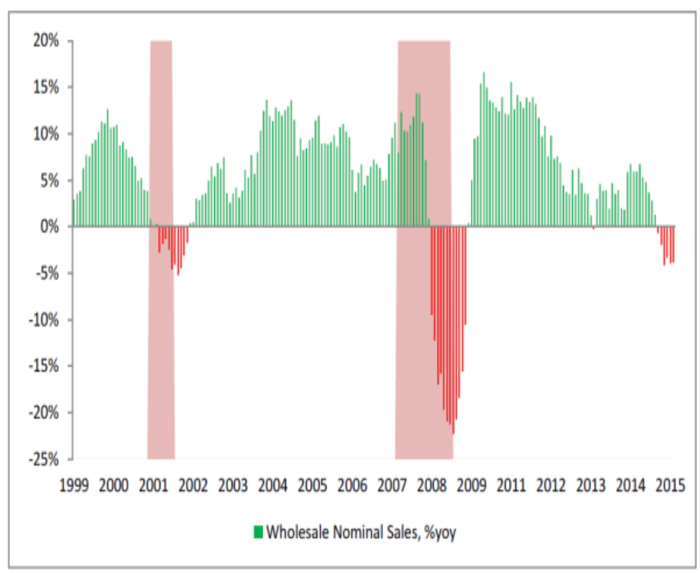
Note: (1) This charts the normal standard deviation of the percentage difference between Consensus estimates and actual U.S. economic data as tracked by Bloomberg
Source: Bloomberg; Axiom Capital Research

Growth in U.S. Exports, %y/y



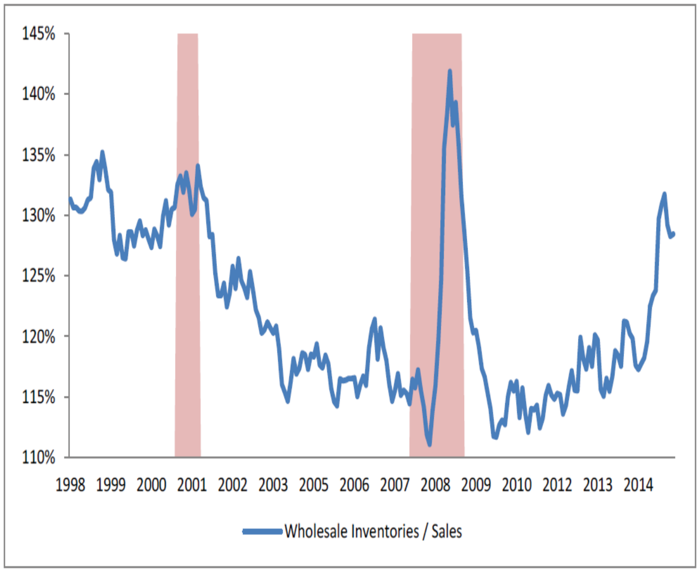
Note: Shaded areas represent recessions, as defined by the U.S. National Bureau of Economic Research.
Source: U.S. Census Bureau.

U.S. Wholesale Nominal Sales, %y/y

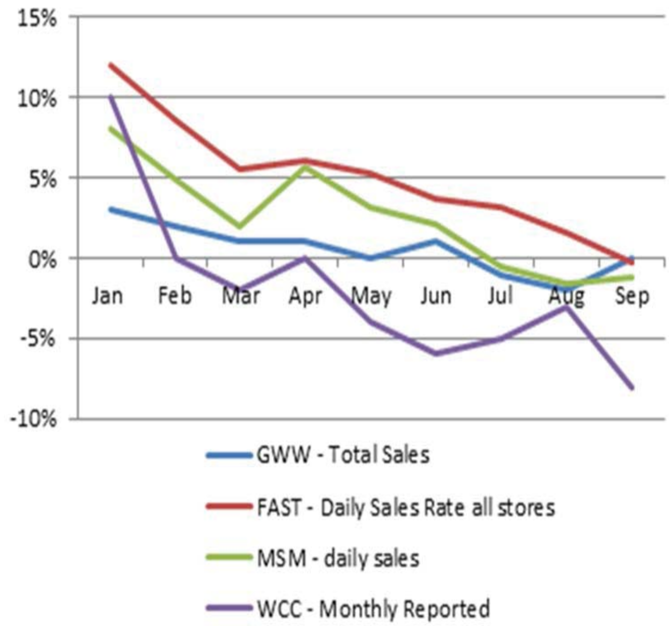


Note: Shaded areas represent recessions, as defined by the U.S. National Bureau of Economic Research.
Source: Bloomberg; U.S. Census Bureau.

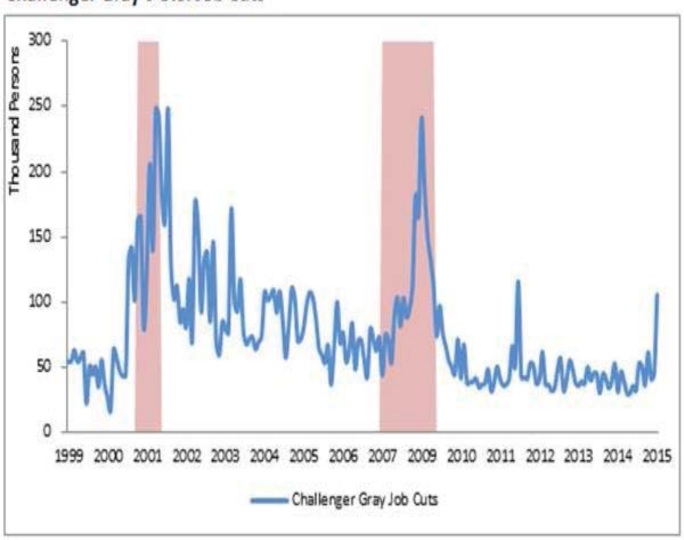
U.S. Wholesale Inventories-to-Sales Ratio



Note: Shaded areas represent recessions, as defined by the U.S. National Bureau of Economic Research
Source: Bloomberg; U.S. Census Bureau; Axiom Capital Research



Challenger Gray's U.S. Job Cuts



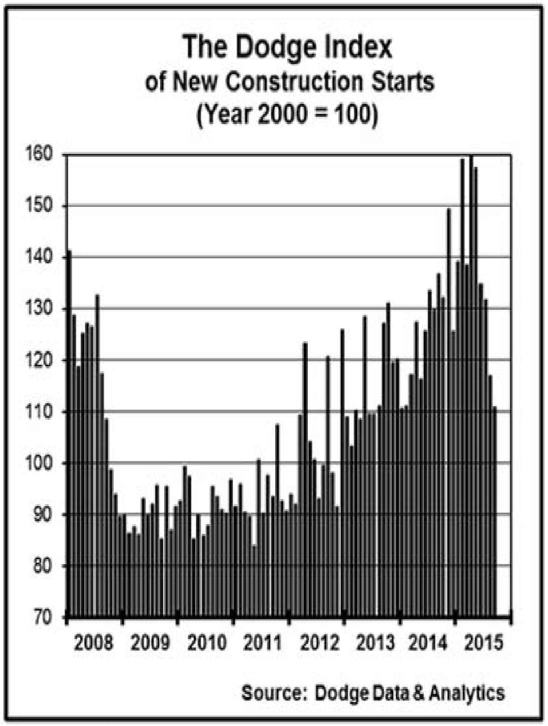
Note: Shaded areas represent recessions, as defined by the U.S. National Bureau of Economic Research
Source: Challenger, Gray and Christmas, Inc.; Axiom Capital Research

Industrial distributors, many of whom had built inventories in expectation of a strong year, are now destocking and cutting back on orders in recognition of that weakness, a trend that ripples back to manufacturers and suppliers and, eventually, to hiring.

Lower commodity prices are likely to exacerbate matters – why buy now if you anticipate lower prices in 2016? There are other cautionary straws in the wind. Truck loadings are down into the mid-single-digit range, confirmation that companies have cut back on ordering. They're also cutting back on other spending – corporate bookings in the lodging sector are weak, probably a reflection of pressure on margins and tough times in the oil patch but also confirmation of a more general wariness on the part of CFOs.

Things also are not well in the construction sector, where Dodge data on U.S. construction in September show that this key sector may have rolled over – total starts were off 5% m/m (still up 12% YTD). Within that, non-residential building was down 4% m/m, down 18% y/y and down 7% YTD; with residential building down 11% m/m but up 17% YTD. The effect on earnings was evident, with Caterpillar recently reporting a 64% decline in third quarter profits and cutting its profit outlook for the full year from $5 to $4.60 a share.

September 2015 Construction Starts



SEPTEMBER 2015 CONSTRUCTION STARTS

MONTHLY SUMMARY OF CONSTRUCTION STARTS
Prepared by Dodge Data & Analytics

MONTHLY CONSTRUCTION STARTS
Seasonally Adjusted Annual Rates, In Millions of Dollars

	September 2015	August 2015	% Change
Nonresidential Building	$152,882	$159,821	-4
Residential Building	236,910	265,855	-11
Nonbuilding Construction	133,912	127,504	+5
TOTAL Construction	$523,704	$553,180	-5

THE DODGE INDEX
(Year 2000=100, Seasonally Adjusted)

September 2015....111
August 2015........117

YEAR-TO-DATE CONSTRUCTION STARTS
Unadjusted Totals, In Millions of Dollars

	9 Mos. 2015	9 Mos. 2014	% Change
Nonresidential Building	$154,188	$165,580	-7
Residential Building	200,227	171,408	+17
Nonbuilding Construction	142,969	106,036	+35
TOTAL Construction	$497,384	$443,024	+12

Source: Axiom Capital Research

While we won't know the full story on retail until the New Year, early indications are that it may not be good. Many stores are bloated with inventory. Halloween retail sales, viewed as a precursor of what will happen during the critical holiday season, are likely to be down 7% y/y and at their lowest level since 2011, according to the National Retail Federation. It may not be a permanent change, but American consumers are currently cautious and very price-sensitive, not a good sign for profits.

Those seeking reassurance didn't find it from the Fed, which stood pat on rates in September and October but said a rate hike is possible in December. The central bank simultaneously acknowledged that job growth has slowed but that opined that hiring and inflation will gain strength in the near future, thereby providing the rationale for liftoff. Maybe so, but it's difficult to discern what the drivers for either of those developments might be. Meanwhile, many investors now see the Fed's dithering and division either as paralysis or implicit confirmation that the global economic slowdown is posing a serious threat to the U.S. economy. In this vein, it's possible that additional monetary stimulus from the European Central Bank and/or Bank of Japan may also now be viewed as bad news.

It doesn't help that various Fed officials have been publicly expressing conflicting views on whether an increase is appropriate. Clear communication – and follow-through – is part of the Fed's job. It's easy to sympathize with the FOMC and Chair Janet Yellen, who as a labor economist is confronted with a thorny global landscape that includes many other factors besides employment numbers – and is currently getting more unsolicited advice than anyone except the baseball managers. Still, the Fed will only magnify uncertainty by saying it's likely to hike and then not doing so.

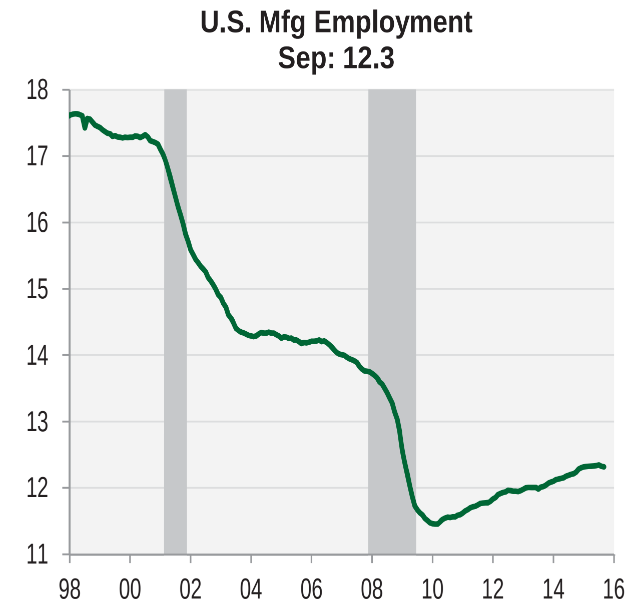
Among those providing counsel to Yellen is the International Monetary Fund, which wants the Fed to hold off and recently again downgraded its outlook for global economic growth in 2015 and 2016, citing the slowdown in emerging markets and rising risks of a worldwide recession. The IMF also warned that a new financial crisis is possible if governments and policymakers mishandle market stability risks. "Shocks may originate in advanced or emerging markets and, combined with unaddressed system vulnerabilities, could lead to a global asset market disruption and a sudden drying up of market liquidity in many asset classes," the IMF said.

The Fed is certainly aware of the risks of a miscue – Vice Chairman Stanley Fischer recently commented that, "Among those risks is the possibility that shifting expectations concerning U.S. interest rates could lead to more volatility in financial markets and the value of the dollar, intensifying spillovers to other economies, including emerging market economies."

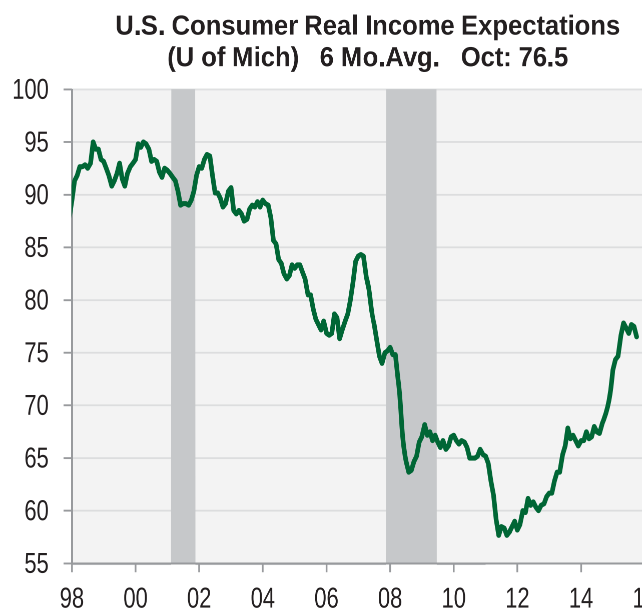
The fragility of EM economies, many of them struggling under huge debt loads and badly hurt by falling commodity prices, led the IMF to cut its forecast for emerging markets growth to 4% this year and 3.6% in 2016. This marks five consecutive years of declining EM growth, according to the IMF, which strangely is still projecting Chinese growth well above what most economists expect. According to the latest figures from Beijing, GDP rose 6.9% in the third quarter in inflation-adjusted terms, down from 7% in the first two quarters and 7.3% for full-year 2014. This would be the slowest quarterly growth rate since the first quarter of 2009 but higher than expectations of 6.7%. Let's pause here to express some sympathy for Beijing's beleaguered statisticians. If they report good numbers, many observers think they're lying. If they serve up bad numbers, it confirms that China is in trouble – and so are they.

The true – and probably unknowable – rate of China's economic growth matters a great deal, because China's slowdown affects not just commodity exporters such as Canada, Australia and Brazil but also Pacific Rim countries such as Singapore, Thailand, Malaysia, and South Korea. For a sense of scale, consider that China's annual growth rate is roughly equivalent to adding an economy the size of Italy's to the global economy every year.

Although it produced lower prices at Walmart and other low-end retailers, American consumers didn't benefit much on balance from China's economic boom, which boosted energy prices and eliminated domestic manufacturing jobs. The inverse is also true – lower pump prices, more jobs and optimistic consumers are positives for the U.S. economy.



Source: Cornerstone Macro



Source: Cornerstone Macro

As the quarter closed, it was clear that investors are very concerned about Beijing's ability to manage the transition from bridges to nowhere to consumption-led growth. That shift isn't going to be swift – or transparent. The law of large numbers applies in China as well as everywhere else. Of course, Beijing doesn't also have to contend with a lot of cynical, nay-saying articles in the press. Consider this portion of a recent directive from the Chinese Communist party to the country's national media outlets: "The focus for the month of September will be strengthening economic propaganda and… promoting the discourse on China's bright economic future and the superiority of China's system." You can't make this stuff up.

Sector Summaries

Global Consumer

3Q15 was challenging, with the SPDR S&P Retail ETF (XRT) down 10%, and the Consumer Staples Select Sector SPDR (XLP) down 1%. While we've seen some recovery in the market in October, it's been a rough year for much of consumer discretionary, with Staples holding up as investors seek some safety and yield as we head into 4Q15.

The consumer backdrop has become more decidedly mixed as we head into 3Q15 earnings. While the outlook for the US consumer remains more favorable than not (consumer confidence remains high, housing steady/improving, improved access to consumer credit), we are starting to see some cracks from slowing job growth, rising layoff announcements and weaker than expected consumer spending during 3Q15. While we have speculated that consumers/households may be feeling some pressure from higher fixed housing costs, higher healthcare costs, increased cellphone/internet usage, higher fixed transportation costs in form of increased payment for new/used car, these pressures are likely to continue in 4Q15/1Q16 and remain cause for some concern on potential spending. Gasoline related savings and price deflation have not resulted in increased consumer spending through 3Q15. These pressures coupled with higher consumer savings rates could provide a challenge to the consumer and spending into 1H16.

Tougher sales comparisons and unfavorable weather could pose a challenge to consumer spending in 4Q15 and into 1H16. Most consumer discretionary companies are now facing tougher sales and earnings comparisons through 2Q16, with 4Q15 being the toughest comparison given the benign winter of 2014 and weak 2013 holiday season (as an example, 4Q14 restaurant sales were strongest since 4Q11). November 2014 helped many retailers get off to a fast start in 4Q14, as colder than average temperatures coupled with drier weather stimulated traffic and sales and boosted early season margins last year. Unseasonably warm weather in September and October 2015 has negatively impacted apparel sales and mall traffic QTD. Albeit early in the 3Q15 earnings season, initial reported results are exhibiting softer sales and elevated inventory levels. Reported inventory levels are now growing faster than expected demand, which could place pressure on future gross margin and earnings despite the benign cost environment. The next six months or so will prove an interesting litmus test for the health of U.S. retail in particular and consumption more broadly as the consumer space faces some of the most difficult comparatives in the past two years. Housing-related categories, auto parts, tobacco, beer/spirits and beauty are groups that still have accelerating sales trends as we enter 4Q15. Lower input costs and rising wages could potentially set the stage for stronger consumer spending and improved sales and earnings for 4Q15/1H16.

We are cautiously positioned within staples and see prospects for estimate reductions for many US multinationals names given weak growth and FX headwinds. While Europe appears to be improving as we enter 4Q15, emerging markets remain a headwind driven by slowing growth in key markets, especially Russia and Brazil. Questions surrounding China and the potential for a slowing economy are beginning to emerge and are worth monitoring as China-exposed companies report 3Q15 results. While the Euro volatility has slowed somewhat, FX still poses a challenge to EPS estimates for 2H15 and 2016. Lackluster volume trends, aggressive international pricing and peak valuations both on a relative and absolute basis make the space challenging at current elevated levels. We expect to see more merger and acquisition related activity in the space given low interest rates, healthy balance sheets and limited organic growth in the current macro environment. We continue to prefer names with greater US exposure given the strong dollar.

Financials

Financial stocks as defined by the XLF were down 7% in the third quarter. There were not a lot of places to hide but the failure of the Federal Reserve to raise rates caused the regional banks to drop 7% while the REIT group appreciated 1% as the fear of a rate increase subsided. Our book was down 0.60%.

Stock picking in financials has not been a lot of fun. Generally speaking, macro has trumped bottoms up, and regulatory overhang has slowed earnings growth to a crawl, particularly in the larger banks. To find growth these days, it generally requires you to pay nosebleed multiples in areas like FinTech, or to pay up for those few banks that seem capable of generating disproportionately strong loan growth (okay, we admit to owning some Visa). We have tried to overweight the few oddball cheap stocks that we can find, while focusing our shorts on areas like money-management where emerging market trends combined with a lousy domestic stock market have produced good results. We continue to keep our book generally 5 to 10% net long, sometimes less, until the overall macro environment becomes clearer to us. Our bias is for no Fed increase for the foreseeable future (but since we got September wrong, maybe Janet Yellen will surprise us yet?), slow GDP growth, and range bound interest rates. Unfortunately, the market seems to agree with that forecast in the short term which always makes us nervous and crowds those few areas with good earnings growth like FinTech at 20+ multiples. Our biggest fear is that we are too optimistic on the economy and we aren't that optimistic.

Our top performer during the quarter was a short on an asset manager that we only very recently closed out. Our theory was that the tough fixed income market coupled with difficult emerging markets, coupled with poor performance at a couple of key funds would push their shares lower. This played out over the third quarter, but the recent relative stability in the emerging and fixed income markets plus the low multiple that caused us to cover our short period. Our next biggest winner was a short on the Russell 2000 used as a hedge, and then we had a good winner on our Canadian dollar hedge against our largest position, Element Financial. Not surprisingly, shorts were better than longs with the only equity long position in our top 10 winners being a long on First Republic Bank.

Our biggest loser was Element Financial, which was also our largest position and still is. Adjusted for the currency gain it was only our fourth worst position, but still a loser. We still think the future is bright with rapid earnings growth, a very reasonable multiple at 12x 2016, and a much lower risk profile than the typical bank or lender. Most of Element's business is fleet leasing which tends to be indifferent to interest rates and relatively stable even in a weaker macroeconomic environment. Our REIT holdings of New Residential and Northstar continue to disappoint and we have trimmed Northstar because it is dependent on raising new equity from time to time with the current cost of capital making that pretty attractive Northstar back significantly. The weakness is not fundamental as far as we could tell, but more due to a lack of catalysts other than the dividends and decent business models. We did initiate a new position late in the third quarter called Spirit Realty, a triple net lessor that mostly focuses on medium-size retail. The bankruptcy of one of their tenants sent the stock down hard and we picked up shares near book value plus a 7.5% yield. Spirit has been one of our top performers in October.

Current positioning is we are net long REITs, net short Europe, roughly balanced in US banks and consumer finance, with an overall net long position averaging in the mid-single digits so far this quarter.

Leisure and Media

While recording negative performance in 3Q15, Leisure and Media stocks outperformed the broader market in the period, losing -4.3% vs. -6.9% for the S&P 500. Cruise (+4.4%), Online Travel (+1.0%), and New Media (+0.6%) beat the index, whereas Casino Operators (-24.7%), Media Conglomerates (-17.3%), Theater Exhibitors (-16.4%) and Lodging stocks (-15.1%) significantly underperformed.

Cruise Lines (+4.4%) held well in Q3, despite the weakening global economy, as earnings commentaries by cruise companies and booking surveys have been generally constructive. Investor sentiment also remained elevated related to the companies' rapid expansion in China. All major cruise line companies eked out gains in Q3, including Royal Caribbean Cruises (RCL, +13.2%), Norwegian Cruise Line (NCLH, +2.0%), and Carnival Corp (CCL, +1.2%).

Online Travel delivered growth of +1.0% in Q3, driven by Expedia (EXPE, +8.9%) and Priceline (PCLN, +5.1%), partially offset by TripAdvisor (TRIP, -27.4%). Expedia and Priceline shares held up relatively well as they showed continued positive trends in their core businesses, despite a weaker economic environment in Europe. TripAdvisor continued to lag the market, as uncertainty remained about the CFO transition and its impact on potential 2015 and 2016 guidance.

New Media gained +0.6% in Q3, with mixed results across the group. Amazon (AMZN, +18.4%) and Alphabet (GOOGL, +17.9%) recorded strong share-price growth on improved profitability expectations post Q2 results and positive intra-quarter checks for Q3. On the other hand, Yelp (YELP, -49.3%) and Twitter (TWTR, -23.2%) were negatively impacted by concerns about viability of their business models, and Yahoo (YHOO) lost -26.2% due to concerns about the Chinese economy and reports that the IRS declined to grant Yahoo's request for a private letter ruling related to its planned divestiture of its Alibaba (BABA, -28.3%) stake.

Cable/Satellite stocks lost -3.1% in Q3, reversing gains of +6.3% they recorded in Q2. DISH Network (DISH, -13.8%) and Comcast (CMCSA, -5.6%) traded down on concerns about weak video subscriber trends in the industry, whereas Charter Communications (CHTR, +2.8%) and Time Warner Cable (TWC, +0.8%) held up better due to early indications of relatively muted opposition to their attempted merger. Cablevision (CVC) gained +36.1%, as it is being acquired by Altice (ATC, -39.4%).

Leisure Products stocks on average lost -10.4% in Q3. Overall, earnings growth potential appeared to be diminishing in the powersports sector, due to significant FX pressures and unique sector-specific headwinds. Polaris (PII, -19.4%) missed Q2 consensus estimates and continued to fight high inventory levels, weakness in oil- and ag-driven markets and more aggressive Canadian and Japanese competition. Polaris also struggled to fix its motorcycle production issues, which had been limiting its ability to fully capture demand for its Indian products. Brunswick (BC, -6.6%) continued to face potentially more aggressive European competition in the boat market and investors feared that Brunswick's increasing investment into new market segments (such as corporate wellness and metal alloys) could pressure margins and increase execution risk. Q3 Harley Davidson (HOG, -3.6%) dealer checks performed by analysts showed continued retail weakness, as the 2016 model launch was underwhelming.

Toys lost -10.6% in Q3, reversing their growth of +15.3% in Q2. Mattel (MAT) declined -18.0% in Q3 due to its significant exposure to the Brazilian Real and fears about the increased competitive nature of the 2015 Holiday season, with Star Wars action figures and Bratz dolls entering the market, among others. Hasbro (HAS) lost -3.2% on concerns that its Star Wars property may represent a smaller portion of the total Disney portfolio than previously hoped by investors.

Lodging companies fell -15.1% in Q3, as investors grew concerned about increasing supply and the lodging cycle coming to an end. Secular concerns related to Airbnb are also starting to more significantly weigh on lodging stocks, and several 3Q15 preannouncements released in September by lodging companies spooked investors. Shares of all major lodging companies we track fell, including Host (HST, -21.0%), Starwood (HOT, -18.3%), Hilton (HLT, -16.7%), and Marriott (MAR, -11.3%).

Theater Exhibitors lost -16.4% in Q3, as investors grew increasingly concerned about a potentially softer 2016 film slate and weaker-than-expected operating leverage in the environment of large blockbusters driving an abnormally large portion of box office. Weak Q3 share-price performers included Carmike Cinemas (CKEC, -24.0%), Cinemark Holdings (CNK, -19.1%), AMC Entertainment (AMC, -17.9%), IMAX Corp (IMAX, -15.4%), and Regal Entertainment (RGC, -10.6%).

Media Conglomerates fell -17.3% in Q3, with a major sell-off starting in August, triggered by Disney's cautious outlook for its ESPN business and negative commentary by other content-production companies. Stock multiples re-rated downwards as investors grew increasingly skeptical about stability of affiliate revenues, which until then had been considered relatively safe, in contrast to advertising revenue, which began to face significant pressures earlier. All major stocks we track fell, including Viacom (VIAB, -33.0%), CBS Corp (CBS, -29.0%), Time Warner (TWX, -22.2%), Discovery (DISCA, -21.4%), Walt Disney (DIS, -10.9%), and AMC Networks (AMCX, -10.5%).

Casino Operator stocks fell another -24.7% in Q3, driven by weak VIP-segment performance and slowing mass-market trends, a result of the Chinese government anti-corruption campaign, softer credit growth and well-publicized junket-operator issues. The 3Q15 decline was led by Wynn Resorts (WYNN, -46.2%), Melco Crown Entertainment (MPEL, -30.0%), and Las Vegas Sands (LVS, -27.9%). MGM Resorts (MGM, +1.1%) recorded stronger performance, as the company explored strategic initiatives, including potential REIT conversion and cost cuts.

Healthcare

The healthcare sector significantly underperformed the broader market in 3Q15 (XLV -11.92% vs. SPX -7.65%). Both Biotech indices led the underperformance with the IBB (iShares Nasdaq Biotechnology ETF) losing 18.00% of its value and the XBI (SPDR S&P Biotech ETF) declining 25.07% in Q3. Healthcare Services also meaningfully underperformed the market; XHS (SPDR S&P healthcare services ETF) declined 13.55% vs. SPX -7.65%. The best performing subsector was the Medical Device group; IHI (iShares U.S. Medical Device ETF) modestly outperformed the S&P, losing 7.51% over the respective period.

The healthcare sector has meaningful outperformed the market for several years now and it's not entirely surprising that the sector has lost some of its luster. At a high level, what we are observing is the culmination of slower growth in commercial and government insured rolls, decelerating growth from many new product cycles, and peak leverage.

Slower growth in covered lives should lead to decelerating growth in paid consumption as evidenced by two recent profit warnings from HCA and CYH. Slower growth in insured rolls portends diminishing y/y benefits from improving payer mix and lower bad debt. With peak multiples and leverage as backdrop, the recent underperformance of Healthcare Facilities subgroup is not surprising.

We are seeing a similar dynamic play out for Pharma and Biotech. Revenue growth from new product cycles has decelerated meaningfully and estimates for many companies in the group should be revised lower (GILD – Harvoni, ABBV Viekira Pak). Thus, the fundamentals are more negative on the margin. In prior years, decelerating script growth hasn't always translated into decelerating revenue and earnings growth (at least for the therapeutics companies) as share dynamics within primary and specialty care markets are fluid and pricing has been lever branded, companies could pull to offset decelerating script trends. While share dynamics appear mostly stable, the perception around pricing has changed following the now infamous "Hillary Tweet." While we are of the view that pricing remains a legitimate lever for the foreseeable future, we fully recognize that the market is far less willing to ascribe certainty to this free cash flow lever – hence compressing multiples across the group.

We remain constructive but selective and are finding long and short opportunities. Many companies within the therapeutics group are approaching financial crisis (2008/2009) through valuations. With respect to shorts, we are finding opportunities among the highly levered names where business models are unsustainable and organic growth is decelerating.

Materials

Chemical companies meaningfully underperformed the broader market during Q3, by falling 17% versus the S&P 500's 7% decline. Within the sector, commodity chemical shares sharply reversed recent strength and followed the price of oil nearly 20% lower. Key commodity chemical products such as ethylene, methanol, and titanium dioxide all saw sizable price declines during the quarter, which we expect to drive weaker margins for producers under coverage during the second half of 2015. This weakness was highlighted in late September by Huntsman, who warned that results were trending 15% below consensus expectations due to weaker product pricing, customer destocking and foreign exchange headwinds. Currency volatility was also a notable headwind for the sector during Q3; chemical companies saw their share prices fall by 10% during the two weeks following China's mid-August currency devaluation announcement. This incited fears of weaker demand in the region and pressured chemical companies whose products are priced on marginal producer economics in China, where cost bases will decline with the Renminbi. Currency concerns also plagued companies with exposure to Brazil, as the Real plummeted 21% during Q3, which will drive translational and in some case transactional headwinds for certain companies under coverage. For example, FMC, which has a sizable crop protection chemical business in Brazil, saw its shares decline 35% during the quarter and in early October nearly halved profit expectations for the remainder of 2015 and announced a restructuring that will cut the size of their Brazilian workforce by 50%. Given the long list of macro-economic headwinds and an above-normal number of negative pre-announcements, we are positioned very cautiously heading into Q3 earnings season and remain focused on high quality, low cost, and cash flow generative companies.

Metals and mining companies substantially underperformed the broader market during Q3, with the S&P 500 Metals and Mining Index falling 28.4%. Shares of both metal producers and miners tracked their respective commodities lower, as copper, steel, and met coal each saw double-digit declines during Q3. Chinese growth concerns amplified during the quarter, coincident with a 29% drop in the Shanghai Composite, contributing to a broad-based commodity selloff. China accounts for roughly half of global consumption for a number of commodities, including met coal, thermal coal, aluminum, nickel, zinc, copper and iron ore. Thus, any slowdown in the Chinese economy can materially loosen the underlying supply/demand fundamentals for these commodities. We have long been skeptical of reported Chinese growth figures, and conversations with our companies over the last year have consistently suggested that the economy is growing closer to low-single-digit rates, or optimistically at half of this year's 7% GDP target. Recent macro data has continued to slow; for example, the Chinese Manufacturing PMI fell below 50 into contractionary territory during Q3. Within the backdrop of weakening macro data and declining commodity prices, we are incrementally cautious on the outlook for the majority of the metals and mining complex. We will continue to closely monitor macro, commodity and company-specific data points for any changes in trend, but are not expecting an improvement in fundamentals in the near future.

Energy

Looking at the energy market through the lens of a 5 stage grieving process (denial, anger, bargaining, depression and acceptance), Q3 saw the energy market enter stage two, anger, where down 25% in Q3 was the norm. We welcome a depressing holiday-laden Q4 so that we can find our way to acceptance, and can get back to the business of finding interesting companies and business models. In September, we actually became positive on a number of stocks that had sold off due to a perceived dividend risk. With a fed rate hike delayed and E&P companies having the ability to control cashflow through CAPEX reductions, we see a strong buy case for high quality E&P's like COP, NBL, APC, EOG. As investors start to see the light at the end of the crude tunnel, we expect them to gravitate towards these high quality E&P's.

Our view on the crude macro is positive up to a certain price. We do see crude fundamentals improving in late 2016. Globally we are 1.0-1.5mmbpd oversupplied, demand in 2016 grows 1.5mmbpd, US supply should see 600k bpd decline, non-US non-OPEC should be flat to slightly down, and Iran likely brings on 300kbpd-500kbpd once sanctions are lifted. At some point in early 2016 we expect that the market will accept this view and send the crude price up to incent drilling of the marginal barrel. However, we know that US E&P's will increase rig count at $60 WTI (this happened in May 2015). More alarming is our estimate that US crude production grows in late 2016 at a flat rig count as drilling efficiencies continue to improve. This is similar to natural gas: The US has gone from over 900 rigs drilling for natural gas to ~200 since 2009 and gas production has doubled. This is the technology factor in US shale at work, and it is now at work in the oily shales. To avoid another collapse we need to see solid demand growth above 1.0mmbpd again in 2017.

Our view is that natural gas will never see $4, and outside of future Polar Vortex scenarios, unlikely to have a 3 handle. We've seen E&P's continue to drill and grow gas production in PA at wellhead prices significantly below $1.50. So once pipeline capacity exists to move gas around the US, gas prices should drop to marginal production plus transportation. Drilling efficiency increases and new monster wells in the Utica add downside price risk.

Going into Q4 we remain convicted that the Golar floating LNG technology works and that there is a market for small batch LNG cargoes with trading houses who desire to build a spot market. We believe the market has given too much credence to the LNG oversupply story. The LNG market is not traded on a spot basis like crude; rather each ton of liquefaction new supply has an attached offtake contract.

Given our crude price scenario and the massive oversupply of offshore drilling rigs, we do not see offshore drilling recovering for years. We remain leary of NOV where we think the Street still does not understand how POC accounting will continue to negatively affect cashflows, and margins are on a downward trajectory as work volumes through high fixed cost facilities dwindle.

Capital Goods

It has been a tough year for industrials and the 3rd quarter offered little relief. The XLI was down 7.71% in Q3. US macro data has moved from stable to weak. ISM manufacturing weakened sequentially through Q3 with July at 52.7, August at 51.1, and September at 50.2. ISM new orders fell from 56.5 in July, to 51.7 in August, and to 50.1 in September. Many regional manufacturing indicators remain negative, with the most recent prints for the Houston PMI at 47.6, Philly Fed at -4.5, Richmond Fed at -5, Chicago PMI at 48.7, and the Empire State Manufacturing Index at -11.36.

Company commentary in October has not offered a different picture. Grainger daily sales were -1% in September, slowing from flat in August and +1% in July. The first two weeks of October were down mid-single digits for Grainger. Fastenal sales slowed from 3.2% in July to 1.6% in in August to -30bps in September. SKF sales in North America deteriorated from -6% in 2Q to -10.8% in Q3. The company indicated broad based weakness in destocking. Emerson underlying orders slowed from -8% in August to -11% in September. Capital goods demand also looks sequentially weaker. Colfax reported a 12.5% order decline in their gas and fluid handling business. Caterpillar took down their sales guidance and gave an initial outlook for 2016 sales being down another 5%. Manitowoc expects 2015 crane revenue to be down 15-20% due to weakness in the Middle East and Asia.

Industrial end markets are also a drag for transportation companies. Fedex lowered guidance as industrial end markets weighed on their freight business. Both Old Dominion and Saia saw daily tonnage slow from July to August (ODFL 7.7% to 5.8% and SAIA -2.6% to -4%). Universal Truckload pre-announced negative due to soft demand from steel and industrial customers. There is also a concern around a muted peak season as inventory to sales ratios remain high. Truckload shipper surveys are mixed and spot prices remain weaker y/y. Rails have also made comments on seeing a delayed peak season. Looking forward, Kansas City Southern took down expectations for automotive growth in 2016, as re-tooling at auto plants ahead of capacity expansions would be a drag in the first half. CSX pointed to coal as a continued headwind into 2016.

There are a few bright spots, but none without some hair. Auto remains strong with US SAAR above 18m and Western Europe SAAR at 13.3m (up 9.4% y/y). China auto was a concern after a few months of y/y decline, but seems to have stabilized with retail sales returning to growth in September. The Chinese government introduced a tax cut on sales of small cars which should offer some support to volumes going forward. Construction commentary and data has become incrementally more mixed. Carlisle commented that commercial roofing demand remains strong but labor shortages in Texas have limited volume growth. Cement channel checks have produced similar commentary. The Dodge construction index is off from its peak in May and is now only slightly positive y/y. Despite this, Lennox delivered strong growth in both residential and commercial HVAC. Management commented that macro data may skew larger project vs. Lennox's light commercial business. United Rentals also commented that both July and August came in better than expected, potentially pointing to stabilization in rate or utilization trends. Europe remains relatively steady with SKF reporting sales down 70bps vs. up 70bps in Q2. Sulzer saw pump orders grow in Europe vs. declines in China and the Americas

Industrials tend to rally from October through April. We would view seasonal rallies as short opportunities. The only market that seems solid to us is Europe. The US is getting weaker and emerging markets have risk of coming unzipped. Companies over the next 4 months will begin the process of reducing consensus 2016 estimates. Currently estimates are for EPS growth near 10 percent. With fundamentals deteriorating, balance sheets full and capacity utilization loose we believe industrials are looking at a flattish EPS year in 2016 with risk to the downside. That said many of the have nots have been hit hard and are heavily shorted, so shorting further could be difficult. We view shorting bounces in the space as an alpha creating endeavor. The key ways for industrials to work are either a China-led recovery or an oil-led recovery. The biggest risk factor to us is price. This time last year companies expected a short term oil correction and strong emerging markets. Customers did push back on price increases, but were not really expecting price declines. We have heard and seen more evidence of real price declines in the last quarter and see a case were profits collapse via price concessions. The strong dollar with weak oil price is not a good formula for the US industrial renaissance thesis that was bandied about through mid-2014. Additionally, we have heard from more companies who are happy with their Mexican facilities and should start to see capacity moves to Canada due to cost advantages. We believe industrials will struggle and see pairing ideas as the way to hopefully profit in industrials.

Technology

Technology slightly outperformed the broader market in Q3, with the S&P 500 Information Technology index producing a total return of -3.7% vs an S&P 500 total return of -6.4%.

Software underperformed the overall tech sector in the third quarter, with an S&P 500 Software Index total return of -4.5%. A big portion of this underperformance can be ascribed to software mega-cap ORCL which delivered a total return of -10.0% for the quarter. Software mega-cap peer MSFT held up better in the selloff, delivering a +1.0% total return. We continue to expect the MSFT CEO upgrade and broader turnaround story will create significant shareholder value in the long term (and we are long the shares). That said, we see MSFT as a unique example and continue to believe the revenue and margin pressures on most legacy software business models will increase over time and the only defense these management teams have at their disposal is an ability to deploy their robust (though declining) free cash flows to defensively buy cloud assets. This sort of capital allocation is usually associated with value destruction over time and we expect similar outcomes here. We are short several legacy software companies that lose in this paradigm shift. We remain short a European IT services company and a European software company where valuations have stretched to new records due to the weak-EUR risk rally in European equities broadly. In these cases the weak EUR does nothing to increase the underlying profitability or FCF generation of the companies and we expect future financial results will drive market capitalization downward to levels more consistent with historical norms.

Hardware and equipment underperformed the overall tech sector in the third quarter, with an S&P 500 Hardware & Equipment Index total return of -10.0%. This performance was paced by the -10.1% total return for IBM in the quarter. In enterprise hardware we see the move to multi-tenant public cloud architectures from legacy on-premise capacity as negative for the existing server, networking, and communications-equipment complex. Utilization of hardware gear across the global system is rising as workloads and applications shift to hyper scale public cloud platforms. We see this as permanently and sustainably deflationary for almost all existing IT hardware business models. Further, we expect returns in the data center space to converge on cost of capital or below as the only barrier to entry in this sector is access to capital and a willingness to spend it. We are short several companies in this sector. We are also long two low-growth/low-expectation hardware companies where we believe ephemeral cyclical effects are being mistaken for a more sustaining secular problem. We also recently initiated long positions in a communications equipment company which stands to see material accretion from a recent market-consolidating M&A event and a newly public domain name registry company.

Semiconductors underperformed the overall tech sector in the third quarter, with an S&P 500 Semiconductor & Semiconductor Equipment Index total return of -6.5%. The PC end market continued to soften in the quarter and we saw estimates and multiples reset on several more companies...following a trend we saw in the first and second quarters. As we have written about consistently for the last year, the PC complex is nearing the end of a multi-year process of continued downward resets in growth expectations due to the rise of the tablet. While we do not expect the PC market to resume growth similar to what we saw in the 2000's, we expect the PC market to revert to GDP-like unit growth rates over time. We see this near term reset a function of inventory adjustment coming out of an overbuild in Q4->Q3 rather than a more sustaining or sinister downward reset of the industry growth rate.

Most of our time continues to be spent on esoteric and niche investment opportunities on the long and short side that do not require some sort of positive or negative call on the overall tech market in order to generate alpha. For example, we are invested against a share shift and margin compression thesis in the consumer optical industry, which has us short the largest player in the space globally. Further, we are short a Europe-based payment terminal manufacturer which has enjoyed above-trend revenue growth for over two years and is entering a period of extremely difficult margin and revenue growth compares. We believe the company is worth 40% less than its current equity market capitalization. We continue to screen business models in all pockets of global tech in an effort to find the next cohort of profitable long and short investments.

Outlook

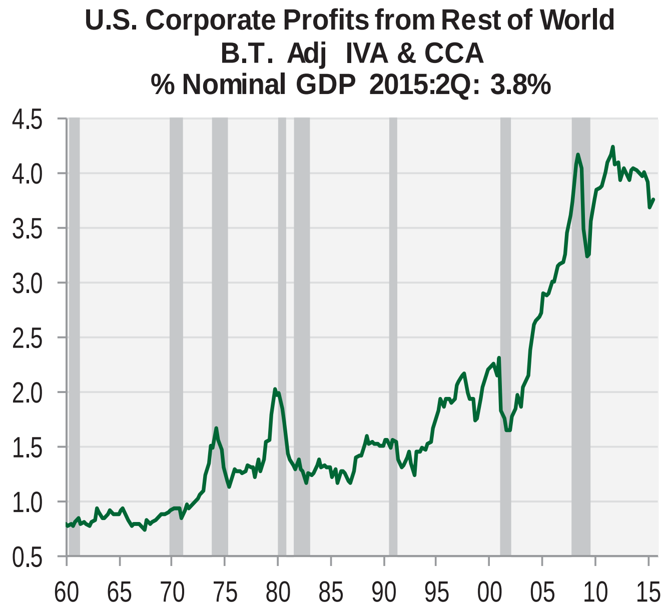
The realization that China, along with Russia, Brazil (the so-called CRaBs) and most other EMs are in a slump that can't be readily reversed has posed a fundamental question for investors, namely: "Are we witnessing the first-ever global recession caused by China and other EMs? Corollary questions abound: How well will Beijing manage its economic transition, and its financial markets? How much will the global slowdown impact the U.S. economy and U.S. corporations? Is monetary stimulus played out? What happens to investment returns in a low-demand, low-rate, low-inflation world? How much worse can Washington (or other players) make things?

"It's tough to make predictions, especially about the future," is variously attributed to the recently deceased Yogi Berra, Danish physicist Niels Bohr, Mark Twain and others (we're going with Yogi). But forecasts of some kind are foundational for investors, so let's look at what might happen.

Perhaps the first point to make is that global recessions, while horrendous, are quite rare. Using the IMF's definition of negative growth in global GDP per capita, there have been only four postwar recessions – in 1975, 1982, 1991 and 2009. What's more likely, and indeed is already occurring, are regional (Latin America) and country-specific (Japan, Russia, Brazil et al) recessions. Yes, the global economy is much more interconnected than ever before, but nations aren't joined at the hip. What we're really seeing is a decoupling of the economic trajectories of EM and developed nations, with multiple implications both for investors and corporate executives. China and other EM economies are no longer driving global economic growth. That's over. How much that affects the U.S. and Euro-area economies remains to be seen. While the U.S. imports a significant amount from China, less than 1% of U.S. exports go to China. The picture is somewhat different in Europe, where exports to China are more meaningful – about 5% of Germany's exports go to China, for example, and Germany's export numbers are dropping. At the same time, the majority of the Eurozone's exports go to other European economies.

It may be useful to note that, like many things, this has happened before. While the comparisons are inexact, the U.S. economy has weathered prior slowdowns in China and other key countries. Between 1992 and 1999, for example, China's GDP growth fell precipitously – from 14.2% to 7.6% – but U.S. growth averaged 3.8%. In 1993, with Germany in recession and Japan's growth an anemic 0.6%, the U.S. economy expanded 2.8% year-over-year. In 1997, Thailand and several other Pac Rim countries went into a tailspin but the U.S. economy grew 4.5% y/y. In 1998, the Japanese growth declined 1.5% and the ruble crisis cratered the Russian economy. In the U.S. growth was again 4.5% y/y. In other words, decoupling isn't new, it's just here again.

What does the slowdown – global and domestic – mean for corporate earnings in the U.S.? Analysts have been predicting a year-over-year decline of some 4.5% in third quarter earnings, along with a 3.3% drop in revenues, the third straight quarter of falling top-line growth. Foreign profits of multinationals are getting hit by the slowdown in EM economies, a trend that has legs. In other words, just as the U.S. and Euro area economies are decoupling – at varying rates – from EM economies, the path of foreign and domestic profits of U.S. corporations are diverging.



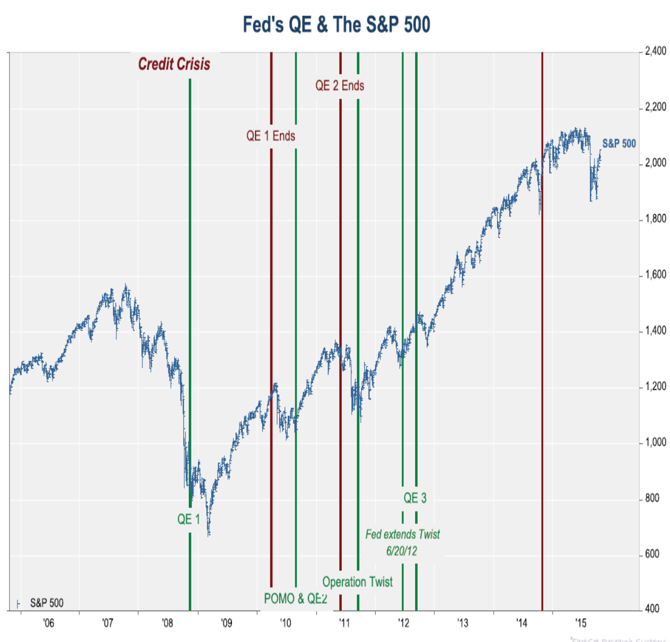
Source: Cornerstone Macro

As far as the U.S. economy as a whole, the pressing question is whether the current slowdown is morphing into something more serious. On this point, recent data points and the initial third-quarter GDP report are not encouraging. Economic growth slowed significantly, the Commerce Department said, coming in at a 1.5% seasonally and inflation-adjusted annual pace, a sharp deceleration from the 3.9% rate posted in second quarter. As mentioned, companies ran down their inventories, with spending by consumers, businesses and governments all slowing down. Consumer spending advanced at a 3.2% rate, Commerce reported, down slightly from 3.6% in the second quarter. Not coincidentally, wage and job growth in the third quarter was unimpressive, which doesn't exactly set the stage for a good holiday season – or for a December rate hike.

All economic expansions end and this one is already our second longest postwar advance. That alone doesn't spell an imminent demise, but to use another immortal quotation – this one from economist Herbert Stein, "If a thing can't go on forever, it won't." This recovery, already slow and halting, also will come to an end. Various pundits are advancing the argument that we now face secular stagnation – a global economy that can't grow at satisfactory rates even with very loose monetary policies – and they may be right. If so, what is needed is fiscal stimulus, something which simply isn't going to be forthcoming in the U.S., given the embedded political dynamics. Meanwhile, the PBOC has cut rates again and another round of QE is quite possible in Europe and Japan. It will be interesting to see what happens to growth there if the spigots are turned on again.

What's on the horizon? Deflationary pressures from China and other EM economies aren't likely to abate anytime soon. Warning signs are appearing throughout the domestic economy. The market's reaction to a 3% devaluation by China serves as warning of what could happen if Beijing decides to take its currency down significantly. A premature hike by the Fed – or widespread perception that it was premature – could spook investors, with consequences we can't foresee but which clearly worry the Fed's Stanley Fischer and others. The geopolitical situation is anything but reassuring. Black swans are always lurking, but their effects are magnified when the overall environment is fragile, as it is now.

All this understandably leaves most investors unable to form a high-conviction view on the course of the markets. The simple equation that worked since this bull market began – buy when QE is on, stay out when it's off – isn't likely to cut it going forward.



Source: Raymond James

Valuations aren't unreasonable, but that doesn't guarantee anything. All else equal, companies with pricing power are more attractive than ever. Volatility seems back to stay, as do rolling sector-by-sector corrections. Correlations are likely to decline further as the economy moves into a late-cycle phase. While it's an overused description, this truly is a stock picker's market. The next few months are going to be very interesting, and we'll all know more in the New Year.

As always, thank you for your continued support of Ascend Capital.

Malcolm Fairbairn

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