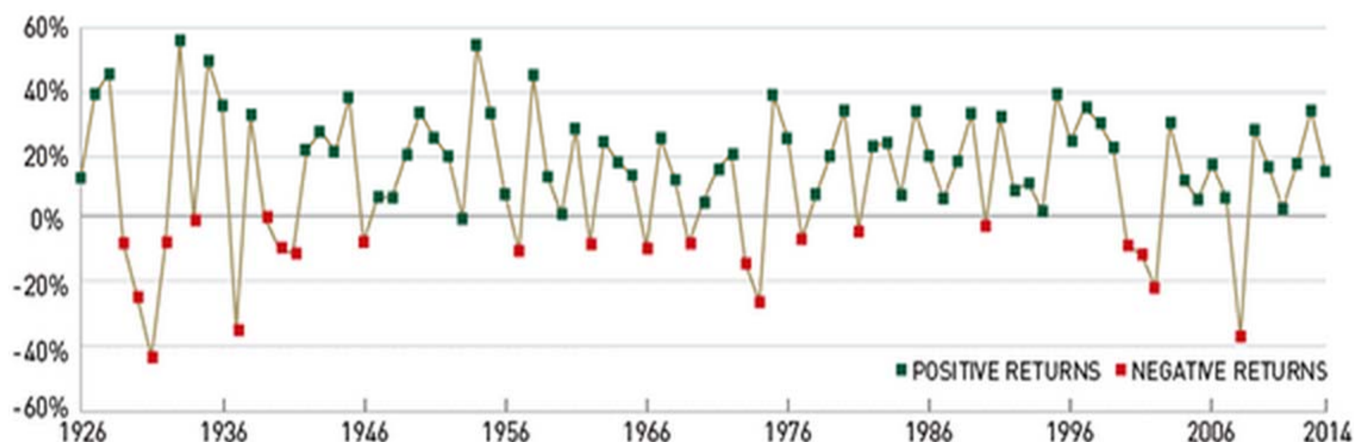
MY TAKE ON THE SOUR MOOD & MARKET VOLATILITY

LAST QUARTER

I've been wanting to discuss a powerful, 48–year study that found a number of interesting relationships between Federal Reserve policy and the performance of various types of assets for a while now, but due to continued volatility in the capital markets, I will address that topic some other time. Previously, I noted that disappointing years are a normal part of the investment process so I included a graph to help keep things in perspective. I figure it wouldn't hurt to glance at that graph again.

Annual total returns for S&P 500 Index, 1926–2014



CHINESE STOCK MARKET VOLATILITY

Investor angst intensified this past August after China devalued its currency — a move that raised questions about the strength of China's economy and, due to its size, the possibility of negative repercussions to the rest of the world. Investors subsequently relaxed and asset values staged a recovery, until recently. For the remainder of this note, I'll try to assess some of the issues I think are in play.

Weakness in China's manufacturing sector has unsettled its stock market. I discussed the fragility of the Chinese stock market in some depth not too long ago, so as a refresher let me just remind you that the combination of an ever-changing mix of capital controls and an investor base that consists overwhelmingly of poorly educated retail investors provides plenty of fire power for an erratic Chinese stock market.

In an effort to thwart this volatility, China recently implemented stock-market "circuit breakers" designed to automatically halt trading once pre-determined declines are reached. U.S. markets have similar safeguards, but China designed its circuit breakers to be much more easily tripped than ours. The ironic result is that China's newly implemented safeguards triggered the very thing they were intended to mitigate — waves of panicked selling. Whether this result is more due to regulatory miscalculation or investor inexperience, the "economic" signals being sent by China's stock market ought to be viewed with a degree of skepticism since those signals are apt to be distorted.

THE RISE OF THE CHINESE CONSUMER

China is transitioning away from an export-based, manufacturing economy to one that is more sustainably reliant upon internal demand from its own citizenry. As with any transition, the realignment of resources causes economic pain. As such, China's manufacturing sector is under pressure and now represents well less than half of China's economic output. The world has taken note, but the service-based portion of China's economy is continuing to grow and now represents over half of its economic output. China's transition away from manufacturing is hurting commodity exporters, but its economy continues to grow so it's worth noting that the resulting pain is at least part of a larger positive, i.e., China's transition toward a more self-sustaining economy.

MIGHT CHINA TRIGGER A GLOBAL CURRENCY WAR?

The pain of China's transition away from manufacturing is reverberating throughout the world in the form of depressed commodity prices, adversely impacting commodity-exporting nations such as Russia, Brazil, and Australia. China could boost demand for its manufactured exports by devaluing its currency again, just as it did this past August. This would certainly give Chinese exports an immediate price advantage versus the rest of the world, thereby boosting China's overall economy, but such a move might also induce other countries to retaliate by devaluing their own currencies. The feared result is a round robin of currency devaluations. The world reacted badly when China devalued its currency last August and investors are concerned that China may do it again.

MAYBE NOT IF CHINA WANTS TO RETAIN ITS RESERVE-CURRENCY STATUS

When international transactions occur, they must be settled in currency. Most often, settlement occurs using one or more of the world's more popular currencies. The most popular of those currencies are said to be "reserve" currencies. In essence, those currencies are so popular that they are widely held "in reserve" across the globe.

To aid world liquidity, the International Monetary Fund (IMF) maintains supplementary currency reserve assets, oddly named "Special Drawing Rights" (SDRs). SDRs do not represent an actual currency nor are they available to private parties to settle transactions. Instead, SDRs are available only to countries that are members of the IMF and are of use primarily as emergency credit. As such, SDRs are backed by a basket of actual currencies.

The IMF evaluates the world's major currencies every five years in an effort to determine which of them ought to back the IMF's SDRs and to determine what the relative weight of each currency ought to be.

Being included in the IMF's underlying basket of currencies confers status upon the countries that sponsor those currencies the same way an honorary degree from a notable school confers status on the honoree. After a review in November, the IMF decided to include the Chinese Yuan as one of the currencies that support its SDRs. Beginning in October of 2016, the IMF's SDRs will be 42% supported by the U.S. Dollar, 31% by the Euro, 11% by the Chinese Yuan, 8% by the Japanese Yen, and another 8% by the British Pound.

Being regarded as a leading global currency requires a difficult-to-achieve combination of economic size, liquidity, a functional regulatory system, reliable investor protections, and overall stability. China still has a lot of work to do in most of these areas, but it's no secret that China has worked very hard to be included at the world's big-boy table of reserve currencies. The world doesn't like it when countries devalue their currencies because it provides the devaluing country with an ill-gotten export advantage, because it causes outside parties who were holding that currency to sustain immediate losses, and because it upsets the global financial system.

While China might stick another finger in the eye of the world by further devaluing its Yuan, I would at least like you to know that China understands that it is not operating in a vacuum and that another major devaluation would not be well tolerated.

CHINESE DEBT

According to McKinsey and Company, China's total debt has more than quadrupled from 2007 to 2014 to about $28 trillion — a figure that represents almost three times its total annual economic output. China's relative debt burden now exceeds that of the U.S., a debt-laden country in its own right. Although much of China's debt is held internally (owed from one party to another within China itself), much of this new debt has been issued to support property development and infrastructure projects sporting questionable economic fundamentals. To the extent Chinese banks compromised their lending standards to grow their loan portfolios, a slowing Chinese economy could trigger a wave of defaults.

In no way do I intend to imply that China is on it's way to a debt crisis, but if a developed country with an advanced regulatory system such as the U.S. could give rise to a mortgage crisis severe enough to bring the world to its knees, it seems plausible that the combination of China's explosive debt growth and its much less well developed regulatory system could spawn something similarly ugly, even if on a lesser scale.

CHINA'S IMPACT ON THE U.S. — LESS THAN YOU MIGHT THINK

Although a big hiccup in China would certainly resonate around the world, the pain would be distributed unevenly. According to the IMF, only about 13% of the economic output of the U.S. is derived from exports. Since the U.S. economy is driven primarily by internal consumption, the U.S. could remain somewhat insulated from a global slowdown. The U.S. Dollar would probably strengthen further versus other currencies. This could pinch corporate earnings, but an increase in consumer spending power could pick up the slack.

EXTENDED GLOBAL BUSINESS EXPANSION

John Greenwood, Chief Economist for Invesco mutual funds, recently did his tea-leaf reading for 2016. Here are a few key takeaways:

- The Fed's intention to gradually raise interest rates throughout 2016 suggests that

the U.S. is back on a path to normal economic growth.

- The Fed's plan of gradual interest-rate hikes is out of phase with the easy-money policies that are still in place in Europe and Japan which may result in increased volatility in the currency and capital markets.
- Because emerging market economies tend to be fairly reliant upon commodity exports, they are likely to continue to be disproportionately hurt by the slump in commodity prices. (Our clients don't have much emerging markets exposure, but as a result of this particular point, we are inclined to trim the exposure we do have in favor of more U.S.—oriented investments.)

Consensus economics	2015 estimate		2016 consensus forecast (Invesco forecast)			
	Real GDP (%)	CPI Inflation (%)	Real GDP (%)		CPI Inflation (%)	
	Consensus	Consensus	Consensus	Invesco	Consensus	Invesco
US	2.4	0.1	2.6	2.6	1.7	1.4
Eurozone	1.5	0.1	1.7	1.5	1.1	1.0
UK	2.5	0.1	2.4	2.4	1.3	1.2
Japan	0.6	0.8	1.3	1.3	0.8	0.8
Australia	2.3	1.6	2.6	2.4	2.4	2.4
Canada	1.1	1.1	2.0	2.0	1.9	1.6
China	6.9	1.5	6.5	6.6	1.9	1.6
India	7.5	5.0	7.8	7.3	5.3	5.0

According to Mr. Greenwood, "my long-standing view has been that the current global business cycle expansion will be an extended one." He supports his view by noting that slow world growth and low commodity prices are holding inflation at bay which allows the world's central banks to continue their pursuit of growth-oriented policies. He also notes that although the U.S. recovery is already 6½ years old, only now is it "starting to take on the typical characteristics of a normal recovery — banks are starting to provide credit instead of the Federal Reserve, business investment is recovering, and consumer spending is regaining its normal momentum." His key takeaway: "In 2016, we expect collective monetary and fiscal responses in the Eurozone, Japan, and China to combine with an improving U.S. economy to produce a slightly better global economic environment than in 2015."

DEVELOPED MARKETS MAY WITHSTAND EMERGING MARKETS TURMOIL

Mr. Greenwood makes an interesting point about the performance dichotomy between emerging and developed markets. While he recognizes that certain companies and sectors will suffer due to the slowdown in emerging market economies, he believes the transmission of key fundamental forces such as monetary policy and balance sheet repair "still goes primarily *from* developed markets *to* emerging markets, not vice versa."

"FEAR INCONSISTENT WITH CONDITIONS IN THE U.S."

Even though the Fed has begun raising short-term interest rates, market strategists at mutual fund sponsor Lord Abbett also think the U.S. is actually poised for better growth during 2016. While this may be surprising or even sound naive, Lord Abbett believes the recent wage growth that finally showed up in the October and November employment data will continue to support consumer spending throughout 2016. In 2009, about 6.8 applicants vied for each job opening, but after years of employment growth, that ratio has improved to about 1.4:1. Now that demand for labor is much better aligned with the supply of it, further wage growth seems likely. In an environment of cheap energy and low inflation, this wage growth should translate into increased consumer spending — further aiding the dominant component of the U.S. economy.

While there's no denying that the oil pumping competition between the U.S. and Saudi Arabia continues to hurt the energy sector, ultra-low energy costs directly aid transportation-related industries and indirectly aid most other industries except for alternative energy competitors who will have a harder time competing.

And, don't forget the consumer. Every dollar not needing to be spent at the gas pump becomes available to be spent or invested elsewhere. Cheap energy is an undeniable stimulant and from what I can tell, the cheapness of that energy seems likely to continue through at least this year.

Much of corporate America has cut costs since 2008/9 and many companies are flush with cash. Banks are generally capitalized well in excess of regulatory requirements and stricter banking regulations would seemingly reduce the likelihood of banks getting into large-scale trouble and households within the U.S. (hope I don't regret writing that).

Households have greatly improved their financial situations since the financial meltdown and they continue to do so.

Fiscal spending increases are another source of incremental stimulation that's set to increase within the U.S. A budget agreement passed in November will increase overall spending by $50 billion this year and by another $30 billion next year. Last month, a front-end loaded, 5-year highway spending bill was passed that will boost infrastructure spending by 10% this year followed by smaller increases over the next four years.

According to Lord Abbett market strategist Zane Brown, "fear in the marketplace seems inconsistent with U.S. economics."

EUROPE "MOVING FORWARD"

Growth in Europe was slow during 2015 and inflation remains stubbornly close to zero. Europe must still contend with Greece's debt overhang, refugees from Syria, rampant terrorism, and double-digit unemployment in many of its countries, but central bank policies matter a lot and the European Central Bank (ECB) continues to push strongly in the other direction. In addition to regular infusions of liquidity, the ECB reduced the rate it pays on its member-bank deposits from an already *negative* .2% per year to an even more *negative* .3% per year. The ECB clearly wants its member banks to lend money to the public.

Although the ECB has signaled that it will continue its growth-oriented policies well into 2017, signs of improvement are already apparent. Recent manufacturing and new-orders data showed the best monthly improvement in a year and a half and most of Europe's leading countries have seen some growth. Zacks Research regards Europe as "moving forward" and expects conditions to further improve during 2016. As such, we are inclined to maintain our exposure to European equities.

SELLOFF IN LOWER-QUALITY DEBT

The credit quality of borrowers tends to vary over the course of any given economic cycle, tending to deteriorate near the end of an economic expansion. In an attempt to leave the party before any dishes need to be done, investors generally try to sell their lower-quality debt prior to the time a recession begins.

Of course, this selling pressure drives bond prices down even in cases where a recession does not actually materialize.

In December, investors dumped mid– and lower-quality fixed-income instruments and fled to Treasury securities. Was that a recession signal, or a misfire? Are the consensus GDP figures that appear on page 5 out of touch with reality? They could be, but since market behavior is often guided more by emotion than well-reasoned intellect, I'm inclined to favor the opinions of professional researchers even though I freely admit that they have had a tendency to be overly optimistic. However, I definitely do not trust the opinions of chartists or market technicians, Internet publishers masquerading as legitimate researchers, anyone who trades in revealed secrets, or anyone who seems to make a living out of scaring people ("permabears").

Lord Abbett investment strategist Brian Arsenault put it succinctly when he wrote, "a recession is not our base case for 2016" as did Zacks Research when it characterized the recent sell-off in fixed income as "overblown."

ECONOMIC DATA VERSUS STOCK RETURNS

Regardless of anything I've written here, please bear in mind that the relationship between economic performance and the returns generated by stocks is, at best, tenuous. — Glenn Wessel