January 21, 2016

The Markets Might be Volatile, but the Data is Getting Steadier
Market & Strategy Update

With the market volatility that began last August, which lasted through September, and with its return at the beginning of this year, it is easy to get caught up in the "fear feedback loop" of fear-mongering rhetoric and doomsday speculation, but the reality of what is going on behind the scenes is actually much more sedate and positive. There is little doubt that the Fed's decision to raise short-term interest rates was a historic event, and it marks the end of an era, but its implications are not as straight forward, or as dire, as many have tried to portray it to be. This new direction is about "normalization", not "decimation" of the capital markets.

"Fear Feedback Loop"

What is the "fear feedback loop"? It goes something like this:

1) **China's stock market falls over 50%** - This is interpreted as a signal of a much deeper economic decline than is reported by government statistics.
2) **China devalues its currency** - This is viewed as a "desperate attempt" by Chinese authorities to avoid an economic "hard landing" by making their exports more attractively priced.
3) **Oil drops more than 50%** - This is interpreted as further support for the notion that global growth is "collapsing" with China leading the way to the bottom.
4) **Global stock markets fall** – This is a clear sign to some that a "contagion" is underway and that China's problems will not be contained within their national borders…"all is lost".
5) **China's stock market falls further, the Yuan falls further, the price of oil falls further and/or the global equity markets fall further** and this additional selling pressure in one area causes selling pressure in one or more of the other three and then the process if further perpetuated.

When or how will this stop? When enough people inclined, and capable, of selling, do, and when others realize what a mistake that truly was because the apparent correlations were not causations and that "rhetoric" and "reality" sound somewhat the same, but that is where the similarities end.

"Fact Feedback Look"

1) The domestic Chinese stock markets rose over 100% in less than one year due to an ill-conceived plan by Chinese officials to encourage Chinese nationals to invest in stocks, which is generally a bad thing to do in any country, but it especially bad when the investors have little stock market experience, have limited investment options, are using leverage and are emboldened by the implicit guarantee that the government is going to help them make money.

   When something unjustifiably rises 100% or more, it has to fall 50% or more to return to where it should have been in the first place, and that is exactly what has happened:

The Harvest CSI 300 A-Share ETF (ticker: ASHR; black line) is representative of the domestic Chinese stock market, where the participants are primarily Chinese nationals, and the iShares FTSA Xinhua China 25 Index ETF (ticker: FXI; blue line) is representative of Chinese stocks that are traded in Hong Kong, a market in which the participants are more global:

As you can see, the ASHR rose almost 140%, but it has now almost returned to within 20% of the FXI, which is/was probably a more fairly valued market given its more diversified participants. It is likely that as the ASHR approaches the "fair value" indicated by the FXI that the pace of decline will abate, and with it many of the fears centered around China's economic growth prospects.

<u>Additional Note</u>: After all that volatility, the ASHR is now largely unchanged from two years ago and it is also largely tied with the S&P 500 (gold line) over that period.

2) One of the frequent criticisms of China is that they are not sufficiently "market-based" and that they try and control too much of their economy. China's recent decision to allow the Yuan to devalue was more of a "market-based" adjustment than a "communist-manipulated" one. Their economy has slowed and so there is not as much investment capital coming into the country (in relation to their much larger economy) as there once was. Trade has slowed so there is not as much cash coming into the country from export sales. Great wealth has been created in China and understandably many wealthy Chinese want to move some of their wealth to other markets, causing an exodus of cash. The U.S. has ended quantitative easing and has started to increase short-term interest rates. This supports U.S. dollar strength and causes other currencies to weaken relative to it. The less government-controlled "offshore" Yuan has been weakened in response to all these factors and the Chinese government's decision to lower the official "fix" was simply a response to market pressures. It is also important to keep the size of

the devaluation in perspective. The below chart shows that the Yuan fell (declining line indicates strengthening currency and vice versa) about 25% from 2006 to early 2014. Since that time it has only retraced about a quarter of that appreciation:

Fun Fact: Renminbi means “people’s currency” and is the official name of China’s currency, much like the British “sterling”; the “yuan” is the monetary unit much like the British “pound” (i.e. you would pay someone 5 yuan, not 5 renminbi, but if someone asked what currency did you pay the other person with you would say “renminbi”)

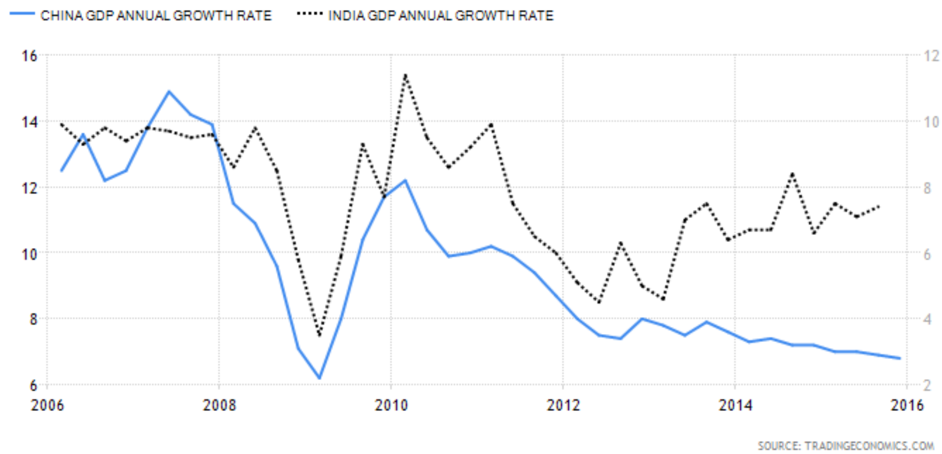
3) The decline in the price of oil is much more about geopolitics (i.e. Saudi Arabia trying to maintain market share and not fund its enemies such as Iran) and technological innovation (i.e. fracking, computer-aided direction drilling, improved seismic imaging, electric cars, hybrid cars, more efficient heating systems, more efficient jet turbines, etc.) than it is about slack demand due to subdued global economic growth. Even before the financial crisis, global oil demand growth was only about 1-2% per year. The combined effects of dramatic oil production increase and greater efficiency, not to mention the switch over to much cheaper natural gas in certain areas, have led to this plunge in oil prices. These lower oil prices will lead to oil industry layoffs, credit defaults and bankruptcies, but billions of people, and the energy-intensive industries of Europe, the U.S., Japan, China and India, will enjoy economic benefits much larger than the losses suffered by those directly employed by the energy industry.

4) Stock markets correct about 10-15% every couple years…on average. The S&P rose for over three years without a 10% correction and now it has had two in six months…back to average. The stock market tends to suffer a negative return year every 3-4 years. In the 90’s we had 9 years of positive returns and then three consecutive negative years…back to average. Stocks tend to provide an average total return approaching 10%. In the 90’s, the S&P 500 provided an average total return north of 18% for about a decade. In the Subsequent 10-year period it provided an average return of about negative 1%...back to average. How long is “long-term” when talking about investing? Most would say at least five years, but sometimes even five years is “short-term” when a powerful trend is in place. The point being that one

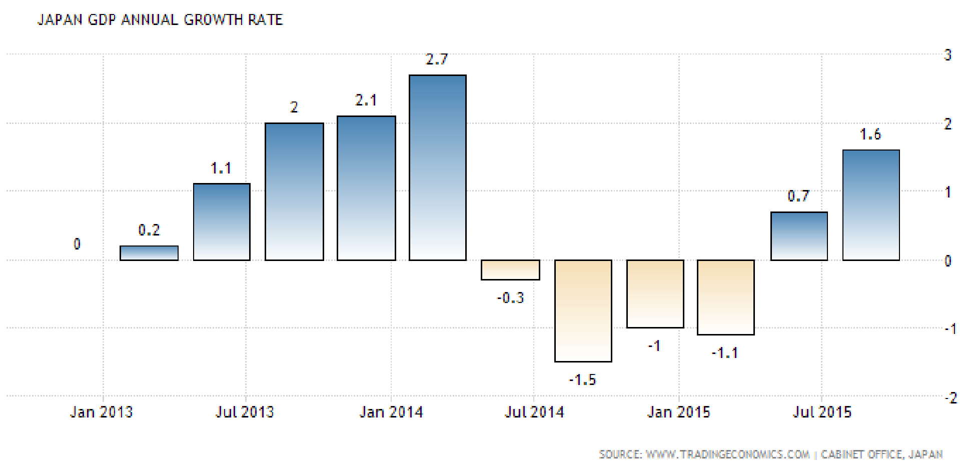
should not interpret volatility in isolation as a sign of some impending doom when what it really is just the "averages" working their magic.

<u>"If volatility is giving a "false" signal than what is the truth?"</u>

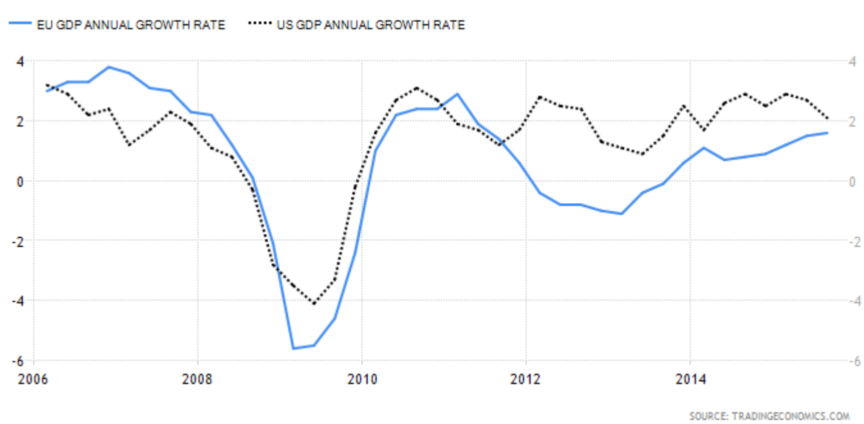
China's growth is slowing to a more sustainable rate, but its deceleration is moderating. Perhaps more interesting than China's growth is that India's growth is accelerating and it is now growing faster than China:



Japan has returned to growth and it is also accelerating:



GDP growth in the Euro area continues to improve and is about to be growing faster than the U.S.:



Strategy Implications

The volatile transition the capital markets are trying to work their way through is part of a "normalization" process not a "decimation" process. The term "decimation" is appropriate here in that "decem" means "ten" in Latin and most all risk asset classes have fallen by more than 10%. Also, the term "decimate" is generally used to describe the "infliction of great destruction" and that is what many investors feel that they are witnessing, but unlike the origin of the term (i.e. a form of military discipline whereby senior commanders in the Roman Army would order the execution of every "tenth man" as punishment for capital crimes committed by a large group), this is not a process of destruction or punishment, it is a process of building new global economic and equity market leadership.

The landscape of energy production, distribution and usage is changing very rapidly. Countries/regions like the Middle East, Brazil, Argentina, Venezuela, Russia and parts of Africa are going to have to reengineer their revenue generation to be less dependent upon energy production as both technology and U.S. production/exports reduce their economic power. China will continue to be a major driver of global growth, but it will need to do that more from its domestic economic activity than by being the world's low cost manufacturer. Europe is getting its footing back and it will be a major player in assisting many of the energy commodity export dependent countries in reshaping their economies. Japan's sun may rise again after decades of stagnation via its technological expertise that will be in more demand than ever as the emerging markets "emerge". China pulled itself out of a half century of ideological retrograde to become the second largest economy, and as a result showed other countries (that were reluctant to adopt pure American-style capitalism) that there is a "middle way". India is "moving on up". It is not only growing faster than China, but its population is younger and is expected to exceed that of China within the next ten years.

The current market turmoil is not indicative of the end of the U.S. economic expansion or of the collapse of the S&P 500. It is a result of too many taking the uncomfortable, but easy, path to embrace fear. It is the result of China trying to "grow up". It is about an abundance of energy that can help many countries with billions in population grow faster. It is about energy-commodity export dependent countries facing the reality that they need to develop their people, their infrastructure and the dynamics of their economies more than their oil fields. It is also about averages working their "magic".

The S&P 500 has dominated global equity market performance scene for over four years and it is time to pass the baton. Europe, Japan and India are some likely candidates to begin to outperform, but there may be some unexpected rebounds in the equity markets in Brazil, China and/or Australia if there is even the slightest lifting of the pessimism that has ravaged their markets. Perhaps more surprising than the prospect of strengthening emerging market equities is that some of the broader commodity indices are performing as well, if not better, than the S&P 500 so far this year, despite significant weights in oil, because some of the "soft" commodities and precious metals are starting to "peel off" from the commodity complex which for the past couple of years has fallen largely as a group. This will call for a highly focused, and patient, entry into narrow parts of the commodity asset class if this trend continues and strengthens.

There have been many opportunities created by both the underperformance of most asset classes relative to the S&P 500 over the past four years, as well as the recent sharp correction, so now is not the time to close one's eyes, or look away, but to…

"Look to the Future, be Optimistic…but Hedge."

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