January 2016

A Weak Start for 2016

Last August, U.S. equity markets corrected for the first time since 2011. The proximate cause at the time was weakness in China, potential action by the Federal Reserve and the declining price of oil. Through the fourth quarter of 2015, risk markets shrugged off these factors, recovering to levels within sight of all-time highs. However, as we closed out 2015, markets started to pull back again. That trend has continued into the New Year and has resulted in a very weak start to January.

At the time of this writing, global equity markets are trading down again. If markets closed at the current intraday trading level, the S&P 500 would close down approximately 8.5% on a year to date basis at a level approximately the same as the August 25, 2015, closing low. This would represent a drawdown of about 12% from last year's highest closing level. In other asset classes, the damage has been more acute. The Russell 2000 small company index has entered bear territory, off more than 22% from the 2015 high. International developed markets are similarly off near 20%, and Emerging Markets have declined nearly 30% from their peak.

Before we examine the causes of this current round of volatility (hint: they are not that different from last year), some context for market downturns may be helpful. First, since 1971 (45 years), there have been 18 years where January returns were negative ranging from -0.56% (1984) to -8.43% (2009). Of those 18 years, 10 ended with positive returns for the full calendar year (including 2014 and 2015), while 8 ended with negative returns. Purely from a statistical perspective, a negative return in January leaves roughly a 50/50 chance that the full year will be negative. Unfortunately, it does not provide a clear signal. Neither does the extent of the January drawdown as two of the most limited drawdowns ended with two of the worst years, while two of the worst drawdowns ended with positive returns. However, a negative January does have notably lower odds than the 96% of years that ended positively when January was positive, which suggests investors should be cautious.

The main causes of the current round of volatility are not that different from the selloff experienced in August: weakening growth in China, realized action by the Federal Reserve, and the continuing decline in the price of oil. An additional factor to consider is equity valuations which no longer contain any buffer for shocks. We will take each of these in turn.

Weakening Growth and Demand in China

The Chinese economy is undergoing a transformation from a manufacturing and export driven economy to a domestic consumer oriented economy. As that transformation takes place, China is importing less and exporting less. China is also a significantly larger economy than it was a decade ago, and growth at double digit rates simply cannot continue. Estimates suggest the Chinese economy may slow to 6.5% growth in 2016, though many economists believe the real growth rate will be much slower than the official number reported by the government.

Over the last year, as growth has slowed, Chinese imports have fallen by more than 10%. This means countries that are dependent on export sales to China are under pressure as the Chinese simply are not buying as much. In part, this is due to an appreciation in the Chinese currency as a result of their peg to the U.S. dollar. Last August, the government loosened the peg and has allowed the currency to depreciate. The impact of this action is two-fold. First, the lower exchange rate value should and has helped to bolster Chinese exports (although it remains to be seen if the bump was a seasonal anomaly or if exports have actually recovered). However, a lower exchange rate is also a negative for foreign capital investment, in particular because it adds uncertainty to the future value of those investments.

China has been responsible for one-third to one-half of global GDP growth recently, and a slowing China bodes poorly for continued global growth.[1] Fortunately, China has a significant foreign reserve account, which it can use to stimulate the economy. However, stimulating an economy that is rotating to domestic consumption is very different from stimulating a manufacturing-based economy by adding to infrastructure spending. Furthermore, the government does not have extensive experience running a consumer-based economy, and there is a risk of policy error by the Chinese government. Overall, expectations are that China will avoid a hard landing, but there will be shocks along the way as the economic transformation continues.

An Error by the Federal Reserve?

Following years of speculation as to when the Fed will initiate a rate increase, the Fed finally acted in December by increasing the federal funds rate range by 0.25%. The amount of the rate increase is not as significant as the fact that it is an inflection point in monetary policy. In particular, the inflection point is important because it puts the U.S. on a different track from much of the globe – The European Central Bank remains in easing mode and recently has extended its commitment to asset purchases into 2017; China has been cutting interest rates; the Bank of Japan has continued in easing mode.

Economists are split on the Fed action. Many argue that the shift in policy was overdue and that equities have been propped up artificially by low interest rates. Others suggest that the Fed acted prematurely in the context of a global economic environment where growth has only recently started to strengthen. To some extent, this latter argument suggests that the Fed monetary policy is really stimulating to the entire global economy, not just the U.S. Of course, the Fed mandate is to foster full employment along with price stability (targeted inflation) in the U.S., not to stimulate foreign markets.

[1] "A Global Recession May be Brewing in China," *Wall Street Journal*, August 16, 2015

When the Fed made their decision in December, it appeared the U.S. recovery was back on track and unimpacted by weakness out of China. In fact, the December labor report was the best labor market initial report for all of 2015 in particular because the report revised up the strength of October and November. However, since that action there has been clear deterioration in the outlook for China and the potential for a slowing China to impact the nascent growth being experienced in Europe and other markets. Through most of last year, the Fed indicated it would consider the impact of foreign developments, and foreign developments likely will be a significant factor under examination at their January end policy meeting. It is unlikely that the Fed will cut the rate back to 0-0.25% at their January meeting, but look for guidance of an even more gradual pace of rate hikes.

The Sliding Price of Oil

The price of oil has continued to slide from a brief rebound experienced through the middle of 2015. Most recently, both the U.S. and international benchmark rates have slid to trade below $30 per barrel. This price level has been a shock to the system as most analysts had projected a price recovery to between $60 and $75 by year end 2015. Instead of recovering, oil prices have continued to decline.

The proximate cause of the decline in the price of oil is a world that is oversupplied relative to global demand. As U.S. production more than doubled since 2007, the normal balance in oil markets has been disrupted. Prior to 2014, these disruptions were somewhat muted as increasing U.S. supply was offset by supply disruptions in the middle east as political turmoil resulted in a slowdown or complete shut-down of oil production coming out of certain countries (for example Libya).

With much of that production coming back online, and in particular with Iran set to start selling oil based on the nuclear non-proliferation deal it has signed with much of the world, supply has continued to outpace demand. While the oil story has mostly been supply related, there is also concern that the price is low as a reflection of oil trader's lack of confidence in future demand growth. In short, if traders think the global economic outlook is weaker than consensus expectations, that suggests lower future demand and therefore a lower equilibrium price for oil.

Here at home, the lower price of oil was the main source of negative earnings growth for the S&P 500 in 2015. Energy stocks, as a group, saw earnings decline by nearly 60% through 2015, dragging growth for the entire index into negative territory despite commendable earnings growth in technology, financials, healthcare, and consumer discretionary stocks. A point of frustration is that the lower price of oil, which has resulted in an energy dividend via fuel cost savings, has not yet resulted in a boost in spending by consumers or in earnings by energy consumers.

The price of oil could fall further and stay down longer than expected. However, it should also be noted that capital investment in the energy sector has been slashed versus planned expenditures. The U.S. rig count (number of wells actively being drilled) has fallen by more than 70% since the 2014 high. Furthermore, at a price below $30, it becomes unprofitable to extract oil via fracking.[2] The near shut-down of capital investment and lack of profitability suggests U.S. supply (as well as Canadian supply) is likely to decline soon. Falling North American supply may lend support to the price of oil.

[2] "How Low Can Oil Prices Go," Capital Economics, 1/15/2016

Lack of a Valuation Buffer

The bull market which started in March 2009 has continued for longer than average. Near the bottom of the cycle in 2009, the price/earnings ratio (P/E) for the S&P 500 had fallen to approximately 10x earnings. That means investors were willing to pay $10 for $1 worth of earnings. Such a low valuation reflects a high degree of uncertainty associated with future earnings. As earnings recover, and more importantly, as certainty of future earnings increases, the price that investors are willing to pay goes up. This is known as multiple-expansion. Historically, the P/E ratio has averaged closer to 16x earnings. Depending on the source, the P/E ratio has recently climbed to between 17x and 19x earnings, which is slightly above the historical average but not near prior peak valuations.

With the current downturn, the P/E ratio has fallen back near the historical average. At a normal P/E, investors are more sensitive to any potential shocks to earnings than at a low P/E. In theory, if earnings decline by $1, investors have more to lose at a higher valuation than at a lower valuation. Therefore, market volatility should be higher when price multiples are higher. With valuations near the high for the current recovery that means the buffer of a lower valuation, which has existed for most of the current recovery, is gone. In this context, the recent volatility can be explained by considering that uncertainty whether earnings growth will be as strong through 2016 and 2017 as initially projected has increased. It is unclear how much China slowing will impact earnings, it is unclear how much Fed policy will impact earnings, and it is unclear how much the continuing low price of oil will impact earnings.

What Does This Mean for Investors?

Over the course of the current bull market, risk assets have overcome multiple periods of uncertainty. There has been the risk of a Greek and Eurozone collapse, the U.S. credit rating was downgraded as the world expected a potential default on U.S. debt andperipheral Europe faced deep recessions and weak budgets. Today, the U.S. continues to grow, most of Europe is out of recession and growing, Japan is growing under Abenomics, and China continues to grow (albeit at a slower pace). Here in the U.S., employment has been growing, consumer confidence has continued to increase, earnings would have grown if not for the energy sector, housing has continued to recover, and low energy costs lend support to family budgets. While current concerns suggest there are risks to growth, overall, that risk appears skewed towards a slowing of growth, not of negative growth or a recession.

Market downturns can be frustrating and painful. Unfortunately, there is no method of market evaluation which has been proven to consistently predict a downturn, the depth of a downturn, or the ensuing recovery. Historically, diversifying a portfolio between stocks and bonds has provided the best method to reduce overall portfolio volatility. Through the current downturn, fixed income securities (bonds) once again are holding up better than equities and helping to limit portfolio downside. Attempting to time markets through a downturn has generally resulted in poor results for investors as most investors miss the turn in the market and end up reinvesting at market levels above their exit point. Beyond portfolio allocation, making sure that investors have adequate short term cash needs, perhaps 6 to 12 months of expenses, can help to delay the need to sell any assets through a down market.

Perhaps the best way to limit the pain of a downturn is to understand what the downturn means for your financial goals. If the current market volatility has you concerned, we advise talking to your HD Vest Advisor to discuss your concerns and to build a financial plan.

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