Insights: September 2015

Market Overview and Performance

In last month's Insights, we talked about how the stock market, mired in a sideways trading range for months, had left many investors complaining about an overall sentiment of boredom and complacency. Well, that outlook certainly changed during the month of August. The equity market broke out of its narrow path, unfortunately to the downside resulting in the first ten percent correction in the S&P 500 in over four years.

Ironically, many investors had previously fretted about the fact that the equity market had gone so long without a ten percent correction. Once the downdraft occurred however, it clearly was not welcomed as a good sign. Last month, we wrote that a return to a focus on fundamental drivers of the markets rather than global macro events would be a healthy development in the long term and we continue to hold that view. Of course, despite the warning signs in the Chinese equity market that we first pointed out in April, the recent sharp pull back in their stock market proved to be surprising enough for some to reconsider their positioning.

We would argue that much of this concern is misguided and overdone as we will discuss, but it does come at a curious time when we are at the cusp of the Fed initiating the move off emergency level interest rates. As the summer comes to a close, it certainly appears like we are poised for an interesting autumn. If anything, increased volatility should be able to keep "bored" investors enaged for a while.

	Month to Date	***Year to Date***
Equity	***Percentage Change (USD$)***	***Percentage Change***
S&P 500 Index	-6.03	-2.88
Russell 2000 Index	-6.28	-2.97
MSCI EAFE Index	-7.36	-0.21
MSCI Emerging Markets Index	**-9.04**	**-12.85**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	-0.14	0.45
Barclay's U.S. Credit Index	-0.23	0.20
Barclay's Corporate High Yield Index	-1.74	0.15
Barclay's Municipal Bond Index	0.72	1.04
Macro Measures		
Gold	3.42	-7.52
Crude Oil	4.41	-11.54
CBOE Volatility Index	**134.57**	**48.07**
USD Dollar Index	-1.30	6.26

September Themes – Return of Volatilty; China Contagion Concerns Intensify; Timing of Fed Rate Hike Still a Wildcard

Equity Market Breaks out of Sideways Trend

For much of the summer, we have been writing about how complacent the equity market has been, seemingly in a holding pattern as investors wait for clear guidance on the right path forward. Even in the face of massively disruptive events like the potential break-up of the European Union via a Greek exit, the market simply bounced along without any real movement either up or down. In truth, the market has been "waiting" for three years for several key developments that are now at our doorstep – the initiation of a rise in interest rates, a slowdown in the Chinese economy and a pause in the relentless march higher seen in the U.S. equity markets. Given this back drop, it's not surprising that we have experienced a spike in volatility as all three of these events are now apparently occurring simultaneously.

The impetus for the sell-off in the U.S. was clearly the rapid collapse of the Chinese stock market punctuated by a yuan devaluation on August 11th. Before we discuss the events in both the U.S. and Chinese markets, it's helpful to take a step back an get some context.

As you can see in the chart at the bottom of the previous column, the Shanghai Composite had trailed the S&P 500 by a wide margin for the better part of the last four years. Within the last 12 months however, the Composite rallied over 120 percent, rapidly erasing the performance gap between the S&P 500 before moving sharply lower. The ripple effects were clearly felt across global markets, but as we will discuss, our feeling is that much of the concern has been severely exaggerated based on the fundamentals in place.

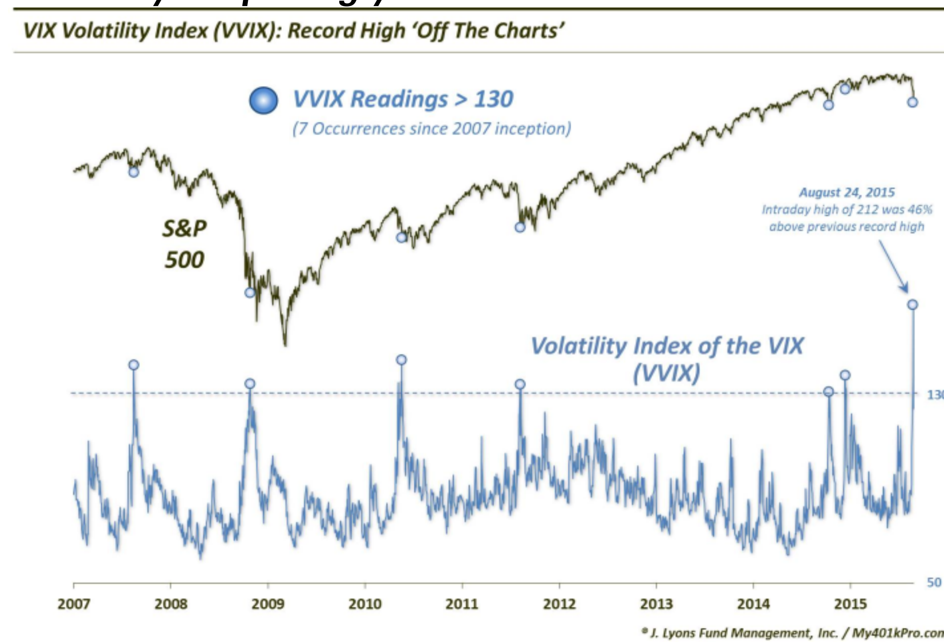
With regard to the long awaited ten percent correction here in the U.S., we would like to stress just three points. First, nothing has changed within the economic backdrop of the U.S. Second, the volatility seen in the market was tremendously outsized relative to what was actually happening. And third, market pullbacks are frequent occurrences (averaging roughly one per year going back to 1900) and the typical performance in the months following has been solidly positive.

Further on the last two points, consider the charts below. The first graph highlights the fact that the VVIX Index, a measure of the expected future volatility in the markets soared way beyond the financial crisis levels and 46 percent above the previous record high. There is no basis for this.

Chinese Stocks Catch up to S&P 500 Before Crashing

Source: Thomson One; S&P Dow Jones

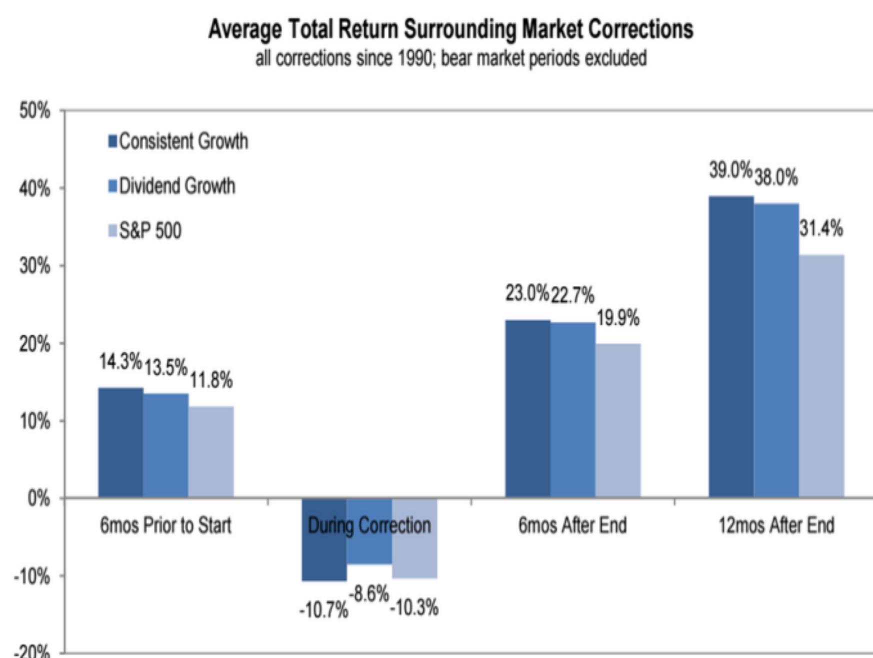
Volatility Surprisingly Far Above Previous Crisis Levels



Source: J. Lyons Fund Management

And despite all the talk on television and dire news headlines, historically, a typical ten percent pullback in the market has not resulted in a bear market, but rather, a strong rebound in the following six to twelve months.

Market Tends to Rebound Solidly After Corrections

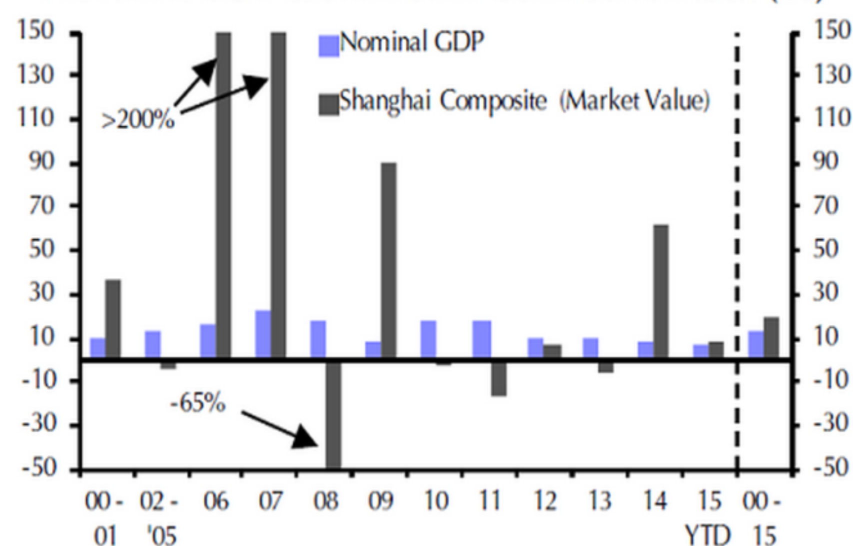


Source: BMO Capital Markets Strategies Group; Factset; IBES

A Closer Look at China

One of the main reasons we feel that the sell-off spurred by China is not a crisis event is because much of what is going on within the country and its possible effects on the global economy are misunderstood. Starting at just the stock market index level, we among others had flagged the growing bubble in the Shanghai Composite back as early as April and the Index itself actually peaked in early June. So these concerns are nothing new. While the Index has fallen roughly 37 percent, as mentioned earlier, it had been up over 120 percent over the previous twelve months so gains are still present. More importantly, the Shanghai Composite is a largely domestic market dominated by unsophisticated retail Chinese investors. As a result, its movements have little impact on the Chinese economy itself and essentially a negligible effect on foreign investors more broadly. Consider the following chart from Capital Economics. It clearly demonstrates that the performance of the Shanghai Composite is in no way related to the annualized GDP of China.

Chinese Equities Not Reflective of Overall Economy



Source: Thomson Datastream;Capital Economics; WSJ

So why all of the turmoil? From the media coverage, it sure seemed like there was a growing global panic, yet safe harbor assets like gold and bonds haven't really moved much, nor has the Dollar which would ordinarily rally if the rest of the world looked vulnerable.

Clearly the concern, although somewhat misguided when speaking in relation to stocks, is that China's economic growth prospects have diminished. And this is true. China is no longer growing at the double-digit pace it once was, however, as the economics team at Bank of America phrased it, the stock market headlines are "blotting out the sun" pulling investor attention away from what are some very reasonable consequences of the transition currently occurring in the Chines economy. As the world's number two economy concerns about a slowdown are warranted, but once again, this is not new news.

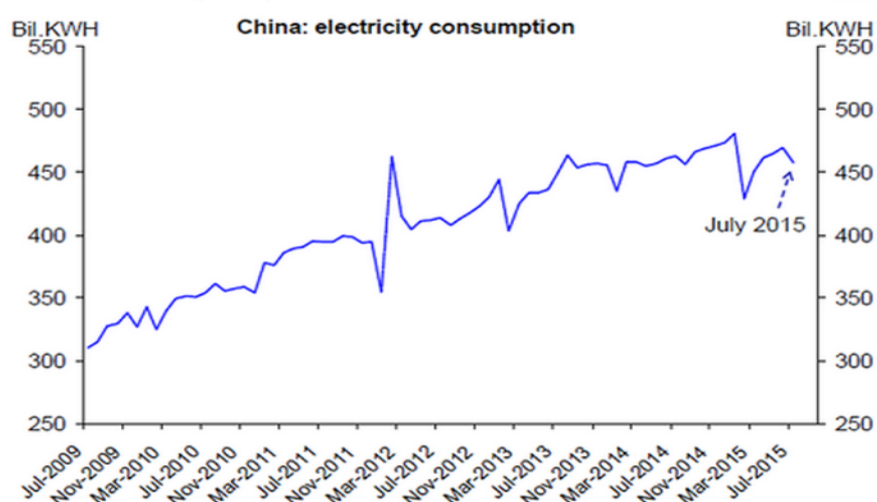
After already having built itself into the only other $10 trillion-plus economy outside of the U.S., China is now at a pivot point in its evolution where it is transitioning from a manufacturing economy to a service oriented one. And despite some road bumps along the way, progress has been made. For example, according to Merrill Lynch, the services component which overtook industrial activity in 2012, now accounts for roughly 50 percent of China's GDP.

Additionally, service activities grew by 8.4 percent in the first half of the year compared with 6.1 percent growth in manufacturing. These trends look to continue as consumption as a percent of GDP remains a very low 38 percent and indicators like retail ecommerce, growing at 40 percent this year, suggest more consumer behavior as a catalyst going forward. Keep in mind that although the pace of growth is slower, the sheer size of the Chinese economy makes its more "muted" growth pace still significant. According to Merrill Lynch, even a four percent growth rate in China would be equivalent to eight percent growth in 2007 when Chinese expansion rates had peaked at 14 percent.

Furthermore, despite the government's commitment to an initiative of market reforms and structural overhauls that will be a near-term drag on growth, the Chinese economy is showing signs of resilience if one simply looks beyond the much criticized official GDP numbers. As Deutsche Bank illustrates in the chart below, fundamental evidence of activity like electricity consumption show no signs of a "hard-landing" economy. (In fact, electricity consumption grew an additional three percent in August, well beyond expectations).

Other anecdotal evidence like urban home prices rising one percent in August for the fourth consecutive month and urban job growth averaging over 13 million (government target was 10 million) add to the body of evidence that the economy is not in "free-fall" as some have suggested.

Underlying Chinese Indicators Don't Point to Crash

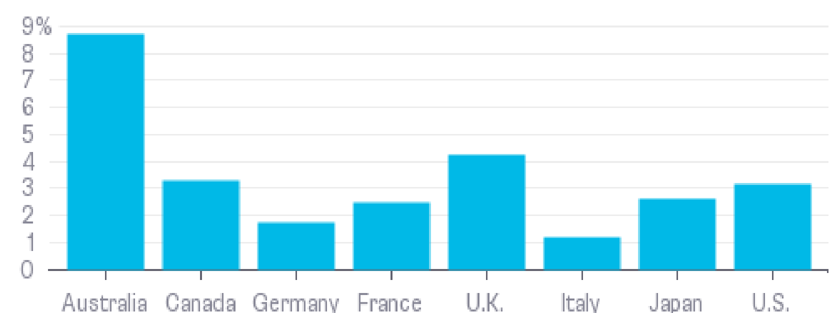


Source: Deutsche Bank Global Markets Research; CEC; Haver

Contagion Effects?

Although we are not believers in a China hard landing scenario, there are risks present and we believe that conflicting information from China will remain a source of volatility for some time to come. However, we fail to find legitimate evidence for the argument that a slowdown in China will adversely impact the global economy in a crisis fashion. History is a good guide here. Unlike periods in the past, global financial institutions have very little exposure to China as a portion of their overall foreign exposure as seen below.

Foreign Bank Exposure to China is Limited



Source: Bloomberg; Bank for International Settlements

Looking beyond banks alone, Goldman Sachs has estimated that roughly one third of S&P 500 companies' revenues come from abroad and only two percent of that is derived from China. They also estimate that exports account for just 13 percent of U.S. GDP of which less than one percent can be tied to China. So risks to the momentum currently underway in the U.S. appear mild.

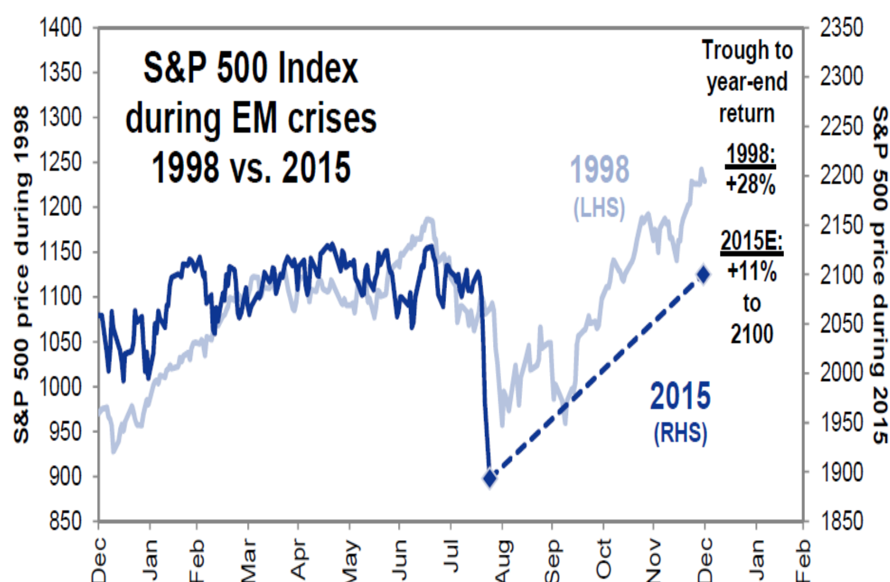
It's likely that the bigger worry to many is the possibility of a currency devaluation war given that the People's Bank of China just devalued the yuan in mid August. To be precise, the PBOC changed the way it values the yuan which allows for the market to play a larger role in the exchange rate. Pressure for this type of measure more towards free market dynamics has been building

for quite some time particularly in light of the fact that the yuan has appreciated nearly 15 percent against several major currencies (especially the Euro and the Yen) in the last year alone.

During past episodes, a devaluation of an emerging market currency had the domino effect of causing other neighbors to devalue as well in an effort to keep their exports competitive. This is what occurred in 1997-1998 throughout Asia. At that time, a series of multiple devaluations played out creating a snowball effect. Now however, China has largely signaled that this move is likely the only one for now, and unlike in 1998, Asian countries have very large dollar reserves. China alone has $3.6 trillion, a massive figure. One more narrative that adds to the yuan devaluation story is the influence of the International Monetary Fund. China is seeking to be added to a basket of currencies that the IMF uses to fund its lending reserves and the move by the PBOC helps bring them closer to inclusion. While this is not 1998 in many respects, some strategists such as Goldman Sachs have suggested that the pieces are in place for 1998-like recovery as the contagion crisis risks seemingly fade away.

Parallels to 1998 Sell-Off and Recovery?

S&P 500 index during Emerging Market crises: 1998 vs. 2015
as of August 24, 2015



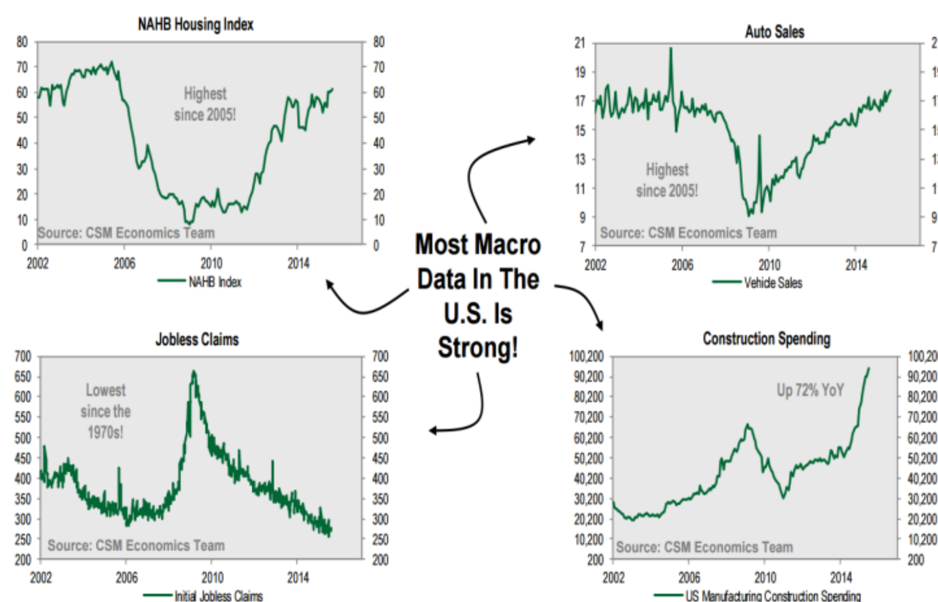
Source: Factset; Goldman Sachs Global Investment

The Fed and Interest Rate Increases

Given the sharpness and global nature of the sell-off in August, many participants have suggested that the Fed would be reluctant to begin the process of raising interest rates in the face of heightened volatility. In fact, the odds of rate hike projected by the futures market has dipped down from roughly 55 percent in early August to just 33 percent by the end of the month. While we can see the logic in this view, it is our position that the Fed will in fact raise interest rates at their September meeting.

There are several reasons behind this thinking. The most obvious is the fact that U.S. economy is undoubtedly strong at the moment. There are a multitude of indicators one could look at, but the collection of charts below from Cornerstone Macro highlight four pillars of the U.S. economy that are at multi-year highs. Housing, the labor market, construction activity and consumer spending together paint a very strong picture of economic health.

Housing, Jobs, Construction and Autos All Strong



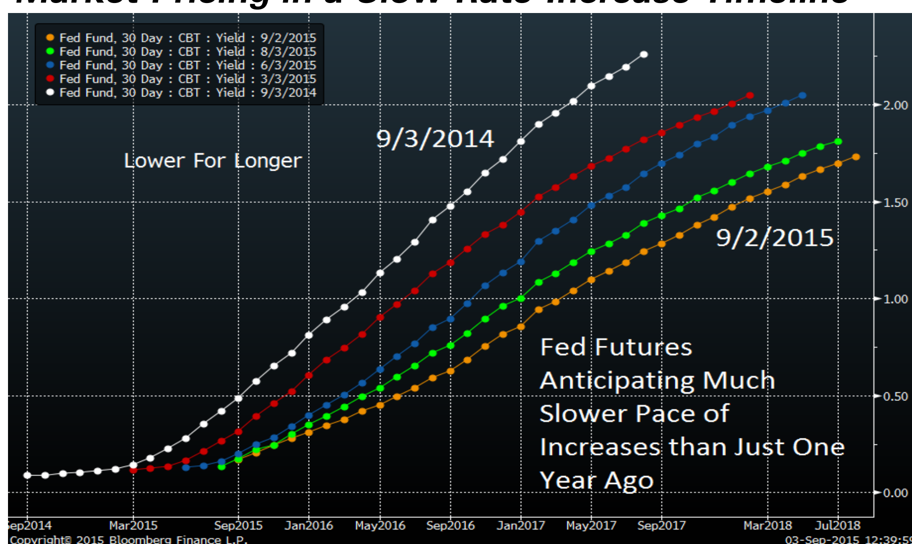
Source: Cornerstone Macro

The second reason we believe they will increase rates this month is because members of the Fed have been fairly clear in articulating their belief that the time is right. At their annual meeting in Jackson Hole in late July, Federal Reserve Vice Chairman Stanley Fischer stated that

"the door is definitely open to a September rate increase." This was followed by a speech from Jeffrey Lacker, President of the Federal Reserve Bank of Richmond, on September 4th entitled "The Case Against Further Delay" in which he argued that many of the targets set forth by the Fed for increasing rates had largely been met. He highlighted the fact that consumer spending growth has been rising at a rate of 3.1 percent over the last three months, that new jobs have averaged 213,000 per month, that the unemployment rate is 5.3 percent and that their preferred inflation measure, personal consumption expenditures, has grown at a rate of 2.2 percent since January. With regard to the current volatility, he added that "direct implications of recent developments for economic developments in the U.S. appear to be quite limited." All of which is to say that there is strong case within the Fed to increase rates now.

The last reason that may compel the Fed to move in September is simply because they really want to move off of the emergency level of zero interest rates that have been in place for six years now. We are clearly no longer in an emergency economic state. Additionally, the Fed would prefer to send the message to market that they are making policy decisions based on their stated criteria and are not beholden to the gyrations of the markets. So messaging plays a big role at this point, and what the market would like best is the uncertainty of the timing of the initial rate hike removed and the inference that the next move higher might not come for quite some time.

Market Pricing in a Slow Rate Increase Timeline



Source: Charlie Biello

Going Forward

Despite the recent market volatility, we are still constructive on equities both in the U.S and in developed markets abroad for the remainder of the calendar year. We believe that current price levels in certain segments represent good long term entry points. That being said, we anticipate further volatility in the near term. Historically speaking, the stock market experiences roughly sixty days of choppy behavior before moving to new highs following a ten percent correction. Additionally, September and October are historically weak periods of performance so we are closely monitoring developments for confirmation that the growth in the U.S. and the recoveries abroad remain on track.

Within equities we continue to favor the large cap segment of the U.S. market. We would prefer to achieve our exposure through cyclical areas of the market such as the technology, health care and consumer discretionary sectors which stand to benefit the most from a strong U.S. economy and a strong dollar. These sectors have fared relatively well so far this year. However, we continue to look for areas of future opportunities in areas such as the financial sector. We think this group is well positioned to benefit from a weaker dollar, higher bond yields and improving global growth and we will be looking to add to our exposure.

Our non-U.S. developed markets exposure has served us well this year. While we are still believers in the strong U.S. growth story, we think that international diversification through allocations to Europe and Japan in particular will allow us to participate in improving economic conditions globally. Both of these global regions continue to provide confirming data points on the progress of their respective recoveries and each remain in a very accommodative policy environment. We are encouraged by the progress of the recovery in the European Union and believe that Europe represents a good long-term investment opportunity. Additionally, Japan continues to make progress on its structural reforms and has given

confirmation of further measures to come.

We remain underweight traditional fixed income. With an anticipated increase in the Fed fund rate most likely coming in September, we continue to advocate an emphasis on less interest rate sensitive options available with shorter duration exposures and unconstrained strategies as a focus. Whether the first hike comes in September or December, the narrative is the same.

Commodities remain structurally challenged in our view. With oil moving sharply down from the mid $60 range back to the mid-$40 range in July and remaining there throughout August, we are carefully looking at entry points for long-term investments, however we continue to cautiously monitor this sector before increasing exposure given the global developments such as the recently requested OPEC meeting on the part of Venezuela and the visit of the Saudi Arabian king to the U.S. just last week.

Thank you for taking the time to read some of our thoughts this month. We look forward to speaking with you soon.

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