



# Portfolio Management Memo

## January 21, 2016

Everyone is keenly aware that the global stock markets are volatile right now. The financial media has piled on as well with headlines and stories that imply the market tumble will continue unabated over both the short and long term. While this has not been the case in the past, the stories often conclude that this time is different. As we write this memo, the S&P 500 is down approximately 7.7% YTD and foreign equity markets have fallen significantly as well. Markets in China, Australia, and Japan are all trading at or near bear market territory – down 20% from their highs. Is this abnormal? Consider the U.S. markets from 1950 through 2015: on average there has been a decline of 5% to 10% once every three years, 10% to 15% once every four years and 20% or more once every five and a half years. In other words, when taken into historical context, the downturn we are currently experiencing is not abnormal. However, we do understand that many investors, including some of our clients, become unnerved by the wild swings in the market and human nature leads us all to consider changing investment strategy in order to deal with the current market action.

Before taking action it is important to examine the drivers of the recent global equity sell off and to view these events in the context of a long term investor. Over the past several years, we have encountered many geo-political concerns that have negatively affected investor sentiment. We have had terrorist attacks in Paris and San Bernadino, civil unrest in the Middle East, military conflicts between Ukraine and Russia, and the near sovereign default of Greece. Each time it made for scary headlines and increased market volatility, only to be overshadowed by the next event or crisis. More recently (past weeks and months) we have had several significant economic related events that are having the experts question their models for inflation, economic growth, monetary policy and market performance. With that, we'll focus on these events to help you make sense of what is impacting the markets this year.

### **OIL**

Oil prices have fallen off a cliff, currently trading at around \$30 a barrel. This is a dramatic drop considering the price hit \$145 a barrel in 2008, and has not been under \$30 a barrel in nearly 12 years according to data from the U.S. Energy Information Administration.

The drop in oil is also strongly related to the supply and demand dynamics. Oil had been consistently around \$100 a barrel from 2010 through 2014 due to strong global demand and tensions within the Middle East that impacted supply. With oil trading around \$100 a barrel, U.S. shale production increased significantly – nearly 63% from 2009-2014. At the same time, OPEC (Organization for Petroleum Exporting Countries) decided to maintain their output in an effort to defend their market share by pushing prices down, thus eliminating high cost producers, specifically U.S. shale production. This has been a slow process, and supplies remain elevated as sanctions on Iran over its nuclear program are set to expire, adding additional supply to the market.

Meanwhile, demand for oil has been tapering off, most notably by China. While the Chinese economy grew at about 10% for the past 25 years, preliminary estimates for 2015 growth are around 7%. In 2014, the growth in Chinese energy consumption was negative according to statistics from Enerdata, the 1<sup>st</sup> time this has occurred in the last 17 years.

In the past, lower oil prices have been a positive for global economic growth. Today, the speed and magnitude of the decline is having negative effects as well:

- Weak demand may be a sign that global growth will contract. Additionally, many emerging and frontier markets are essentially petro-states that are entirely dependent on oil.

- Lower oil prices have slashed capital spending plans for many oil and oil related companies. According to consulting firm Wood Mackenzie, oil companies have delayed \$380 billion in new investments over the past 18 months.
- Many of the smaller shale producers are highly leveraged, and the falling price of oil has affected their ability to service their debt. The Bank of America/Merrill Lynch High Yield Energy Bond Index recently closed at the worst level in the indexes 20 year history.

The likely outcome is that the supply and demand will find an equilibrium price, above current prices and below the extreme highs of previous years. The stabilization of oil prices, as well as other commodity markets, will likely reduce the volatility that we have recently experienced.

## CHINA

Stocks in the largest economy in the world have entered bear market territory for the second time in seven months. Despite a variety of market interventions, the Chinese A share market continues to slide amidst heightened volatility. The chairman of the China Securities Regulatory Commission, Xiao Gang, recently commented, "The abnormal stock market volatility has revealed an immature market, inexperienced investors, an imperfect trading system and inappropriate supervision mechanisms." This was in response to perceived mismanagement of the Chinese markets and the implementation of "circuit breakers" meant to limit market losses, which have instead exacerbated selling pressures.

China has been an important source of global growth with significant spending power. Over the past several years, it has attempted to move from an industrial and manufacturing oriented economy to more of a service and consumption driven economy. This has suppressed economic growth which for many years was in excess of 10% annually. While 2015 GDP estimates have been around 7%, it is potentially even lower. Compounding this issue is the lack of reliability in the economic statistics generated from the Communist state. Investors do not have a clear sense of just how strong—or weak—the underlying Chinese economy may be. Furthermore, a weaker yuan has heightened concerns that the slowdown in China's economy is deeper than official data suggests.

The U.S. stock market represents 53% of the world stock value and China's stock market is about 3% of the global stock value as of December 2015. As previously noted, the Chinese economy has grown at 10% annually for 25 years, which is not realistic in perpetuity. It has been slowing for the past 3-4 years, so this is not necessarily a new story. Moreover, the Chinese A share market had increased significantly over the past several years. Including the 40% drop since June 2015, China's Shenzhen A share market is still up 90% over the trailing three years, or about 24% a year.

## EARNINGS, RECESSION AND BEAR MARKET RISKS?

US corporate sales and earnings per-share estimates are being revised downward in some cases with the worst write downs occurring in the energy sector. We are also seeing US multinational companies begin to report the negative impact of the strong dollar on their earnings.

Economic forecasting is a highly imperfect exercise. However, as of the most recent data, the leading economic indicators have not turned negative and this has always been a precursor to a recession. Interestingly, a decline in energy in the past is not normally associated with the start of a recession. If the US economy can avoid recession, it will increase the odds we will also avoid a prolonged bear market in stocks

## WHAT SHOULD YOU DO?

The long and short answer to this question is probably not much, assuming that your portfolio matches your risk tolerance. However, here are some things to consider:

1. **Remain diversified** – You are not invested in only stocks, but also in bonds, alternatives, and cash. These asset classes will not all move in the same direction or magnitude in the current environment.
2. **Maintain perspective** – Focus on the longer term and any financial planning we have done for you. We specifically examine and model these types of return scenarios.
3. **Resist the "recency bias"** - The "recency bias" is when individuals use recent experience as a baseline for the future outcomes. It is human nature - one of the greatest struggles for investors, and one of our greatest challenges.
4. **Understand markets are cyclical** – Markets go up and down, and tend to move in cycles. Volatility from time to time should be expected. Market timing and short term thinking are your enemy.

5. **Stick with your plan** – We regularly meet with our clients to discuss and review financial goals. Your investment portfolio is designed to meet your financial goals given your individual risk tolerance.
6. **Ignore the news** – The financial media, even prestigious and trusted publications, intentionally use alarming headlines with the goal of enticing the reader. There is no emotion more powerful than fear, and the media exploits this emotion at the expense of your financial well-being. We understand this is a difficult undertaking in today's "wired" world.

#### WHAT WILL WE DO?

1. **Remain vigilant** - We will continue to diligently monitor your investments and developments within the capital markets. Should we find the need to alter your asset allocations based on our research, either to reduce risk or exploit market opportunities, we will promptly inform you and take action on your behalf.
2. **Keep you informed** - We will continue to keep you abreast of any important developments and continue to provide regular commentary and educational information.
3. **Rebalance & harvest losses** - We will generate tax loss harvesting trades as opportunities arise, and we will regularly rebalance your account.
4. **Always be available** - We will be available to discuss any questions, comments, or concerns you may have. Feel free to send us an email or give us a call.