New Albany Investment Management

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Many Reasons for Volatility, But the Big Picture is still Solid

Most forecasters expected 2016 to be more volatile than last year, but the depth and breadth of selling across the global markets has been a surprise. The markets have been in a free fall since the start of the year, yet underlying fundamentals have not dramatically changed. Headlines site turmoil in the Chinese markets and plunging oil prices as the culprits and the concern is this will lead to a recession in the US and/or globally. It is easy to get swept up in the day to day emotions of the market, as emotions can push the market rapidly to extremes. But as an investor, it is important to step back and look at the forest from the trees, or the fundamentals rather than emotions, because eventually, it is the fundamentals that drive the markets.

Last week I listen to JPMorgan's chief economist David Kelly discuss the current market situation in the context of the fundamental picture. Here are the key take aways:

- China is migrating from a manufacturing led to service led economy and with that there will continue to be bouts of volatility. However, China is still a growing economy.
- Oil price drop is due to oversupply, not weakening demand. This imbalance could take several years to correct.
- US Economy is on solid footing. Consumption is 70% of GDP and thus the main driver of growth. With employment, credit and housing strengthening, the consumer is healthy and should continue to be a source of growth.
- Earnings (as measured by the S&P) were negative for 2015 due to strength of US dollar and falling energy prices. If both remain at current levels, earnings will grow in mid-single digits.
- Valuation now looks somewhat cheap by historical measures.

China: The transformation from a manufacturing led to a consumption led economy in China is just in its infancy. With this change, dramatic spurts of volatility should be expected. This is a whole new frontier for all participants involved including the Chinese government, who is 'learning' how to manage and control their currency, an evolving stock market, and a changing economy. Though China is the second largest economy in the world, it only represents 7% of the US GDP (thru exports). So slowing growth will have a very small impact of US GDP. In the future, however, as the Chinese consumer sector grows, so will opportunity for US companies to grow market share (and earnings) in this region.

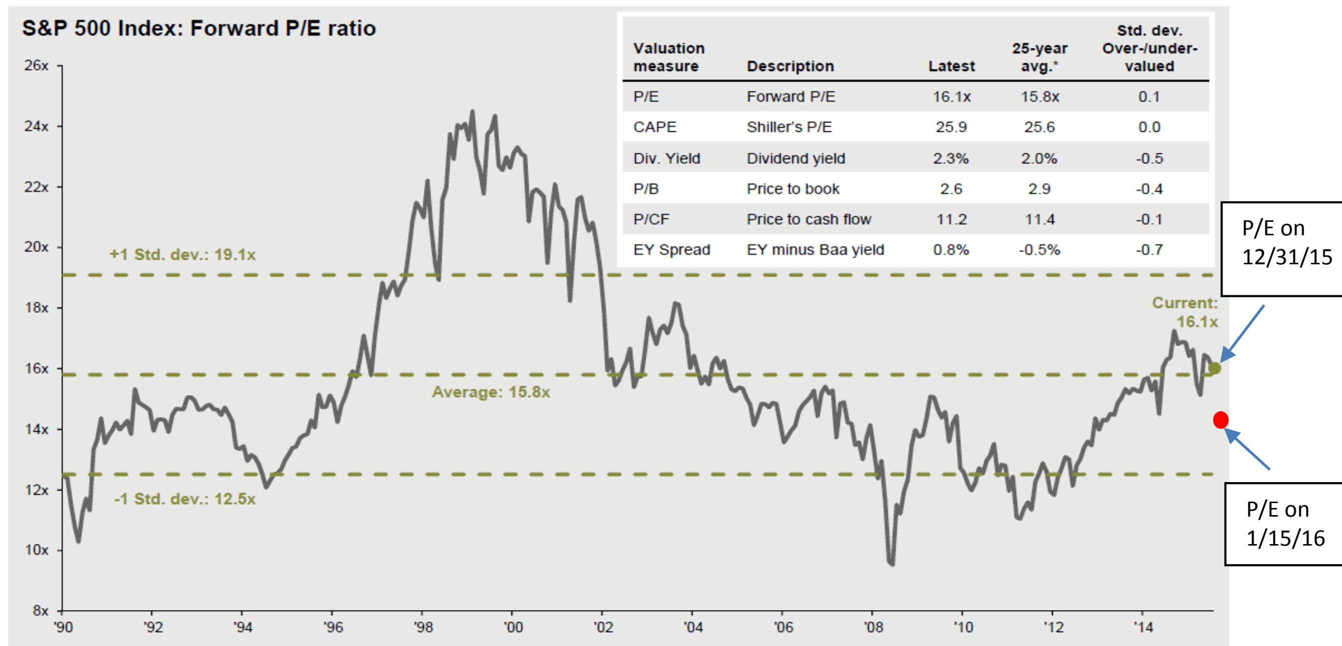
Oil: The energy sector is experiencing a 'perfect storm', and with that, all related services in this sector are experiencing major declines in revenue and employment. However, in the US, the energy sector represents only 0.5% of GDP and supplies about 266,000 jobs. By comparison, the Homebuilding sector represents about 6% of GDP and employs over 6.5millon workers. Though the energy sector is contracting significantly, it is not large enough to cause a recession. At the same time, the benefit of cheap energy is being enjoyed by the consumer and this savings will eventually be spent back into the economy.

US Economic growth is solid and slowly growing. Components of growth include: Consumption (+ 69%), Government Spending (+18%) and Manufacturing/Investment (+14%) and Net Exports (-3%). It is important to recognize the major driver of growth is <u>not manufacturing but the consumer/service sector</u>. Thus even though manufacturing is slowing, it is highly unlikely to pull the service sector down. The best measure of the health of the consumer sector is the unemployment rate which now stands at 5% and the debt service ratio of 10%. Both rates have continue to decline and are now at very healthy levels. This means the probability of sustainability of growth in the US economy is quite high.

Earnings: A major headwind to earnings in 2015 was the large decline in energy and rising dollar. These two factors subtracted over 9% from earnings growth and explains why total S&P earnings fell (-7%) for the first time since 2008. If oil and the dollar remain at the current levels, earnings are expected to see mid-single digit growth. If there is some improvement (rise in oil price or weakening in the dollar) earnings will be in the double digits. If however oil continues to decline and stay at $20 a barrel, total S&P earnings are likely to be flat for 2016.

So what does this imply for the market? There is a positive but 'loose' correlation between earnings growth and stock price movement. This means day to day volatility can be totally disconnected with the fundamentals; but over time, stock prices do follow the earnings. Even if energy continues to decline, there are other areas of the market (economy) that are still growing strongly, namely Health Care, Technology, and Consumer Services.

Valuation: At the end of 2015, the S&P forward P/E ratio was 16.1. As of Friday's close, the P/E ratio is now at 14.7 and below the historical average. The chart below shows the historical forward P/E and other valuation measures as of 12/31/2015. The red dot shows the new P/E of 14.7 as of 1/15/2016.



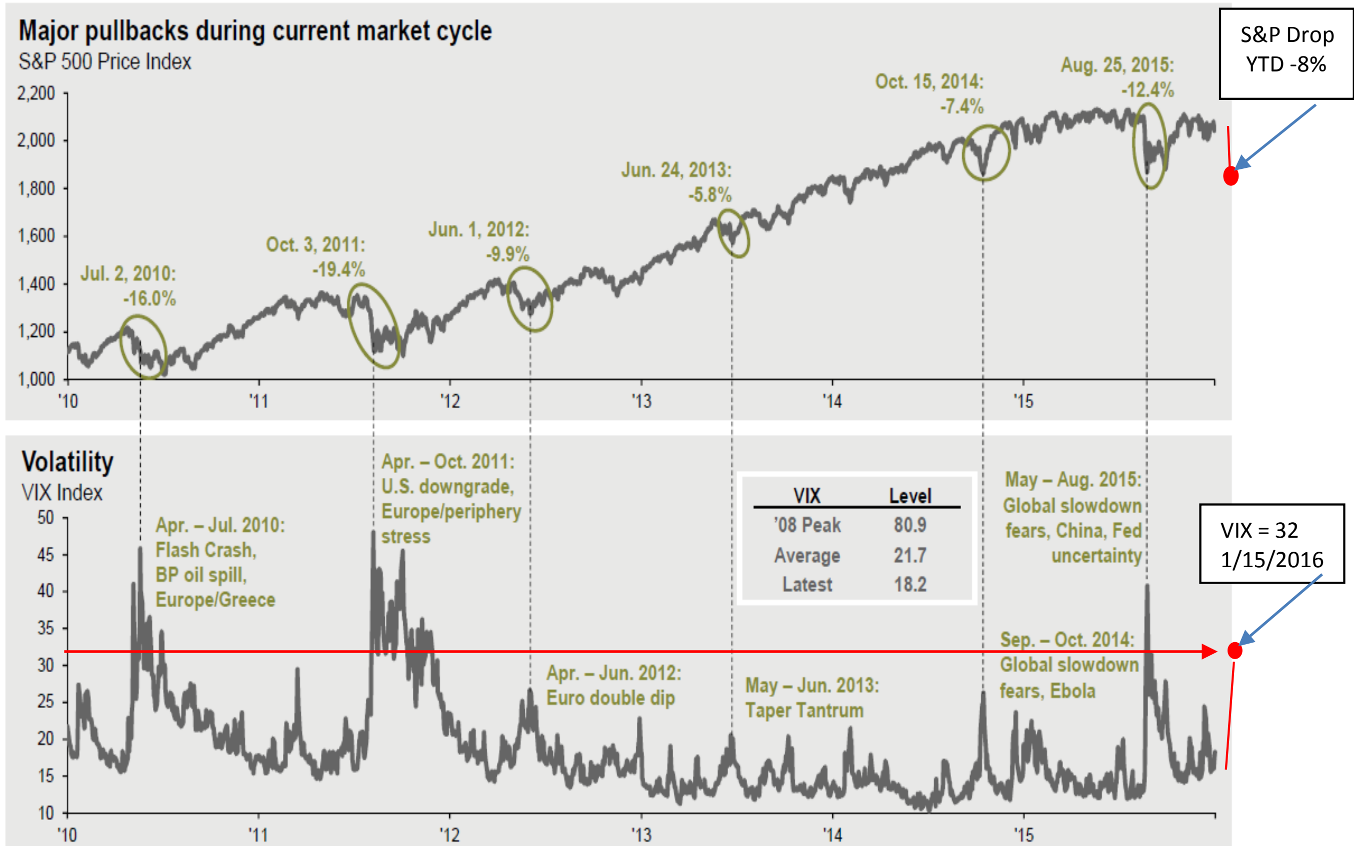
Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-valued
P/E	Forward P/E	16.1x	15.8x	0.1
CAPE	Shiller's P/E	25.9	25.6	0.0
Div. Yield	Dividend yield	2.3%	2.0%	-0.5
P/B	Price to book	2.6	2.9	-0.4
P/CF	Price to cash flow	11.2	11.4	-0.1
EY Spread	EY minus Baa yield	0.8%	-0.5%	-0.7

One could argue that today's P/E of 14.7 is about where the market was prior to the 2008 crash, and hence it could go significantly lower. But there are two big differences today: Interest rates are substantially lower, making equities relatively much more attractive than bonds. Secondly, the bursting

of the oil price bubble (if you want to call it) pales in comparison on the economic impact of the housing bubble burst.

Market Volatility: One indicator that measures traders' expectation of future volatility is called the VIX. The VIX can also can be used as a contrarian sentiment barometer of investors' bullishness or bearishness. The VIX rises when the market experiences rapid and extreme price movement down and investors are uncertain (bearish) about the future. The VIX falls and remains low in a rising and trending market and indicates investors are confident about the future. The chart below shows the major pull backs of the S&P 500 since 2010 and the level of the VIX. With the recent selloff, the VIX now stands above 30 and indicates a very negative/ unsettled market environment. This means prices will likely probe lower levels before buyers will return with confidence.

How Long/How Far? The top chart shows the major pullbacks during this bull cycle. YTD, the S&P has dropped -10.0% from its recent high and is near the middle of the range in magnitude of declines. These pullbacks have lasted as short as 2 weeks to as long as four months.



VIX	Level
'08 Peak	80.9
Average	21.7
Latest	18.2

Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management; (Bottom) CBOE.
Guide to the Markets – U.S. Data are as of December 31, 2015.

What lies Ahead? Markets don't like uncertainty, and until there is more clarity over the impact of slowing China growth and where oil prices will stabilize, heightened volatility and perhaps lower prices are possible. But based on the most recent data, it is highly unlikely neither the US nor the global economy is headed for a recession. Thus the recent decline should ultimately reflect a correction, not the beginning of a bear market.

Portfolio Strategy: Successful investing is about identifying risk and opportunities across asset sectors and then sticking with a solid investment strategy that incorporates both growth and income. Consumer Services, Technology, and Healthcare are still the best bet for growth. High Yield bonds with low exposure to energy, Bank Loans, and Mortgages are the best sectors for income. In addition, broad diversification is key to reducing volatility.

This is a rough market to sit through. Please contact me if you wish to discuss the markets in more detail or have questions concerning your portfolio.

Kind Regards,

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