New Albany
Investment Management

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Market Insight: Is There Still Hope for Stocks?

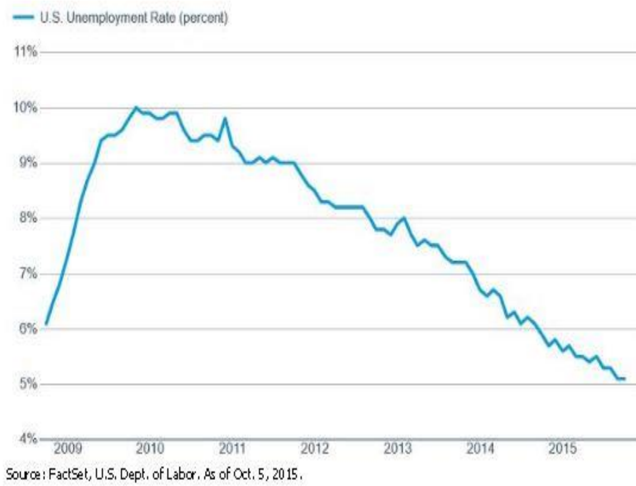
It was a nasty 3rd Quarter, the worst since 2011. Slowing growth in China, Fed uncertainty, a rising dollar, and falling commodity prices stoked fears of a global recession. Investors quickly discounted lower earnings and drove stock prices significantly lower. Volatility more than doubled from the sanguine levels experienced for almost four years as daily market swings of two percent or greater became the new norm. Investors' confidence have clearly been shaken, and rightly so. Is this the new norm? In some respects, yes, but there is still hope for stocks. And here is why…

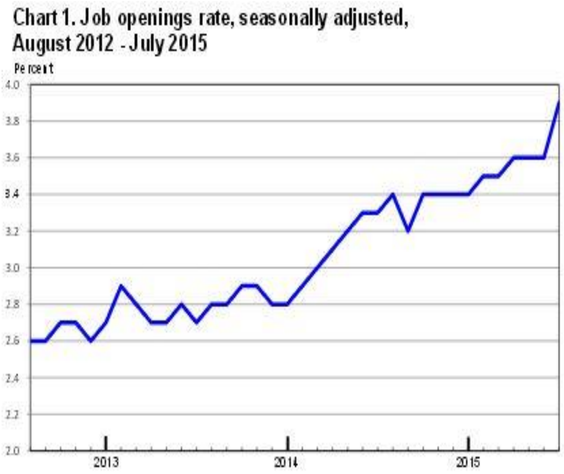
Fear not fundamentals, are driving stocks: The markets have been obsessed with the Fed's point of view lately. Stocks around the world fell by nearly 6% after the Fed announced they were delaying hiking rates in September. Investors feared the Fed knew something about the global growth situation that the markets had not seen. Then stocks rose all the way back to the pre-Fed announcement level when the minutes to the meeting came out last week revealing no material change in the Fed's outlook and the expectation that interest rates would be raised soon. This wild gyration is symptomatic of fear, not fundamentals, driving the market. But it is time to refocus on the true fundamentals because that is what ultimately influences earnings and stock prices in the long run.

What the Fundamentals say:

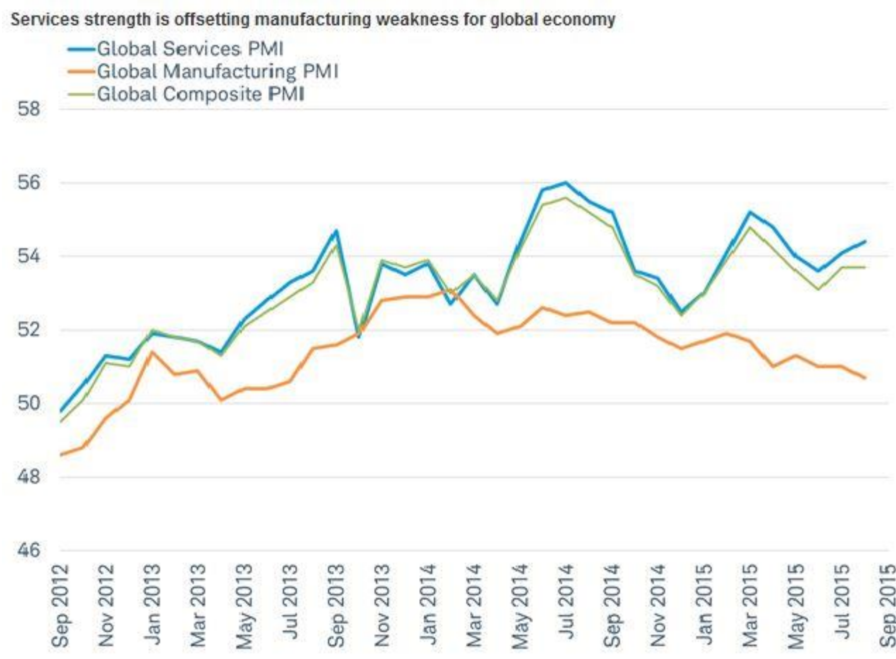
1) US Consumer is in good shape: Personal consumption expenditures (including health care) make up 70% of US GDP and is a good leading indicator of the US economy. The chart below shows personal spending is in the same solid range as it has been since 2010. No sign of recession here.

At the same time, the employment picture continues to improve. The unemployment rate now stands at 5.1%, a level not seen since prior to the market crash in 2009. And the JOLTS report, which shows the number of Job openings, continues to rise and indicates employers are looking to hire. (See charts on next page)





2) Services driving growth and still expanding: Though the market has been focused on the slowing manufacturing component of the economy, <u>it is the service side that is the main engine of growth</u>. An important gage of growth and a leading indicator is the Institute of Supply Management's Purchasing Managers Index (PMI). It measures activity in both the manufacturing and service components of the economy. When the index is above 50, it indicates the economy is expanding, and below 50, it is contracting. The chart below shows the Manufacturing component (orange line) fell again, barely remaining in expansion territory and indicating a slowing. But the Service component (Blue line), remains well above the key level of 50, indicating expansion. Combined, the composite PMI (green line) shows the global economy is still expanding.



3) China and other Emerging Markets are evolving from manufacturing to service led economies. Presently, most of the EM countries are dependent upon commodity and manufacturing exports for growth and have financed this growth with ultralow interest rates. Hence, EM debt has risen dramatically over the last 4years. Now, with the Fed on the brink of raising rates and commodity prices falling (significantly), there is real concern that many of the EM countries will not be able to service their debt and growth will stagnate. This is why the markets have fallen so hard. But as with China, each of these countries are in a long and slow process of evolving from a manufacturing to a service sector led economy. China takes the lead in this regard. This transition will take time (many years) but should lead to a rebalancing and eventual normalization of economic activity and profits. Global growth may be stagnating right now, but long term, there is still much more potential for growth.

4) Stronger world growth forecasted for 2016: Last week the IMF issued its forecast of global GDP. Although somewhat lower than previous forecasted, they maintained their outlook for stronger growth in 2016. In addition, most forecasters, including the World Bank, the Organization for Cooperation and Development (OECD), and the consensus of economists' forecasts tracked by Bloomberg, foresee a stronger world economy in 2016 than in 2015 or 2014.

Here are the details of the IMF's forecast:

- The Eurozone will accelerate slightly (to 1.6%) from the pace in 2015 which was already the fastest growth since 2010.
- Economic growth in the United States will improve slightly (to 2.8%), making for the fastest annual pace of growth since 2005.
- Japan's weak economy will reaccelerate by about half of a percentage point (to 1.0%) from 2015 in 2016.
- Emerging market economies are also expected to grow about a half of a percentage point faster in 2016 (to 4.5%).
- The biggest downgrades to the IMF growth outlook were in commodity-driven developed and emerging economies in recession: Brazil, Russia, and Canada. Of these, only Canada's economy is expected to grow in 2016.

In addition, the IMF sees an increase in global inflation from 0.3% in 2015 to 1.2% in 2016, potentially marking a big step back from the risk of deflation.

Why pay attention to IMF forecast? According to a study by Bloomberg, the IMF has more often been a better predictor of growth and inflation than central banks, including the Fed, European Central Bank, Bank of Japan, and Bank of Canada. That's right. The IMF was a better forecaster of U.S. economic growth than the Fed in seven of last 10 years. This doesn't mean the IMF forecasts are always accurate; there is never certainty in forecasting. But if the market is going to focus on forecasts, it may be best to pay closer attention to those from the IMF which point to better growth in 2016, rather than reacting to fears of a continued global slowdown seen in 2015.

In addition to the IMF**,** Charles Schwab's economists are also expecting world growth to improve in 2016 to 3.5%. They say, "while slightly below the pace of the mid-2000s, this would mark a return to the average pace of growth over the past 50 years. Faster global economic growth should translate into better

sales for companies and drive faster earnings growth than in 2015, potentially supporting the stock markets around the world."

Looking Ahead: The markets are likely to remain volatile but seasonality suggest they will be better supported. The consumer is in good shape, interest rates will still be quite low even if the Fed does raise rates, and the much larger service side of the economy is expanding. Outside of the US, every major central bank is still pushing stimulus into their economy. The fundamentals are pointing to modestly improving growth and this should provide a positive investing environment. But keep in mind, moderate growth translates into moderate returns. Yes, the new norm is higher volatility but there is still hope for stocks.

Portfolio Strategy: There has been no change in the investment strategy. High volatility and rapid sector rotation make it very dangerous to 'time' the market. The portfolios are well diversified and performing according to their designated risk structure.

Please contact me with any questions or concerns.

Kind Regards,
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