New Albany
Investment Management

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Market Insight: Communism Clashes with Capitalism

It has been a wild couple of weeks in the global markets. Anticipation over the Fed's interest rate hike this month and China's stock market crash have shaken investors' confidence in global growth. Every stock sector across the financial markets has been hit hard and daily volatility has nearly doubled from what had been a very calm market environment for almost three years. Has the risk of a global recession increased? Is the rapid drop in stocks justifiable? Questions like these drive uncertainty and create market volatility.

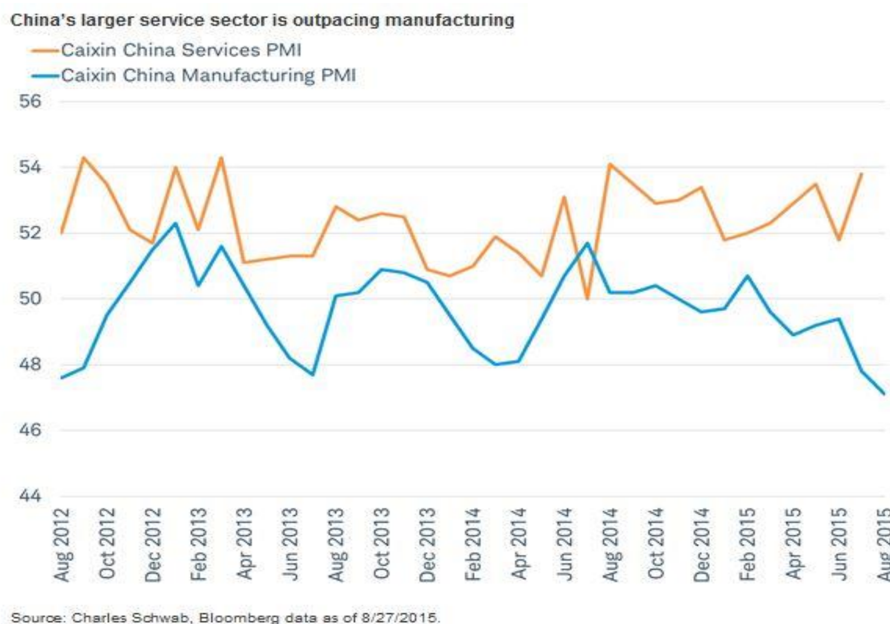
In the midst of uncertainty, it is best to stand back and sort out the facts. In almost every past recession, the root cause has been triggered by either rampant inflation, war, or an asset bubble (Stock's and Real Estate). Setting aside the prospect of war, today the economic landscape is rather dull. Inflation is quite low and for the most part, there are no price bubbles in financial assets. Thus the odds of a recession are quite low. Here in the US, economic growth is slow but on reasonably solid footing as evidenced by the healthy job and housing markets, falling consumer debt, and strong capital base of businesses.

But what about China? Why has their stock market fallen so hard and fast? Will this stock crash bring down global growth?

Communism Clashes with Capitalism: The volatility in China's financial markets is a result of the government's attempt to allow capitalism to operate within the confines of communism. Several initiatives to create growth have backfired because of bungled execution of government policy which has undermined the process of free markets at each turn in the road. For example, it was the huge government spending on infrastructure that created a false sense of growth and fostered a real estate bubble. By mid-2014 the Chinese government was concerned and decided to deflate this bubble by encouraging investors to divert their money into stocks. Since that time, the Shanghai stock market rose over 150% by early June of this year before plummeting over 40% in two months. The stock market boom was supposed to be a source of capital for Chinese business but now investors are fleeing the market. Other examples of botched intervention include the municipal debt reforms that resulted in fiscal tightening, and the surprise exchange rate devaluation that further destabilized investors' confidence. Now besides dealing with the realities of slowing growth, the government has to do damage control over their markets. Until the authoritarian nature of the Chinese government (communism) loosens its hold, the flow of free markets (capitalism) will continue to be disrupted and affect the global markets.

China changing drivers of growth from government to consumer spending. Though China was once heavily dependent upon export manufacturing and infrastructure spending for growth, now the consumption/service sector of GDP exceeds the combined share of manufacturing and construction. For

the first half of 2015, the service sector has grown at an 8.4% pace, the fastest pace in four years and outpacing the 6.1% growth in manufacturing and construction. The chart below shows the relative growth of services to a slumping manufacturing purchasing manager indexes.



China's Growth Risk: With the service sector taking the lead for growth, the major risk is China's own government enacting non-traditional policy initiatives which have brought instability to the financial markets, curtailed business investment, and weakened the consumer. If China can stop making surprise unconventional monetary policy moves and stick to more traditional tools to stabilize growth, the transition to a service led economy will be much smoother. The positive side of this recent market volatility is that it has gotten the attention of the Chinese government and hopefully they will be more diligent in future policy actions. The Chinese government will do anything to avoid embarrassment.

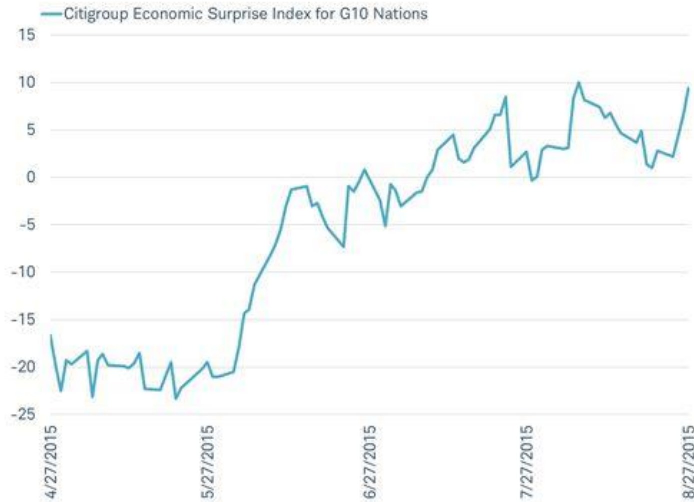
With regard to China's stocks and the relationship to its economy and the US, here are two key points:

- **No correlation between China's stock market and their economy**. Yes, that's right, NONE! Unlike most other countries, where the stock market can be a leading indicator of economic growth, this has not been the case with China.
- **The US economy is not dependent on China for growth**. In fact less than 8% of all US exports go to China. While China's growth is slowing, it is still growing, and growing very rapidly by U.S. standards.

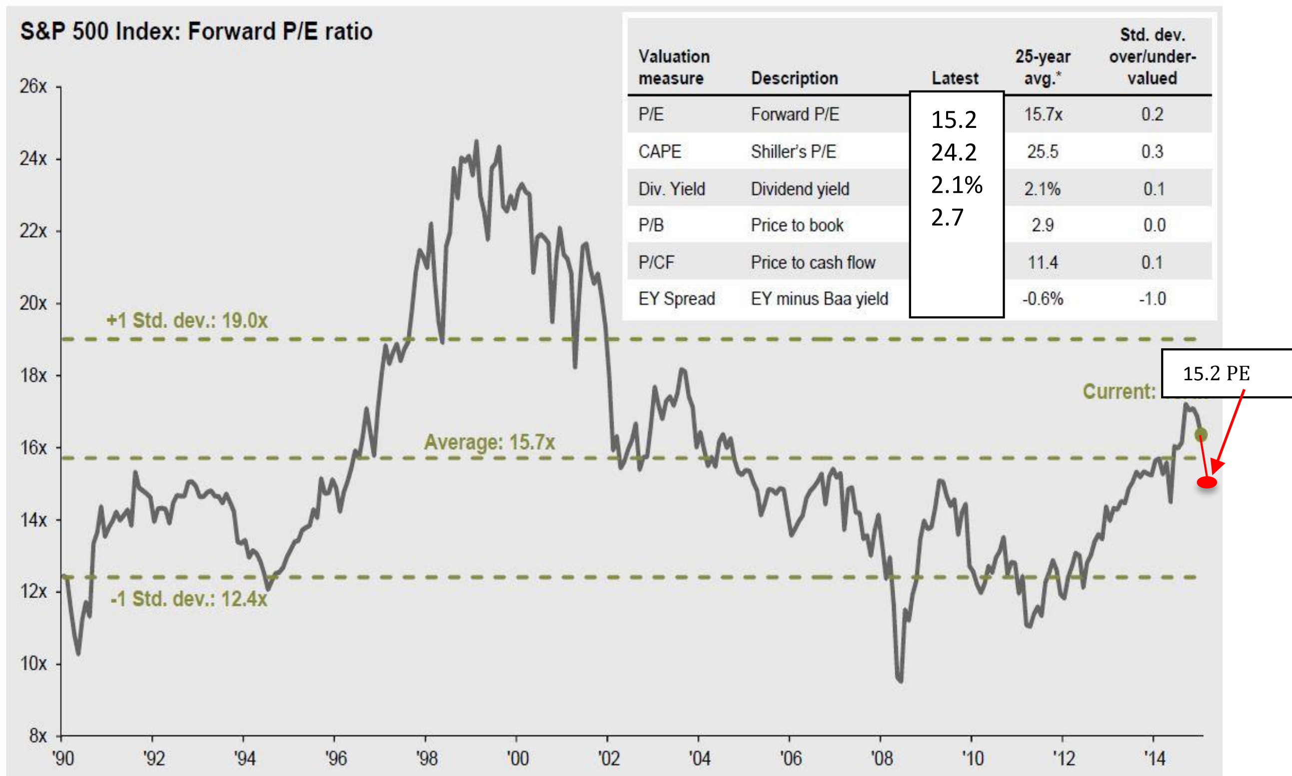
Outside of China, Signs of Improving Global Growth: Despite the disruptions in China, global growth is expected to rise in 2016 from 3.2% to 3.8% according to the International Monetary Fund. The Eurozone is forecasted to accelerate growth to the fastest pace since 2010 and Japan will likely see the strongest back-to-back years of growth since before the financial crisis.

In addition, the Citigroup Economic Surprise Index is also projecting global growth to accelerate. This index reflects how global economic data for the G10 nations (United States, Canada, United Kingdom, France, Germany, Italy, Japan, Switzerland, Belgium, Sweden, and the Netherlands) is faring relative to

economist expectations. The index has been rising reflecting stronger than expected economic data. (See chart on next page).



Valuation Neutral: With the recent sell-off, stocks now are actually slightly below their historical of 15.7, at a current P/E of 15.2 (red dot on chart below)



Valuation measure	Description	Latest	25-year avg.*	Std. dev. over/under-valued
P/E	Forward P/E	15.2	15.7x	0.2
CAPE	Shiller's P/E	24.2	25.5	0.3
Div. Yield	Dividend yield	2.1%	2.1%	0.1
P/B	Price to book	2.7	2.9	0.0
P/CF	Price to cash flow		11.4	0.1
EY Spread	EY minus Baa yield		-0.6%	-1.0

Earnings Growth Positive for 2016: Earnings should improve next year as the effect of falling oil prices and a rising dollar roll off**.** Both have been a significant headwind to earnings during 2015. In fact if you take out the drop in oil prices, S&P 500 earnings as a whole have risen 8% year over year. If oil prices and the dollar remain at current levels, multi-national company profits should see double digit growth in profitability in 2016.

In sum, the big picture shows the investing landscape is still very much intact. The Fed may raise rates, China's growth is slowing, but the world economy is growing. Emotions are currently driving the markets, but over time, it is the fundamentals that ultimately provide the foundation for investing and direction of the markets.

How to invest: The last two weeks has been a gut check for investors' risk tolerance. If volatility in the markets and a drop in value of the portfolio has one lying awake at night, then this is an indication risk is too high and perhaps needs dialing down. Sector rotation is rapid, thus the key to managing risk is broad diversification. Volatility will likely remain elevated thru earnings season in mid-October. Confidence in growth must be regained before the market can find stability and begin to track higher.

As always, please contact me with any questions or concerns.

Kind Regards,

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