Economic updates. Please read!!!

Chapel Hill Investment Analysts, Inc.
Financial Planning • Investment Management

"Cup of Joe"



Welcome back, volatility! We haven't seen you in months! As expected, volatility has reared its ugly head due to a myriad of events, some expected, and some not so much. The market's biggest hurdle is almost here as well (interest rate hikes) and China just made things more "colorful", if you will, with a big...SURPRISE! "WE DECIDED TO DEVALUE OUR CURRENCY!"

First, what the heck is China doing and why now? A couple of days ago, China decided to UNEXPECTEDLY devalue their currency. In the most simplistic of terms, they made the Yuan cheaper in relation to the other currencies. Why? To make the products they export cheaper for you to buy at Wal-Mart. In our opinion, they did this for a number of reasons. The easiest answer would be that their economy is slowing down and what better way to help a fledgling economy than to lower their costs of goods to make them more enticing to the world's importers. What everyone is up in arms about is that the move was unexpected and runs the risk of undermining the recovery of Europe and Japan (they need their own products to be affordable for you to buy as well). If you remember in past email blasts, we always stress the fact that markets don't like surprises. They need time to digest what's going on and factor in amounts of risk to each scenario. In this case, the world markets sold off first and asked questions later. The timing of the move is also in question considering that the U.S. is just about to raise rates which will cause the dollar to appreciate making our exporter's lives miserable (the products we make in the U.S. become more expensive relative to those from Europe and China). Relatively speaking, it would be like Janet Yellen, our Federal Reserve Chairman, coming out one day and saying, "Surprise, we decided to raise rates today!" But, this wasn't the case. Janet Yellen and the FED have been advertising a rate hike in every way, shape and form for the last year now. This gives the markets time to digest such a move, for advisors to create new portfolios for their clients that accommodate the move, and for other countries around the world to brace for possible currency ramifications and how they might affect their own economic models. Did China do that? Note: that doesn't make a sound case for anyone to trust the Chinese and their finance ministers!

So, coupled with a surprise Chinese currency devaluation, what else is going on? Well, our Federal Reserve Bank is looking to raise rates very soon. Everyone knows that the metaphorical morphine drip of Fed money is about to dry up and the market is scrambling to adjust appropriately. Interestingly, this is new for most of the advisers and portfolio managers. What do you do if you don't have history to fall back on for guidance? You employ the wait and see method. In over 90 years, the market has never been so tightly range-bound (no big moves up or down) in over the first 6 months of a year. If that doesn't prove how unprecedented a time we are in, nothing will. It's an anomaly on so many

levels, causing what we refer to as a “flat market”.

Last, but not least, oil has crashed once again. Strangely enough, economically this is a double-edged sword. In past email blasts, we’ve discussed how low oil prices would be an obvious win for consumers. Less money paying for gas means more money in the consumer’s pocket. But, the severity of such a momentous oil decline caught the industry off guard and chopped the 13% of the S&P’s energy sector in half, causing many Americans to lose their jobs. This is not a good thing. On the one hand, the consumer loves cheap gas. On the other hand, if you are invested in the stock market, you’ve been seeing a decline every day that oil declines. What gives? Well, not to make things worse for big oil, but a possible Iran anti-nuke deal is now on the table presenting a very real possibility that millions of barrels of Iranian oil will soon flood an already saturated oil market. Predictions are that the oil glut will now last through 2016, barring a move from OPEC to cut supply.

China, U.S. interest rate hikes, oil price declines….oh my! Volatility is here but is this all bad? Let’s look at the potential outcomes. The U.S. has stated that further declines in the Yuan will not be tolerated. If this would continue, countries and regions such as the U.S. and Europe could impose tariffs on Chinese imports. Tariffs would make Chinese products more expensive at Wal-Mart and negate the effects of the devaluation of the Yuan. Also, the world needs a healthy China for stability. If China slows, so does the world - China makes all the stuff we buy. And remember, China’s goal is to create a consumer-driven economy in their country, much like the U.S. In order to do this, it must start to rely less on exports and government-funded investment and more on their own people buying their own goods. The way we look at it, the Chinese economy has to slow down to more normal levels. To give you some insight, right now China projects their GDP growth to be around 7%. We think more like 3-5%. Europe would kill for this. In hindsight, they aren’t struggling as bad as suggested. They just can't sustain the level of GDP growth experienced over the past 5 to 10 years at these elevated levels without serious consequences.

Oil will begin to normalize. In years past, oil was artificially controlled by regulations. Once deregulated, the market manipulators and OPEC drove the prices to all time highs. Who remembers $147.50/barrel oil and $4.00/gallon gas??? Now that regulations were put back in place and OPEC has given in to a more market-driven price structure, oil will eventually find a bottom. Oil companies will consolidate and consumers will start to realize they have a ton more money in their pockets and start to spend. And once the oil supply glut diminishes and demand picks back up, oil will start to rebound.

Finally, not to beat a dead horse, but interest rates "WILL" rise at some point in time. If you remember just one thing, remember this: **"the FED rate hike signals that our economy is strong enough to stand on its own two feet again...and that's very good for everyone".** It was only 7 short years ago that we faced the Great Recession. The markets will toss and turn, much like a kid throwing a fit when you take his pacifier, but it will recover. And remember, too, that this rate hike is tiny in comparison and future hikes will remain slow and steady for years to come. **No one wants to throw the economy back into the abyss!**

At Chapel Hill, we remain calm but attentive to the daily events that affect our client’s portfolios, but we must remain vigilant in our goal as long term investors. It is fruitless to try to time the market. If you get out and are too scared to jump back in at the bottom (when things really look bad) you are doomed to the anemic returns of the banks that will allow inflation to eat away at your buying power. Of course there will be more unexpected events that shock the system, but if we continue to trust in the premise that everyone wants their respective economies and lifestyles to improve, we are confident that things will turn out just fine. The economy is resilient and just like someone dealing with something new, things take time to digest. Thank you to all of our loyal clients who read our email blasts and remember to keep your eyes on the more prosperous future.

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