Economic Updates and Outlook



"Cup of Joe"

Spring has sprung, and so has the stock market. Since mid-February, the S&P alone has had a nice gain, while quelling the fears that a recession was imminent. With this market update, we will discuss what has changed, what we have learned from this most recent bout of volatility, and the power of FEAR.

What a crazy stretch we have had in the markets! Looking back, we have had three corrections (when the market goes down 10% or more) in less than 2 years. The first correction occurred in August 2014, while the second came in August of 2015, and the last taking place in January 2016. What's interesting is how fast the market rebounded from these sharp declines. This is the primary reason why the experts tell you that you cannot time the market. If you listened to the talking heads on television and radio, and sold out, you not only solidified your loss of 10% or more, but you also missed the almost immediate rebound. Most of the time, people only see downside risk. Looking at the 2008 collapse as an example, most investors thought the world was ending when they sold out and never bought back into the market. No one realizes that the market bottomed in March of 2009, roughly six months after the worst collapse in history. This is what FEAR does to the average investor. The market declines, the average investor immediately starts worrying until they can't take it anymore, they sell at a loss, the market rallies and they can never get back in. It happens over and over again. As advisers with a long-term time horizon, we realize that these corrections are natural and healthy. Some last a month, some last six months, but they do not last forever! That's why you have advisers in the first place. We help guide you through these hard times and make sense of what's actually causing the correction.

So, here is what's going on. Throughout all of these corrections, you've been hearing that China was imploding, the world was melting down, we were about to enter a currency war, oil was going to $20/barrel, and the U.S. was heading towards a recession. Well, that all turned out to be untrue. The real culprit was, in fact, oil. When oil dropped like a rock from $147/barrel to $26/barrel, it sent shockwaves throughout the world. The people hit the hardest were the oil-producing countries, such as Saudi Arabia, Russia, Venezuela, etc. When it came time for those countries to fund their budgets, the money from their oil revenue wasn't there. These countries were then forced to sell the stocks held in their sovereign wealth funds. This started at the end of 2014 - the first correction. These countries use the revenues from their commodity exports (oil) to invest in global stocks. When they need

money (due to the price of oil being down), they sell stocks to make up for the deficit. Bring on the massive oil shock that we are experiencing and the collapse in commodities, and you have a HUGE economic shortfall for these countries. They sell billions worth of stock, sending the markets plummeting. The short sellers (hedge funds) then figure out what's going on and they short the market, exacerbating the problem even more. Then the guys on TV - who are journalists - start spouting off that the world is coming to an end and that financial ruin is imminent. The average investor panics and the selling continues to provide the hedge funds the ability to buy back low and make a ton of money. The more fearful the average investor gets, the more money they make!

Now, I'm not saying that the world is in great shape. It's probably average, at best. Growth is slow. But, slow growth is better than no growth. And as money managers, we look at the fundamentals:

- Trillions of dollars are coming back to the consumer from decreased gas prices
- Only 18% chance of recession
- Unemployment at 4.9%
- Consumer confidence is high
- Housing market is still booming - prices are up and mortgage rates are still low
- Bonds are paying nothing (little-to-no interest on bonds and CDs)
- Wage growth is starting to pick up
- Europe just launched a massive stimulus package this past Thursday
- Recessions start because of oil SPIKES, not oil DECLINES. When oil spikes, it takes money out of the consumers' pockets that would otherwise be spent on purchases.

It makes sense when you look at market returns, and they are basically moving sideways. It's frustrating, for sure. But, this was caused by one of the biggest oil shocks in history. An exogenous event. And why we always harp on these events is that you can't predict when they are coming, how long they will last, or the severity of the damage. What you can do is look at the facts. And the facts indicated that the market was not heading over a cliff.

Moving forward, we see slow yet steady growth in the U.S. and areas such as Emerging Markets and Europe starting to show signs of life as well. Oil has jumped over 40%, which has provided a cushion to the many energy companies that were on the brink of default. High yield has started to come back nicely. Additionally, Europe has just launched a new bout of stimulus. We see modest gains this year, assuming oil has stabilized and the production cuts in OPEC turn out to be of substance, not just talk. (Note: there is a chance that oil declines again if this last "agreement" by OPEC doesn't pan out. If this happens and the market declines, the average investor will have more confidence that this isn't recessionary). We also see U.S. multi-national companies starting to do better once the price of the dollar comes down. What we don't see is a recession coming in the short term, and that is good news. The last piece of good news is the TRILLION DOLLAR savings at the pump that the consumers around the world have not yet started to spend. All along, we viewed the cause of this spending malaise to be psychological. The market crash in 2008 is very fresh in everyone's minds, and to quote Mark Twain from a recent research note -

"If a cat sits on a hot stove, that cat won't sit on a hot stove again. That cat won't sit on a cold stove either. That cat just doesn't like stoves." "In 2008, a whole generation of investors sat on a hot stove. The sub-prime market that was supposed to be small and containable wasn't, and millions of investors got burned. Thus, perhaps it should not surprise us that investors have reacted with a hairpin trigger to what we view as reasonably modest stresses in what strikes us as an overall good economic picture. Nevertheless, we think the stove is cold, particularly as it relates to the large US Bank's credit quality outlook.

Basically, 2008 wasn't that long ago, and investors are still very worried that they could be equally badly burned

again. Kind of like the cat that still doesn't like stoves."

Thanks to all of our clients for remaining patient through this last stretch of market volatility and please feel free to check out some of the interesting articles we have listed. Have a great spring!

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