

Investment Commentary—January 2016

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The first weeks of a new year bring prognostications regarding the twelve months ahead. We've never put much stock in these predictions, but as we think about the investment landscape for 2016 (and the years beyond), there are a number of questions that strike as particularly significant. These are the issues we are paying close attention to and that we think about in managing client portfolios. If we had a crystal ball—and sadly we don't—we'd use it to answer the following:

When will global oil supply and demand come into balance?

The collapse in oil prices that began a little over a year ago cast a shadow over capital markets throughout 2015. Cheap oil has been good for consumers, but U.S. oil and gas producers have been slashing budgets. Advances in "fracking" technology over the last decade have dramatically increased U.S. shale oil production, but recent cutbacks by shale operators are one of the reasons manufacturing data softened last year.

Despite a 65% drop in the number of active domestic oil rigs, there hasn't been much of a decline in global oil supply. In part that's due to increased efficiency as drillers maximize production from remaining rigs. Further, Saudi Arabia has been putting the pedal to the metal, hoping, it seems, to drive the price of oil low enough to bankrupt U.S. shale operators and inflict some pain in Moscow and Tehran in the process. Thus far, bankruptcies in the oil sector have not been widespread but that may change in 2016 and could be of help in reducing production.

Until oil supply and demand do come into balance--and sub \$2 gas helps considerably on the demand side--U.S. producers will continue to ratchet back on capital expenditures with negative ripple effects on the economy. Beyond that, cheap oil has had a deleterious psychological effect on investors. A key reason for excess supply is lower demand for oil coming out of China as their economy continues to gradually decelerate. Each new leg down in the price of oil stokes investor fear that it could be the harbinger of a "hard landing" in the Chinese economy, which could, in turn, trigger a global recession. Which brings us to our next question.

Will consumers in China prevent a "hard landing" in the Chinese economy?

Problems with the Chinese economy preoccupied markets last August and September and are doing so again at this writing. There is no doubt that manufacturing and construction are slowing down significantly as the country reckons with competition from lower-wage neighbors and the fallout from years of excessive construction of roads, bridges, office buildings and apartments.

Economists have long harped on the need for China to encourage domestic consumption and wean its economy from dependence on exports and infrastructure. The good news is that significant headway has been made over the last several years. In 2010 the industrial sector represented 46% of Chinese GDP compared to 44% for the services sector (a good proxy for the consumer economy). In 2015 the services sector led the way, contributing around 49%¹ of GDP with the industrial sector constituting only 42%.

The explosive economic growth in China over the last two decades has created a huge middle class in the prosperous coastal provinces. (At the same time, the weakening industrial sector is creating a “rust belt” in the interior). Demand for everything from cars to smart phones to movies is surging. More importantly, given historically very high savings rates, consumption could grow rapidly for many years even as the “old economy” decelerates. On the other hand, if for whatever reason—declines in the stock market and/or real estate prices come to mind—the consumer pulls back, the feared hard landing could materialize. Thus far, no signs of a pullback, but stay tuned.

Will investors continue to shun emerging markets?

Emerging market countries—many of them at any rate—are facing two severe headwinds. First, lower commodity prices (not only oil but metals as well) are wreaking havoc with economies that depend on natural resource extraction like Russia, Indonesia, Brazil and South Africa. Second, countries that rely heavily on external debt financing, often dollar denominated, are hurt by a strong dollar. This is especially problematic for countries such as Turkey, Malaysia, and the aforementioned Brazil and South Africa that have not engaged in financial and economic reform.

While the headwinds of lower commodity prices and a strong dollar are unlikely to reverse in 2016, valuations of emerging market stocks are low enough, especially in relation to valuations of U.S. stocks, that even if the headwinds simply get worse more slowly, performance could improve significantly. In general, emerging markets went into this very difficult period in much better financial condition than in past crises, with flexible exchange rates, sizeable foreign reserves and more limited reliance on dollar-denominated debt. That isn’t reflected in emerging market stock prices, but perhaps it will be as 2016 unfolds.

Will low gas prices finally provide a significant lift to developed market economies?

When the price of oil began to collapse a little over a year ago, it was evident that oil exporting countries in the Middle East and elsewhere would suffer considerably. Europe, Japan and the U.S., on the other hand, stood to benefit. With the U.S. still importing around 5 million barrels of oil a day there was good reason to think that the hit to the economy from decreased oil exploration and production would be more than offset by higher consumer spending resulting from cheap gas.

That scenario has yet to play out as lower gas prices have mostly led to an uptick in the savings rate. Between the early 1990s and the mid-2000s the U.S. savings rate had fallen from a healthy 9% to a dangerously low 2% or so. The current savings rate of 5.5% isn’t particularly high but the

¹ By way of comparison, the comparable figure for the services sector in the U.S. would be over 80%!

fact that it's been creeping up over the last year or so hasn't been helpful to the economy. One explanation may be that gas prices didn't stay low enough for long enough to have a big impact. After dropping quickly in late 2014 and very early 2015, gas prices began to rebound last February, topping out around \$2.80. Perhaps if gas stays at or near its current level for an extended period of time, the benefit will flow through to consumption in a way that didn't happen last year. If so (and if the collateral damage to oil producers is not too severe) the Federal Reserve may have growing confidence that the economy can withstand further interest rate increases. Which brings us to our next question.

How will monetary policy unfold in the U.S. and Europe and how will markets react?

After seven years at zero, the Federal Reserve finally lifted the Fed Funds rate by 0.25% in December. The Fed's published forecast suggests it will raise rates by a steady 1.0% per year--a 0.25% hike every other meeting--for the foreseeable future. Notably the bond market seems to be forecasting a much slower pace, around 0.5% per year. Meantime, if job creation continues anywhere near its current pace—over 220,000 new jobs a month over the last six months—the labor market could tighten enough to trigger significant wage inflation and force the Fed to become even more aggressive than planned. As second guessing the central bank becomes increasingly common, one prediction we're willing to make for 2016 is this: at some point we'll see headlines asking "is the Fed moving too fast?" and at some other time we'll see headlines asking "is the Fed moving too slow?"

The European Central Bank is a long way from raising interest rates and may still be smarting from its premature move to increase rates in 2011. Through the third quarter of 2015 euro zone GDP had climbed 1.6% year over year. While that may not sound like much, given Europe's stagnant population growth, it's pretty respectable. Still, having narrowly escaped its third recession since the financial crisis, and with core inflation uncomfortably close to zero, the ECB is facing calls to step up the program of quantitative easing that it initiated ten months ago.

For investors, the pace of tightening (in the U.S.) and easing (in Europe) is important, but equally significant is whether capital markets retain confidence in the ability of the respective central banks to set rates appropriately. Fed chairwoman, Janet Yellen, will be under particular scrutiny as every twist and turn in the global economy and financial markets prompts questions as to how Yellen will (or should) react.

What will happen to the U.S. Dollar relative to other currencies?

With the Federal Reserve steering interest rates in the opposite direction of the ECB and the Bank of Japan, the dollar has become more attractive relative to the Euro and Yen. In fact, between mid-2014 and March of last year, the value of the U.S. Dollar relative to a basket of other currencies² surged by fifteen percent. Since then the dollar has bounced around a bit but with a

² The broadest measure of the strength or weakness of the U.S. Dollar, and the one we use here, is an index that compares the dollar to a "trade-weighted basket of currencies."

continuing upward trend. The strength of the dollar impacts U.S. investors in several ways. First, it has a negative impact on the domestic economy as exports to foreign markets become more expensive. Along with cutbacks by oil producers, this has been the chief reason the economy has weakened a bit over the last two or three quarters.

Lower export volumes put a damper on profits of companies with significant overseas revenues. Earnings are further reduced when those revenues are translated into more expensive dollars. The profit impact in 2015 was considerable. It will ease some in 2016 but unless the dollar pulls back meaningfully, the effect will continue. Just as currency translation can reduce overseas profits, securities or funds denominated in Euros or other currencies, if unhedged, suffer when translated into stronger dollars. For all these reasons a stronger dollar can hold back investment returns.

A strong dollar has a further consequence that is particularly important in the current environment. Because oil is priced in dollars, a stronger dollar lowers the price of oil. For reasons outlined above a continuing decline in oil prices, even if it were currency-induced, would be unwelcome and further exacerbate concerns about the possibility of a global recession.

How will European leaders handle tensions over the migrant crisis (and fiscal policy)?

In addition to all of the above, there is always the possibility of a wild card, an unanticipated event that exerts a significant impact on capital markets. Some pundits might put the U.S. presidential election or further ISIS-inspired (or orchestrated) attacks at the top of the list. We'd look instead at simmering tensions within the European Union. Relations within the union were bruised last year as Germany took a very hard line in negotiations over the most recent Greek debt bailout.

Tensions within Europe have been further strained by waves of Syrian refugees. The flood of migrants has strengthened xenophobic parties such as Marine Le Pen's National Front in France. This growing nationalism makes it more difficult for mainstream leaders to work cooperatively to absorb hundreds of thousands fleeing the Syrian civil war. Most likely Europe will continue to muddle through in spite of internal conflicts, but that's not a sure thing.

After this survey of the nettlesome set of issues at play going into 2016, and in light of the stock market tumble of the last two weeks, it would be well to remember that market corrections are inevitable (even healthy) and occur much more frequently than the kind of dramatic declines witnessed after the tech bubble and in 2008. In spite of problems in China, pressures on exporters and commodity producers, and troubles in the Middle East that have no end in sight, the global economy continues to be characterized by moderate growth and low interest rates, a combination that has tended to treat long-term investors quite well.

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