CONWAY• JARVIS LLC
Investment Outlook

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Dead Ahead: Correction or Bear Market?

In our last Outlook, published a few weeks ago, we reiterated our view that this much-maligned bull market reflected the strength of the recovery in the US economy and the positive effects of that on the Global Growth story. Currently, we see few, if any, traditional warning signs that foretell of a cyclical downturn that could trigger the next bear market. We noted the absence of a market correction over the past three years and steered the conversation toward identifying potential causes of the next downturn in the stock market. We broke it down to either a geo-political event or a rapid rise in interest rates whichever comes first. Given recent economic data, it's highly unlikely we'll see rates rise dramatically in the near future. That leaves us with event risk as the most proximate cause for the next pullback in equities. So far, there've been no lasting tangible effects on the global economy from any doom and gloom headlines in the post-crash recovery period. However, there are a couple of developing stories that have the potential to change that.

Interest Rate Change on the Horizon

While higher interest rates are not currently a proximate cause for worry, it's not a matter of if we'll see them but when. An improving US economy should bring about both an increase in consumer demand and higher inflation. Critics of the Fed point to the risk of inflation as a reason to "normalize" key rates right now. We couldn't disagree more. The Fed is employing an adaptive process in steering the economy back to sustainable growth coupled with moderate inflation. And they have a plan.

Step 1 is ending Quantitative Easing ("QE"). In January, it began reducing its $85 billion monthly purchase of Treasury paper by $10 billion per month and is on track to finish this month. The goal is to do this while keeping the economy on an upward trajectory. Step 2 for the Fed is moving the needle on the recovery north of idle speed. That requires deferring any interest rate normalization until we see an uptick in inflation. We're starting to see rosier expectations for employment in 2015. Data indicates the labor market is slowly tightening and economists are starting to talk about wage inflation translating to higher personal income and consumption. That's good news for the economy but also a reason for the Fed to raise key rates down the road. *That can spell bad news for stocks unless the rise in rates is gradual.*

Critics of the Fed say it's already behind the curve in addressing inflationary pressures. We say that's exactly where Janet Yellen's Fed should be. Preempting inflation in the current environment risks seeing the recovery falter and possibly succumb to deflationary pressures. That's why the Fed isn't alone in providing stimulus to the global economy. Both the European Central Bank and the Bank of Japan are taking measures to inflate their economies, so far without success. In the absence of an assist from fiscal policy in the US, it's unlikely that monetary policy alone can do much to increase the pace of this recovery. Until there's a change in Washington, we'll have to be satisfied in seeing an annual GDP growth rate in the 2.5%-3% range. We believe the markets will continue to advance on that expectation. Given the currently benign outlook for interest rates, that leaves us on the lookout for an event that could change the trajectory of the Global economy.

Putting Event Risk in Perspective

It's been three years since the S & P 500 has posted a decline of more than 10%. During that time there's been a constant drumbeat of events around the world that would normally have triggered a sell-off in stocks. Instead, these events proved to be footholds on the Wall of Worry the market has climbed to make new record highs. What's changed? **We think investors, suffering from headline fatigue, have finally figured out that a lot of what makes headlines around the world has little or no tangible effect on the trajectory of the global economy.** The stock market used to react to almost every event like an emotional barometer. The half-life of these events was typically less than two weeks as the media moved on to the next crisis in search of new ad-dollars and higher ratings. That's why the intentional downing of an airliner over the Ukraine is yesterday's news. Nowadays, folks are using Facebook, Twitter, or other venues to react to big events instead of buying and selling stocks on the basis of what they see on TV.

However, there are a couple of events that have the potential to alter the story line of the global economy and change the tone of the markets in the near future. The first is the Russia-Ukraine conflict. Russia shows no signs of backing down from its intent to reclaim part of the Ukraine. Putin is intent on taking advantage of a perceived void in US leadership in foreign affairs and a divide between Europe and the US in crafting a response to Russia's incursion. It's one thing to talk tough to a distant and insignificant trading partner and another to confront a neighbor with whom significant trade is conducted. That's where we find Barack Obama and Angela Merkel today.

Russia is one of Germany's biggest trading partners and an important supplier of energy to what is Europe's leading economy. The US has very little at stake with Russia as its 20th largest trading partner. Germany, Europe's leading economy, is reliant on Russia as its primary supplier of natural gas and is the 7th largest exporter to that country. Despite that, it's remained steadfast in support of the economic sanctions imposed on Russia at the behest of the US and the UK. However that support could exact a cost to the global economy. The German economy contracted in Q2 as the result of an unexpected surge in unemployment and a reduction in GDP growth. *A slowing Germany could tip the Eurozone into recession.* As China's biggest customer, Europe's recession would have a cooling effect on their economy and others in Asia. That would leave the US alone as the primary driver of growth in the global economy.

We think we're up to the task as long as conditions favor a continuing of the recovery that is currently in place. Unfortunately, there's another event that has the potential to detour the US economy from its current path. The developing Ebola crisis in West Africa has the *potential* to disrupt the global economy on a massive scale. The 2002-2003 outbreak of SARS resulted in 800 deaths as it spread from Hong Kong to 37 countries. Retail sales in Hong Kong and adjacent regions plummeted 50% while travel and commerce ground to a halt. Fear of SARS spreading throughout Asia had a tangible effect on the Emerging Markets and the Global Economy in the wake of 9/11. Those events combined to cast a pall over the markets until March of 2003.

Could the Ukraine conflict combine with the Ebola scare to weigh heavily on the stock market? Without a doubt, *IF* we see a worst-case scenario develop. Escalation of hostilities in Eastern Europe would likely result in a protracted period of economic sanctions that could lead to global recession. So far, Ebola has killed 3000 in Africa and that toll is expected to rise exponentially while spreading to developed nations. The *fear* of that spread becoming unchecked would have a chilling effect on travel, commerce, and consumption far greater than what we witnessed with SARS. A worst-case outcome in either event could transform the long-overdue market correction into recession-driven bear market.

It’s Here: The Correction

The convergence of these two events make it likely that we’re seeing the beginning of a correction. We’re viewing it as the long-awaited pause that refreshes the markets. We think it’s highly improbable that either of the above-mentioned events spins out of control. So what should investors do? We recommend maintaining asset allocations that are consistent with long-term investment objectives while maintaining levels of liquidity and/or fixed income investments sufficient to bridge an investor through the next twelve months. *We don’t suggest “getting to the sidelines” unless you plan to stay there permanently. There will be no “all clear” given to signal when it’s time to re-enter the market.* Abandoning long-term objectives due to short-term events does irreparable harm to investment and retirement plans. Remember those investors who left the market in ’08 and never returned? Ouch!

Seeing a containment of Ebola and absence of an escalation of the Ukraine conflict, we expect the stock market to move higher in 2015. We advise remaining allocated across all asset classes, using cash and bonds to meet estimated liquidity needs. Doing that will allow investors to remain invested along the way to the next stage of this bull market.

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